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Tax Proposals Target Canadian Business Owners

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Although Canadian individuals are already subject to some of the highest tax rates in the world, the Canadian federal government released a discussion paper for consultation on July 18, 2017 which includes proposals that would substantially increase taxes paid by Canadians who carry on business through a corporation. The proposal with the broadest impact is one that would impose tax at a combined rate of 73% on passive income earned by a private corporation that was funded with active business earnings. There are other proposals in the discussion paper that will also have a material impact on many Canadian business owners (a discussion of the other proposals can be found here).

Canadians Already Among the Highest Taxed in the World

In Ontario, the marginal income tax rate for earnings in excess of $220,000 is almost 54%. Six years ago the top marginal tax rate in Ontario was 46.41%. In 2012 the Ontario government announced a new income tax bracket that would tax earnings in excess of $500,000 at 49.53% by 2014. At that time, the Ontario government stated that the new tax bracket was a temporary new "Deficit-Fighting High-Income Tax Bracket" for individuals earning more than $500,000 annually, which was to be eliminated by 2017-18.

The Ontario government subsequently reduced the threshold for applying the top tax rate from $500,000 such that the top marginal tax rate of 49.53% would apply to earnings in excess of $220,000 and the notion of this being a temporary tax appeared to have been abandoned. Moreover, the newly elected Canadian federal government announced in December 2015 that the top marginal rate for income in excess of $200,000 would increase by 4% beginning in 2016. As a result, an Ontario resident earning in excess of $220,000 is now subject to income tax at a rate of 53.53%. Similar increases were seen in other Canadian provinces – for example, in Québec the top personal income tax rate increased from 48.22% to 53.31% over the same period as Ontario and in Alberta the rate increased from 39% to 48% over 2015 and 2016.

In reviewing tax rates around the world, only a small number of countries with comparable tax rates can be found, which include countries such as Austria (the top rate is 55%) and Finland (the top tax rate is 54%). Countries that represent Canada's significant trading partners have far lower tax rates. In a 2016 paper by the Fraser Institute entitled "Canada's Rising Personal Tax Rates and Falling Tax Competitiveness", it is stated that even before the recent tax rate increases in Canada "the country's combined federal and provincial top marginal tax rates compared unfavourably to those in the United States and other industrialized countries." The paper also states that "Canada's 2016 tax rate is 19.0% higher than the 2014 top rate in the United Kingdom and 15.7% higher than the top U.S. rate". Even though Canada's top tax rates are comparatively excessive, they also generally apply at much lower income levels than the top tax rates in other jurisdictions and many of these jurisdictions either allow spouses to file joint tax returns or increase the income thresholds before the higher tax rates apply to married individuals.

The paper by the Fraser Institute also cautions that tax rate increases generally do not result in the increase in tax revenues expected by governments. It is quite possible that the recent increases in personal tax rates by the federal government did not raise the additional revenue it expected (or possibly resulted in a decrease in revenue), which may well have been the impetus for the recently released tax proposals in respect of private corporations.

Proposal to Increase Tax on Passive Income to 73%

The corporate tax rate on active business earnings by a corporation is substantially lower than the personal tax rate. When the corporation distributes the earnings to the individual shareholders as dividends, the shareholders pay personal tax such that the combined personal and corporate tax is roughly the same tax rate as if the shareholder had earned the income personally.

If the corporation reinvests its active business earnings, the additional personal tax is deferred until the cash is ultimately distributed to the individual shareholders. If the earnings are reinvested by the corporation in passive assets, the corporation pays an additional refundable tax on the earnings from the passive assets so that the aggregate tax paid by the corporation is almost equivalent to the tax that would be paid if the individual shareholders had earned the passive income personally. The additional refundable tax is refunded to the corporation when it pays taxable dividends to its shareholders.

One of the government's proposals is to make the additional refundable tax paid by the corporation non-refundable such that the total tax paid by the corporation and the individual shareholders will be 73%. In the face of a punitive 73% tax rate it is clear that the government's proposal is designed to ensure that Canadians who carry on business through private corporations do not use their corporation's active business income to make passive investments.

The tax policy behind the current system is to encourage reinvestment. The policy behind the new proposal is that a person carrying on business through a corporation should be subject to tax at the same rate as an employee before they can use the earnings from the business to reinvest in passive assets (which would include shares in corporations that carry on the same or similar business as the one carried on by the corporation).

The premise of the new proposal is flawed in assuming it is not necessary to invest active business profits in passive assets within the corporation as there is often a valid business-related reason for doing this. As seen in many growth stories, a war chest may be necessary to protect the business against economic fluctuations, to provide for acquisitions or to support the business's credit rating with lenders.

What the government also has not taken into account in its consultation proposals is the fact that business owners generally have significant capital at risk in their businesses. Having to pay the excessive personal tax on the active business earnings by the corporation before reinvesting those funds will significantly reduce the amount of capital business owners have to reinvest and likely limit their appetite to take on additional risk with their investments given they already have significant capital at risk and will have substantially less funds to reinvest.

Many employed individuals have stock options, share appreciation rights, phantom units, pension plans and/or supplemental plans that provide deferred compensation and in some cases are taxed at preferential tax rates. Business owners do not have these forms of deferred compensation nor do they typically have paid medical, disability, maternity and other benefits and they have no severance or employment insurance entitlements. Over the years, the provincial governments have modified their rules and regulations for the specific purpose of allowing doctors and other professionals to carry on their practices through corporations. This was presumably done on the basis that these professionals are small business owners that generally have substantial capital at risk in their businesses, do not have other forms of deferred compensation or other benefits and they also have no severance or employment insurance entitlements.

The current system is designed to encourage entrepreneurs to take on risk and reinvest in the economy, which promotes innovation and growth of the economy for the benefit of all Canadians. The government's proposal represents a fundamental change in tax policy to the detriment of Canadian business owners and likely to the Canadian economy as a whole as it may result in less reinvestment and may provide an additional incentive for business owners to leave Canada.

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