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INTEGRATED FINANCIAL SERVICES

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Brief

Presented to the Honourable William F. Morneau

New July 18, 2017 measures on holding passive investments within a corporation

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Table of Contents

ABSTRACT 3
I. INTRODUCTION 7
II. PRELIMINARY THEORETICAL CONCEPTS: TAX SHELTERS AND PASSIVE INVESTMENTS WITHIN A CORPORATION 7
A. Introduction 7
B. RRSPs 8
1. The taxpayer's point of view 8
2. The government's point of view 12
C. Passive income within a corporation 15
III. PROPOSED MEASURES FOR PASSIVE INCOME 17
A. Actual taxes paid by entrepreneurs 17
B. The government's lost returns 21
C. The capital dividend account 23
D. Economic considerations and a sovereign wealth fund 24
IV. THE TOP PERSONAL INCOME TAX RATE 25
V. POSSIBLE APPROACHES 31
A. The apportionment method 31
B. Other methods and other options 33
C. Public corporation dividend income and Part IV income taxes 33
D. Temporary investments in view of future investments 36
VI. WHAT IS PASSIVE INCOME? 36
VII. TRANSITIONAL RULES 37
A. Taxation of future returns 38
1. Unrealized gains 38
2. The top income tax rate 39
B. The need for a fourth pool 39
1. What value to use 39
2. Reinvestment 39
3. Pool selection when paying a dividend 39
4. The capital dividend account 39
C. Other transition-related aspects 40
1. Changes in status 40
2. The capital dividend account 40
3. Tax pool tracking 40
4. Harmonization with provincial laws 40
5. Capital gains on assets necessary to operate a business 41
6. Coexistence of two sets of rules 41
VIII. SOME ARGUMENTS OF A MORE SUBJECTIVE NATURE 41
IX. ALTERNATIVES 43
A. RRSPs and TFSAs 43
B. Some abuses of the current system and the consultation process 44
X. CONCLUSION 44
APPENDIX 1 TABLE 7 – CONSULTATION DOCUMENT 48
APPENDIX 2 TABLE 7 – CONSULTATION DOCUMENT, YEAR BY YEAR 49
APPENDIX 3 SUMMARY OF SCENARIOS USING TABLE 7 FROM CONSULTATION DOCUMENT 50
APPENDIX 4 TABLE 11 FROM CONSULTATION DOCUMENT (AND CONTINUING TO PERSONAL TAXES) 51

ABSTRACT

Some of the tax changes regarding private corporations that Minister Morneau announced on July 18 concern passive income. This brief addresses these measures only. We represent an integrated financial planning firm and have advanced expertise in the field of investment income assessment, as well as investment management in general.

The government wants to put an end to what it sees as an undue advantage for corporation owners who make passive investments using the additional funds available to them as a result of the lower tax rate they pay on active income compared to taxpayers who do not own a corporation. According to the government's calculations, entrepreneurs are getting richer by not paying their fair share in taxes.

Please note that all figures provided below are from the government—we did not make them up.

Section II contains basic theoretical concepts that make it easier to understand the rest of the brief. These concepts show that the government has joint ownership of all current investments (except TFSAs). Whether it be RRSPs or investments in private corporations, the government benefits from returns just as investors do. Section II-B concerns RRSPs and is very accessible to the general public. It shows that contrary to popular belief, RRSPs are tax shelters, pure and simple. They are not just for deferring taxes, and are most certainly not interest-free loans. If taxpayers get an 8% return on their RRSP, so does the government. We theoretically demonstrate that in a perfectly integrated tax system, the same holds true for funds placed in private corporations; they generate the same returns for the government and shareholders. However, we acknowledge that the current system is not perfect and that it actually benefits the government (overtaxation). In short, we conclude that the government could potentially benefit from letting taxpayers keep their money so it can get a better return, one likely much better than the cost of its debt. Tables 1 and 4 show these returns in simple situations (but which require technical calculations).

Table 7 of the consultation document presents a situation where an individual and an incorporated entrepreneur both earn $100,000. After being taxed at the top personal income tax rate, the individual is left with $49,633 to invest, and the entrepreneur with $85,600 (within his corporation), a difference of $35,967. The amounts are invested at 3% for ten years. Table 7 shows the results after ten years. In appendices 1 and 2, we obtained the same results as the government, but we also included the total income taxes the entrepreneur and employee would have paid over ten years. Here are some comments regarding these calculations:

- After ten years, the individual's investment would have a net value of $57,539 after taxes. The entrepreneur, on the other hand, after declaring the full amount as a taxable dividend, would be left with $62,424 after taxes. The entrepreneur would therefore have earned $4,885 more than the individual. The consultation document stops there. It's understandable that an uninformed reader might be a bit upset given the data being presented.

- We believe a key detail is missing: the entrepreneur generated an extra $6,658 in income taxes, to the benefit of all taxpayers. We do not understand why this important piece of information was not presented. The entrepreneur may be ahead by $4,885, but he also paid $6,658 more in taxes, for an income tax rate of 57.67%. The additional money the entrepreneur invested in his corporation ($35,967) returned $11,543, of which $6,658 went to the government. At that rate, we have a hard time understanding how the entrepreneur can be accused of not paying a fair share? We believe this information needs to be properly explained so people are not misled into thinking that entrepreneurs are getting wealthier without giving anything back.

An important nuance must be made here. The government uses theoretical income tax rates in its example. But when we use actual Quebec and Ontario rates, the government benefits even more. Here are some excerpts from Table 2. Line 1 presents the government's theoretical situation. Line 2 shows that a Quebec entrepreneur would be left with only $3,891, for an implicit rate of 65.34%.

Excerpt from Table 2
Actual impact on entrepreneur net worth under CURRENT tax rules

1	2	3	4	11	12	13	14
						(11-12)	(12/11)
	Scenario	**Corporate rate**	**Top personal rate**	**Added value generated by investments held within corporation**	**Additional taxes (current rules vs. employee)**	**Net value added (current rules vs. employee)**	**Implicit tax rate (current rules)**
1	Table 7	14.40%	50.37%	$11,543	$6,658	$4,885	57.67%
2	Quebec	18.50%	53.31%	$11,228	$7,337	$3,891	65.34%
17	Ontario	15.00%	53.53%	$12,437	$7,329	$5,107	58.93%

The government's goal with the new measures is to introduce additional taxes in order to ensure that all added value generated by investments held within a corporation are taxed. This excerpt from Table 3 shows the results for certain situations.

Excerpt from Table 3
Actual impact on entrepreneur net worth under NEW tax rules

1	2	3	4	11	15	16	17
						(11-15)	(15/11)
	Scenario	**Corporate rate**	**Top personal rate**	**Added value generated by investments held within corporation**	**Additional taxes (new rules vs. employee)**	**Net value added (new rules vs. employee)**	**Implicit tax rate (new rules)**
1	Table 7	14.40%	50.37%	$11,543	$11,543	$0	100.00%
2	Quebec	18.50%	53.31%	$11,228	$11,840	$(613)	105.46%
17	Ontario	15.00%	53.53%	$12,437	$11,904	$533	95.72%

In the government's theoretical example (line 1), the entire $11,543 in added value generated by investments held within the corporation is taxed at a rate of 100%. However, using Quebec's actual tax rate, the entrepreneur's net value added is actually negative (meaning that an individual would pocket more money), for an implicit tax rate of 105.46%. This means that the entrepreneur would pay more than what he earned, which is absurd. And the next section shows that the result can be even worse.

The top personal income tax rate

To fully tax the value added within a corporation, the government plans to use the top personal income tax rate for passive investment income earned by the corporation. Unlike the current situation, these taxes would not be refundable when subsequently declaring a dividend. This approach unduly penalizes almost all entrepreneurs (including those who earn less than $150,000, contrary to the government's recent claims).

The reasoning for using this rate: When an entrepreneur retires and withdraws money from a corporation, income generated from investments already withdrawn from the corporation during the entrepreneur's active period will be taxed assuming a personal taxable income of $202,800. During their active lives, entrepreneurs will take steps to remain in the lower brackets so as to not have to pay the top rate later on.

This is impractical—an entrepreneur's life is not so simple and predictable. Regular withdrawal of surplus funds each year is premised on a situation of absolute stability with no uncertainties or risks. Yet starting (and maintaining) a business obviously involves sacrifices and uncertainties. The fact is that not all entrepreneurs who are just starting out would be able to withdraw money and place it in an RRSP.

More broadly speaking, in order to be taxed in the top bracket, one has to get there first! It's unfair to assume that an entrepreneur's income is already at least $202,800. But that's exactly what the new measures do, penalizing lower-income entrepreneurs in the process.

Our calculations show that even if an entrepreneur were able to follow the government's advice and make annual withdrawals during their active period in order to take advantage of lower tax brackets, they would still not reach the top bracket on retirement. Other analyses in the past have reached similar conclusions.

This excerpt from Table 5 illustrates how the new rules would affect the net worth of an entrepreneur who withdraws money from their corporation when not in the top income tax bracket. Column 16 shows that the entrepreneur would actually pocket significantly less money than an individual, resulting in implicit income tax rates bordering on the surreal.

Excerpt from Table 5

Actual impact on entrepreneur net worth under NEW tax rules considering an effective tax rate BELOW the top rates in Ontario and Quebec

1	2	3	4	11	15	16	17
						(11-15)	(15/11)
	Scenario	**Corporate rate**	**Personal rate**	**Added value generated by investments held within corporation**	**Additional taxes (new rules vs. employee)**	**Net value added (new rules vs. employee)**	**Implicit tax rate (new rules)**
1	Table 7	14.40%	50.37%	$11,543	$11,543	$0	100.00%
4	Quebec	18.50%	47.46%	$9,223	$11,152	$(1,929)	120.92%
5	Quebec	18.50%	37.12%	$5,602	$10,471	$(4,869)	186.91%
18	Ontario	15.00%	43.41%	$8,951	$10,340	$(1,388)	115.51%

Using the top rate is therefore completely unacceptable and invalidates the entire government process.

A monster to manage

Everyone knows how complicated tax laws are. Accountants and tax specialists have gotten used to them, but the new rules will make the system completely unmanageable, flying in the face of one of the government's goals, i.e., a reform that doesn't make the law any more complex.

- The rules would require an annual reconciliation of sources having contributed to passive investments within the corporation. Three new tax accounts would be required to balance the books annually, and the wide range of practical situations would make the process a major burden, requiring many hours of work. All this on top of compliance work that's already very demanding for entrepreneurs. Not to mention new types of dividends.
- Passive investments already in hand would apparently not be affected by the new rules, even with respect to future returns. In other words, the two systems would coexist for decades. Yet another account would have to be created—in addition to the three mentioned above—for investments in hand, and the market value of all assets (including real estate) would have to be assessed, with all the extra work and costs involved.

Other aspects

- Section VI addresses the question: What is passive income? We feel that this aspect has not really been covered and requires clarification.
- All but one of the sections in the brief provide objective and demonstrable justifications and analyses in order to dispel any suspected conflict of interest, considering the type of business we run. Arguments of a more subjective nature are presented in Section VIII (risks for entrepreneurs, the economic impact of businesses, the concept of equity, departure risk, misinformation, government resources, tax havens, etc.).
- Alternatives are proposed, in particular regarding RRSPs, which could have higher limits and more flexible rules. We also identify the main disadvantages to TFSAs. But the most important suggestion we make is one many stakeholders agree on: The government should put all proposed measures on hold and start a clear consultation process with specific deadlines in order to address all areas in need of improvement. The current 75-day timetable is clearly too short considering the scope of the changes and past experiences with other reforms.

In sections II-A and III-D, we discuss some important economic aspects. In Section III, we demonstrate that the new measures would hurt all taxpayers. Entrepreneurs may be wealthier than employees, but they contribute far more to the community in taxes than they get back. The government is taking a big risk by targeting these types of investments and tax revenues. The taxes it expects to collect under the new rules may never materialize, because entrepreneurs will not want to play along and hand the entire fruit of their labour over to the government (they will not leave the money in their corporation). Moreover, many professionals will choose not to incorporate. Future tax revenues could be lost—the government may actually end up losing money.

Here's a suggestion: If less money is kept in corporations, the government could take the extra taxes it collects in the short term and invest in a sovereign wealth fund. That way the added value will benefit everyone. We discuss this option (which the government is not planning for) in Section III-D. However, it presents some major risks, and this has led us to the following conclusion: Without a well-managed, well-thought-out, well-structured, and apolitical sovereign wealth fund with no indirect complexities, we are much better off with the current system.

I. Introduction

The purpose of this brief is to respond to the federal government's call for comments about the changes proposed on July 18, 2017, concerning tax planning using private corporations.

We are limiting ourselves here to the proposals about the taxation of passive income. We represent an integrated financial planning firm and have advanced expertise in the field of investment income assessment, as well as investment management in general. We will leave it to career tax experts to cover the other aspects of the government's July 18 proposals.

In this document, we will show that:

- The government is on the wrong track regarding the proposed measures for passive income. We believe that it is important to look at the situation in its entirety and analyze how the current structure for taxing investment income within corporations benefits the Canadian economy. As our calculations will show, the overall benefits for the government under the current system are greater than those that would be generated under the proposed new rules. In fact, the government stands to lose tax revenue instead of gaining it. The proposed rules would leave entrepreneurs, self-employed workers, and the Canadian public less well off. We will discuss this in section III.

