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MORNEAU'S MANIFESTO – *by Hamilton & Rosenthal*

Canada's current Minister of Finance, Mr. Morneau's technical paper of July 18th, 2017 purports that under our current tax laws, owners of corporate small businesses are paying less tax than employees, resulting in an overall "unfairness" to employees. He concludes that the employee has an "unfair disadvantage" as they end up with less cash after tax in their pocket than does a corporate small business owner. To that, we feel obliged to respond to Mr. Morneau's claim of "unfairness" in our current tax system and to demonstrate that this is an inaccurate conclusion. As C.P.A./C.A.'s who have been practising tax for almost 30 years, we know more about income taxes, both corporate and personal, and the plight of corporate small business owners than the average Canadian and are therefore compelled to offer our perspective and comments.

The aim of this paper is not to get into specifics but rather to highlight the flaws in Morneau's underlying premise wherein he is attempting to make a direct comparison between the tax treatment of small business corporations and employees, and to draw attention to his ill-conceived notion that small business owners have an unfair advantage compared to employees.

We believe that corporate small business owners and their families pay significantly more to Ottawa relative to their own earnings than does an employee. We further believe that any income tax advantage or break that the corporate small business owner may enjoy, if they are in fact profitable, are in recognition of the risks they take and the additional costs they incur.

We suggest that uprooting, undoing, overhauling and rewriting a substantial amount of Corporate Tax Law, the most dramatic change to the Income Tax Act in 50 years, warrants more than a rushed and meagre 75-day consultation period in the middle of summer when most people are on family vacations. A dramatic shift in tax doctrine deserves a detailed comprehensive review, perhaps a Royal Commission like the Carter Commission in 1972 which took 6 years. Morneau's proposal reads like a "Manifesto" and swings at everything that moves. After reading the technical paper and consulting with other professionals who have reviewed it in detail, we conclude that it will have an immensely negative impact on our economy but particularly on the middle-class Mr. Morneau is purporting to help. Furthermore, his proposals, if accepted, will come at unimaginable costs. Hundreds of millions will be spent on technical rewriting, implementation, administrative policy development, auditor training, etc., and the only thing that will have been achieved is more complexity within a current overly complex tax system.

Mr. Morneau is using adversarial and emotionally charged buzzwords aimed at confusing and enraging the public. We resent his treating the small business sector of the economy as if they were "tax cheaters" using "tax loopholes" to receive "unfair advantages". Nothing could be further from the truth. The corporate small business owner should be appreciated for the different entrepreneurial type of people they are, the employment they provide to over 8 million Canadians, and the tax dollars they send to Ottawa each year not only in the form of corporate taxes, but also in the Employer Portion of CPP and EI. They certainly shouldn't be vilified and punished for having made different choices, which are legal in every way.

We believe that Mr. Morneau's proposals are, for lack of better terms, a Tax Grab and Vote Buying!

- A Tax Grab - to finance the unprecedented spending of the Liberal government that has resulted in a shameful federal deficit. The Liberal's projected deficits for their four-year lifespan is currently **$78.2 billion higher** than the $24.1 billion projected during the 2015 election campaign.

- Vote Buying - by insinuating that "the long outstanding injustices of our current tax system" and "tax cheaters advantage" will be eradicated and "fairness" will prevail. These words were purposely designed to manipulate the naïve, idealistic, or uninformed voter.

From our point of view, the real victims are those middle-class Canadians who are already paying far too much tax, only to finance unprecedented spending on social programs, tax free subsidies, marketing and social media campaigns, celebrity type travel for diplomatic relations and giving foreign aid excessively disproportionate to our GDP.

Aside from the impact these proposals will have on the small business owner, the other victims will be the average person who is currently employed by such business owners. Small business owners will strive to earn the same after-tax dollars as before these proposals and will reduce every possible expenditure to do so in this unfriendly small business environment. As payroll typically constitutes the most significant part of business overhead, it stands to reason that this is likely going to be at the top of list when cost cutting commences.

The corporate small business owner is the person who wants to be in control of their family's future by doing things their own way, or the entrepreneur who has a dream and stimulates and grows the economy to achieve it. Corporate small business owners provide employment to over 8 million Canadians, provide products and services and represents the engine of the Canadian economy.

