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INVESTMENT INDUSTRY ASSOCIATION OF CANADA
ASSOCIATION CANADIENNE DU COMMERCE DES VALEURS MOBILIÈRES

LETTER FROM THE PRESIDENT

Vol. 111

Another blow for small business capital-raising

HIGHLIGHTS:

The proposed tax changes for private corporations will significantly raise effective tax rates on income earned from passive investments. Under one of the proposals, the effective tax rate on income from passive assets held in private corporations would increase from 56 percent to 73 percent.

Private corporations are active investors in the shares of new and emerging small businesses across Canada. The much higher taxation of passive income will discourage corporate participation in private equity and public venture markets, at a time many small companies find capital-raising increasingly difficult.

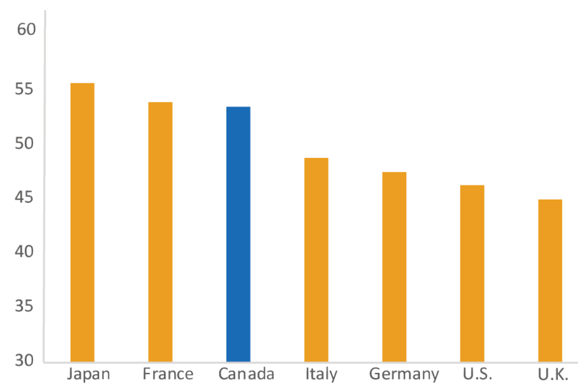
A tax deferred rollover provision would be a timely remedial step. It would unleash locked-in capital by deferring capital gains tax on the sale of assets if proceeds are re-invested in the shares of small business. The deferred tax would eventually be paid when the re-invested assets are sold. In the interim, no tax revenue loss would accrue to the federal treasury, as the original asset would never have been sold without the tax deferral.

BACKGROUND ON THE RECENT TAX PROPOSALS

In the dead of summer on July 18, the federal government proposed significant tax changes to address the issue of tax planning using private corporations. The initiative was explained as an effort to increase tax fairness between middle class Canadians paying tax on personal income, and Canadians flowing income through small corporations to get better tax treatment. These tax proposals have created a firestorm of protest. Despite the well-intentioned objective to achieve tax fairness, these tax changes will constrict the flow of capital to new and emerging enterprises, reflecting the active role of private corporations in financing the private equity and venture public markets. Moreover, the changes will make it difficult for small business owners and professionals to build capital to fund retirement savings and meet other contingencies.

Such unintended consequences are not a surprising outcome for a highly complex, inter-connected and multi-purposed tax system. Pulling on one lever to achieve greater fairness for a group of tax-payers can have a countervailing and unintended impact on other taxpayers, and on behaviour that influences saving and investment. Moreover, these tax proposals have followed on the heels of recent hikes in the federal and provincial top marginal personal income tax rates, already ranked nearly the highest among the developed countries (nearly 8 percentage points higher than the top rate in the UK and 7 percentage points higher than the U.S. top rate), with the top rate applying at much lower personal income levels than many countries. For example, income exceeding $202,800 is subject to the top marginal rate at the federal level in Canada, whereas in the U.S., the top marginal personal income tax rate applies on income exceeding $418,400 for single filers and $470,700 for married couples filing jointly. While new tax proposals may have been introduced in part to blunt efforts to reduce personal taxes through a corporate structure, they have had a much more far-reaching impact.

G7 - Top Combined Statutory Marginal Income Tax Rates (%) in 2016



Source: OECD

Despite the complexity of the tax system and, indeed, the proposals themselves, the proposed changes were not only introduced in an unexpected rush, but put forward in the summer months with an unreasonably short 75-day period for comment. If fairness is in question—not just between categories or taxpayers, but for all taxpayers—then the government should undertake a comprehensive review and reform of the tax system, focused on evaluating the myriad tax-preference measures (exemption, deductions and credits) that are part of the tax code to determine if they are cost effective and achieving their intended purpose, and broadening the tax base and lowering rates.

The new proposals that have attracted most publicity is the prohibition on “income sprinkling” to stop small business owners and professionals from distributing corporate income to family members that may not be actively involved in the actual enterprise. The government plans to impose a tighter and more complex regime on shareholders entitled to income from the private corporation. Small business owners will be in for more complicated system of tax compliance.