- The assumption related to using the top personal tax rate to tax passive income is inadequate if the tax is non-refundable. This measure doesn't take into consideration the reality of the taxpayers affected, even the wealthiest ones. It is unjust and will penalize all taxpayers over and above what the government is trying to accomplish through the proposed changes. We understand that the assumption was necessary to ensure that the calculations associated with these changes are consistent, but we conclude that the system doesn't hold up to scrutiny and should be abandoned. We will discuss this in section IV.

- The new rules will generate some very complex outcomes, given their nature and the way they will be implemented, but also because of the transitional rules they will involve. Furthermore, having two concurrent systems will make the whole thing unmanageable. We will discuss this in sections V and VII.

With the new proposed measures, the government will not achieve the objectives set forth in its consultation document.

II. Preliminary theoretical concepts: Tax shelters and passive investments within a corporation

A. Introduction

There is much confusion among professionals and the general public about the real effects of tax shelters and investments in holding companies. It is often said that the government is making 0% loans or that there is deferred tax. We will see that, TFSAs aside, these investments are instead "jointly owned" with the government, providing it with competitive returns that are generally greater than the cost of its debt. This prevents the government from "overconsuming" in the short term by saving for the long term to ensure cash inflows for future years.

We will also see in the tables shown in the *Tax Planning Using Private Corporations* consultation document (hereafter the "consultation document"), the authors stress the added value for the investor but neglect to mention the additional taxes collected by the government.

The federal government's net debt is currently $615 billion.[1] There are also $1,141 billion in RRSPs currently in circulation.[2] People talk a lot about government debt, but often forget government assets. We're not necessarily referring to non-income producing assets, like buildings used to provide public services or serve the government's own needs, but rather the income-producing assets held in RRSPs. If we were to consider federal tax only—let's say at a rate of 20%—on the withdrawals of these sums (voluntarily or otherwise), we're talking about some $225 billion in assets indirectly invested on behalf of the government to be cashed in on sooner or later. That's great news! Add to that all the assets held in company pension plans and even government pension plans (more than $2,000 billion). And that's not counting all of the sums held in management companies that will, sooner or later, be collected by the government. Considering that the cost of Canadian debt is extremely low, the anticipated returns on these RRSPs, and in management companies, will probably be higher on average than the cost of debt. The government is unlikely to lose anything by leaving these sums in the hands of taxpayers, quite the contrary.

We will demonstrate our argument using real figures in the following pages, but to convince you, just have a look at appendices 1 and 2 of our brief. They completely replicate Table 7 of the consultation document (page 44). According to the government table, an entrepreneur comes out $4,885 ahead of an individual for a $100,000 investment held for ten years at 3%. What the consultation document doesn't say is that the entrepreneur had to pay $6,658 in additional taxes in the process. We didn't make any of this up. The figures are right there in the document. The new measures would probably eliminate this additional revenue for the government in addition to leaving the taxpayer worse off than before. Everyone will probably lose, including the public!

B. RRSPs

In order to explain the effect of new measures on passive income within a corporation, we will take a closer look at the true nature of RRSPs to try to clear up some the confusion that this type of investment vehicle has created among the public, and even some specialists. We will then show that funds held in management companies generate the same kind of outcome, but on a smaller scale.

1. The taxpayer's point of view

There is a popular notion that the RRSP is a plan for averaging taxable income. We believe this is the wrong way of looking at things or, at best, a very incomplete picture. According to another popular notion, there are two advantages of an RRSP: tax savings and deferred tax on returns. Again this is false or at best wrong-headed way of viewing these plans. An RRSP is in fact a pure tax shelter. At a marginal tax rate that is equal over time, RRSP holders can obtain an after-tax return that is equal to the before-tax return. The interplay of tax savings on contributions and tax payments on withdrawals has the net effect of making the return on investment non-taxable. Consequently RRSPs do not have two advantages (tax savings and differed taxes), but one: sheltering investment returns from taxation, just like a tax-free savings account (TFSA). Figure 1 shows a simple example over one year, complete with the necessary figures.

[1] *Fiscal Reference Tables*, October 2016, Department of Finance Canada.

[2] Statistics Canada. Table 378-0117 – Pension satellite account, pension assets at market value, by type of plan, annual (dollars), CANSIM (database).

Figure 1

Example: $1,000 contribution – Tax rate 40% – Return 8%

With an RRSP contribution			
	1 year →		
RRSP	$1,000	$1,080	8%
Personal	($1,000)	1,080	
Tax	$400	($432)	
After tax	($600)	$648	48/600 = 8%
Without RRSP contribution			
Personal – Capital gain	($600)	$648.00	
(–) tax: $48 × 50% × 40%		($9.60)	
		$638.40	38.40/600 = 6.40%
Personal – Interest income	($600)	$648.00	
(–) tax: $48 × 40%		($19.20)	
		$628.80	28.80/600 = 4.80%
With a TFSA contribution			
	($600)	$648	48/600 = 8%

Figure 1 shows the results for a $1,000 investment with an expected return of 8% and a marginal tax rate of 40%. We present two scenarios: one with or without an RRSP contribution, and one with a TFSA contribution.

Here's what happens with a $1,000 RRSP contribution over the course of a year:

- At the beginning of the year, there is $1,000 in the RRSP.
- The taxpayer's actual investment at the beginning is $600 ($1,000 minus the $400 tax reduction). The taxpayer's investment is therefore $600.
- After one year, there will be $1,080 (8%) in the RRSP.
- Withdrawing the funds after one year would net the taxpayer $648 after tax ($1,080 minus 40% tax).
- This represents a net return of 8% ($48/$600) for the taxpayer.
- Consequently, the after-tax return of 8% is equal to the before-tax return in the RRSP (8%).

- The RRSP is a tax shelter. The taxpayer obtains an after-tax return equal to the before-tax return. The interplay between the initial tax reduction and the tax payment upon withdrawal results in the return becoming net of tax. No tax is saved on the contribution itself, nor is tax deferred.

Now here's what happens with an investment made outside an RRSP:

- Without an RRSP contribution, the taxpayer's initial investment is actually $600 ($1,000 minus $400 in taxes, which is paid immediately). After a year, the investment would be worth $648. However, the taxpayer must immediately pay taxes on this amount.
    - In a capital gain situation, the taxpayer would have $648 minus $9.60 ($48 x 50% x 40%) = $638.40 (for a 6.4% return). An RRSP would therefore save the taxpayer $9.60 in tax on the before-tax return of $48.
    - In the case of interest or dividend income, the RRSP savings would be greater (e.g., $19.20 on interest income), while the return on a non-RRSP investment would be only 4.8%.

In conclusion, the RRSP allows taxpayers to avoid (and not just defer) taxes on returns. It does not allow them to save or defer taxes on contributions. The taxpayer actually saved $9.60 (or $19.20) on the $48 return. They did not save $400.

The final result is the same as with a TFSA, but the mechanics are more complex. As indicated in Figure 1, the TFSA also results in a $48 profit for the taxpayer and an 8% return. Indeed, most authors come to this same conclusion when comparing the TFSA with the RRSP (they get the same results with a marginal tax rate that is identical at the beginning and end). Despite these numbers, many of them continue to attribute various virtues to the RRSP, ignoring their own calculations in the process. Has anyone ever seen an author claim that TFSAs are a way to defer taxes? No. Then why—if the results are identical—isn't it the same for RRSPs? Real tax deferral is what happens when a specific sum of money is taxed later rather than immediately (e.g., a capital gain generated on January 1 instead of December 31, or ongoing work carried forward a year). It's not about putting sums in a registered vehicle, making investments, and generating returns. The RRSP is much too sophisticated for such a limitation.

The one-year calculation already gives a clear answer. There is no need to perform calculations for a longer period of time. Even when you take 20 years of compound returns into account, the conclusion is the same. The RRSP investment will always yield an annual compound return of 8%, whereas the non-RRSP investment is always taxed as gains are realized.[3]

In other words, the RRSP entails a compound after-tax return of 8% on $600, whereas the non-RRSP investment yields 6.4%. In both cases, the taxpayer's actual investment is $600, but in the RRSP, the return is net of tax. The deferred tax is not relevant, because in both cases, the taxpayer's actual investment is $600. Outside an RRSP, the tax is paid immediately, leaving $600 to invest. Inside an RRSP, the taxpayer foregoes $1,000 to contribute to the RRSP and also gets a $400 tax reduction for a net investment of $600. In both cases, there is actually $600 working for the taxpayer. It is false to believe that RRSPs make more money available to the taxpayer in the short term. Yet, we will see below that the additional $400 in the RRSP benefits the government and that in fact, there is $1,000 in total investment money at work.

[3] To convince you, after 20 years, there would be $4,661 in the RRSP (still with an 8% return). At a 40% tax rate, this leaves $2,797. Without an RRSP, assuming the best option—an 8% return in capital gains without the gains ever having been realized—the investor would end up with $2,797 before tax. After tax, $2,357 would remain. The RRSP always comes out ahead thanks to the tax-sheltered returns.

Here are some additional comments:

- Note that at any marginal tax rate, the after-tax return is still 8% (with the same rate at the beginning and end). If you are not convinced, you can redo the calculations using a 30% or 60% tax rate. The outcome will be the same, whatever the inclusion rate for capital gains. RRSP contributions always allow contributors to avoid taxes, regardless of the amount. Even at capital gains inclusion rates of 25% or 10%, RRSP contributions remain worthwhile. Too much attention is paid to the marginal rate. The important thing is not the rate in and of itself, but the fact that the rate is equal to (or greater than) the taxpayer's probable "normal" marginal rate in the future. In fact, for a taxpayer with a normal future marginal rate of 30%, it would still be profitable to contribute to an RRSP if the marginal rate for the contribution year in question was 30% (or more).
    - On this subject, it is worth noting the error on page 39 of the consultation document, which reads as follows:

> The tax benefit of saving within a private corporation can also exceed the tax benefits that individuals can receive from passive investment in RRSPs or TFSAs, and can provide more flexibility than investments in such vehicles. Among the factors providing an advantage are:
>
> - Tax savings associated with assets generating capital gains or portfolio dividends would in many situations be greater if held in a private corporation than in a registered account. This follows from a number of factors, including:
>   - Capital gains realized in an RRSP are fully taxed as regular income when withdrawn by the individual, while capital gains realized within a corporation are subject to the 50-percent inclusion rate.
>   - Dividend income earned in an RRSP is also fully taxed as regular income when withdrawn by the individual, with no divided tax credit available, in contrast to dividends received directly from a corporation, which are taxed at a reduced rate as a result of the dividend tax credit.

  - The fact that the nature of the income is not considered in an RRSP is neither a problem nor an inconvenience for taxpayers. Given that individuals do not pay any tax on the investment income earned within an RRSP, it no longer matters whether that income is in the form of capital gains, dividends, or anything else. All tax is eliminated! Taxpayers who only hold RRSPs are not penalized.

- Generally, there is a tendency to exaggerate how differences between the marginal tax rate at contribution and at withdrawal impact tax reduction in the long term. It would obviously be disastrous for the taxpayer to deduct an amount at 28.53% one year and to make a withdrawal at 49.97% the next. However, when the period between the contribution and the withdrawal is longer, the effect is considerably lessened. For example, let's use the numbers from Figure 1 again, but with a tax rate of 45% at withdrawal, i.e., 5% more than the rate applicable at contribution. In this case, instead of 8%, the after-tax rates of return would be as follows:

  - An after-tax rate of return of 7.5% in the case of withdrawal after 20 years

  - An after-tax return of 7.75% in the case of withdrawal after 40 years

  These rates are still better than the 6.4% and 4.8% rates given in our earlier examples.

  Conversely, if the tax rate decreases between the time of contribution and the moment of withdrawal, the rate of return will improve. Taking the same example, if the tax rate at withdrawal is 35%, the rates of return would be as follows:

  - 8.43% in the case of withdrawal after 20 years

  - 8.22% in the case of withdrawal after 40 years

A marginal tax rate that is lower on withdrawal than when the contribution is made results in a higher rate of return, whereas a marginal rate that is higher on withdrawal has the opposite effect. We tend to take it for granted that the rate will be lower on withdrawal, but that is not always the case. For example, in the event of premature death, the entire RRSP is taxed in the same year at a higher marginal tax rate. What's more, in 2017, the Canada Old Age Security pension (OAS) clawback for people with a taxable income between $74,788 and $121,279 also increases the 8% marginal rate to 9% at withdrawal.

2. The government's point of view

Let's now look at the situation from the government's perspective. Many people wrongly believe that RRSPs are a kind of interest-free loan, a tax deferral mechanism that is a gift to taxpayers from the government. The consultation document echoes this perception on page 39, where it refers to "…tax-assisted savings vehicles (RRSPs and TFSAs)…" This is true for the TFSA, but not necessarily for the RRSP.

RRSPs are not a pure gift from the government, because the government participates actively in their performance, obtaining the same 8% return as the RRSP investor (instead of receiving $400 immediately, it receives $432 a year later, i.e., 8% more). In essence, the government joins the taxpayer in making the same investment at the same rate of return; by no means is it a 0% loan. If the government doesn't make this investment (no RRSP), it immediately collects $400, which will generate $9.60 in taxes the following year (assuming return in the form of capital gains) for a 2.4% return. In other words, the RRSP provides the government with an **additional** return of 5.6% (instead of collecting only $9.60 a year later, it collects $32). If the return is in the form of interest, the government will immediately collect $400, generating $19.20 in taxes the following year, for a 4.8% return. The RRSP therefore yields an **additional** 3.2% for the government (instead of collecting only $19.20 a year later, it collects $32).

