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Unexpected Canadian Private Company Tax Proposals: A Critique And International Comparative

by Nathan Boidman and Michael Kandev

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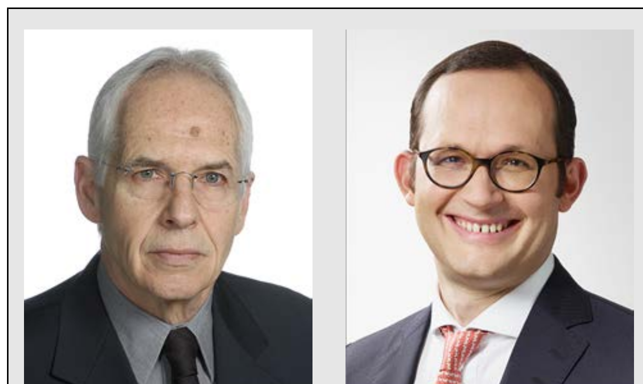
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The Canadian government recently announced plans for radical changes to the Income Tax Act ostensibly aimed at curbing tax planning using private corporations. Among the changes are new rules regarding reinvestment of active business income in passive assets, which, in the authors' view, are based on incorrect assumptions, are not in line with global practices, and may pose a threat to the Canadian economy.

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On July 18, further to an announcement buried in the spring 2017 budget, the Canadian Department of Finance released for consultation drastic proposals to curb tax planning by business owners using private corporations (the proposals). After summarizing the proposals, this article proceeds to challenge the basic assumption that underpins the proposals dealing with reinvestment of active business income and then provides a comparative law perspective on them.[1]

Summary of the Proposals

The proposal package, which includes a detailed consultation document, draft legislation, and explanatory notes, addresses three broad areas of concern to the government:

- the use of private corporations for so-called income sprinkling (a notion explained below);
- the use of a private corporation's low-taxed active business income for reinvestment in passive assets; and
- the conversion of income into capital gains.

Income Sprinkling Rules

The first set of proposals, aimed at income sprinkling, target two separate situations. One is the use of the lower marginal tax rates of family members who are in lower income brackets. For example, this can be achieved by having the spouse and adult children of a business owner own shares in an operating corporation, allowing them to receive dividends that are taxed in their hands. Twice, in *McClurg v. Canada*, [1990] 3 S.C.R. 1020, and *Neuman v. M.N.R.*, [1998] 1 S.C.R. 770, the Supreme Court of Canada has held that dividends are not subject to a reasonability test. The government now proposes overruling these cases and, effective 2018, extending the existing antiavoidance rules applicable to minor children[2] to all adults who do not contribute reasonable labor or capital to the underlying business.

[1] Unless otherwise specified, section references are to the Income Tax Act (Canada).

[2] Section 120.4 substitutes the top personal marginal rate for the rate otherwise applicable.

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The income sprinkling proposals also contain a substantial limitation on the use of the lifetime capital gains deduction (LCGD). Briefly, the LCGD exempts from tax the first C $835,716 (for 2017, indexed annually to the consumer price index) of capital gain realized on the sale of qualifying small business corporation shares. Well-established planning techniques have enabled the multiplication of the LCGD by allowing relatives of a business owner to each use their own LCGD. Now the government proposes to severely curtail this practice by allowing only adult family members who are involved with the business to access their own LCGD.

Tax on Reinvested Active Business Profits

The second set of proposals, likely intended as the centerpiece of the package and the focus of this article, addresses a basic (perceived) difference in tax law. Employees can only earn income in their own hands and must pay Canada's very high personal income tax rates, which hover above the 50 percent mark in most provinces. In contrast, business owners can operate through corporations and benefit from Canada's corporate income tax rates on active business income, which range between 26 and 31 percent and can be as low as between 12.5 and 18.5 percent for small businesses (generally applicable to the first C $500,000 of profits). As a result, if an employee makes passive investments with after-tax earnings, she would have less than 50 cents on the dollar to use; meanwhile, an operating company might be able to use more than 85 cents on the dollar, as long as its after-tax active business profits are not distributed out of corporate solution.