The other two tax proposals are measures to prohibit the conversion of corporate surplus into lower taxed capital gains (commonly referred to as surplus stripping), and an additional tax on passive investments (i.e. income earned beyond what is needed to re-invest and grow the business) held within a privately-controlled corporation.

The focus of this President's Letter is the proposed tax on passive income and its impact on access to capital for small companies and capital formation in the country.

CHANGING A 45-YEAR PRECEDENT TO TAX PASSIVE INCOME HELD BY SMALL CORPORATIONS

Active business earnings by a corporation are taxed at a lower rate than personal income. However, if these corporate earnings are paid out to an individual shareholder, the shareholder will pay personal tax such that the combined personal and corporate tax is roughly the same as if the shareholder earned the income personally. If the active income is re-invested in the corporation, corporate taxes would be paid, and the personal tax deferred until the funds are eventually paid out to the shareholder.

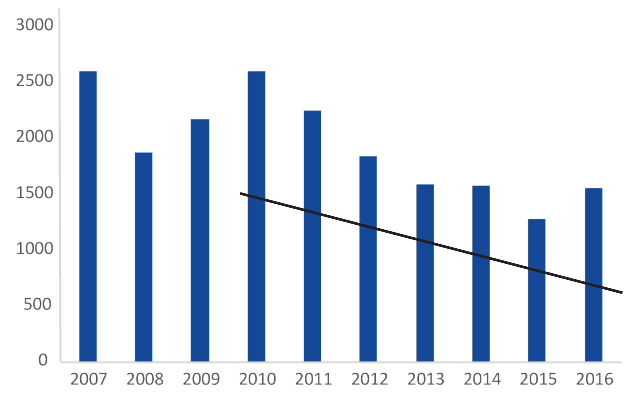
If the re-invested income in the corporation is earned from passive financial assets, and not paid out, the corporation pays an additional refundable tax on the earnings from passive assets so that the aggregate tax paid by the corporation is equivalent to the tax paid by the individual shareholder as if the income was earned personally. The so-called refundable tax paid on these investments is refunded to the corporation at the time income from the passive assets is paid in dividends to individual shareholders.

Under one likely option in the new proposals, the corporate tax paid on the income earned on passive investments is not refundable when income is paid out to the shareholder. This means that the total tax paid by the corporation and the individual shareholders will be 73 percent. This much higher effective tax rate will discourage private corporations from accumulating diversified financial investments to provide reserves to meet contingencies, and to fund potential acquisitions.

Private corporations have been one of the more significant participants in private equity and public venture markets in the country. These companies have funded many new and emerging businesses and, at times, provide funding right through to the IPO stage. Some of these private corporations include both companies engaged in active business, as well as private corporations organized as investment vehicles. These companies, often with sector-specific knowledge, have accumulated financial investments to build diversified contingency reserves, identify possible acquisition candidates, or simply boost overall earnings. The non-refundable corporate tax paid on these investments, together with personal tax paid on distributions to individual shareholders, dramatically reduces net return relative to risk on these speculative investments, and will discourage investment in small businesses, damaging small business capital formation.

The irony is that the fairness consideration that drove these tax changes in the first place has limited relevance in the context of proposals related to passive income earned in private corporations, as shareholders have always been taxed on distributions of corporate income as if the income was earned personally. This provision is in place to encourage buildup of financial reserves. The provision is good for overall economic growth as it gives flexibility for companies to invest in financial assets, if returns exceed the rate of return of the active business. On the other hand, the proposed tax increase will discourage investment in passive assets, as appears the Minister's intention, despite the importance of these financial portfolios to provide a contingency reserve for downturns in business performance, and/or build up assets for potential acquisition. Moreover, the tax increase will significantly reduce passive investments by private corporations as a critical source of capital for Canadian small business.

