Support for Small Business and Fairness for the Middle Class

The Government's Commitment:

"As we reduce the small business tax rate to nine per cent … we will ensure that Canadian-Controlled Private Corporation (CCPC) status is not used to reduce personal income tax obligations for high-income earners rather than supporting small businesses"

An **Economy that Works** for the Middle Class

When you have an economy that works for the middle class, you have a country that works for everyone. As the Government reduces taxes for small businesses, it must ensure that Canada's low corporate tax rates is supporting businesses, rather than giving unfair and unintended advantages to a small number of high-income and wealthy individuals using private corporations as a tax planning tool.

The Government's plan to invest in people, in communities and in the future of our country is working:

- Canada's economy is growing faster than it has in over a decade, and over 400,000 jobs have been created in the last two years. As our economy grows, the Government will make sure that middle class Canadians see the benefits of this growth.

Canada's combined federal-provincial-territorial average tax rate for small business is the lowest in the G7 and fourth lowest among Organisation for Economic Co-operation and Development countries (see Chart 1).

Canadian businesses benefit from a combined general corporate tax rate that is 12 percentage points lower than that of Canada's largest trading partner, the United States.

- In its first Budget, the Government introduced the Canada Child Benefit (CCB)— a system that provides greater support to those who need it most: single-parent families—single mothers in particular and low- and middle-income families. During the first benefit year, over 3.3 million families received more than $23 billion in CCB payments, with nine out of 10 families receiving more help than they did under previous programs. With the CCB, hundreds of thousands fewer children are living in poverty than in 2013 and, by the end of this year, child poverty will have been reduced by 40 per cent over this short period.
- In December 2015, the Government raised taxes on the wealthiest one per cent, so that it could introduce a middle class tax cut for nearly nine million Canadians.

The Next Steps: Greater Fairness and Lower Taxes for Small Business

The Government's next step is to address tax planning strategies using private corporations that encourage high-income and wealthy individuals to incorporate, so they can pay a lower tax rate than middle class Canadians. In achieving greater tax fairness, over the next 14 months, the Government intends to lower the federal small business tax rate from 11 per cent in 2015 (10 per cent, effective January 1, 2018, and nine per cent effective January 1, 2019), knowing that a continued tax advantage for Canadian businesses – including the lowest small business tax rate in the G7 – will help them to create more jobs and grow our economy.

Overview of Proposed Changes

Roughly two months after the Government came to office, the small business rate was reduced to 10.5% on January 1, 2016, but the Government paused on further reductions in order to better understand the use of the small business tax deduction and the potential to be used as a tax planning tool for the wealthiest of Canadians. In Budget 2017, the Government highlighted a number of issues regarding tax planning strategies using private corporations. A variety of unintended tax reduction strategies are available to these wealthy individuals that are not available to other Canadians. The Government committed to review these strategies and consult on possible changes.
These strategies include:

- Sprinkling income using private corporations, which can reduce income taxes by moving income that would otherwise be received by an individual facing a high personal income tax rate to a family member who has a lower personal tax rate (or who may not be taxable at all).
- Holding a passive investment portfolio inside a private corporation is financially advantageous for owners of private corporations compared to otherwise similar investors. This may result in the use of the private corporation as an unlimited, personal, tax preferred savings account, far beyond what is available to other Canadians.
- Lastly, converting a private corporation's regular income into capital gains, which can reduce income taxes by taking advantage of lower taxed capital gains.