These rates of return are probably higher than the government's borrowing costs! Leaving money in taxpayers' hands might be a good deal!

Assuming a tax rate of 40%, the profits are shared 60/40 between the taxpayer and the government. If there is $1,000 at work (with an RRSP), the total return will be $80, split between each party ($48 and $32). If there is only $600 in play (without an RRSP), the proceeds decrease to $48, and each party receives less ($28.80 and $19.20, assuming income in the form of interest). In short, the government doesn't lose out with the RRSP. It leaves more money in the economy and itself profits.

This is even more true knowing that the tax rate at withdrawal is often higher than at contribution (particularly at death, as shown earlier). The government is getting a good deal with the RRSP!

Like the taxpayer, the government may lose out or benefit from fluctuations in the marginal tax rate over time. However, the relationship is the opposite of the taxpayer's.

- If the marginal rate increases in comparison with the rate used for the deduction, the government will see its rate of return increase above 8%. We often take for granted that the rate will decrease over time, as shown above, but this is not necessarily the case (e.g., death, link with OAS, loss of the Guaranteed Income Supplement (GIS) for the most disadvantaged).

- Conversely, if the marginal tax rate decreases, the government will see its rate of return decrease. Of course, this situation also affects some RRSPs, especially for taxpayers who have been well advised.

In other words, RRSPs allow the government to save for its "retirement," while also allowing the taxpayer to grow their wealth. Consequently, the government might be better off avoiding collecting sums too quickly in order to avoid spending and prepare for the future, especially in the current context of an aging population.

The above example is based on an 8% rate of return in the RRSP. The government also receives 8%. We created Table 1 below with a 5% return in the RRSP. We chose to use a lower—and possibly more realistic—rate. In every case, the government therefore also receives a 5% return. We have shown that RRSP investments generate **additional** returns for the government in comparison to non-RRSP investments (like the 5.6% or the 3.2% shown above in the case with an 8% return in the RRSP). This rate varies with the type of income that the taxpayer would have earned on their non-RRSP personal investments. We have taken four options into account: 100% in interest, 100% in eligible dividends, 100% in capital gains, and a more balanced portfolio weighted as follows: 50% in interest, 14% in eligible dividends, and 36% in capital gains (with a realization rate of 20% per year). We have also used a marginal tax rate of 37.12% (and the corresponding rate for the eligible dividends and capital gains). This scenario is conservative because we know that those who use RRSPs more often have a higher tax rate. The higher the rate, the higher the government's share of the returns.

Table 1

Government rates of return on tax not collected immediately
Personal tax minus tax with RRSP

5% return in RRSP vs. 5% personal return

Personal tax rate of 37.12% in Quebec

	Interest	Eligible dividends	Capital gain	Balanced portfolio
1 year	1.86%	3.52%	3.43%	3.10%
5 years	1.97%	3.54%	3.46%	3.42%
10 years	2.11%	3.57%	3.49%	3.48%
15 years	2.24%	3.60%	3.53%	3.52%
25 years	2.50%	3.66%	3.59%	3.59%
40 years	2.84%	3.75%	3.69%	3.70%

Again, the government obtains a 5% rate of return in these four scenarios thanks to RRSPs, but compared to the situation for non-RRSP investments (where the government still collects), it receives the **additional** returns shown in the table. We note that the rate of return improves over time, which is normal since, with time, the compound effect improves the scenario with an RRSP.

We have published an even more comprehensive paper on RRSPs that gives further details and explanations, Its content exceeds the requirements of this brief, but it is available at: http://brassardgouletyargeau.com/media/documents/articles/vraie-nature-REER.pdf (French only).

When we compare the RRSP to the TFSA, we notice that, even though the effect is the same for the taxpayer, it isn't for the government. The government collects $400 immediately but does not participate at all in the portfolio's growth afterwards. Assuming, once again, that overall returns on the public's investments are generally greater than the government's borrowing rate, we can say that the government is not necessarily getting a good deal with the TFSA. Unlike the RRSP, the TFSA really is a "...tax-assisted savings vehicle..." as cited above, and we know it mainly favours the wealthy. The TFSA is a real gift that will expand significantly over time. Was this gift really necessary? Would it not have been a better idea to increase RRSP contribution room? Discussing this issue is beyond the scope of this brief, but in reading the consultation document section on passive income—in which the government attacks the advantages of passive income within corporations, even though it benefits from it—we can't help but ask ourselves whether the government fully understands the gift that is the TFSA compared to passive income within corporations.

Of course, we know that the government needs annual cash inflows to cover its expenses (just like an individual who has annual expenses and cannot save all of their income for retirement). But it is also wise to think about the future and not leave too much money available, since it won't necessarily be used to reduce debt or create core programs. This is especially true if the funds invested benefit both taxpayers—who are able to manage their finances and taxes in a competitive, optimal way—and the Canadian government and economy. What's more, the additional savings generated by Canadian taxpayers' investment income will probably be spent (when they retire) in Canada and will help keep the economy going, while also providing additional cash inflows to the government through sales tax.

Now what about passive investments within a corporation? The goal of this lengthy preamble on RRSPs was to help us fully comprehend the real effect of investments within a corporation. We will see that the principle is the same as for RRSPs, but in a less pure way.

C. Passive income within a corporation

Passive investments within a corporation function according to the same logic as that used for RRSPs:

- The government allows more money to be working overall.
- This additional money does effectively benefit the taxpayer, but it also benefits the government, while at the same time helping keep the market strong instead of taking money out of circulation.
- The government directly benefits from returns on investments held within corporations (e.g., real estate, securities). It still co-owns all investments held by Canadian taxpayers (except those in TFSAs). It also benefits from good diversification.

However, there are still differences to consider in comparison with the RRSP:

- An immediate tax is applied when the initial income is earned (unlike with RRSPs). The capital at work will therefore be less than in an RRSP.
- Taxes on investment income are applied over the years, unlike the RRSP.

Despite these differences, there is still more capital at work, which benefits everyone. By leaving more money in the economy, less cash will flow into government coffers in the short term (like with the RRSP), but the government will gain in the long term thanks to the returns realized on the investments (like with the RRSP). Again, it is not a question of 0% loans or a tax deferral (even if this term is a handy shortcut in everyday language to avoid explaining all the details). The Canadian government leaves money in the hands of taxpayers and lets them manage it as they see fit while profiting at the same time from their investments.

We will use the same numbers as those in our earlier example, ($1,000 with an 8% rate of return) with a theoretical corporate tax rate of 20% (on active and investment income). This would generate a 6.4% return for the taxpayer instead of 8% because of the 20% tax rate (8% x 20% = 1.6% less). The government would also get 6.4% (just as it earned 8% with the RRSP). For this, we need to assume perfect income tax integration: the <u>theoretical</u> gross-up of dividends must be equal to the taxes paid within the corporation, and the <u>theoretical</u> dividend credit must be equal to the gross-up (i.e., given the 20% tax rate, the gross-up equals 25% and the dividend credit equals the gross-up). We will see in the next section that tax integration is not actually perfect and that this benefits the government more. We will limit ourselves for the moment to a strictly theoretical example to show how this system works in general and then we will look at what happens in real life.

<u>Without a corporation,</u> assuming interest income, the return will be 4.8% for the taxpayer, as shown in the previous example in Figure 1. The taxpayer will have $628.80 in hand. The government will collect $400 at the beginning and $19.20 after one year (for a return of 4.8%).

- $400 in tax on the initial income (without a corporation)
- $19.20 on the investment income a year later (outside RRSP)

With a corporation and a tax rate of 20%, we get the following results within the corporation:

Income:	$1,000	(A)
Tax on active income (20%):	$200	(B = A x 20%)
Balance for investment:	$800	(C = A - B))
Interest return (8%):	$64	(D = C x 8%)
Tax on passive income (20%):	$12.80	(E = D x 20%)
Balance for the dividend payment to the shareholder (800 + 64 - 12.80):	$851.20	(F = C + D - E)
Tax on dividend Grossed-up dividend (851.20 x 1.25) = ($1,064) 40% tax $425.60 (–) dividend credit = at gross up ($212.80) Total tax $212.80	($212.80)	(G = (A + D) x 40% - (B + E)
Balance on hand (851.20 - 212.80):	$638.40	(H = F - G)
Taxpayer's rate of return: 38.4/600 = 6.4 %	6.4%	(I = 38.40/600)

The taxpayer obtains an after-tax return of 6.4% on an initial before-tax return of 8%, which is logical when using an "imperfect tax shelter" providing for a 20% tax. This return is better than that of the employee, who made 4.8% (at a tax rate of 40%). The entrepreneur ends up with $638.40 in hand—$9.60 more than the employee. This difference is due to the additional $200 ($800 vs. $600) at work at a rate of 8% and the integrated tax rate of 40% (200 x 8% x 60% = 9.6).

But what about the government? It collects $425.60 in total tax with a corporation, as shown in the previous table and broken down here:

- $200 in tax on active income within the corporation
- $12.80 in tax on investment income within the corporation
- $212.80 in tax when the dividend is distributed to the shareholder

The government is therefore foregoing $400 (which it would have obtained had there not been a corporation) to collect $425.60 one year later. This represents a 6.4% return (25.60/400). This way, it obtains the same return as the shareholder, as was the case with the RRSP. In other words, a corporation works a little like an RRSP, but with a tax levy of 20% instead of no levy.

The extra $200 in working investments generated an additional $16. Of this sum, $9.60 went to the entrepreneur and $6.40 to the government. The government therefore had a return (or an opportunity cost) of 3.2% on the tax it went without at the beginning ($200).

In comparison with the returns it would have obtained without a corporation, this represents 1.6% more (6.4% versus 4.8%). However, we note that in reality, there is an **additional** return of 3.2% for the government. In the short term, the government foregoes $200 ($400 of immediate tax on the in-

come without a corporation versus $200 of immediate tax on the active assets within a corporation) to obtain $206.40 more one year later (12.8 + 212.8 - 19.2, or the tax on the investment income within the corporation plus the tax at dividend distribution minus the tax that would have been collected on the investment income without a corporation), for an additional dollar return of $6.40 ($206.40 - $200) or 3.2% over one year ($6.40/$200).

From this theoretical analysis, we can already see that the government is not necessarily getting a raw deal by leaving money within a corporation. It's not just a matter of deferring immediate payment of $200 to pay $200 one year later, because the amount paid a year later is actually $206.40. The government is getting a good return (probably much better than what it's making on its debt)—and that's good for all Canadians.

Keep in mind, however, that the calculation in this section is theoretical because it assumes perfect income integration. In reality, under current tax rates, the government will collect a much larger portion of the $64 generated by the investment within the corporation because of poor tax integration. The next section will deal with the real implications.

III. PROPOSED MEASURES FOR PASSIVE INCOME

The government wants to put an end to what it sees as an undue advantage for corporation owners who make passive investments using the additional funds available to them as a result of the lower tax rate they pay on active income compared to taxpayers who do not own a corporation.

According to the government's calculations, entrepreneurs are getting richer by not paying their fair share in taxes. In this section, we will concentrate on analyzing objective, demonstrable factors before moving on to more subjective arguments in section VIII.

A. Actual taxes paid by entrepreneurs

In section II-C, we saw that money held within a corporation was similar to an "imperfect tax shelter" that benefits both the government and the taxpayer. We will see in this section that all existing tax measures (particularly poor integration) benefit the government even more. To do this, we will use the scenario in Table 7 of the government's consultation document. Please note that all figures provided below are from the government—we did not make them up.

We encourage you to consult appendices 1 and 2 of our document.

Here are the main parameters used by the government. They match those based on national averages and standard adjustments.

- Initial income: $100,000
- Top personal tax rate: 50.37%
- Tax rate on active income within the corporation: 14.40%
- Tax rate on investment income (non-refundable): 19.70%
- Refundable tax rate (non-refundable with the new rules): 30.67%
- Rate on ineligible dividend: 42.02% (based on a calculation explained in the government consultation document)
- Return: 3% as interest

Table 7 shows calculations for one year, but gives the results after 10 years. In appendices 1 and 2, we obtain the same results as the government, but we also include the total income tax the entrepreneur and employee in the example pay each year and in total. Appendix 1 shows the overall results after 10 years, and Appendix 2 shows the year-by-year breakdown.

The following are comments on Table 7 in the consultation document and Appendix 1 in our brief:

- The employee (first column) effectively pays more tax at the beginning, leaving $49,633 left to invest. After ten years, the employee has an after-tax amount of $57,539.

- The entrepreneur (second column) pays taxes within the corporation at the rate of 14.4% and still has $85,600 to invest within the corporation. Each year thereafter, the entrepreneur pays 50.37% in tax on investment income (a portion of which is refundable); he will also pay tax after 10 years when the entire amount is paid as dividends. After 10 years, this leaves the entrepreneur with $62,424 in hand once all taxes are paid.

- The entrepreneur thus has additional assets of $4,885 when compared to that of the employee. The consultation document stops there. It's understandable that an uninformed reader might be a bit upset given the data being presented.

- We believe a key detail is missing: the entrepreneur generated an extra $6,658 in income tax for the government's coffers, and this benefits all taxpayers. We do not understand why this important piece of information was not presented.

- The entrepreneur may be ahead by $4,885, but he also paid $6,658 more in taxes, for an income tax rate of 57.67%. At that rate, we have a hard time understanding how the entrepreneur can be accused of not paying a fair share? We believe this information needs to be properly explained so people are not misled into thinking that entrepreneurs are getting wealthier without giving anything back.