However, if after-tax active business profits are reinvested inside the corporation in passive assets, the corporation also pays an anti-deferral refundable tax on the earnings from the passive assets so that the aggregate tax paid by the corporation (around 50 percent) mirrors the tax that would be paid if the individual shareholders had earned the passive income personally. Under the current system, the refundable tax on aggregate investment income is refunded to the corporation when it pays sufficient taxable dividends to its shareholders to properly integrate the corporate- and shareholder-level taxes.

The government is unhappy with this basic situation. Instead, it suggests effectively imposing tax penalties when active business income not needed for the business is retained and not distributed. In particular, to induce business owners not to use their corporation's active business income to make portfolio investments, the proposal suggests that the tax of approximately 30 percent on the investment income earned on reinvested active business profits become nonrefundable. Ultimately, the total tax paid by the corporation and the individual shareholders would be at a punitive and expropriatory rate above 70 percent.

Surplus Stripping Rules

The third set of proposals is more technical in nature and deals with the conversion of dividends into more favorably taxed capital gains.[3] Various planning techniques have been used to achieve this result, which is broadly called "surplus stripping." For example, instead of receiving eligible dividends from an operating company that would be taxed at around 40 percent, a business owner could cause a corporate reorganization that would allow him to extract the surplus through the internal realization of a capital gain at an effective rate of around 25 percent. The government has issued legislative proposals that, effective immediately, significantly narrow the planning opportunities in this area.[4]

Critique of the Proposals

Much can be said about how broad and upsetting the proposals are. For our purposes, it suffices to simply note that they appear to be based on certain basic misunderstandings. Underpinning the government's initiative — particularly the section on the use of low-taxed corporate active business income for reinvestment in passive assets — is the essential premise that employees and business owners are in similar

[3] While employment, business, and property income are fully included in taxable income, only 50 percent of capital gains are taxable.

[4] Michael N. Kandev, "Proposed Section 246.1," 25(8) *Canadian Tax Highlights* 5-6 (2017).

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economic positions but that employees are treated less favorably under the ITA.

To illustrate this point, the government uses the example of a fictional character called Andrea. As set forth in the consultation document (emphasis in original):

> Andrea's private corporation owns a manufacturing plant in Saskatchewan. Last year, the corporation generated $800,000 of taxable business income (after payment of employee salaries and other expenses). The corporation is large, and is not eligible for the small business rate. The applicable federal-provincial corporate income tax rate in Saskatchewan was 25 per cent in 2016, leaving the corporation with after-tax income of $600,000. Andrea would like to use $200,000 of that amount to modernize her plant next year, and keep the balance, or $400,000, for longer-term personal savings. As the controlling shareholder, she can either pay herself a dividend or invest the $400,000 in an account held within her corporation. Andrea has already made contributions to her Registered Retirement Savings Plan and her Tax-Free Savings Account up to the maximum limits.
>
> Andrea will be better off if she keeps a diversified passive investment portfolio inside the corporation, rather than investing it as an individual.
>
> - If she invests *within the corporation*, Andrea has an after-tax amount of $400,000 to add to her portfolio.
> - If she were to invest *in a personal account*, she would have about $280,000 to invest (her marginal personal income tax rate is about 48 per cent in 2016, given that Andrea is a high-income earner, and dividend income is subject to the dividend tax credit).
>
> When Andrea invests through her corporation, she benefits from a bigger initial portfolio, which compounds to larger investment income every year that can be reinvested. Although there is some reconciliation at the end — when Andrea winds down the portfolio and pays personal income taxes on it — she still ends up better off than if she had chosen to invest in a personal account. After 30 years, she would end up with about $570,000 more, after payment of corporate and personal income taxes, if she invests inside her corporation.
>
> Unlike Andrea, an individual earning salary income would have no alternative but to invest in a personal account. As a business owner, Andrea can realize a personal portfolio advantage that is the consequence of the low corporate income tax rate, which is intended to support the growth of active businesses — not to confer a personal savings advantage.[5]

