September 26, 2017

BY EMAIL: fin.consultation.fin@canada.ca
Department of Finance Canada
14th Floor
90 Elgin Street
Ottawa, Ontario
K1A 0G5

Subject: **July 18, 2017, Proposed Tax Reform**

Dear Sir/Madam,

We are writing to you in response to the consultation document entitled "Tax Planning Using Private Corporations".

Marcil Lavallée is a chartered accountant firm with 85 employees. We serve approximately 1,800 SMEs in the National Capital Region that will be adversely affected by the tax-reform proposals.

This letter is not meant to be exhaustive, but is rather a summary of those elements that we believe are the most important. For easier reading, each is addressed briefly below.

We strongly believe that the proposed measures will have significant adverse consequences for Canada and a direct impact on the entrepreneurial spirit that is so crucial to a society's development. Middle-class entrepreneurs will be profoundly affected by these measures – the opposite of the objective of penalizing the rich, who, it must not be forgotten, already pay a very high tax rate of 53% (in Ontario and Quebec) on income over $200,000. The excessive tax burden is discouraging investment in Canada's economy.

Here are some of our concerns and comments:

1. General

The very basis of this reform is flawed, as it is meant to ensure employees and entrepreneurs have a level playing field. The authors of this reform failed to take into account the major impact it will have on entrepreneurs, on their operations and needs, and on the sustainability of SMEs. At the end of the day, the reform is punitive and will discourage entrepreneurship.

The *Income Tax Act* is an economic development tool for Canada; therefore, it must be crafted not only to ensure fairness among all Canadians, but also to develop our country. Measures may seem advantageous for certain groups of individuals or corporations in the absence of a good understanding of what those measures actually contribute to Canadian society. The authors have presented the reform in a very simplistic manner by putting employees and entrepreneurs on a level playing field without examining the consequences the tax-reform measures will have on the Canadian economy. The *Income Tax Act* has numerous provisions that help to stimulate the economy. Focusing only on the sections of the *Act* that seem to favour SMEs amounts to a violent attack on a specific category of citizens who, each day, strive to build our economy.

Here are some employee benefits that the proposed tax reform has not taken into account: paid vacations, paid statutory holidays, paid sick leave, paid overtime, pension fund, pension income splitting with a spouse, parental leave, severance pay, Employment Insurance, group insurance (life, medical and dental).

Here are some additional responsibilities that entrepreneurs must shoulder: financing their business (personal security, injection of capital, personal loan or mortgage on the family home), no financial safety net, no guaranteed pension fund, risk of losing it all, hours of work, stress and greater responsibilities.

The document includes no analysis of the proposed measures' economic impact. Given the scope of the measures and the group affected by them (SMEs), it would have been prudent to conduct such an analysis in order to gain a good understanding of the impact the proposed measures will have on the Canadian economy.

The tax reform, released in the middle of the summer, leaves very little time for a well thought-out response. A condensed 75-day consultation period is clearly insufficient and does not allow for a serious evaluation of the proposed measures' impacts.

2. Passive Investment Taxes

The passive investment measures will discourage many entrepreneurs who will be faced with an excessive tax rate on their retirement investments. It would seem as though the authors believe that RRSPs and pension funds are the only valid retirement planning instruments, forgetting that entrepreneurs do not necessarily favour these instruments due to their very different needs. Entrepreneurs need as much flexibility as possible to support their businesses, invest in them, and acquire other businesses. RRSPs and pension funds do not provide that flexibility. The authors further forget that no tax is paid when RRSP and pension contributions are made. In fact, RRSP and pension contributions reduce taxable income so as to eliminate the tax on such contributions. Entrepreneurs, on the other hand, are required to pay at least 15% tax when they contribute to their retirement fund within their corporation.

Add to that the complicated calculations that will be needed to enforce the proposed measures. The complexity is worrisome and will lead to significant tax compliance costs for SMEs and the government (citizens) through additional tax audits that will be needed to validate the calculations.