- The amounts left within the corporation generated $11,543 in extra income. Of this amount, $4,885 went to the entrepreneur and $6,658 to the government. Where did this $11,543 come from? We see that an additional $35,967 is available within the corporation as a result of incorporation ($85,600 - $49,633). By separating this amount and considering a 3% return, we get the following table:

Year	Balance at start	Return	Corporate tax	Balance at end
1	$35,967	$1,079	($543)	$36,503
2	$36,503	$1,095	($552)	$37,046
3	$37,046	$1,111	($560)	$37,598
4	$37,598	$1,128	($568)	$38,158
5	$38,158	$1,145	($577)	$38,726
6	$38,726	$1,162	($585)	$39,302
7	$39,302	$1,179	($594)	$39,888
8	$39,888	$1,197	($603)	$40,481
9	$40,481	$1,214	($612)	$41,084
10	$41,084	$1,233	($621)	$41,696
Total		$11,543	($5,814)	
After-tax increase ($41,696 - $35,967)				$5,729

Within the corporation, we see the $11,543 of generated income, $5,814 of which goes to the government, and $5,729 to the entrepreneur. Factor in personal income tax and the government's share increases to $6,658 in total, leaving just $4,885 for the individual, as shown in appendices 1 and 2. This corresponds to an implicit tax rate of 57.67% ($6,658/$11,543).

But we must take this line of thinking a step further, because the figures provided in the consultation document don't match up with everyday reality. We redid the same calculation, but used the actual situation in Ontario and Quebec for corporations entitled to the small business deduction (reduced corporate rate). See the summary of calculations in Appendix 3 and Table 2 below.

- For Ontario, the results show an increase in the entrepreneur's wealth of $5,107 and additional taxes of $7,329. This corresponds to a tax rate of 58.93% (line 17 and columns 12 to 14).
- For Quebec, the results show an increase in the entrepreneur's wealth of $3,891 and additional taxes of $7,337. This corresponds to a tax rate of 65.34% (line 2 and columns 12 to 14).

In the same appendix, we also show the same calculation, but using the actual situation in Ontario and Quebec for corporations not entitled to the small business deduction (general corporate rate).

- For Ontario, the results show an increase in the entrepreneur's wealth of $2,736 and additional taxes of $6,009. This corresponds to a tax rate of 68.71% (line 20 and columns 12 to 14).
- For Quebec, the results show an increase in the entrepreneur's wealth of $1,721 and additional taxes of $6,843. This corresponds to a tax rate of 79.9% (line 12 and columns 12 to 14).

The following is a summary of the results:

Table 2

Actual impact on entrepreneur net worth under the CURRENT tax rules and actual TOP tax rates for Ontario and Quebec

(Excerpt from Appendix 3)

1	2	3	4	11	12	13	14
						(11-12)	(12/11)
	Scenario	**Corporate rate**	**Top personal rate**	**Added value generated by investments held within corporation**	**Additional taxes (current rules vs. employee)**	**Additional net worth (current rules vs. employee)**	**Implicit tax rate (current rules)**
1	Table 7	14.40%	50.37%	$11,543	$6,658	$4,885	57.67%
2	Quebec	18.50%	53.31%	$11,228	$7,337	$3,891	65.34%
7	Quebec	22.30%	53.31%	$10,008	$8,800	$1,208	87.93%
12	Quebec	26.80%	53.31%	$8,565	$6,843	$1,721	79.90%
17	Ontario	15.00%	53.53%	$12,437	$7,329	$5,107	58.93%
20	Ontario	26.50%	53.53%	$8,745	$6,009	$2,736	68.71%

The calculations above show the current situation, and the results speak for themselves! The additional taxes generated by the entrepreneur are significantly greater than the entrepreneur's corresponding increase in wealth. The table also shows that the increase in wealth is not as great as indicated in the consultation document (line 1 of the table) when we use the actual rates.

But the actual situation is even less favourable.

The calculations above compare the entrepreneur's current situation with that of the employee. The last column in Table 7 in the consultation document (our Appendix 1) shows that the new measures would leave the entrepreneur with the same amount as the employee. The government will claim all the added value generated by the entrepreneur ($11,543), apparently presuming the entrepreneur will carry on like before. What's more, using the actual tax rates for Ontario and Quebec, we find the entrepreneur would pay more in tax than what he earned. In other words, the tax rates are more than 100%. As a result, the entrepreneur will have less than the employee. We redid the calculation, but used the actual situation in Ontario and Quebec for corporations entitled to the small business deduction (reduced corporate rate). See the summary of all our calculations in Appendix 3 and Table 3 below.

- For Ontario, the results show an increase in the entrepreneur's wealth of $533 and additional taxes of $11,904. This corresponds to a tax rate of 95.72% (line 17 and columns 15 to 17).

- For Quebec, the results show a decrease in the entrepreneur's wealth of $613 and additional taxes of $11,840. This corresponds to a tax rate of 105.46% (line 2 and columns 15 to 17).

In the same appendix, we also redid the same calculation using the actual situation in Ontario and Quebec for corporations not entitled to the small business deduction (general corporate rate).

- For Ontario, the results show a decrease in the entrepreneur's wealth of $1,653 and additional taxes of $10,398. This corresponds to a tax rate of 118.90% (line 20 and columns 15 to 17).

- For Quebec, the results show a decrease in the entrepreneur's wealth of $2,613 and additional taxes of $11,177. This corresponds to a tax rate of 130.51% (line 12 and columns 15 to 17).

See below for a summary of the results:

Table 3

Actual impact on entrepreneur net worth under the NEW tax rules and actual TOP tax rates for Ontario and Quebec

(Excerpt from Appendix 3)

1	2	3	4	11	15	16	17
						(11-15)	(15/11)
	Scenario	**Corporate rate**	**Top personal rate**	**Added value generated by investments held within corporation**	**Additional taxes (New rules vs. Employee)**	**Additional net worth (New rules vs. Employee)**	**Implicit tax rate New rules**
1	Table 7	14.40%	50.37%	$11,543	$11,543	- $	100.00%
2	Quebec	18.50%	53.31%	$11,228	$11,840	($613)	105.46%
7	Quebec	22.30%	53.31%	$10,008	$13,094	($3,086)	130.83%
12	Quebec	26.80%	53.31%	$8,565	$11,177	($2,613)	130.51%
17	Ontario	15.00%	53.53%	$12,437	$11,904	$533	95.72%
20	Ontario	26.50%	53.53%	$8,745	$10,398	($1,653)	118.90%

Once again, the figures speak for themselves. Under the new rules, the entrepreneur will end up with less money in hand than the employee. The additional amounts will simply disappear because the measures are so harsh that entrepreneurs will stop leaving new money in corporations, especially considering the maintenance costs. Many self-employed workers will stop considering incorporation, and each time they do, the government will lose out. In addition to leaving entrepreneurs worse off, Canadians as a whole will suffer and see tax revenues decrease. We repeat: these conclusions are based on numbers supplied by the government but use actual tax rates for Quebec and Ontario.

But the actual situation is even less favourable.

The data in Table 7 (and the results in the two tables above) assume the entrepreneur will withdraw these amounts at the top marginal rate for individuals. This is an unrealistic and very detrimental premise. We will address it in Section IV, where we present implicit tax rates that are even higher than those shown above. The situation becomes simply surreal!

B. The government's lost returns

In Section II-B on RRSPs, we presented Table 1, which shows the extra returns the government nets by allowing taxpayers to contribute to an RRSP. We saw that the government makes a 5% return thanks to the RRSP, but since it already receives a certain return without the RRSP, we have shown the additional return in Table 1. The same principle applies to passive investments within a corporation because, as we saw in Section II-C, such investments are like "imperfect tax shelters" (6.4% return in the example used).

We have tried to determine the additional returns generated by passive investments within a corporation. We could have relied solely on the calculations in the previous section, which already show that the entrepreneur pays a large share of tax (columns 12 and 15 in tables 2 and 3), but we wanted to

objectively show what the government is really giving up by putting these measures in place. It is true that the entrepreneur in the example pays more than his share of taxes, but this payment comes later than that of the employee. The government must therefore wait to collect these sums, so it is fair that it seek some form of compensation and take steps to ensure the compensation is at least greater than its borrowing costs. As stated earlier in this text, it is completely legitimate that the government save "for the future," knowing that it stands to gain in the longer term. It is this type of thinking that yields RRSPs and passive investments within corporations.

To determine these rates of return, we must make assumptions about the returns on investments held in corporations and the type of income they generate (interest, rent, dividends, or capital gains). We must also compare what an employee with the same investments would make, but with smaller amounts and a simpler tax situation than a corporation.

We have considered a 5% return in the four portfolios shown in the table below. This return may be a bit high for a portfolio generating interest, but a bit low for one generating capital gains. The balanced portfolio is probably the most realistic. It is weighted as follows: 50% in interest, 14% in eligible dividends, and 36% in capital gains (with a realization rate of 20% per year). We used a personal income tax rate of 49.97% (Quebec) and an 18.5% tax rate on active income within the corporation.

Table 4

Government returns on taxes not collected immediately (personal tax minus corporate tax)

5% return within the corporation vs. 5% personal return

Personal tax rate of 49.97% in Quebec[4]

Year	100% interest	100% dividends	100% capital gains – 20% realized gains	Balanced portfolio
1	6.17%	5.19%	4.80%	5.29%
2	4.44%	3.48%	3.07%	3.57%
5	3.50%	2.53%	2.11%	2.62%
8	3.33%	2.37%	1.94%	2.46%
10	3.31%	2.35%	1.91%	2.43%
15	3.35%	2.40%	1.94%	2.48%
20	3.45%	2.51%	2.04%	2.59%
25	3.57%	2.66%	2.17%	2.73%
30	3.69%	2.83%	2.32%	2.89%
35	3.81%	3.00%	2.48%	3.05%
40	3.93%	3.18%	2.64%	3.21%
50	4.15%	3.52%	2.98%	3.52%
60	4.34%	3.83%	3.29%	3.80%

[4] The rate of return declines in the initial years and then climbs. In the beginning, overtaxation due to liquidation increases government returns because it has access to the proceeds quickly. However, the effect lessens with time because it is spread over a number of years. With time, the tax on investments catches up to overtaxation, which allows the government to collect more taxes and increase its return again.

This table shows the government's return (or opportunity cost) on the taxes it foregoes by leaving more money within Canadian private corporations. If these rates are higher than the cost of government debt (or initiatives), it is better for the government to leave the current system in place.

We repeat: these are **additional** returns that accrue to the government on taxes that aren't collected immediately, i.e., the difference between taxes paid by the individual (unincorporated) and the taxes paid by the corporation. The government not only obtains a higher return on investments held within corporations, but in comparison with the returns it realizes on investments outside a corporation, it obtains an **additional** return. As seen earlier, a corporation is a sort of imperfect tax shelter. If investments held within the corporation yield 5%, the government obtains a lower return (as in the example in Section II-C, where an 8% return within a corporation yielded 6.4%—20% less—for the government). If a corporation obtains a 5% return, the government probably gets around 4.1%, taking into account corporate taxes (18.5%, and 19.8% in Quebec). However, we also need to consider overtaxation, which plays in the government's favour. The actual return is good, and the **additional** return is also good in comparison with the unincorporated scenario.

We are aware that there are numerous potential scenarios (especially if we add real estate investments). But as Section II-C shows, investments held within a corporation allow the government to benefit from returns generated by taxpayers, who do their best to optimize their returns in accordance with their tolerance for risk. All our calculations show that the government usually comes out ahead, both in dollars and percentages.

C. The capital dividend account

In order for the new rules to be consistent and in keeping with the government's aim, they require the phasing out of the capital dividend account (CDA) for the non-taxable portion of capital gains. In theory, this makes sense, given the government's objectives. Table 8 on page 46 of the consultation document shows the results of a calculation for this purpose.

This table has the same weaknesses and repercussions as Table 7. We will not show all of the calculations, as we did for Table 7. Instead, we will limit ourselves to the following observations and the presentation of certain results:

- To achieve the same result with the new rules as the employee ($79,000), the government uses a fictitious and theoretically impossible dividend rate. According to this table, under the current rules, the entrepreneur comes out $20,242 ahead of the employee. However, the government also pockets an additional $8,203 (information that—once again—isn't mentioned in the table).
- When we use actual figures for Quebec, we obtain instead a difference of $13,189 in favour of the entrepreneur, but $14,340 more in taxes collected by the government. The government collects roughly the same amount as the entrepreneur, not to mention that the capital gain is usually taxed at one-half the rate.
- The calculation above has the same limits and weaknesses as the one used in Table 7. It assumes that the taxpayer is taxed at the highest tax rate.
    - If the Quebec taxpayer is taxed at the marginal rate of 47.46%, the result shows a difference of $9,396 in favour of the entrepreneur, but $13,507 more collected by the government in taxes.
    - If the Quebec taxpayer is taxed at the marginal rate of 37.12%, the result shows a difference of $2,038 in favour of the entrepreneur, but $12,686 more in taxes collected by the government.

Once again we note that, even for income that is taxable at 50% only, the tax losses for the general public are huge. Nobody wins.

D. Economic considerations and a sovereign wealth fund

For investments already held within corporations, we assume that the transitional rules will be applied correctly (if the government decides to put passive income measures in place) and that the current rules will remain in effect for these investments. In his September 5, 2017 open letter published in *La Presse*[5]*,* the Minister said, "Our intention is to have the changes apply in the future only; existing savings, and the investment income they yield, will not be affected," which is to say that there will be no positive effect on government revenue from currently held investments.

