CONNORS STILWELL

VIEWPOINT: MEANINGFUL QUESTIONS THAT MUST BE ANSWERED BEFORE TAX REFORM FOR PRIVATE CORPORATIONS IS IMPLEMENTED

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On August 1, 2017, Connors Stilwell published a legal update for our clients explaining the impact on private corporations and their shareholders of the July 18, 2017 tax proposals released by the Department of Finance. A copy may be found here.[1]

Now, we provide our critical viewpoint.

The Language of Loopholes

The spring release of the federal budget is one of the most anticipated and important annual events for me as a tax lawyer. Each spring, the budget lays bare not only the government's spending priorities, but it announces the government's planned changes to the federal income tax regime. These changes routinely keep me and the tax profession at large on our toes as we strive to deliver knowledge and know-how to our clients about the Canadian taxation system. It is not an easy job, but it is one that I believe in and love.

Budget 2017 was quiet from a tax law and policy perspective. Among the professionals I interact with on a regular basis, we noted how slim the budget was and how few tax changes were announced relative to recent years. I did not even flinch, but rather nodded in agreement, as I read this, promising further tax changes to come:

> To help ensure everyone pays their fair share of tax, the Government will identify and close tax loopholes and tax planning schemes that disproportionately favour the wealthy—including tax planning strategies that involve private corporations.[2]

This, I thought, was good. The lion's share of what I do is advise on and implement tax planning strategies that involve private corporations. I am familiar with the flaws – the loopholes – that exist inside the system and in principle I welcome efforts to close them.

In hindsight, the budget quiet should have seemed eerie. Four months later, on July 18, 2017, using the March 2017 language of "closing loopholes" and ensuring payment of "fair share of tax", the Department of Finance released tax proposals and draft legislation that, rather than taking precision aim at flaws, represents nothing short of a paradigm shift. It obliterates the system that has defined the taxation of private corporations and shareholders in Canada for decades. I was and remain utterly taken aback for, it bears emphasis that, what the government has proposed to close is not a "loophole" or a mere collection of them, but a *system,* a framework, a highly-functioning piece of legal machinery, with decades of economic, social, political and legal justification for its existence.

This is tax reform.

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[1] http://connorsstilwell.com/legal-update-tax-proposals-affecting-private-corporations/

[2] http://www.budget.gc.ca/2017/docs/themes/tax-fairness-equite-fiscale-en.pdf

And yet, the government uses the language of "closing loopholes" to describe its proposals. Since it is evident – or at least to be assumed - that the government knows what it is doing, I can only infer that this language is intended to obfuscate and to persuade the public that its proposals are virtuous and just while inviting as little critical thought as possible. It is a linguistic tactic that makes those of us now crying foul seem the defenders of loophole abuse.

> What is a loophole? I am well aware that loopholes are repeatedly disapproved with persuasive vehemence. But we should not assume that what is roundly condemned is always clearly perceived. It is usually easier to deplore sin than to explain its content.[3]

So wrote one scholar Louis Eisenstein in a think-piece on tax loopholes wherein he concluded that:

> Better answers require wiser questions. […] We cannot learn very much by asking what is a loophole. The only meaningful questions are those which focus on the precise purposes and effects of a dispensation. Of course, the answers will vary, for they will reflect different standards of good and evil. But at least they will deal with the relevant issues.[4]

Indeed.

In my view, by speaking to the Canadian public using the value-laden language of loopholes and tax fairness rather than taking on the intellectually honest though certainly more difficult task of explaining the content, purpose and effects of the system of taxation of private corporations that it seeks to wipe out and why, the federal government has engaged in manipulation of the public intellect. It has consequently and necessarily degraded the quality of the public debate that could and should take place in advance of tax reform.

And it has done this in the dead of summer while providing a whopping 75 days for consultation. Make of that what you will.

Wiser Questions

If better answers require wiser questions, here are a few questions to which I believe the public deserves the government's answers in advance of tax reform.

- Who Will Benefit?: The government states that it seeks to protect the "middle class", but it fails to define this demographic with any specificity. If the tax proposals provide any insight into the government's thinking, then we must infer that, in the view of our government, the incorporated self-employed, regardless of income or wealth, do not form a part of the middle class, let alone the heart of it. The proposals as drafted deliver a striking blow to the self-employed, whether the independent construction worker, the local restaurant owner, the local retail shop owner, the psychologist, the dentist or the doctor. The proposals have next to no impact on large national or multi-national corporations, the

[3] Louis Eisenstein, *The Ideologies of Taxation,* (New York: The Ronald Press Company, 1961) at 181.
[4] Ibid., at 197.

shareholders of national or multi-national corporations, C-suite executives, or individuals with accumulated family wealth.