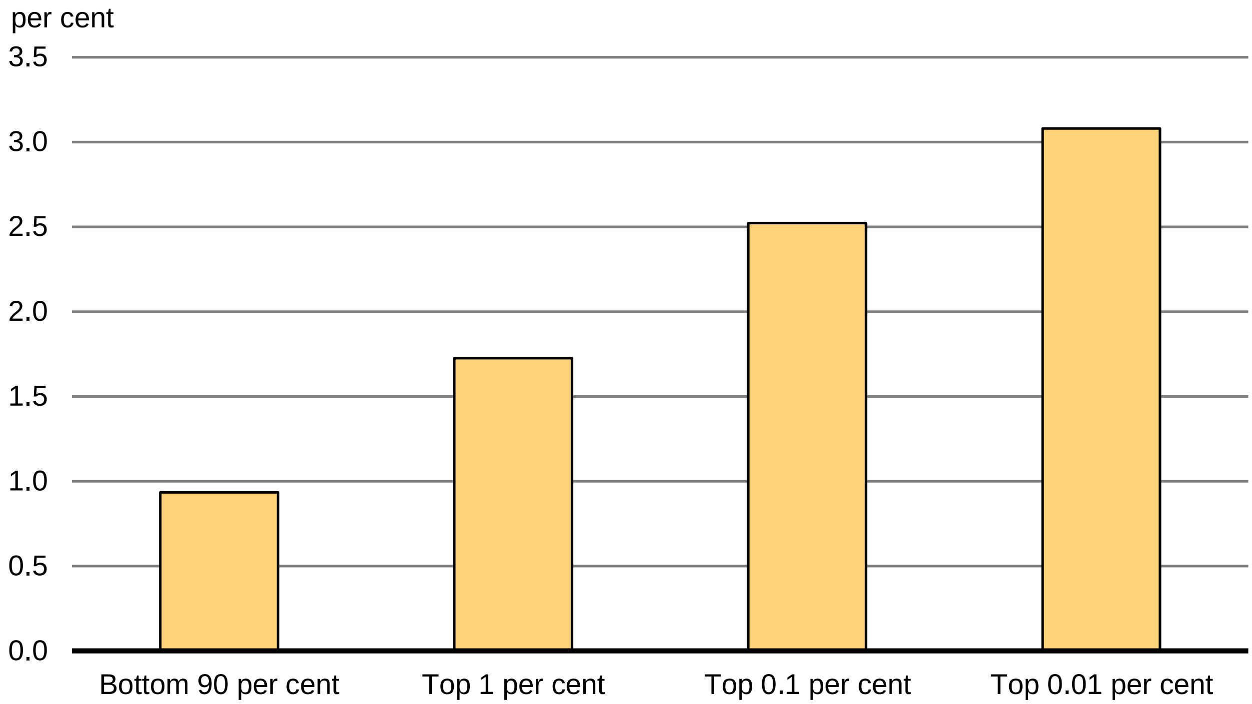
Why Change is Needed

Canadians work hard and expect and deserve to be rewarded for that work with greater opportunities for themselves, and for their families. This sense of optimism is essential to growing our economy. Over the last several decades, however, the benefits of economic growth have not been evenly shared. Over the past 30 years, the median real wage income has barely risen, leaving many Canadians concerned for their future. However, among the wealthiest 0.01 per cent of Canadians, after-tax after-transfer incomes have risen dramatically in the past 30 years. Individuals earning more than $1.8 million per year have, on average, seen their incomes rise by nearly 156 per cent in that time (or 3.1 per cent per year on average) after inflation. To help to create jobs and economic growth, federal and provincial governments of all stripes have made corporate income tax rates more competitive in Canada. Since 2000, the gap between the top personal income tax rate and the small business rate widened from about 26 percentage points to over 37 percentage points (see Chart 2).

This gap, along with other legislative changes, has had the consequence of encouraging high-income individuals to use incorporation as a means to access the lower tax rate, and gain an unfair tax advantage.

The tax planning strategies involving private corporations have exacerbated the problem of income inequality.

Average Annual Growth in Real family income, 1982–2013



Notes: Base year for growth rates is 1982. Growth for the top 1, 0.1 and 0.01 per cent is based on individual real after-tax after-transfer income of Canadian tax filers from the Longitudinal Administrative Databank. Growth for the bottom 90 per cent is based on real after-tax, after-transfer household income (adjusted for family size) from a combination of the Survey of Consumer Finances, the Survey of Labour and Income Dynamics and the Canadian Income Survey data. After-tax, after-transfer income is the sum of all income from market and government sources, minus income tax.
Source: Statistics Canada.

To lower the small business tax rate without addressing these tax planning strategies would further increase tax advantages that benefit the wealthiest Canadians over the middle class, providing greater incentive for high-income and wealthy individuals to use these structures to avoid paying personal income tax rates.