Some may argue that the government should still immediately pocket the money targeted under the reform, not for the purpose of spending it or paying down the debt, but rather for investing it itself. The added value generated would thus benefit all Canadians instead of just entrepreneurs. It's a little bit like what Quebec is doing with the Generations Fund. It may sound like a good idea, but there are considerable limits to this strategy.

- The purpose of the money invested in the Generations Fund is to reduce the government's net debt. Instead of applying the sums directly to the debt, the decision was made to make investments that yield a higher return than the rate of return on the debt. It's a good idea in and of itself.

- But we must remember that the purpose of the funds invested in the Generations Fund is not to finance current operations or future government operations. Politicians don't have to make any decisions about cashing out a portion of the fund's returns or capital.

- In the case that concerns us here, however, the amounts in play are much greater. We are talking about 26.8 billion dollars of taxable income generated by so-called passive investments held within corporations (page 12 of the consultation document). We're not far from the mark in suggesting that the actual investments held could be as high as $500 billion if we assume a 5% return. This $26.8 billion in taxable income probably generates more than $10 billion in tax revenue annually. Your guess is as good as ours, but these are the kinds of sums we're dealing with.

- Given the sheer size of these amounts and the fact they are intended to generate income to finance the government's current and future operations, establishing a sovereign fund, as some countries have done, could be a possible solution. But a venture of this scope can't be implemented with a snap of the fingers. Who would decide on the rules for income and capital allocation over time? What would the investment constraints be? How would we ensure that a portion of the funds be used to actually improve the Canadian economy? Who would manage the fund? It's easy to picture the lengthy discussions required to improve upon than the current situation. Cynicism aside, there's a good chance that partisan and electoral forces influence the debate. And in any case, the consultation document makes no mention of such an initiative. In our opinion, it would be wiser to take more time to assess the consequences of the proposed reform measures before implementing such restrictive rules for private Canadian corporations. It's a wide-reaching initiative that demands further reflection.

- Paying down the debt is another possible use for the money collected under the proposed measures. However, since history has shown us that taking additional risks pays off in the long run, this avenue strikes us as a way to destroy value for the Canadian economy. The government is making a much better investment in the long term by leaving money management in the hands of entrepreneurs. It should be seen as a leveraged investment whose long-term returns surpass the cost of government financing. Given the low cost of debt financing in

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[5] http://plus.lapresse.ca/screens/663507e8-e61d-41ba-8f6e-3b148dec5e9e%7C_0.html

Canada compared with many other countries, we should take advantage of this situation to invest in ventures that pay off in the long term. Investment in corporations is one form of investment that benefits the government, in addition to encouraging entrepreneurs to take risks that create wealth for the Canadian economy.

- But as we have already explained, there's worse. Under the new measures, the amount of money available for investment will decrease dramatically as entrepreneurs refuse to play along and pay the price for leaving money within corporations. New incorporations by professionals will fall off dramatically or dry up altogether, and the additional tax revenues anticipated will probably never materialize. It will take discipline to capture the annual inflows of additional short-term funds coming from earlier tax payments and route them to a sovereign wealth fund. And, all of this would create extremely burdensome complications for entrepreneurs in terms of tax compliance.

- We doubt whether Canadian society is currently inclined to put such a highly centralized mechanism in place. We aren't saying that it is impossible or bad, but rather that it's not on anyone's political agenda right now and the consultation document doesn't even mention it.

- Without a well-managed, well-thought-out, well-structured, and apolitical sovereign wealth fund with no indirect complexities, we are clearly better off with the current system.

The $500 billion in investments currently in circulation is an enormous sum; playing with that kind of money is fraught with peril. The government's proposal would considerably reduce the amount of capital at work, reducing its annual revenues—and Canada's economic vitality—in the process. When the government says it wants to prevent entrepreneurs from accessing $85 and leave them with only $50, that's the equivalent to removing over 40% of working capital from the economy. It's a chilling alternative! And the long-term effects could be devastating.

IV. The top personal income tax rate

For the sake of consistency, the government's proposed new system for taxing passive income would tax corporate passive income at the top rate for individuals (over 50%) and would be non-refundable. While we understand the technical aspects underpinning this proposal, we find the new system unduly penalizes nearly all entrepreneurs. What's more, the basic assumptions motivating the decision are not realistic.

We could argue that the debate ends right here on the following grounds:

- For consistency with the new system, this rate would have to be used

- The rate penalizes entrepreneurs and would make it so the vast majority of them would actually pocket less money than an employee with the same income (which is not the purpose of the reform)

- The new system is therefore inadequate and the measures must be abandoned

We could stop our analysis there and call it a day, but let's keep going!

On page 51 of the consultation document, the government attempts to justify using the top tax rate for corporate passive income, suggesting that any potential negative consequences could easily be avoided. Let's have a look at an excerpt from the consultation document.

> ***Marginal Tax Rate of the Corporate Investor***
>
> *As is the case under the current tax system, taxes on passive income would be aligned with that of an individual earning income at the top personal income tax rate. Similar assumptions are also made in other sections of the Income Tax Act, for example, those that relate to the tax treatment of trusts. Under the new system, a corporate owner that pays personal taxes at a level below the top personal income tax bracket could have an incentive to withdraw corporate earnings not required for business reinvestments as they are earned, in order to invest in a personal savings account. This would maintain the ability to pay taxes on passive investment income at a lower rate.*

This is impractical—an entrepreneur's life is not so simple and predictable. Regular withdrawal of surplus funds each year is premised on a situation of absolute stability with no uncertainties or risks. Yet starting (and maintaining) a business obviously involves sacrifices and uncertainties. The fact is that not all entrepreneurs who are just starting out would be able to withdraw money and place it in an RRSP.

The reasoning for using this rate: When an entrepreneur retires and withdraws money from a corporation, income generated from investments already withdrawn from the corporation during the entrepreneur's active period will be taxed assuming a personal taxable income of $202,800. During their active lives, entrepreneurs will take steps to remain in the lower brackets so as to not have to pay the top rate later on.

Let's go back to Table 7 of the consultation document presented in appendices 1 and 2. We were discussing a $100,000 ten-year investment at 3% interest. We already showed in the previous section that an entrepreneur would earn less than an employee under the new mechanics. Tables 2 and 3 show the differences. But the calculations assume that the entrepreneur's withdrawals are being taxed at the top rate (53.31% in Quebec). That would require $202,800 in taxable income for the current year. Clearly, not everyone has that kind of income! If the entrepreneur is not in the top bracket, then the new rules are very penalizing and the gap with employees earning the same income shoots up (see Appendix 3 and Table 5 below):

- With a marginal rate of 37.12% ($45,916 to $84,404 in taxable income) and a corporate rate of 18.5%, the entrepreneur loses $4,869, paying $10,471 in additional taxes. The result is a tax rate of 186.91% (line 5, columns 15 to 17).

- With a marginal rate of 47.46% ($103,915 to $142,352 in taxable income) and a corporate rate of 18.5%, the entrepreneur loses $1,929, paying $11,152 in additional taxes. The result is a tax rate of 120.92% (line 4, columns 15 to 17).

- With a marginal rate of 37.12% ($45,916 to $84,404 in taxable income) and a corporate rate of 26.8%, the entrepreneur loses $5,807, paying $8,746 in additional taxes. The result is a tax rate of 297.53% (line 15, columns 15 to 17).

- With a marginal rate of 47.46% ($103,915 to $142,352 in taxable income) and a corporate rate of 26.8%, the entrepreneur loses $3,547, paying $10,107 in additional taxes. The result is a tax rate of 154.08% (line 14, columns 15 to 17).

The table below shows the results for each major tax bracket below the top rate. Data is also provided for Ontario. In all cases, the entrepreneur loses a considerable amount of money in relation to an employee with the same income. The gaps are significant. We are well aware that, with these brackets, it's not always possible to fully cover distributed amounts, and that income is likely to be spread across multiple brackets. For us, the main goal was to make a comparison using the same starting point, and to show how severely entrepreneurs are penalized when not in the top tax bracket.

Table 5

Actual impact on entrepreneur net worth under NEW tax rules considering an effective tax rate BELOW THE TOP RATES in Ontario and Quebec

(Excerpt from Appendix 3)

1	2	3	4	11	15	16	17
						(11-15)	(15/11)
	Scenario	**Corporate rate**	**Personal rate**	**Added value generated by investments held within corporation**	**Additional taxes (new rules vs. employee)**	**Net value added (new rules vs. employee)**	**Implicit tax rate (new rules)**
1	Table 7	14.40%	50.37%	$11,543	$11,543	$0	100.00%
3	Quebec	18.50%	49.97%	$10,087	$11,417	$(1,330)	113.18%
4	Quebec	18.50%	47.46%	$9,223	$11,152	$(1,929)	120.92%
5	Quebec	18.50%	37.12%	$5,602	$10,471	$(4,869)	186.91%
6	Quebec	18.50%	28.52%	$2,517	$10,455	$(7,938)	415.34%
8	Quebec	22.30%	49.97%	$8,868	$12,842	$(3,974)	144.82%
9	Quebec	22.30%	47.46%	$8,004	$12,708	$(4,704)	158.77%
10	Quebec	22.30%	37.12%	$4,384	$12,557	$(8,174)	286.46%
11	Quebec	22.30%	28.52%	$1,298	$12,985	$(11,688)	1,000.60%
13	Quebec	26.80%	49.97%	$7,424	$10,535	$(3,111)	141.91%
14	Quebec	26.80%	47.46%	$6,560	$10,107	$(3,547)	154.08%
15	Quebec	26.80%	37.12%	$2,940	$8,746	$(5,807)	297.53%
16	Quebec	26.80%	28.52%	$(148)	$8,193	$(8,341)	IND.
18	Ontario	15.00%	43.41%	$8,951	$10,340	$(1,388)	115.51%
19	Ontario	15.00%	29.65%	$4,059	$9,298	$(5,239)	229.05%
21	Ontario	26.50%	43.41%	$5,260	$8,597	$(3,338)	163.46%
22	Ontario	26.50%	29.65%	$368	$8,245	$(7,878)	2,242.67%

Observation: Under the new rules, investments held within a corporation are subject to a non-refundable tax at a rate equivalent to the top personal income tax bracket, even if the entrepreneur is not actually in this bracket. The entrepreneur is therefore heavily penalized in relation to an employee with same income. The entrepreneur's effective tax rate would be well above 53.31%, which makes no sense. And yet, most entrepreneurs would find themselves in this situation. It's wrong to think that all entrepreneurs are able to pay themselves a salary corresponding to $202,800 in taxable income. The new system is flawed, and despite what the media is saying, some entrepreneurs who earn less than $150,000 would also be penalized.

Of course, the government will argue that entrepreneurs just have to make regular withdrawals to take advantage of lower tax brackets. But that's simply not true. We have run the numbers and entrepreneurs almost always lose out. Here's an example:

- A 30-year-old entrepreneur wants to take advantage of the lower tax brackets, as the government suggests. He wants $202,800 in pre-retirement taxable income, so he pays himself a salary of $228,810 and contributes $26,010 to his RRSP, giving him $202,800 in taxable income. He then contributes to his TFSA and pays his income taxes, leaving him with $114,290 in disposable income. At that pace, after 35 years (assuming 2% inflation and a 4.5% return on investment pre-retirement and 4% post-retirement) he will be able to maintain a $114,000 lifestyle (adjusted) for just 11 years, i.e., until he's 76. This scenario does not work, which is normal since we know RRSP and TFSA contributions are not enough for people in the top tax brackets to maintain their lifestyles. The entrepreneur therefore has two options: reduce his standard of living or save additional money within his corporation.

- If he reduces his cost of living to $94,290 and saves an extra $20,000 in a personal investment account, he will be able to maintain his $94,290 lifestyle from 65 to 95, which is acceptable. However, his taxable income will never even get close to the top tax bracket post-retirement ($202,800 in today's money). In his best retirement year, when he's 72, he will still be $220,378 shy of the top bracket of $465,881 in future dollars. If he instead opts to save additional money within his corporation and then withdraws the money, he will be taxed at a much higher rate than normal, despite following the government's advice. He will have to pay the top rate for investments in his corporation, despite not actually being in that bracket post-retirement.

- If the entrepreneur wants to maintain a $114,290 lifestyle during retirement, he will have to save money within his corporation. He will need about $3.6 million in his corporation by the time he turns 65 (i.e., $48,500 in annual savings indexed at 2%). Under this scenario, he will be able to maintain his lifestyle until he's about 95. Again, though, despite maxing out his RRSPs and TFSAs and taking advantage of lower tax brackets during his active life, he will not be in the top tax bracket post-retirement, before corporate dividends. In his best retirement year, when he's 87, he will still be $132,000 shy of the top bracket of $627,015 in future dollars. He will never reach the top bracket in his retirement years, but will still be taxed at the top rate within his corporation.