3. Intergenerational Business Transfers

The proposed measures will make it even more difficult to transfer a family business to the next generation. It is difficult to understand how tax rules can promote the sale of a family business to outsiders instead of the next generation. A sale to outsiders triggers the capital gains exemption for shares held in an SME (approximately $835,716 non-taxable) and also results in a tax rate on the amount that exceeds the exemption that is similar to that on the sale of shares held in public corporations. There is currently no capital gains exemption for the transfer of shares held in an SME to children without compelling those children to bear an unreasonable tax cost.

Instead, the tax reform proposes to make the transfer of family businesses even more punitive. The new proposed measures would require children to pay a significant amount of tax immediately if the transaction is financed by the future profits generated by the business that has been sold. This would result in double taxation (capital gains for the parents and taxable dividends for their children). This proposed measure does nothing at all to help keep Canadian businesses in the family.

4. Income Sprinkling

Income sprinkling with spouses and children seems to be the original source of this tax reform, which introduces a highly subjective and complex justification mechanism based on a reasonableness test. This complexity will lead to significant fees for taxpayers who will have to justify the dividends paid out to family members, whether they are directly or indirectly involved in the business, whether they take significant financial risks or not, or whether they have significantly contributed to the business' success. The government is seeking to meddle in how amounts that may or may not be paid to family members are determined. Entrepreneurs will have to justify their compensation to the CRA because, in tax matters, the burden of proof lies with the taxpayer. This intrusive justification principle will cause an unprecedented amount of anxiety for entrepreneurs when responding to the CRA's requests, result in significantly higher tax compliance costs, and discourage entrepreneurship.

The Minister of Finance failed to indicate that retired employees are able to split their pension income with their spouse. There are questions regarding the degree to which this would be fair for entrepreneurs who decide to build their pension fund through their corporation because it would be impossible for them to split their pension income with their spouse.

5. Tax Rate upon Death and for the Estate on SME Shares

Under the new proposed measures, the fair value of shares held by a deceased individual in an SME will ultimately be taxed as a dividend instead of a capital gain. Such shares have been taxed as a capital gain for many years. In order to adequately plan for the tax impact upon death, entrepreneurs purchased life insurance contracts in order to ensure their SME's sustainability after their death. This change will put at risk business sustainability and the planning already done because it will almost double the tax impact upon death, since the capital gain will be taxed as a dividend.

6. Other Impacts

- Where the CRA has ruled that the amount is unreasonable, a spouse's split income will be taxed at a rate higher than the rate that would be in effect considering that the dividend would have been attributed to the other spouse.

- Discourage family members from financing start-ups because the dividends paid in exchange for their investment might be considered split income, which is taxed at the highest marginal rate.

- Force entrepreneurs to restructure in order to avoid additional unjustified taxation (e.g. family members holding the same class of shares) once the new income splitting measures are enforced.

- Negative impact on entrepreneurs who have based their financial decisions on established tax principles.

Conclusion

In brief, the proposed measures will discourage many entrepreneurs and unduly tax them. The reasons for supporting this reform are hard to understand and disregard entrepreneurs' efforts and the risks they take.

We urge you to abandon this reform and to review the *Income Tax Act* in a much broader context in order to not negatively target entrepreneurs. Many other measures could be introduced to ensure greater fairness among all Canadians without jeopardizing Canadian SMEs' vitality and sustainability. Any changes should be supported by an economic impact analysis to ensure they do not shake the very foundations upon which our SMEs and economy are built.

Yours sincerely,

Michel Coulombe, CPA, CA, Partner

Luc Labbé, CPA, CA, CIA, Partner

Lionel Nolet, CPA, CA, Partner

Pierre-Yves Daoust, CPA, CA, Partner

Gilles Berger, CPA, CA, Partner

Jonathan Paquet, CPA, CA, Partner

Marc Brazeau, CPA, CA, Partner

Sophie Beaulieu, CPA, CA, Partner

Edgar Chénier, M.Fisc., Partner

Julie Bureau, CPA, CA, Partner

Valérie Marcil, CPA, CA, Partner

Stéphanie Côté, CPA, CGA, M.Fisc., Partner

Philippe Renaud, CPA, CA, Partner