If these trends are allowed to continue, the significant growth in the use of CCPCs by high income individuals will continue to weaken the tax base, increasing the tax burden on those who cannot benefit from incorporation.

A number of facts support these conclusions:

- Reductions in corporate income tax rates since 2000 have resulted in a widening gap between top personal income tax rates and combined small business income tax rates that has risen from about 26 percentage points in 2000 to over 37 percentage points today.
- This has led to a shift to incorporation, especially acute in service industries (e.g., financial services), and particularly so among professional services (e.g., lawyers, accountants, and physicians) (see Table 1) – the annual growth in the number of professional corporations has been 14.9 per cent from 2001 to 2015.
- This shift is expected to continue, particularly as the service sector is expected to account for more of our economy in future years – services now account for 71 per cent of GDP, and 79 per cent of employment (see Chart 4); in 2000 services accounted for 64 per cent of GDP.

- Over the 2001 to 2015 period, the number of CCPCs has grown by 8.7 per cent per year, far surpassing a rate expected by economic growth – the number of active CCPCs has increased substantially, from 1.2 million in 2001 to 1.8 million in 2015.
- The growth in passive investment income earned by these corporations has grown by an average of 16.8 per cent per year over the 2010 to 2015 period.
- CCPC taxable active income as a share of GDP almost doubled from 2002 to 2014, and was $70 billion higher in 2014 than if it had matched the growth in GDP. Meanwhile, the share of non-incorporated self-employment income declined and there has been little change in the share of income from public corporations and private corporations other than CCPCs (see Chart 3).

Tax planning using private corporations disproportionately benefits high-income individuals. Eighty per cent of the passive investment income in Canada is earned by two per cent of all CCPCs, and it is estimated that more than 80 per cent of passive investment income is earned by CCPC owners making more than $250,000. In addition, only an estimated 50,000 family-owned private businesses are sprinkling income in ways that could be affected by the Government's proposals to ensure tax fairness.

The majority of owners of private corporations are men, and men receive a greater percentage of dividends received from small business corporations (66 per cent in 2014). Men represent over 70 per cent of higher-income earners initiating income sprinkling strategies. The Government will continue to carefully consider the gender impacts of measures proposed to address tax planning involving private corporations.

Results of Consultation to Date

The Government was elected on a commitment to openness and remaining focused on the people it is meant to serve. In July 2017, the Government released a consultation paper with proposals to address tax planning strategies using private corporations.

In the course of this consultation many Canadians indicated their support for these proposals but also raised significant concerns and areas where improvements were required:

- The complexity of the proposed income sprinkling measures, the potential impact on small family businesses and the need to simplify the draft legislative proposals;
- Unintended consequences regarding the proposed measures on the conversion of income to capital gains, and the multiplication of the Lifetime Capital Gains Exemption, which could impair estate planning and the transfer of farms and small businesses to the next generation; and
- The way in which passive investments within a private corporation are used by business owners, particularly small and medium-sized businesses, to manage personal income risk in the case of a downturn, sick leave or maternity or parental leave. In many cases passive investments are used as a retirement tool for small business owners as other savings vehicles such as Registered Retirement Savings Plans are not sufficiently flexible and adaptable to address business volatility.

The Government has listened and is committed to addressing unintended consequences.
The Government's focus is on strengthening Canada's hard-working, middle-class small businesses, their growth and their job creation, while targeting unfair advantages that largely benefit the wealthiest of Canadians.

The Way Forward

Action is needed to ensure that the low corporate tax rates and the preferential small business tax rate are used to support businesses, not for personal tax advantages. Fairness in the tax system allows the Government to keep taxes low, while ensuring programs and services for all Canadians. Moving forward, changes to the tax treatment of private corporations will be informed by the many Canadians who contributed to the consultations and five guiding principles:

1. Support small businesses and their contributions to our communities and our economy.
2. Keep taxes low for small businesses, and support owners to actively invest in their growth, create jobs, strengthen entrepreneurship and grow our economy.
3. Avoid creating unnecessary red tape for hard-working small businesses.
4. Recognize the importance of maintaining family farms, and work with Canadians to ensure we don't affect the transfer of a family business to the next generation.
5. Conduct a gender-based analysis on finalized proposals, to ensure any changes to the tax system promote gender equity.
6.