- Even when taking advantage of the lower tax brackets, the new system doesn't stand up to scrutiny. Not to mention that this entire scenario rests on the assumption that the entrepreneur would be able to withdraw considerable sums from his corporation, which is not always the case. The entrepreneur could have maintained a $94,290 lifestyle with no personal savings (RRSPs, TFSAs, and non-RRSP savings). He would have had to limit his salary to $154,800 rather than $228,810. To take advantage of lower tax rates, the entrepreneur would have had to withdraw $74,010 more from his corporation (i.e., $228,810 minus $154,800, not to mention the social contributions he would have to pay on that additional salary). This $74,010 would be used to contribute to his RRSP ($26,010), TFSA ($5,500), and personal investments ($20,000), and to pay an extra $22,500 in taxes. That's what the entrepreneur would have to do to follow the government's advice of taking advantage of lower tax brackets. But many entrepreneurs do not have access to this kind of money. They put everything in their business. After selling part of his business, a somewhat embarrassed entrepreneur once told us: "You're going to scold me for this, but I have $161,000 in unused RRSP room. I haven't saved for my retirement." Of course, that was not the case, as he had just converted part of his life's work into a lump sum of cash. Still, over all these years, he had never thought to contribute to his RRSP because his business needed his full attention. The money he made from selling his business remained within the corporation. As such, he never had the

opportunity to gradually withdraw this income during his active period. Under the new measures (apart from a $161,000 withdrawal for his RRSP), he would be subject to the top income tax rate, despite not actually being in the top bracket. He should have to reach $202,800 before being taxed at the top rate. Any income below that mark should not be taxed at the top rate, but it would be. In his case, if the new rules had been in effect, he would have been at a disadvantage compared to an employee, which is not the purpose of these new rules at all. This is a very common situation!

In almost all scenarios, the basic assumption is false.

The previous example and the calculations in Table 5 (which uses data from Table 7 of the consultation document) clearly show that the premise according to which money withdrawn from corporations will be subject to the top personal rate just doesn't hold up, even when following the government's advice.

Here's a summary of real situations and arguments explaining why the top rate is inadequate:

- Entrepreneurs cannot always make annual withdrawals from their corporations to save money. Real life does not work that way!
- Even those who can make such withdrawals cannot necessarily maintain an annual taxable income that would put them in the top tax bracket.
- Entrepreneurs do not necessarily pay the top marginal personal tax rate during their active lives, and are even less likely to do so once retired, when much of the money they withdraw from the corporation is not taxed at the top rate. You have to reach $202,800 to be taxed at the top rate. It's simply not realistic to assume that assets withdrawn from the corporation during the active period are subject to the top rate (or that there are other sources of income) before dividends even come into play. Even if a retired entrepreneur has $300,000 in taxable income including dividends, the initial $202,800 in taxable income is not taxed at the top rate. But that's exactly what the new rules assume.
- Running a business is fraught with risks. Entrepreneurs rarely get to withdraw corporate funds to contribute to their RRSP. Many of them have lots of unused contribution room. Investing in their business is their top priority—they only withdraw what they need to get by.
- Entrepreneurs often receive their income through dividends because it makes more sense for them, so they do not necessarily have RRSP room. Dividends often involve fewer short-term expenses than a salary, and are often favoured by entrepreneurs in need of tight cash flow management. Detailed calculations show that young entrepreneurs and entrepreneurs whose corporations are in a lower tax bracket tend to favour dividends over a salary.
- Cost of living often goes up with time. Entrepreneurs are obviously looking to improve their lot (and that of their employees, families, and indirectly society in general). At first, they may limit themselves to a $50,000 lifestyle in hopes of raising that amount to $150,000 later. Either way, even if their cost of living goes up, it will never push them into the top tax income bracket. Contrary to what the government is telling the media, even entrepreneurs with incomes below $150,000 will be heavily penalized.
- The measure assumes that capital growth is progressive and linear, making it possible for entrepreneurs to save money every year. More often than not, this is simply not the case.

- Entrepreneurs often generate much of their wealth from selling their business. For these entrepreneurs, withdrawing funds on an annual basis is out of the question. At the time of the sale, the funds often end up being held by a management company (or by individuals if a capital gains deduction is used, which would be harder to do under the new measures). Investment income from funds held within the corporation will be subject to the top income tax rate since the entrepreneur (as with most entrepreneurs) will not have been able to make regular withdrawals each year.

- The reform will force some small entrepreneurs with surplus cash to make an agonizing decision. They can keep the money within their corporation and have more funds on hand for future investments, but pay 50% in non-refundable taxes, or they can withdraw the money right away and pay less taxes on future returns, but have much less cash on hand to reinvest in the business. The government will force them to make immediate decisions for needs that will only be known 5, 10, 15, or 20 years later, and if they choose wrong, they will pay more taxes than necessary. It's just not fair to all these small entrepreneurs. They have enough on their plate—they should not have to worry about what to do with their surplus every year.

- The measure assumes that entrepreneurs are very wealthy. An entrepreneur who builds up $2 million in savings will likely be proud of his accomplishments, but he will not necessarily be in the top tax bracket after retiring. If he still has 25 years to live, he cannot afford to withdraw $300,000 a year from his corporation! The dividends he receives will therefore not be subject to the top rate, but investments within the corporation will be (and taxes paid on those will be non-refundable). That's a harsh penalty. Once again, the measure wrongly assumes that entrepreneurs withdraw money from their corporations in order to save for retirement so they have money on hand to take advantage of the lower tax brackets, and that income from their corporation will be taxed at the top marginal rate. This is a terrible assumption to make; it will penalize the vast majority of taxpayers and leave only a few unaffected. In such cases, entrepreneurs end up worse off than employees.

- There are, of course, rare situations where an entrepreneur's taxable personal income will be in the top bracket even **before** receiving dividends. Here are some examples (one or more may apply):

  - A major windfall (inheritance, lottery, etc.) used to generate personal investment income (real estate or securities).

  - A generous retirement pension (assuming the entrepreneur was able to work and run the business at the same time or the pension was earned before or after running the business).

  - A big salary over a given period of time from another source (new job, member of board of directors, etc.).

  - Another personally owned business that provides income or was sold and provides a lot of investment income.

  - RRSP withdrawals derived from contributions made during the entrepreneur's active life. The same is true for non-registered personal investments derived from withdrawals from the corporation made during the entrepreneur's active life (quite rare). It should be noted that with pension income splitting, RRIF withdrawals are likely to be split with the spouse.

  Aside from RRSP withdrawals (and even then!), these situations are exceptions (and there's no proof that they allow entrepreneurs to reach $202,800 in taxable income before withdrawals from the corporation). Most entrepreneurs do not have such major sources of personal income. The vast majority of their wealth is concentrated in their corporation.

- When justifying using the top rate, the government indicates that some trusts already use it. This comparison strikes us as inappropriate for the following reasons:
  - The top rate may be used by some trusts, but if the income is immediately attributed to a beneficiary, there is no tax to pay within the trust. This would not be the case for private corporations under the government's proposed measures. Taxes would be paid at the top rate before dividends are even distributed to shareholders (and they would be non-refundable). This comparison is therefore completely unjustified.
  - When the measure was established for trusts, the goal was to make it so they could no longer use progressive rates (in particular testamentary trusts). It had nothing to do with employees or the current situation.
  - Trusts do not typically seek to directly hold passive investments. They are more concerned with asset protection and flexibility regarding the attribution of future income and capital.

In conclusion, almost all entrepreneurs would be heavily penalized if their income from investments held within their corporation were taxed at the top personal rate and the taxes were non-refundable. This measure is completely unfair and inequitable and is based on false assumptions. The measure will not work as intended. It will not level the playing field between entrepreneurs and employees who earn the same income—entrepreneurs will simply be less well off.

V. POSSIBLE APPROACHES

To achieve its goals, the government offers two possible approaches on page 41 of the consultation document: the 1972 approach (page 41) and the deferred taxation approach (page 43). In previous sections we assumed the deferred taxation approach would be used (even though we dislike this term since taxes are not actually being deferred, as shown in previous sections).

We strongly believe that the 1972 approach must be eliminated. Running a business is already complicated enough without having to manage liquidity based on annual income tax returns. Economic momentum would be lost if funds were put on hold instead of leveraged to the benefit of society as a whole.

As indicated in previous sections, we also dislike the deferred taxation approach because it would have adverse effects on Canadian society. That said, we would still like to address certain aspects of the methods that would be used under this approach, in particular the apportionment method (page 47).

A. The apportionment method

The apportionment method is explained in the consultation document. The government wants to track the source of income used to acquire each investment asset owned by a corporation. There are three options under this method:

- Income taxed at the small business rate (e.g., 18.5% in Quebec): the lower rate means more funds are available for investment and shareholders receive ordinary dividends (more heavily taxed).
- Income taxed at the general rate (e.g., 26.8% in Quebec): the general rate means fewer funds are available for future investments and shareholders receive eligible dividends.
- Shareholder contributions: The government is not concerned with these since personal taxes have already been paid. The corporation's after-tax returns could be paid thereafter, with no personal income taxes for shareholders.

The balances of these pools would have to be determined at the end of each year. "Active" income would be allocated to one of the first two pools at the established tax rate. Net passive income generated in a given year would be apportioned to the three pools based on end-of-year balances in the previous year. Distributed dividends (by pool type) and new shareholder contributions would also be tracked.

All our remarks in this section on the apportionment method are premised on the assumption that the corporation is starting from scratch, i.e., it has no investments at the beginning. In Section VII, which covers transitional rules, we address various specific issues that will affect corporations that already have passive investments.

If we ignore the major drawbacks associated with using the top income tax rate, not to mention the tax revenue the government would lose, we think this method would probably be best. Nonetheless, there would still be several complex issues to deal with:

- It's quite likely that the total of the three pools will not always be equal to total investments. However, reconciling these figures will be critical for apportioning sums to shareholders and determining the type of dividend or distribution these sums apply to, even if only for the liquidation of the corporation (or its merger with another corporation). Balancing everything will require a huge amount of work, especially considering all the special situations that could arise and all the potential discrepancies between tax and accounting data. Under the current rules, paid-up capital and the GRIP are for eligible dividends, and any other available funds are for ordinary dividends—no reconciliation is required for the latter.

- The non-taxable portion of capital gains, even if it can no longer be added to the CDA, will still have to be allocated somewhere, or there will be an imbalance. Perhaps it should be apportioned to the three pools on a pro rata basis like net passive income.

- Annual taxes due will have to be distributed between the first two active income pools and investment income.

- Debt will create apportionment problems between pools. All sorts of loans are available for various purposes, especially if a corporation has both active and passive income.

    - A company buys a building worth $1 million, financing the purchase entirely with debt. At the start of the year, all three pools have a balance of zero, as there have been no contributions or active income. The company starts off with debt only ($1 million in assets and $1 million in debt). After one year, let's assume that no distributions have been paid and the company has made $70,000 in net rental income. How would the rental income be treated and how would the after-tax amount be apportioned between the three pools, considering that they had a balance of zero to start with? This scenario may seem both highly theoretical and rare, but it would happen regularly, even in a context where all three pools have an initial balance and where debt always causes an imbalance. When a loan is involved, passive income is financed by none of the three pools. This situation will penalize entrepreneurs, who will pay more taxes than employees because the investment was not financed with earnings at the lowest active income rate. Debt could also be considered a contribution, but that would create a problem when it's repaid with earnings. The contribution pool would have to be reduced and the two active income pools increased. Tracking all this would be impossible, given the thousands of other transactions being made. What's more, various types of debt (supplier debt, lines of credit, intercompany loans, etc.) can be used for different operations and may each be subject to different repayment terms. The same problem would arise when a company takes out a loan to invest in securities, whether directly or through its brokerage account (line of credit). The securities would be passive investments—they would not be financed by any of the three sources indicated in the three pools.

- An asset can be used to generate both active and passive income. Their use can also change over the years. Here are a few scenarios:
  - Let's go back to the above example. The building can produce active income, passive income, or a combination of both. This combination may also vary over time. Let's say that 30% of the building is used by an active business and the remaining 70% is rented out. A few years later, the debt has been repaid in full and the building is now worth $3 million. On average, the building generated $100,000 in active income and $70,000 in rental income a year. When the building is sold, how will the $2 million in capital gains be handled? Will it be treated as active income or passive income? This is a common situation for businesses that prefer to own the building they operate out of, but don't need all the space. The situation is made all the more delicate if the debt is not repaid (in full or in part) and active income is used for something other than paying off the debt.
  - Due to time constraints, we did not attempt to determine how these types of transactions would be treated initially, over time, and in the end when the building is sold.
- Many strategies could be developed to boost the contribution pool before the fiscal year ends so it's higher the following year, especially if a significant increase is expected. Many strategies will undoubtedly be developed to optimize the taxpayer's situation.

There are many other examples we could point to in various sectors, as well as even more problems. We are convinced that many other professionals will identify additional complications in managing these three pools—the scope of which we can scarcely imagine. Our goal is not to conduct a comprehensive study on the matter, as we only have 75 days to submit this brief. But the fact remains: the law will become exponentially more complex.

B. Other methods and other options

The consultation document provides an alternative to the apportionment method: the elective method. If taxpayers can look past the lack of precision and potential drawbacks associated with this method, they can either decide to have all future dividends treated as ordinary dividends (no active income taxed at the general rate or contributions), or forego the SBD and have all future dividends treated as eligible dividends. We have no objection to these choices if some taxpayers find them suitable, but they clearly complicate the law. We also assume that these choices may be revoked at some point.

Whether the apportionment or elective method is selected, corporations with passive income only (presumably management companies) have another option (page 50) available to them that allows them to continue using the current rules if they pay a refundable tax equal to surplus capital. This choice has the same drawbacks as those presented in previous sections. Whether you keep the money under the new rules or pay a refundable tax under the current rules, the result will be the same. Also, this option requires the government to expressly accept the possibility of having these two rule sets coexist, with all the complexities that entails.