The above example is necessarily simplistic; more importantly, however, it is incorrect. Underpinning the proposals is the principle of horizontal equity, which, reasonably enough, requires that persons in similar economic positions be treated similarly by the tax system. In our view, however, an employee and a business owner are in very different positions. The ITA explicitly recognizes this when it taxes employment income and business income differently. Moreover, this separate tax treatment reflects the basic economic fact that employees and business owners are in very different positions given the capital they use, the functions they perform, the risks they take, and the overall direct and indirect effects they have on the economy. Furthermore, despite their differing economic positions, employees and business owners may often, in practice, be treated more similarly by the tax system than the proposals assume.

Accordingly, as we argue below, the proposals dealing with reinvestment of active business income are presumptuous in trying to force business owners to make choices that may be contrary to what business judgement would otherwise dictate and therefore should be abandoned.

[5] Consultation document, 14.

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The Proposals Contradict the ITA's Architecture

Perhaps the most obvious and fundamental flaw in the notion that employees and business enterprises should be subject to the same rules for passive reinvestment of retained income is that it contradicts the architecture of the ITA as to the two groups. The ITA, which was originally inspired in part by the U.K.'s schedular system of taxation, computes employment and business income completely separately. While employment income is computed under ITA subdivision I(B)(a), business income computation is subject to a separate set of rules contained in ITA subdivision I(B)(b).

The most important difference between the two systems is that while ITA sections 18 and 20 provide businesses with immediate or eventual deductions for essentially all outlays and expenditures incurred to earn income from the business being carried on, ITA section 8 strictly limits what an employee can deduct to a small number of very specific outlays. The obvious reason for the difference in treatment is that while a business owner must constantly lay out funds to make a profit, an employee essentially inhabits a risk-free environment that does not require any initial or ongoing expenditures.

The much more generous deductions afforded to business enterprises have spurred litigation regarding the distinction between an employee and an independent contractor. Case law has established a series of tests to determine whether a contract is one of service (an employment contract) or for the provision of services (an agreement with an independent contractor). While not exhaustive, the following are the tests most often referenced:

- the degree or absence of control exercised by the alleged employer;
- ownership of tools;
- chance of profit and risks of loss; and
- integration of the alleged employee's work into the alleged employer's business.[6]

The ITA also contains rules that prevent an employee who uses a corporation to provide his services to his employer from using the corporate tax rates applicable to business profits or deducting expenses.[7]

The proposals seem to disregard the essential difference in the tax treatment of employees and business owners reflected in the architecture of the ITA. We submit that ignoring that difference is wrong because the distinction reflects the important and fundamental differences between employees and business owners in an economic sense.

How Employees and Business Owners Differ

Employees and business owners differ in the capital they use. Employees never invest any capital with their employer. Meanwhile, business owners need to use their own savings, money from relatives and friends, and capital from third parties to start and build a business. Beyond monetary investment, most small and medium-size business owners make a tremendous time and emotional commitment to their business.

Employees and business owners are also different in the functions they perform. Employees work under the direction and control of their employer. Even senior executives, despite the potentially broad discretion bestowed upon them, must remain within the framework of the strategic directions imposed by the business owners as is generally reflected in decisions of the board of directors of the employer company. In contrast, business owners are the ones that must develop and take responsibility for the strategic decisions that make or break the success of the business.

The risk taken by employees and business owners is another distinction between the two groups. Generally, the only risk an employee takes is possibly losing, either temporarily or permanently, his job. This risk is typically mitigated by vacation pay; sick leave pay; maternity leave pay; and, ultimately, severance pay, a retirement pension (sometimes a defined benefit pension), or government-provided employment insurance. The risks taken by a business owner are substantially larger: A business owner risks all the capital invested and oftentimes has no protection to mitigate against

[6] See the oft-cited decision *Wiebe Door Services Ltd. v. Canada*, [1986] 86 D.T.C. 553 (FCA).