Annex

Chart 1
General and Small Business Corporate Income Tax Rates

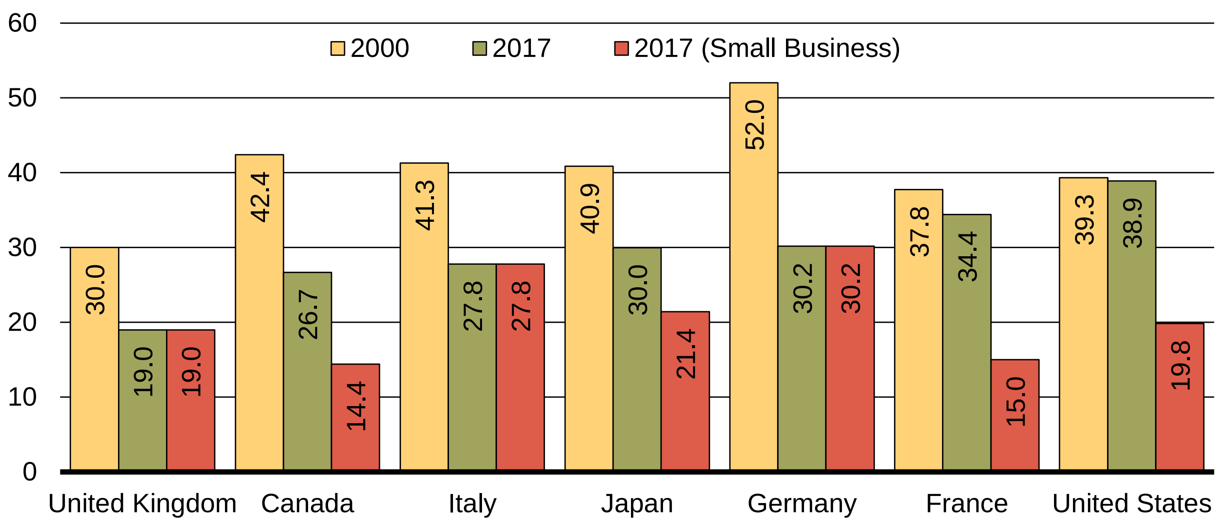


Chart 2