C. Public corporation dividend income and Part IV income taxes

The consultation document does not deal directly with taxation under Part IV, except for Table 11 (page 53), where it appears that the rate will remain unchanged (38.33%) and the tax will become non-refundable.

The new rules prescribe a non-refundable tax on corporate passive income at the top rate for individuals. For income such as interest, taxable capital gains, and rental income, the rate would be about 53.31%.

Under the current rules, a corporation receiving a dividend from a public corporation pays a 38.33% refundable tax (because the vast majority of the time it's a non-connected corporation). The tax is the same in all provinces since only the federal government collects it. The corporation can receive a refund when the dividend is paid to shareholders. Under the new rules, dividends from a public corporation would no longer benefit from Part IV income tax rules. Instead, they would be subject to a 38.33% non-refundable tax, as shown in Table 11 of the consultation document. Also, under current rules, when a corporation receives an eligible dividend, it increases the GRIP and enables the corporation to pay an eligible dividend to shareholders. Under the new rules, as mentioned above, it will be important to determine whether the money used to invest in the public corporation was taxed at the lower or general rate for active income. Depending on the situation, dividend income from a public corporation may give rise to ordinary or eligible dividends.

In Quebec, when an individual earns a dividend from a public corporation, they must pay an eligible dividend tax of up to 39.83%. That's because the public corporation has already paid taxes, so individuals are entitled to a dividend credit. When a corporation earns such income, as indicated above, it must pay a 38.33% non-refundable tax. This rate is close to the top rate of 39.33% in Quebec and 39.44% in Ontario, but six provinces have lower rates. These people will clearly be at a disadvantage. With a non-refundable tax at the federal level only, it's impossible to achieve a neutral outcome. Some provinces will benefit while others lose out depending on their top income tax rate on eligible dividends.

A corporation can also earn dividends from sources other than public corporations, e.g., when a private corporation receives a dividend from another private corporation. Currently, non-connected corporations (10% share or less in paying corporation, and other nuances) pay the same tax rate as on dividends from public corporations (38.33%). We need to know if this provision will remain in place.

- If we keep this provision, the dividend will be treated as investment income (and not a non-taxable intercorporate dividend). The after-tax amount will be distributed between the three pools. Under the new rules, there would be no issues with individuals or connected corporations receiving the dividend as shareholders. Unfortunately, any non-connected corporate shareholder would have to pay non-refundable taxes as well. Having to pay non-refundable taxes in succession like this would be a big disadvantage.
- If we abandon this provision and the concept of non-connected corporations no longer exists (at least for private partners), any dividends received will simply be treated as a transfer depending on the nature of the three pools, as with any private corporation. The current logic that investments in private corporations be considered "normal" investments if they represent only a small proportion of total holdings would therefore be eliminated. We do not know the department's intentions in this regard.

In short, the new measures will cause the following problems:

- Having non-refundable taxes on public corporation dividends at the federal level only will result in some taxpayers losing out, depending on the top tax rate for eligible dividends in their province.
    - It should be noted that the issue raised in Section IV regarding the use of a non-refundable top rate still exists, and further compounds the problems mentioned here.
- For private and non-connected corporations:
    - There will either be problems if the corporate structure includes a series of non-connected corporations and non-refundable taxes on intercorporate dividends are retained
    - Or the concept of connected corporations will have to be dropped for private corporations

None of this will simplify the law. If we have to maintain two sets of tax rules for passive income, we will have multiple types of dividends and many different ways to tax investment income. Here's the situation in Quebec:

- Current rules
  - Corporation: Tax on investment income (50.47%) other than dividends (capital gains, rental income, interest income, and foreign income), which are eligible for a refundable tax of 30.67%.
  - Corporation: Refundable tax of 38.33% on dividends from non-connected corporations (public or private).
  - Individual: Ordinary or eligible dividend depending on corporation's GRIP balance.
  - Individual: Non-refundable dividend from CDA.
- New rules
  - Corporation: Non-refundable tax on investment income (50.47%) other than dividends (capital gains, rental income, interest income, and foreign income).
    - This investment income will provide "passive income" to be distributed between the three pools (maybe four under the transitional rules).
  - Corporation: Non-refundable tax (federal only) on dividends from public corporations and possibly all dividends from non-connected corporations (public or private).
    - Again, the after-tax amount will have to be distributed between the three or four pools.
  - Individual: Ordinary or eligible dividend depending on the balances in the two relevant pools using apportionment method.
  - Individual: Non-refundable dividend from the contribution pool.
  - Individual: Depending on the transitional rules, there may be a fourth pool producing the same type of dividend as under the current rules, and special tracking will be required due to reinvestment and unrealized gains.
  - Individual: Non-taxable dividend from CDA on sale of assets used to operate business (we hope).

As you can see, the proposed measures will make the system much more complicated than it currently is. All these situations could apply to a single corporation!

Appendix 4 presents all the data from Table 11 of the consultation document. We expanded the table to show how individuals would fare with the new setup. Under the new rules, entrepreneurs clearly have no advantage over individuals when it comes to dividends from public corporations ($63,328 for entrepreneurs compared to $64,839 for individuals). This difference is due to the lower tax rate (32.29%) that employees pay on eligible dividends in comparison to corporations (38.33%). In order to arrive at the same net after-tax amount, the tax rate on dividends received within the corporation would have to be the same as the top marginal income tax rate on eligible dividends received by employees (as is the case with interest income in Table 7, where the tax rates are 50.47% in both cases). As mentioned above, it's impossible to make it so the same rate applies for all provinces. Adding a non-refundable tax is what creates this problem.

D. Temporary investments in view of future investments

Contrary to what's indicated in Table 11 of the consultation document (page 53), the amounts available for future investment in the business would not be the same if temporary surplus cash was held within the corporation under the new system. Once again, the problem stems from the use of non-refundable taxes and the top rate.

- Under the current system, a portion of the taxes is refundable if a dividend was paid to shareholders to help them cover their cost of living. This means less money available for investment (temporary passive investments having been taxed at a rate of 50%, compared to about 20% under the current system of refundable taxes when dividends are paid).
- At some point, a dividend will be paid to shareholders, but their incomes will not necessarily warrant the top tax rate. In Section IV, we saw that it's clearly unfair to assume that all taxpayers would have incomes over $202,800 at this point in time, given that the current system uses refundable taxes as a way to adjust to the taxpayer's actual income tax rate.
- Also, as indicated in the previous section, we have found that an entrepreneur would be left with less money than an employee after liquidation, even using the top rate.

VI. What is passive income?

The new measures are supposed to target passive income, but government documents don't spend enough time clearly defining exactly what this is. In the consultation document, the government stresses that it wants to promote job and economic growth, but the proposed measures may actually end up directly hindering efforts in this regard.

- Real estate
  - It's wrong to treat all real estate operations as passive income (even those with fewer than five full-time employees). Many investors have interests in this sector—some don't even bother to invest elsewhere. Real estate investors spend a lot of time managing their buildings, and for many of them, this work is anything but passive! Real estate also generates a great deal of economic activity, on par with many small businesses in other sectors.
  - As indicated in Section III, the new measures will reduce the amount of money available in the economy, hurting the real estate market. We know this market is vulnerable to reductions in available capital. This can be observed whenever interest rates go up or are rumoured to be going up. The new measures will hit this sector hard.
- Direct investment in start-ups and more mature small businesses
  - Many investors finance small businesses through private investments (equity or private debt), without getting directly involved in the business. These investments are critical to economic vitality. The government appears reluctant to consider such investments as active income in all circumstances (according to page 51 of the consultation document), which we think is a mistake. And once again here, reducing the amount of money available in the economy will make it harder for these small businesses to get the funds they need. Whether directly or otherwise, the amount of money in circulation in this sector will shrink.
  - It should also be noted that investors often prefer to make such investments through corporations rather than directly for various financial and legal reasons. This is often a necessary strategy!

- Canadian small caps
    - The same reasoning applies to smaller corporations already listed on the stock exchange, and for which equity and debt financing are crucial. Reducing the amount of available capital on the market will hurt these businesses. Once again, we have to ask ourselves whether these types of investment truly represent passive income in a context of stimulating the economy.
- Canadian large caps
    - We understand why this type of investment could be considered passive income, but we can't help but wonder how the new measures will affect larger Canadian corporations in terms of equity and debt financing. One thing is for certain, these changes do not bode well—the results will either be neutral or negative. If you take money out of the economy, there are bound to be consequences somewhere.
- Foreign investments
    - We can understand why these are treated as passive income, but do we really want Canadian investors to pass up on global growth potential, and for Canadians to lose out on all the added value it would generate through additional returns and taxes?

We believe the question of what truly constitutes passive income merits further discussion, and that it would be dangerous not to seek a more nuanced perspective. Any measures affecting the vitality of the economy and the amount of money in circulation should only be introduced after careful consideration, not on the basis of principles that could be detrimental to everyone.

VII. TRANSITIONAL RULES

We firmly believe the proposed rules on passive income should be abandoned for the reasons laid out in this text.

If the government still decides to move forward with these changes, we foresee many issues and complex situations in an already convoluted environment. We feel the government underestimates this problem on page 49 of the consultation document when it indicates that all amounts have already been established. We have tried to identify potential issues, but in our experience, such a wide range of practical situations always leads to unforeseeable problems when new rules and constraints are introduced, especially on this scale. We have flagged a number of them, but our objective at this point was not to conduct a comprehensive analysis.

The government indicates on page 51 that it wants to take existing passive investments into account and make a proper transition. The document reads as follows:

> *Existing stocks of passive assets held in Canadian private corporations are significant. It is the intent that the new rules would apply <u>on a go-forward basis</u>. Once a new approach is determined for the tax treatment of passive investment income, the Government will consider how to ensure that <u>the new rules have limited impacts on existing passive investments</u>. The Government will bring forward a detailed proposal following these consultations, and time will be provided before any such proposal becomes effective.*

A. Taxation of future returns

For consistency with the two goals underlined above, the new measures should not apply to investments already in hand. Future returns should continue to be taxed as they are now, with refundable taxes and the capital dividend account. The current rules should remain in place for such investments. This means having to operate under two different sets of rules for years to come, and with everything that entails.

To avoid having to juggle two rule sets, we think the value of current investments could be taken into consideration in the third pool presented in Section V-A, and treated as contributions. On the face of it, the problem appears solvable, but two items must be taken into account: unrealized gains and the top income tax rate.

1. Unrealized gains

When the new rules come into force, some investments—whether in real estate or securities—will have unrealized gains. How should these unrealized gains be handled?

- When these unrealized gains are finally realized, they must be taxed under the current rules. Otherwise, they would be taxed retroactively. It bears remembering that new investments will be added to these investments in hand over the years. The three pools suggested by the government are of a theoretical nature and will not necessarily be connected to all of the taxpayer's actual investment portfolios (securities or real estate).

- The fair value of all investments in hand must be assessed when the new rules are implemented. This will be a "V-Day." For some investments, the work will be relatively easy, but for others, it will be difficult and expensive.

  - Real estate: The fair value of all owned buildings must be assessed, a process that could be very expensive. This will be a massive countrywide undertaking!

  - Investments in private corporations: Assessment will be no small task and will be very costly. According to the following excerpt (page 51), the capital dividend account (CDA) will be recognized.

    > That said, the Government will be considering whether additions to the capital dividend account should be preserved in certain limited situations, such as a capital gain realized on the arm's length sale of a corporation controlled by another corporation, where the corporation being sold is exclusively engaged in an activity earning active income.

    Investments in private corporations will therefore likely benefit from the CDA, but the taxable portion of capital gains must continue to benefit from the former rules, hence the need for value assessments. The government should simply indicate that these investments are not passive income, and are not governed by the new measures.

  - Other types of investments: works of art (paintings, sculptures, etc.), vintage cars, collections, etc.

  - We anticipate numerous discussions and disputes with tax authorities when audits are carried out to assess the fair value of investments on V-Day. Is it really worth it for everyone to go through all this hassle and waste so much time preparing for new measures that will end up bringing in less tax revenue?

2. The top income tax rate

Even for the contribution pool, the top income tax rate is used to assess the net passive income to be apportioned between the three pools (like the $8,953 in Table 9 of the consultation document). As indicated in Section IV, using the top rate heavily penalizes the vast majority of taxpayers, and applying it to investments in hand would constitute retroactive taxation.

Unfortunately, this means the contribution pool cannot be used for unrealized gains. A fourth pool would be required, which we could call the initial investment value pool. This pool would have to be completely separate from the other three and would continue to use the current rules.

B. The need for a fourth pool

The apportionment method envisions three pools. The previous section shows that a fourth one will be required because it will not be possible to include investments already in hand in the contribution pool when the new rules come into effect.

1. What value to use

Once the fair value of all assets has been assessed, the next step will be to determine the amount to attribute to the fourth pool. Should it be the fair value of investments or the fair value of investments minus potential taxes on unrealized gains? This complicates matters, but in theory it's better to take this into account for consistency's sake, and to not give the pool an undue advantage. If an investment's current cost is $1,000, its fair value is $1,500, and the anticipated taxes on unrealized gains is $100, it would make more sense to analyze the advantages of putting $1,400 in the fourth pool to have after-tax amounts (like the initial cost of $1,000, which is also after tax). Estimates will still be required, and discrepancies between anticipated and actual taxes on unrealized gains managed.