[7] *See* sections 18(1)(p), 123.4(1), 125(7), and 248(1).

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either a temporary reduction in activity caused by external factors or a permanent loss of the business.

Finally, it is the business owner who, through the capital employed, functions performed, and risks undertaken, creates jobs that grow the economy and is responsible for all of the economic synergistic effects of business activity.[8]

How the ITA Treats Employees and Owners Alike

In practice, employees and business owners may find the ITA treats them more similarly than the proposals suggest.

Since individuals make personal and living expenses with personal after-tax dollars, it is obvious that both employees and business owners need a base amount of personal after-tax funds to pay for groceries, lodging, transportation, school supplies, and other necessities. As employees and business owners become successful and make more money, typically, at first, their personal and living expenses also increase. For example, they opt to go to restaurants more often, buy a bigger house in a nicer neighborhood, purchase a second car, and send their kids to private school. Not to be forgotten, both employees and business owners typically try to max out their personal registered retirement savings plans (ITA section 146) and put money aside in other tax-advantaged savings vehicles. This shows that most employees and small business owners are likely taxed very similarly under the ITA, as they need most of their net pay (or net profit) in personal hands for personal and living expenses and personal savings. In other words, most small business owners will not enjoy the benefit of tax deferral in corporate solutions.

To have material after-tax corporate active business profits available for reinvestment into corporate-owned portfolio investments, a business owner must be generating substantial net profit. An employee with a comparable compensation package is likely in a senior or executive capacity with a large employer. Senior employees, though unable to incorporate, are often able to defer or reduce their tax burden using stock options and phantom stock units. Ultimately, these employees often become business owners themselves, after being invited to join in the share ownership of the employer business.

The Presumptions Underlying the Proposals

The fundamental premise of the proposals dealing with the reinvestment of active business profits is not only incorrect but also presumptuous in imposing behaviors on business owners that may be contrary to what business judgment would otherwise dictate. The proposals assume that after-tax active corporate business profits should not be reinvested in passive assets within the corporate solution. This could not be further from the truth. Although reinvestment may not qualify for active business treatment,[9] it often has a valid business-related reason. Maintaining a war chest may be necessary to protect the business against economic fluctuations, to make (or fend off) acquisitions, or to support the business's credit rating. Even if the reinvestment is solely intended as an investment fund for the business owner, arguably this is not contrary to the ITA's policy of encouraging entrepreneurs to start and build businesses. This implicitly takes into account the fact that business owners take a lot of risk and do not enjoy the

[8] The foregoing factors were put exquisitely as follows by a practicing physician and treasurer of the Ontario Medical Association, Dr. Michael Verbora, "Letter re Ottawa Cracking Down on Tax Loopholes," *National Post* July 25, 2017, at A8:

> In all societies, small businesses are the backbone of a successful economy. Business owners undergo significant risk with large investments in time and personal money in trying to build their businesses. Many work for free and also work inhuman hours to launch their businesses. Incentives exist to stimulate growth, encourage risk taking and entrepreneurship. Business operators are not rewarded at any point in time with any of the benefits that employees are entitled to, such as holiday pay, health benefits, maternity leave and pension plans. Health benefit packages alone are typically worth 20 per cent of one's salary. Business owners pay for their personal benefit packages, or save in their corporation to be able to afford retirement. . . .
>
> As a physician business owner myself, married to another physician business owner, we are about to have our first child come October. My wife will be leaving for a one-year maternity leave without government financial support. If it was not for our personal professional corporations that help us save for these sorts of situations, we would not be able to afford for her to have a maternity leave. Surely this is not in keeping with Canadian values.

[9] *Ensite Ltd. v. R.*, [1986] 2 S.C.R. 509.

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benefits that many employees do, such as paid medical and dental plans and pension plans.