Federal-Provincial Tax Rates

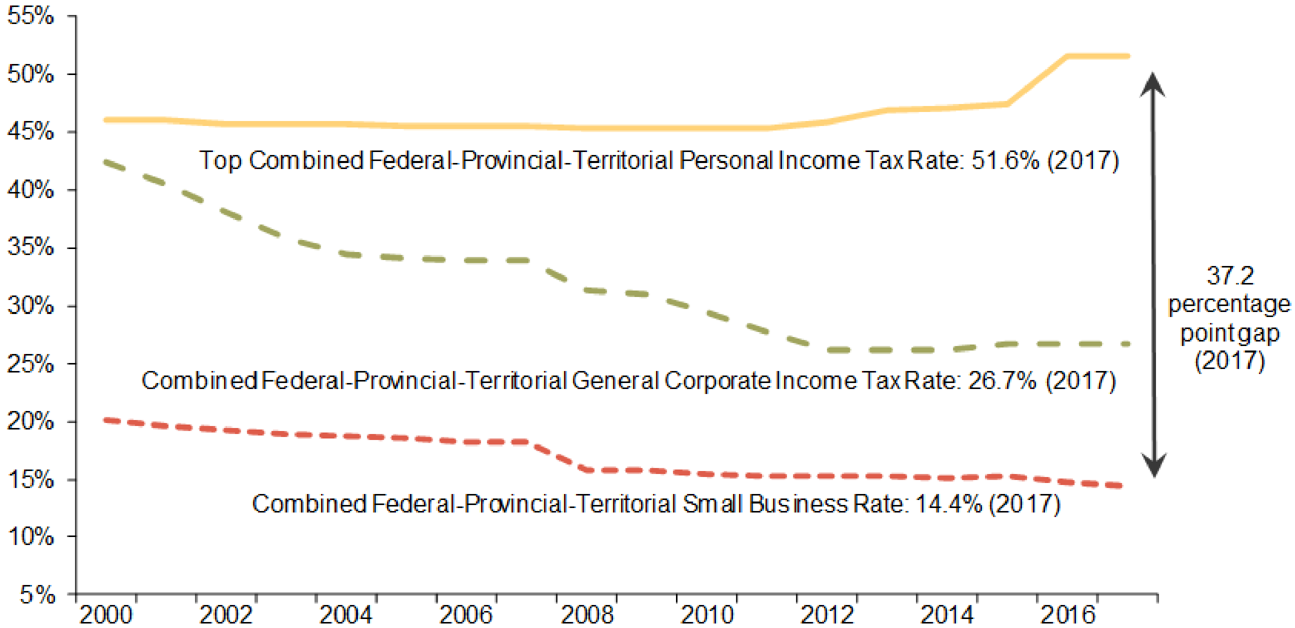


Chart 3
Trend in Taxable-Active-Income-to-GDP