MEMO

Subject: Consultation on Proposed Changes to Canada's Tax System

BACKGROUND

On July 18, 2017, Finance Minister Bill Morneau announced the launch of consultations on tax planning using private corporations, in an effort to improve the fairness of Canada's tax system. This consultation comes after the passage of Bill C-44: *Budget Implementation Act, 2017, No. 1* and marks the next step in the federal government's plan to close tax loopholes that benefit the richest Canadians.

While the government has stated that their intention is to ensure that the richest Canadians pay their fair share of taxes and that people in similar circumstances pay similar amounts of tax, these changes will result in unforeseen consequences for many small business owners.

The consultation is focused on three tax practices that the government believes are being used to gain an unfair tax advantage. These include:

1. **Income sprinkling.** A tax planning strategy commonly used by incorporated businesses that allows them to reduce income taxes by transferring income to family members (via a salary or dividends) in lower income tax brackets. The government is proposing rules to require the corporation to prove that the salary received by the family member is reasonable and was based on their contribution of value and financial resources to the business.
2. **Passive investment income.** Leaving passive investment capital inside the corporation in order to tax advantage of lower corporate tax rates (versus income tax rates if the money is withdrawn). The government proposed several measures to eliminate this (focused on either limiting deferral options or taxation on those amounts) and has outlined in detail within the consultation document.
3. **Capital gains.** Converting regular income into capital gains in order to lower the tax rate. The government is proposing amendments to the *Income Tax Act* to prevent this and has released draft legislation along with the consultation materials.

These changes would affect a range of business owners including doctors, accountants, electricians, and other individuals and families who have incorporated, including naturopathic doctors.

SITUATIONAL ANALYSIS

The Liberal government has been vocal about their commitment to helping to grow the middle-class as this was a fundamental pillar of their election campaign. While they continue to explore and implement legislative changes that will help middle-class Canadians, they also remain mindful of their pressing need to generate and unlock revenue wherever possible to offset the funding commitments they have made.

While it is clear that the government's intention with these proposed tax planning changes is to level the playing field and ensure that our tax system is not unfairly benefiting the wealthiest Canadians, this change will have adverse effects on several middle class Canadians. Many farmers, restaurant owners, health care professionals etc. incorporate and employ income sprinkling practices. While the government may view this as an unfair loophole, it is important to remember that self-employed Canadians have to pay into drug, health and dental plans and do not receive pensions or vacation and sick days like most salaried Canadians do. In light of this, small business owners use tax planning strategies to offset the additional costs they must shoulder as entrepreneurs.

Small business owners also use passive investment income to build capital within their businesses that they use as emergency, rainy day funds or as leverage for things like bank loans. Encouraging owners to liquidate their capital from the business could have the negative effect of raising borrowing rates as businesses with smaller savings will be forced to borrow money to cover unforeseen or catastrophic expenses.

In addition to being committed to helping the middle class, the government is also very much focused on innovation. The first tenant of the government's Inclusive Innovation Agenda is to foster an entrepreneurial and creative society. Given the negative impact these proposed tax planning strategies would have on small business owners, these changes will likely also discourage entrepreneurship, representing yet another unintended consequence of these proposed changes.

NEXT STEPS

While the Canadian Medical Association has been extremely vocal about this issue as it impacts physicians, it may be difficult for them to generate sympathy from government as they are not typically seen as being representative of middle class Canadians. In light of this, it is important that other groups of professionals and small business owners who also benefit from these tax planning strategies communicate to the government the impact these changes would have on them and their families. The best way to do that would not only be to writing your local member of parliament but also participating in the formal consultation process. The Department of Finance is currently inviting Canadians to submit comments on the proposed changes. Written comments can be sent to fin.consultation.fin@canada.ca and will be accepted until October 2, 2017.