Accordingly, we believe that the proposals dealing with reinvestment of active business profits should be abandoned.

Comparative Law Analysis of the Proposals

The proposals aimed at discouraging privately owned Canadian corporations from investing after-tax active business profits in passive assets give rise to two comparative law questions: Have other countries considered the same issue and written legislation to deal with it? Has an international norm developed that the proposals are ignoring?

To address these questions, we canvassed qualified and reputable local tax practitioners in 16 countries: Argentina, Australia, Belgium, Brazil, Denmark, France, Germany, Israel, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Sweden, the U.K., and the United States. We posed the following hypothetical situation and consequential questions to each:

> If a local family owns a local corporation that carries on a product manufacturing business, makes a taxable profit, pays corporate tax thereon, and then uses the after-tax profit to invest in portfolio securities and earns investment income:
>
> - Will the corporation pay the same rate of tax on the investment income as it does on profits from the manufacturing business?
> - Will there be any other tax or tax penalty (such as a special tax on the amount invested in the portfolio securities or a special tax on dividend distribution of the investment income derived therefrom) because the corporation did not either distribute the after-tax profit as dividends to the shareholders or redeploy the profit in the manufacturing business?

A limitation in the survey is that it did not specifically seek to determine (1) whether a distribution of the after-tax profit would attract tax (which might be avoided by not making the distribution) or (2) the comparative rates of tax on investment income and business income paid by individuals and corporations. Subject to this limitation, in response to the first question above, we found that in all 16 of the surveyed countries a corporation pays the same rate of tax on investment income as it does on profits from an active business.[10]

In response to the second question, we found that in 14 out of the 16 countries there is no other tax or tax penalty applicable because the corporation did not distribute the after-tax profit as dividends to the shareholders nor did it re-deploy them in its active business. As detailed below, only Israel and the United States have rules that may penalize the retention and passive investment of after-tax active business profits. Interestingly, Japan has retained earnings tax rules that apply even if all profits are reinvested in the business. Significantly, countries that are considered very high-tax jurisdictions, such as Denmark, France, Germany, Italy, and Sweden, do not have any tax rules penalizing the reinvestment of after-tax income in passive assets.

In the U.S.,[11] IRC section 531 generally imposes a tax of 20 percent on the "accumulated taxable income" of a corporation that retains earnings in order to enable shareholders to avoid income tax on a distribution or dividend.[12] A tax-avoidance purpose is presumed when the corporation accumulates earnings in excess of the "reasonable needs of the business."[13] Treasury regulations provide some guidance regarding what uses of retained earnings constitute reasonable needs of the business for this

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[10]In both the Netherlands and the U.K., additional rules may apply if the reinvestment of operating profit into passive investments leads to the corporation ceasing to qualify predominantly as an operating corporation. In the U.S., there may be a personal holding company tax if the investment income is not distributed and it represents more than 60 percent of the gross revenue of the corporation.

[11]We thank our colleagues Peter Glicklich and Heath Martin of Davies Ward Phillips & Vineberg LLP (New York) for their input on this section.

[12]The predecessor of this U.S. rule appeared in the first version of the Internal Revenue Code enacted in 1913.

[13]Fanny Karaman and Béate Erwin, "Accumulated Earnings Tax Will Hit Taxpayers Despite Lack of Liquidity or Control," 4(2) *Insights: The Tax Journal of Ruchelman P.L.L.C.* (Apr. 2016) (reading IRS Chief Counsel Advice dated Dec. 30, 2016).

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purpose.[14] Reinvestment of profits to continue or to expand the business that earned the profits, or to acquire another business, are considered to be for the reasonable needs of the business and thus are not taxed under IRC section 531. In the U.S., when profits are invested in passive assets (such as portfolio securities), the corporation has the burden of showing that those profits are for the reasonable needs of the business; in other words, the corporation must overcome a presumption that the purpose for retaining profits is to avoid shareholder tax on distributions. The accumulated taxable income of a corporation that is not able to rebut the tax-avoidance purpose presumption is based on the corporation's taxable income, with certain adjustments (including for taxes paid by the corporation and amounts retained for the reasonable needs of the business).