One must remember that corporate small business owners pay for many taxes:

- Corporate income tax on the business taxable income,
- Business taxes to operate,
- Employment taxes being CPP and EI for their employees,
- Income tax on money they personally take from the business

Not recognizing the myriad of taxes that the corporate small business owner pays to government is an easy oversight to make if one has never operated a business or prepared financial statements and income tax returns for these businesses. Comparing the "unfairness" of the taxation of a corporate small business to an employee is like comparing apples to oranges. Unlike employees, corporate small business owners:

- invest personal savings and/or borrow personally guaranteed loans to start their business
- incur the expense of employer's portion of CPP and EI
- do not get paid for working overtime or working statutory holidays
- do not receive holiday pay or sick pay
- do not get health insurance premiums paid for
- do not receive any employer funded pension income for their retirement years
- incur the expense of annual business taxes to operate
- face the expensive risks of failure

A non-monetary and intangible truth is that corporate small business owners have decided to forgo certain advantages for the chance to make a living doing it their own way. They have decided to rely on their own efforts and ideas without the intervention of an employer. For this decision, they live with uncertainty, the risk of losing personal capital/ savings, and with the pressure of the continuously changing competitive forces. With so much at stake for much of their business endeavors, one would have to wonder why they would do this.

Aside from the personal satisfaction of building a business, providing livelihoods for their employees, and independence, why would anyone choose to have a corporate small business owner's life unless there were some benefits?

One such benefit is the ability to split after tax profits with any adult family members who are also corporate owners of the business. Currently, dividends paid to a shareholder who is a minor child (less than 18 years old) are subjected to what is commonly known as the "kiddie tax". These dividends are taxed at the top tax rate, removing any tax advantage of giving dividends to individuals in lower tax brackets. Any dividends paid to shareholders 18 years of age and older, have full use of their lower marginal tax brackets and various tax credits. The new proposals regarding dividends to family members are effectively expanding the application of the kiddie tax (top rate tax) to all shareholders unless the dividend is considered "reasonable". While we consider this to be totally subjective, the technical briefing outlines a number of factors which will be taken into consideration in assessing "reasonability". Among other things, reasonability will depend on the degree the recipient works for, or contributes capital to, the business, and whether the recipient assumed any risk in connection with the business. *(Should these proposals be implemented, we predict CRA will be spending years in tax courts debating the question of "reasonableness" as penalties and interest mount on unpaid disputed tax bills).*

Effectively, "non-active" shareholders are going to be penalized with the application of the kiddie tax (top rate tax) rate tax on any dividends paid to them. Millions of Canadians invest in the publicly traded stock market to receive dividends from their investments and are taxed on such dividends using 'normal' tax rules utilizing their marginal tax brackets and available tax credits. These shareholders do not have to prove they did anything for that dividend other than invest in shares of a company. Although these companies are publicly traded, why should the law be different for a spouse or adult child who invests (directly or indirectly) into the family corporate small business? Most small business owners attribute their success to their family, who with them made financial and relationship sacrifices and took debt risks to enable the business to succeed. To propose that family members not directly active in the business are not able to receive 'normal' tax treatment on dividends received, is a direct affront to their contribution.

Under Family Law, the Matrimonial Property Act fully recognizes that the value of a family business is equally divided upon marital breakdown regardless of who was active in the business. This law clearly recognizes that the worth of a small business comes from the efforts, support and risk taken by the family as a whole.

Currently, to the extent that the profits of the small business exceed what is taken as a wage or dividend by the owner, those remaining profits are taxed at prevailing corporate rates. The after-tax cash balance left in the corporation is to provide a cushion for future slower times and/or for a retirement fund. The government has outlined approaches to substantially increase the tax rate on any income generated from investments held in a corporation, subjecting this income to instances of double taxation when these funds are paid out to shareholders. These passive investments are in effect, a self managed Owner's Pension Plan which is essentially equivalent to an Employee Pension Plan. Under such Employee Pension Plans, personal taxes are paid only when such funds are withdrawn from the plan.

The point being, a tax deferral is not tax avoidance but a postponement of tax until the funds are actually paid to the individual. It provides small business owners the opportunity to build up funds within their corporation to be ultimately used for retirement purposes.

Let's be clear; these proposals will not only negatively impact the business owner and family but also the many individuals employed by small businesses. Therefore, if you are in agreement with the content of this paper, we encourage you to contact your federal government representatives and express your concern as to the impact this will have on the millions of us working hard to sustain what even the Federal government has acknowledged as the 'back bone' of the economy – **small business.**

OTHER SOLUTIONS:

There are other possible ways of dealing with any perceived inequities that would, in fact, benefit all Canadians equally.

Married or common-law couples could elect to file joint personal income tax returns so the family unit is what is subject to tax. This would allow all families to take advantage of the lower income family members and eliminate any perceived benefit to dividends being paid to family members. This would be a much simpler and minor administrative change than and would have a potential benefit for all families.

Another positive suggestion would be that all individuals be subject to a fair **FLAT TAX** of 20% for all taxable income over, say, $30,000 annually. This is a great incentive as each taxpayer person would be able to retain 80% of their income over $30,000. It would be simple to understand, to implement and would be fair.

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