Just who makes up the middle class that the government states that it seeks to serve with these proposed tax changes? How do the proposed tax changes purport to benefit this vision of the “middle class”?

If benefitting or protecting the middle class is the aim, the public deserves a well-reasoned explanation of how these proposals assist this demographic. As written, the proposals rather only dole out a superficial concept of tax justice to small and medium sized business owners and carry with them no discernible corresponding benefit to the “middle class”, however that demographic is defined.

- How Should Canada’s Small and Medium Sized Business Be Taxed?: This is not an easy question, but since the proposals take straight aim at the taxation of small and medium sized business, the public debate must include consideration of this question. There is no denying that the paradigm that has defined the taxation of private corporations and their shareholders in Canada for the last several decades has provided tax relief and incentives for self-employed individuals who incorporate. For instance, certain corporate structures and family trusts allow family members to claim as their own a portion of the income earned. This reduces the overall household or family tax burden. Through family trusts, the lifetime capital gains exemption may also be shared among family members to shelter a portion of the gain that would otherwise be taxable upon sale of a business to a third party or a child.

  These features are not and were never “loopholes” but were deliberate policy choices intended to provide support, through the tax system, for incorporated self-employment, growth of business, and self-funded retirement savings for those for whom no employer provides a pension. This paradigm also provides recognition through the tax system for the tremendous risk that entrepreneurs take on in order to start, maintain and grow their businesses, the risk that their families indirectly take on since their family home, assets and savings are usually on the line, and for the contribution that small and medium sized business makes to the economic life of the country.

  These features have been proposed to be completely eradicated. On what basis has the government decided that the virtues of our current system, to the extent it supports entrepreneurship, are no longer required or desirable? Is a more measured response possible? If not, why not? How will small and medium sized business react when the paradigm that has defined the taxation of incorporated self employment is fundamentally altered? What will the impact on the economy be? What, if any, differential impact will there be across industries and regions?

  I do not have the answers to these questions, but I have some very strong intuitions – and fears - based upon my familiarity with the tax system, small business owners and the way the tax system has historically worked. Similar opinions and fears from individuals well qualified to opine have been expressed and more are released each day.

  Any transparent and responsible government should have well considered, researched and articulated answers to these questions, should have proactively provided these

answers concurrently with the announcement of tax reform, and should have allowed sufficient time for consultation. If we are going to throw the baby out with the bath water, the public ought to know why, to what end, and what the price tag will be.

- How Should Private Corporations Be Taxed?: A fundamental feature of the system of taxation of private corporations in Canada is that it strives to achieve integration. It strives to ensure that income that travels through a corporate structure to an individual is taxed at an overall rate that is no more than but also no less than the rate that would have applied if the income had been earned by an individual directly. The purpose of integration is to create as much neutrality as possible between income earned in a corporation and income earned directly.

  The mechanics of integration are messy and the result is never perfect. On the one hand, there is a tax deferral advantage associated with letting money sit in a corporation undistributed. On the other hand, there is an inherent danger in any corporate structure of double or even triple taxation as income travels through the structure out to an individual. Integration is an ideal and achieving something that approximates it is a delicate balancing act.

  The proposed new rules for the taxation of corporate investment income and the taxation of capital gains and dividends eschew integration completely. For example, while aiming to reduce or eliminate certain deferral advantages, the proposed legislation creates potential for obscene integrated tax rates that have been predicted to hit rates between 73% and 93%. And, while aiming to reduce or eliminate the potential for amounts to be taxed at capital gains rates rather than at dividend rates, the proposed legislation invites potential double and even triple taxation in the context of death of a shareholder and other circumstances.

  Integration is not a bell or a whistle. It is a fundamental feature of our corporate taxation system. Any tax measure that strays from it ought to be justified from some other perspective. On what basis does the government justify its decision to abandon integration as a norm of corporate tax policy? In favour of what principle does it do so?

Conclusion

Better answers require wiser questions. We deserve better answers - and the time to consider them - than those the government has chosen to give us. It should go without saying that small and medium sized business is too vital to the health of the country, that tax law and policy are too vital to the health of the country, to be tampered with in a hurried manner for unknown reasons and with unconsidered consequences – much less for a set of reasons that degrade and manipulate the public intellect. So far, the only answers our government has provided us with are those of the sort that mute public discourse and create unnecessary tension between members of the “middle class”. So far, the government has provided so little time for consultation that the “consultation” can only be inferred to be superficial. The public at large and our entrepreneurs deserve better.

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