In Israel,[15] effective since the beginning of this year, 50 percent of the profit of a "small company," defined as a company controlled by five persons or fewer (generally, family members are considered one person for the purposes of this section), may be deemed distributed (and thus trigger shareholder-level tax) if the following cumulative conditions are met:

- the small company did not, within a period of five years following the given tax year, distribute at least 50 percent of its taxable income that given tax year;
- the small company had accumulated profits exceeding ILS 5 million;
- the small company would be able to distribute the dividends without negatively affecting the ongoing existence and development of the business;
- the reason for the nondistribution is tax avoidance/tax reduction; and
- after the notional dividend was imposed, the small company's accumulated profits for that year and for the tax year prior to the notional dividend imposition, cannot be less than ILS 3 million.

As the comparative law review above indicates, the Canadian proposals relating to the reinvestment of active business profits in passive assets are drastic and largely exceptional. Most of the countries we have canvassed have either not developed the concerns that the Canadian government has or have dismissed the concerns and not undertaken any legislative action in this regard. Also, the norm among the countries we canvassed is clearly not to create any rules that discourage the reinvestment of active business profits in passive assets within the corporate solution.

As for the two countries that have adopted similar rules, on the one hand, it is notable that the U.S. accumulated earnings tax is largely irrelevant to private U.S. business owners because the combined effect of the modified U.S. classical double tax corporate-shareholder tax model, the U.S. check-the-box system, and the comparative U.S. personal and corporate tax rates, almost invariably leads to carrying on businesses through fiscally transparent vehicles, such as LLCs. On the other hand, the Israeli experience is inconclusive as its rules are very recent. Still, it is significant that the Israeli rules are subject to a series of objective and subjective criteria that presumably narrow the scope, rendering the deemed distribution rule quite targeted. Finally, it is also notable that both the U.S. and Israeli rules provide for situations when passive investments are related to or supportive of the business and when a distribution would adversely affect the operation and development of the business.

Conclusion

The July 18 Canadian federal proposals to curb tax planning using private corporations by business owners have left Canadian tax

[14] Treas. reg. section 1.537-2(b) lists the following uses of accumulated earnings as presumptively reasonable:
(1) — To provide for bona fide expansion of business or replacement of plant;
(2) — To acquire a business enterprise through purchasing stock or assets;
(3) — To provide for the retirement of bona fide indebtedness created in connection with the trade or business, such as the establishment of a sinking fund for the purpose of retiring bonds issued by the corporation in accordance with contract obligations incurred on issue;
(4) — To provide necessary working capital for the business, such as, for the procurement of inventories;
(5) — To provide for investments or loans to suppliers or customers if necessary in order to maintain the business of the corporation; or
(6) — To provide for the payment of reasonably anticipated product liability losses, as defined in section 172(j), [section] 1.172-13(b)(1), and [section] 1.537-1(f).

[15] We thank Harel Tow of KPMG Somekh Chaikin, Israel, for his input on this section.

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practitioners and their clients, whether small or large businesses, in shock. The above summary of the proposals should show even a casual reader that, if ultimately enacted, the proposals will in many ways upset the fundamental architecture of the ITA and undermine well-established aspects of the Canadian income tax system in a way that we believe will harm the Canadian economy. In particular, the proposals regarding the reinvestment of active business income in passive assets are punitive and, more fundamentally, they seem based on the false premise that there is no fundamental business or economic difference between an employee reinvesting her after-tax salary and a business owner reinvesting its corporate active business income in passive assets and that, therefore, their tax treatment should be the same. We believe that the foregoing analysis shows why the premise is false. Finally, our comparative law review shows that, except for the United States and Israel, the Canadian government's concern here is unparalleled. Accordingly, we assert that the proposals regarding the reinvestment of active business income in passive assets should be abandoned. ■

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