Number of Financing Transactions on TSX Venture Exchange

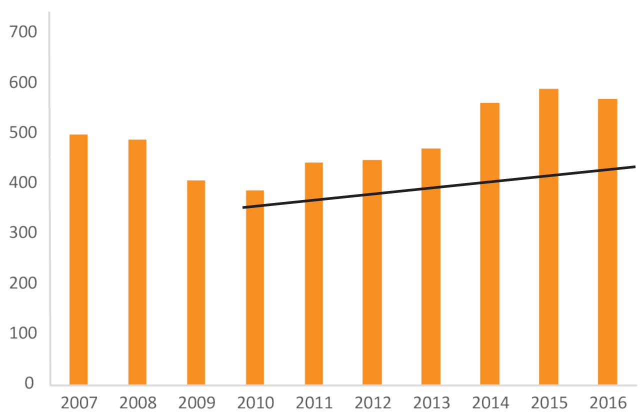


Source: TMX Group

MAKING A DIFFICULT SITUATION WORSE

The proposed corporate tax changes could not come at a more inopportune time for small business and the Canadian economy. First, the flow of equity capital to small business has collapsed in recent years, partly reflecting a weak and uncertain business climate, and structural adjustments that have reduced investor participation in small business markets. Overall, small business financing transactions have fallen one-third over the last ten years, particularly worrisome in an expanding economy. The number of financing transactions on TSX Venture Exchange fell more than 40 percent, while the number of Canadian private equity financing transactions trended up slightly. The Canadian economy needs steadily expanding capital flows, not stagnating flows, to drive capital formation, job creation and economic growth. Second, despite buoyant growth in the first half of the year, economic momentum is likely to falter later this year, placing more importance on support from a growing small business sector. Third, a strengthening U.S. economy, boosted by the likelihood of tax reform, will draw Canadian capital south of the border as well as reduce the capital flows of U.S. venture funds to the Canadian small business markets.

Number of Canadian Venture Capital Financings



Source: Thomson Reuters

THE CAPITAL GAINS ROLL-OVER PROVISION: A COST-EFFECTIVE WAY FOR GOVERNMENT TO ASSIST SMALL BUSINESS

The proposed tax treatment of income from passive investments in private corporations should not only be reversed, but the federal government should make positive proactive reforms to the tax system to promote equity investment in small private and public businesses. It is true the cash-strapped federal government has few policy levers to boost the flow of capital to the small business sector. However, there is one option that could be considered — a "roll-over" provision that enables investors to sell at least a portion of "locked-in" capital in financial and real estate investments without incurring capital gains tax, or with a substantial reduction in capital gains tax rate, if the proceeds are re-invested in the equity shares of small business. The tax owed on the proceeds of the "locked in" investment would not be exempt from tax, but in fact deferred as the proceeds, channeled into private equity and venture capital investments, are paid when these small equity investments are eventually sold. Without the deferral option, it should be recognized the federal government would collect no tax revenue at all, since the original investment would remain "locked in" and not subject to tax.

ENTERPRISE INVESTMENT SCHEME

A further option that could be considered is a Canadian version of the UK Enterprise Investment Scheme. While the EIS provides a personal tax credit for the purchase of small business shares, and an exemption from capital gains if the shares are held for more than three years, the tax expenditure can be limited by the size and eligibility of the investment. Moreover, cost-benefit analysis by the UK EIS Association has demonstrated that the employment gains from small business expansion are worth the expenditure. Moreover, the taxes paid on salaries from increased employment and taxes on increased corporate income from the expansion of the business mitigate the government tax expenditure.

Finally, a third option to assist small business access capital could be a moderate expansion of the Tax-Free Savings Account (TFSA) program, say an increase in the annual allowable contribution limit from the current $5,000 to $7,500. These TFSA accounts have proven to be popular savings instruments by middle class Canadians who have invested in a range of different financial assets including shares of small business. A modest increase in the allowable limit would still leave these savings vehicles within reach of middle income Canadians.

CONCLUSION

The new tax proposals were introduced to bring greater fairness to the tax system. However, these tax proposals will result in much higher tax rates on income from passive investments paid out to individual shareholders. Private corporations are an important source of capital for private equity and venture public companies. These corporations typically invest in new and emerging businesses, providing the investment opportunities for venture capital funds, and encouraging capital formation in the country. The tax changes, unless modified, will constrict already scarce funds for small businesses. If these tax proposals for increased tax on passive income in private corporations go forward, there is even greater need for tax incentives to encourage equity investment in small business. The capital gains roll-over provision (and its concept of deferred capital gains tax) and a Canadian version of the UK Enterprise Investment Scheme should be considered. Finally, the decision to wade into these tax proposals with little aforethought and minimum comment period, not to mention the anticipated serious unintended consequences if the proposals are implemented, has damaged small business confidence in government's stewardship of an effective tax system.

Yours sincerely,

Ian C. W. Russell, FCSI
President & CEO, IIAC
October 2017