Ratio, by Type of Business

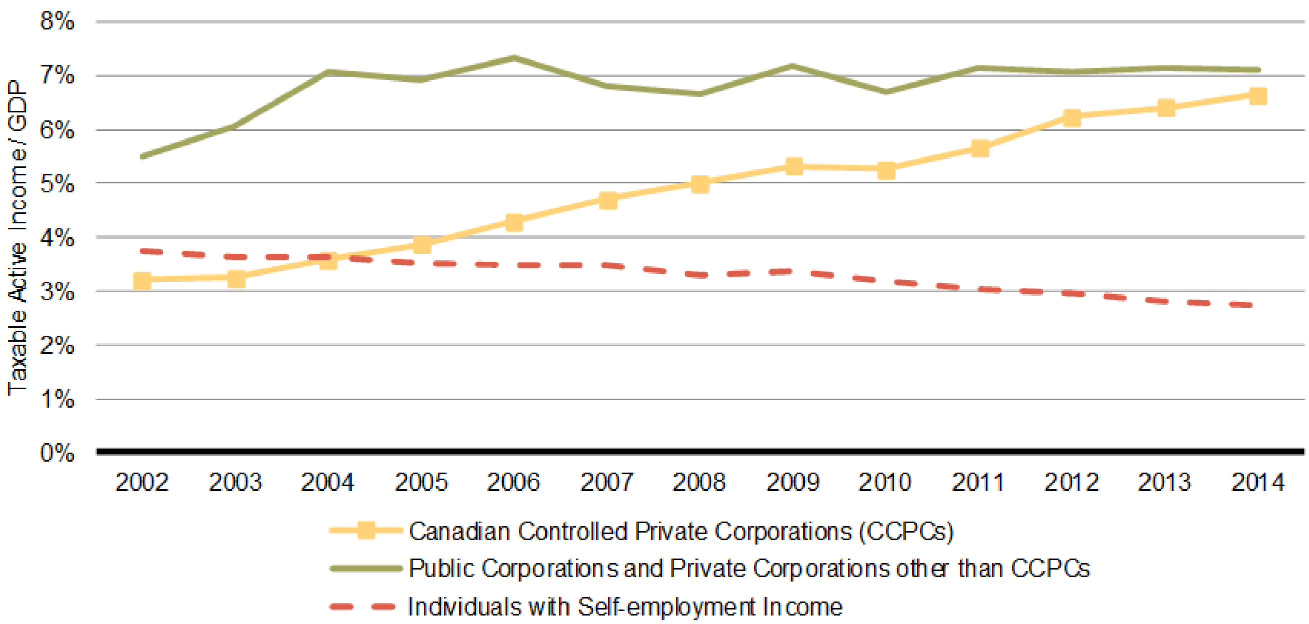
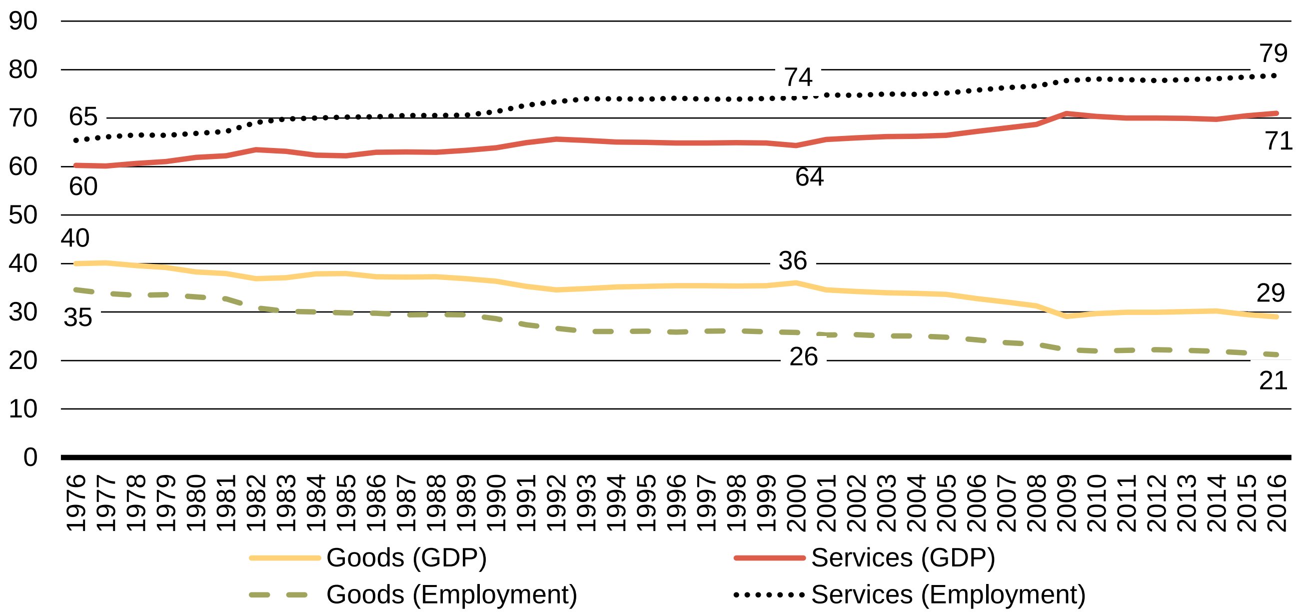


