Department of Finance Canada Consultation: Tax Planning Using Private Corporations

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Executive Summary

CFA believes the proposed tax changes related to the Department of Finance Canada's consultation will hurt Canadian franchisees, who are independent small business entrepreneurs that currently use these legal avenues to create jobs and support the communities they serve.

In franchised small businesses, family members often contribute in many ways, making it difficult to determine the threshold at which a family member would be considered to earn a "reasonable" income. Further, franchised business owners put their own capital and equity into a business, and they assume 100% of the risk. Particularly for franchisees, the income they hold within their corporation is often reinvested into the existing business or used for expansion, all of which creates jobs that support the Canadian economy.

Based on the collective concerns of our membership, CFA's recommendations are as follows:

1. Reverse the proposals set out by the Finance Minister;
2. Continue Consultations outside of the original 75-day period; and,
3. Ensure changes to existing tax policies do not adversely affect those who it intends to help, i.e., middle-class earners, small business owners, etc.

About the CFA

The Canadian Franchise Association (CFA) is the recognized authority on franchising in Canada. With over 600 corporate members representing many of Canada's best- and lesser-known brands, with 48,000 franchisees nation-wide, CFA is the indispensable resource for the franchise community and advocates on behalf of franchisors and franchisees in Canada to enhance and protect the franchise business model. CFA promotes excellence in franchising and educates Canadians about franchising, specific franchise opportunities and proper due diligence through its many events, programs, publications, and websites (www.cfa.ca, www.LookforaFranchise.ca, and www.FranchiseAwareness.ca).

As the only national trade association serving the franchise industry, the CFA is a one-stop resource for franchisors, franchisees, and anyone considering new business opportunities in the franchise sector. CFA was founded in 1967 by a group of franchisors who saw a need for a national organization committed to the growth, enhancement, and development of excellence in franchising in Canada. CFA's wealth of knowledge flows, in part, from its prominent role in the nation's business community.

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Introduction

In July 2017, Federal Minister of Finance Bill Morneau unveiled a proposal the government believes will close the following "loopholes" in the federal tax system that they claim disproportionately benefits wealthy Canadians:

1. Sprinkling income using private corporations
2. Holding a passive investment portfolio inside a private corporation
3. Converting a private corporation's regular income into capital gains

Major tax policy change like this necessitates a lengthy and in-depth consultation before any changes are brought forward. This review should be based on creating the right tax policy to support the growth of Canadian private businesses, who are the backbone of the Canadian economy, taking into account the risk that entrepreneurs and their families take in establishing and running a business. Unfortunately, these changes will not only affect the wealthy as the government intends, but instead will directly target small business owners like franchisees who make daily sacrifices to keep their businesses alive, support their families, and invest in the communities in which they live.

The following outlines the concerns and recommendations of CFA and our members in response to the *Tax Planning Using Private Corporations Consultation.*

Income Splitting

Tax policy in Canada with respect to income splitting has been very clear since 1999, when rules were introduced to restrict income splitting opportunities with minors. The proposed changes to these rules would be disruptive to how Canadian businesses are structured.

Tax mechanisms like income splitting are available to entrepreneurs because they are not eligible for the same types of benefits that salaried employees are, such as EI benefits, paid maternity leaves, or guaranteed vacations. Many entrepreneurs have not been maliciously using these tax "loopholes" to their benefit as it has been suggested, but have instead been using these legal avenues to support their family and continue to grow their business.

As currently proposed, changes to income splitting could affect countless Canadian franchisees. In many cases, family members are heavily involved in the business, either as a direct employee or by providing other informal support. Implementing a "reasonableness test" to assess if family members legitimately work for a small family-run business will be difficult to quantify and will only place additional rules on small businesses, making the tax system even more confusing and unfair, while adding to the overall regulatory burden.

Passive Income

Current tax rules allow Canadians to keep certain passive investments or excess income in a business or a holding corporation. These investments are important for owners investing in their businesses, because accessing financing can be difficult. Many small business owners like franchisees use these types of investments for unforeseen costs, to save for retirement, towards benefits for themselves and their families, and to reinvest in or grow their business.

Franchised business owners put their own capital and equity into a business assuming 100% of the risk to secure the future of their families with few government support systems available to them. Particularly

for franchisees, the revenue that they generate within their corporation is often maintained in the existing business or used for expansion for the longer term, all of which creates jobs that support the Canadian economy.

Business owners need to save profits earned to reinvest, particularly when there is an economic downturn, which could very well be the determining factor that allows them to stay in business or avoid cutting jobs and/or employee hours. Canadian tax policy should support business owners investing for these purposes; introducing tax policy that discourages savings by Canadian business owners is counterproductive.

The government considering increasing taxes on small business owners' passive investments will harm their ability to invest in their businesses and save for their futures. Specifically for franchisees, growth and expansion can often rely on leveraging these tax mechanisms, something that would not be available should the rules change.

Converting Income into Capital Gains

As it currently stands, business owners can convert their surplus into capital gains, which are taxed at a lower rate than dividends or salary. The proposed changes seek to curb this type of tax planning, which could affect business value appreciations from the past, as a form of retroactive taxation. It could also result in the double taxation of some estates. Retroactive changes are unfair to Canadians who structure transactions based on tax law in effect at the time of the transaction; this is the opposite of creating a "fair tax system" amongst Canadians.

Again, these planning measures are not "tax loopholes" like the government claims. They are legitimate tools for small businesses to reinvest in the business, ensure stability of the firm, and/or save for the retirement of the business owner(s).

Recommendations

The proposed changes will not solely affect the wealthy as the government has implied; many small business owners like franchisees will also be negatively impacted by these rules. The proposed changes will directly target these entrepreneurs who make daily sacrifices to keep their businesses alive, support their families, and create jobs within their communities.

Based on the collective concerns of our membership, CFA's recommendations are as follows:

1. **Reverse the proposals set out by the Finance Minister**
   Unfortunately, the proposed changes announced by the Federal Finance Minister will affect more middle-class citizens than the government anticipates, and will directly target hard-working franchised small business owners, who are unfairly being labeled as "wealthy Canadians who take advantage of the tax system". Targeting entrepreneurs will be counterproductive to the government's stated policy of job growth and economic prosperity.

2. **Continue consultations outside of the original 75-day period**
   We propose the government continue consulting small business owners, and the greater public outside of the original 75-day time period. The timing of this consultation was not conducive to participation of the public as a whole, and should be lengthened to determine the long-term economic impacts certain tax changes will have on middle-class citizens as well.

3. **Ensure changes to existing tax policies do not adversely affect those who it intends to help, i.e., middle-class earners, small business owners etc,.**
   Many middle-class taxpayers will be hit by the new rules, not just those with typically high-paying careers (i.e., doctors, lawyers, etc.). CFA believes the proposed changes conflict with the realities of the Canadian small business economy and recommend the government ensure these groups of business owners are protected.

CFA would be pleased to meet with Finance Canada officials to discuss our consultation response in more detail.