Chart 4
Goods and Services Sectors, as a share of GDP and Employment



Source: Statistics Canada, Department of Finance Calculations.

Table 1
Annual average growth in the number of CCPCs and taxable passive income by industrial sector

	2010-2015 Period		2001-2015 Period	
	Growth in Number of Corporations	**Growth in Total Taxable Passive Income**	**Growth in Number of Corporations**	**Growth in Total Taxable Passive Income**
Finance and insurance	7.4%	16.3%	8.6%	8.9%
Real estate, rental and leasing	8.3%	16.4%	10.4%	15.8%
Management of companies and enterprises	7.0%	15.8%	8.5%	8.6%
Professionals*	13.6%	28.9%	14.9%	19.5%
Wholesale and Retail Trade	6.1%	21.7%	5.1%	7.0%
Agriculture, forestry, fishing and hunting	7.5%	15.6%	6.9%	12.5%
Construction	6.9%	16.4%	7.6%	13.0%
Other	8.4%	16.1%	7.7%	9.8%
All Sectors	**8.4%**	**16.8%**	**8.7%**	**10.5%**

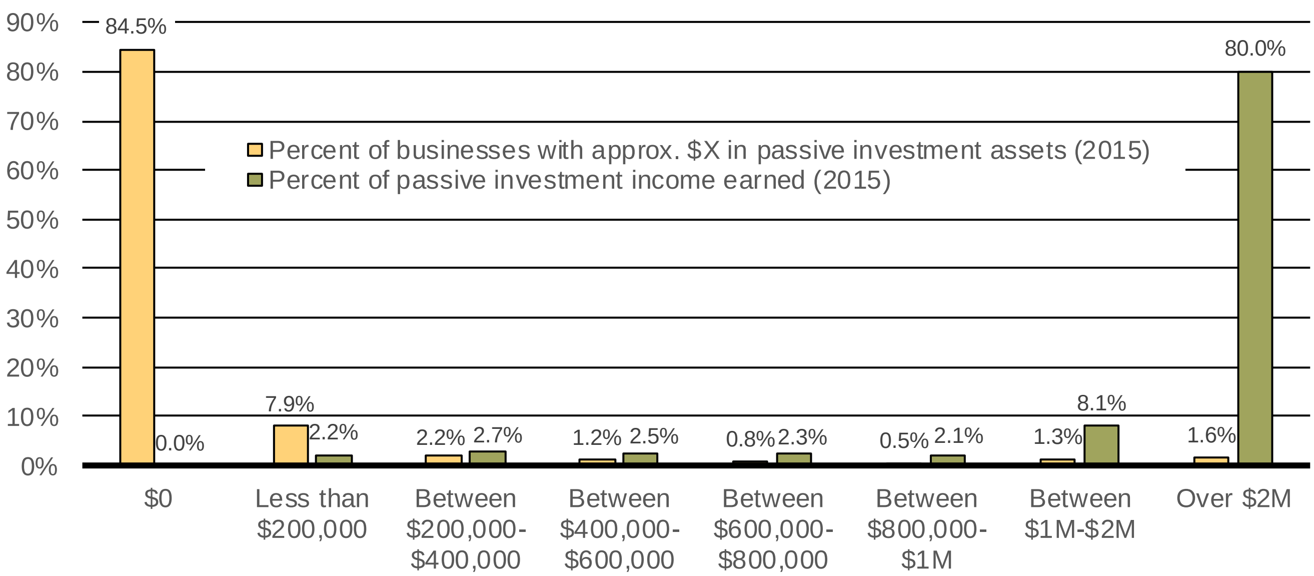
Note: Professionals refer to lawyers, notaries, accountants, veterinarians, physicians, dentists and chiropractors.

Table 2
Taxable passive income of CCPCs, by taxable passive income range, 2015

Passive Income Range	Taxable Passive Income ($M)	# CCPCs	Share of Total: Taxable Passive Income	Share of Total: # CCPCs
$0	-	1,525,646	0.0%	84.5%
Less than $10,000	452	143,173	2.2%	7.9%
$10,000 to $25,000	828	50,911	4.0%	2.8%
$25,000 to $50,000	1,162	32,651	5.7%	1.8%
$50,000 to $75,000	926	15,170	4.5%	0.8%
$75,000 to $100,000	738	8,535	3.6%	0.5%
Over $100,000	16,441	29,339	80.0%	1.6%
Total	**20,548**	**1,805,425**	**100.0%**	**100.0%**

Note: Excludes firms that may not have benefitted from a tax deferral advantage.

Chart 5
Who holds Passive Investments vs. Passive investment income (2015)



* The asset values used to produce the chart were imputed from passive investment income amounts reported by private corporations for tax purposes, using an hypothetical rate of return of 5%. These amounts include capital gains, portfolio dividends and other investment income such as interest.

Table 3
Taxable Passive Income of CCPCs by Personal Income Range of Shareholders, 2015

Income Range		Share of Total		
		Taxable Passive Income	Male Per cent of income range	Female Per cent of income range
Less than $14,500	(bottom 25 percentile)	0.03%	38.4%	61.6%
$14,500 - $31,500	(25-50th percentile)	0.17%	46.6%	53.4%
$31,500 - $58,500	(50-75th percentile)	0.95%	51.3%	48.7%
$58,500 - $93,500	(75-90th percentile)	2.49%	56.3%	43.7%
$93,500 - $123,000	(90-95th percentile)	2.66%	58.6%	41.4%
$123,000 - $250,000	(95-99th percentile)	10.36%	61.5%	38.5%
More than $250,000	(Top 1 percentile)	83.36%	74.4%	25.6%
All		**100.0%**	**71.9%**	**28.1%**

Note: Based on passive investment income reported by CCPCs with active business income earned directly or through a subsidiary, and for which individual shareholders could be identified.