2. Reinvestment

The fourth pool will require a reinvestment system so that it's not reduced when investments are cashed in (except maybe if an investment loses value—yet another aspect to manage). Initial investment balances and future gains (unrealized gains or new future gains) must be tracked so funds can be reinvested (in real estate or securities) while maintaining the current rules.

3. Pool selection when paying a dividend

Even for the fourth pool, shareholders should be the ones to determine from which pool dividends are paid. It will be in the taxpayer's interest not to choose the fourth pool in order to retain the current rules for longer. Ultimately, pools 1 and 2 could be subject to a pro rata calculation when taxpayers do not want to use the contribution pool. And even more complications are expected in this area!

4. The capital dividend account

This account must remain available in the future for the non-taxable portion of all unrealized gains held when the new rules are implemented, and realized thereafter.

C. Other transition-related aspects

1. Changes in status

We know there are rules in place to determine what corporations qualify as small businesses. However, these rules could change.

To be considered a small business, a corporation involved in real estate must have at least five full-time employees year-round. Let's assume a growing business with passive investments becomes an active business at some point. We must examine how property acquired before the change in status will be treated and how everything will be handled (unrealized gains, three pools, etc.).

The same could be said for people who manage their investments "normally," but subsequently decide to spend more time actively managing them, at which point their income is no longer treated as capital gains but rather business income.

There are surely more situations like this!

2. The capital dividend account

This account must be retained for various transactions involving capital gains made after the new rules enter into effect. For example:

- Sale of assets necessary to operate an active business: the consultation document is unclear as to whether this type of transaction will remain eligible for this account. We hope this was just an oversight.
- Sale of interests in an active business: the consultation document seems to accept this situation (page 51)
- Capital gains on assets already owned when the new measures were implemented:
  - For the non-taxable portion of all unrealized gains held when the new rules are implemented, and realized thereafter.
  - For the portion of capital gains realized after the new rules are implemented.
- For net passive income attributed to the contribution pool using the apportionment method.

3. Tax pool tracking

Tax pools must be maintained, at least for balances that already exist when the new rules enter into effect (RDTOH, CDA, GRIP, LRIP, etc.). It will be necessary, among other things, to determine how carried forward capital losses (and related capital losses) are to be handled.

4. Harmonization with provincial laws

In Quebec, Quebec government tax rules must be applied, resulting in a slew of additional complications, assuming full harmonization.

5. Capital gains on assets necessary to operate a business

These assets should not be affected by the new rules, which means that capital gains on assets necessary to operate a business should not be subject to a non-refundable tax, as stipulated in the new rules. The current rules should continue to apply.

6. Coexistence of two sets of rules

The consultation document already stipulates that taxpayers will have the option to continue using the current rules (page 50 for corporations that receive intercorporate dividends). This means that, for investments already in hand, the current rules will have to be maintained (as proposed in Section VII).

Everyone we have spoken to agrees that the tax system will become much more complex with two sets of rules and multiple types of dividends, as indicated in Section III-D, even though the government has expressly stated that it wants to avoid making the law more complicated. In addition, we also have to factor in the cost of bringing public officials up to speed and the practical issues that will arise when entrepreneurs change accountants.

We know that our section on transitional rules is incomplete. We are a financial services firm, and while we are comfortable with some tax concepts, we are not tax specialists who constantly have to juggle with reorganizations and compliance obligations. It's clear that the number of complications will multiply as more and more special situations are encountered.

VIII. SOME ARGUMENTS OF A MORE SUBJECTIVE NATURE

In other sections of this brief, we tried to limit ourselves to objective and demonstrable arguments. Since we are a financial services firm, some people might think that our opposition to the new passive income measures represents a conflict of interest. That's why we limited ourselves to objective calculations.

However, there are many other more subjective arguments that can be brought to bear. Since July 18, we have read many texts written by various individuals and organizations and have found that most of the subjective arguments have already been presented. Even so, here's some food for thought:

- Entrepreneurs take more risks than employees. We are not saying that employees don't work hard or that they don't take risks; we are just saying that entrepreneurs generally work longer hours, take more risks, use personal assets as collateral, and lead stressful lives. It's only natural that the system should recognize this and do more to reward them.

- Entrepreneurs create a lot of jobs. Small businesses are already widely recognized as the leading job creators, providing people with work one job at a time! Every effort should be made to ensure that entrepreneurs are rewarded for their contributions. Keep in mind that for every success story there are many failures, and the latter can be quite devastating to an entrepreneur's finances.

    - Every new job means more taxes and social contributions for the government and a more vibrant economy, which in turn benefits the entire population. Entrepreneurs contribute a lot more than the income taxes they pay.

- The proposed measures will reduce the amount of money available in the economy. The impact could be worse than many an interest rate hike, and we know the Bank of Canada warns Canadians of potential interest rate hikes in advance to avoid panic. We are not sure the government realizes the full impact these measures will have. What's being seen as a tax increase is actually a withdrawal of liquidity from the economy. The government won't receive the tax revenues it expects because the measures will weigh down the economy. Incorporation, total income taxes, and economic activity will all be down. The financial and tax services sector will lose momentum, and this, we reiterate, will hurt the government.

- The government says it wants to help entrepreneurs run their businesses, but then hampers their efforts by collecting the fruits of their labour on the grounds that they should not be earning more than employees do. The path to wealth should not be obstructed as it benefits everyone. Of course, parameters must be established to prevent potential abuse, but the proposed rules do nothing of the sort.

- Fair does not mean equal. It seems to us that this principle is accepted in many spheres of life (personnel management, childhood education, etc.). The idea that the tax system should put entrepreneurs on the same footing as employees with the same income is highly debatable.

- It should also be noted that the measures will affect the retirement planning of many people who were counting on a more stable tax situation. Taxpayers between the ages of 45 and 50 who calculated how much money they would have to save to reach their retirement goals will have no choice but to keep working or reduce their future cost of living. This is (especially) true for entrepreneurs with less than $150,000 in income.

- We tend to believe that all entrepreneurs are wealthy. And while it's true that the most successful entrepreneurs belong in this category, that doesn't mean they are the majority. Many entrepreneurs are part of the middle or upper middle class that the government says it wants to help according to the consultation document.

- Whether we like it or not, wealthy people are more mobile and have more opportunities abroad. Whether we're talking about medical specialists, well-to-do retirees, or entrepreneurs with good ideas, there's always the possibility that they will leave the country if the tax situation becomes too unfavourable and the opportunity cost too high. While few people may actually take this step, the new rules certainly won't help the situation. They will be neutral in the best case, or simply negative. It is never good for a country to have fewer affluent people to tax.

  - We realize this may sound like an easy quip to make, but there's a certain practical side to the following question: "Do we want to tax the rich more or have more rich people to tax?"

- The mobility of tech companies and entrepreneurs could work against us —especially in light of the government's recent budget pledge to invest millions of dollars to support and stimulate this sector. The proposed tax reform is out of step with its support for economic development.

- But the most damaging aspect of the reform, in our opinion, is the disinformation spawned by this type of debate. Someone who is misinformed may well believe that entrepreneurs are abusing the systems, whereas we have clearly shown that they pay more in taxes than they accumulate in wealth, and indirectly contribute the vitality of the economy through their investments. Disinformation perpetuates the myth of the big bad entrepreneur who abuses the system. We should instead be tackling the aspects of the system that do procure an unfair advantage instead of dropping a bombshell that destroys everything in its path.
  - In the same vein, it's worth noting the accusatory tone of the consultation document. It reads as if it were aimed at tax evaders and cheaters, and seems to ignore the fact the vast majority of taxpayers are law-abiding citizens who manage their companies in good faith and according to the rules. As we mentioned earlier in our brief, passive income rules have been in place for 45 years (since 1972). If they were so terrible, other governments would certainly have changed them long before now. In reality, as we pointed out in previous sections, the rules benefit all Canadians, which may explain why they haven't been changed.
- How will Department of Finance and Canada Revenue Agency resources be used in the coming years? Given limited means, is this the right way to boost tax revenues and improve the government's financial situation? When we look at the billions of dollars in revenues lost to tax havens as a result of strategies deployed by multinational companies, wouldn't it make more sense to rethink efforts in this area instead of going after the assets of Canadian taxpayers who work hard here at home for the benefit of their communities?
- According to the consultation document, the government is making every effort to avoid negatively impacting the financial status of women. For now, at least, most business owners are men. So any negative impact on men will inevitably affect the women who often run the house while their spouses are away. As for women seeking to start their own business, they won't have access to the same benefits men previously enjoyed if the new rules are implemented. Many professionals are women (especially in the medical profession), and the new rules won't help them either.

IX. ALTERNATIVES

We believe the government is on the wrong track with its proposed passive income rules. Our suggestions are not meant as variations on the proposed measures because we believe the premises underpinning these measures are false, that the current system already fulfills its purpose, and that entrepreneurs already contribute generously—and well in excess of the wealth they accumulate.

Other solutions could be adopted to improve tax fairness.

A. RRSPs and TFSAs

Here are some quotes from the consultation documents:

- On page 39: "As discussed below, the ceilings on the amounts that can be contributed to tax-assisted savings vehicles (RRSPs and TFSAs) may be below the annual savings of high-income individuals. In contrast, there is no limit on the amount that can be invested in a corporation."
  - As we indicated in Section II-B on RRSPs, the government benefits in the long term from this investment vehicle. If there really is a problem with the RRSP contribution limit for higher-income employees, the simple solution is to increase it. Everyone would be better off in the long run, including the government.

- The same can't be said for TFSAs, which are set up in such a way that the government can't benefit from the income they generate (see Section II-B). TSFAs favour the wealthy, and do little for the broader community, although they do help some lower-income seniors by allowing them to avoid Guaranteed Income Supplement (GIS) clawback. The government could end the annual increase in the TSFA contribution limit without affecting the elderly, thereby ending the advantage to the wealthy. It could also introduce an overall contribution limit or eliminate certain particularly generous features of the TFSA (such as the possibility of reinvesting all previously withdrawn gains).

- On page 39: "There are no restrictions on the type of assets that can be held in a corporation, while some exist for tax-assisted savings vehicles (e.g., real estate)."

  - Once again, if this is the only problem, the government need only make real estate eligible for RRSPs (but not TFSAs). The government would benefit significantly in the long term. And in the event of abuses with respect to related party transactions, the government need only take steps to manage them. Such transactions are already subject to numerous rules, which could be readily adapted for RRSPs. And if the government is worried that some people might overload their RRSPs, it should be thrilled instead. Contrary to what we might think, all the extra money flowing into these register plans will benefit the government in the long term. That said, it must not allow such strategies for the TFSA.

- There is nothing to fear in allowing different types of investments in RRSPs, because the government participates directly in the profit. Of course, we realize that the government also needs short-term revenue for its current activities. Restrictions on RRSP contribution amounts could be eased gradually.

B. Some abuses of the current system and the consultation process

Instead of pushing through such far-reaching measures with so little time to react, the government should put its proposals on hold (both the passive income measures and the other proposed reforms) and undertake a clear consultation process with a precise timetable in order to examine all of the aspects that could be improved. We are convinced that tax professionals could help develop a system that would prevent abuse without eliminating its most attractive aspects.

X. CONCLUSION

With all due respect for the work carried out by Department of Finance employees and their efforts to achieve tax fairness, a goal we completely agree with, we believe that the passive income proposals should be abandoned because they fail to achieve their objective. Here is a summary of the reasons that compel us to make this suggestion:

- In Section III, we showed that all taxpayers stand to lose out under the new measures. Entrepreneurs may indeed be better off than employees, but they contribute considerably more to the broader community in taxes than what they get back. The table in the consultation document itself shows a $4,885 gain for entrepreneurs and $6,658 more in taxes for the Canadian public, and that's just for a simple investment of $100,000 at 3% interest over ten years. Imagine the effect of $26 billion in passive income from corporations! And these figures don't even take into account actual tax rates or the impacts that entrepreneurs have on social contributions, salaries, and professional fees.

- For the sake of consistency, the proposed new system would tax passive income at the highest individual rate, and the tax would be non-refundable. We understand the technical imperatives behind this choice. But it seriously penalizes almost all taxpayers. The premises on which the decision is based are not realistic. It is wrong to believe that the income generated from investments within a corporation will be taxed at the top rate. In many situations, entrepreneurs will be less well-off than employees with the same income. We discussed this in detail in section IV.

- All of these changes will lead to increased complexity, generating additional costs and inefficiencies for businesses and for society in general. The government clearly states that one of its goals is to avoid further complicating laws. It is clear that this objective will not be achieved. It is virtually certain that the two systems (the old and the new) will have to coexist. The current system is already complicated enough in its own right. Imagine two systems! What's more, given the vast stocks of passive investments already held within corporations, the transitional rules will be incredibly complex and will need to remain in effect for a very long period (decades, in fact). We discussed both of these points in sections V and VII.

    - If this additional complexity at least resulted in a better system and more tax revenue for the government, it might be worth it. But the opposite is true. All of this complexity will be accompanied by reduced tax revenues for the government and less wealth for the public in general. Everybody will lose!

- We think the concept of passive investment needs to be clearly defined, as discussed in section VI.

- We believe our recommendations are based on objective, demonstrable calculations and data, and that our objectivity cannot be called into question. The subjective arguments in Section VIII do not really affect our point of view, even though they have value and should be considered.

We recommend that the government not proceed with the proposed passive income measures. As indicated in Section IX, we suggest that it take the time to implement a more structured consultation process in order to look at ways it could improve the fairness and efficiency of the current system. The proposed measures will have extremely serious, potentially negative repercussions on the economy, and it would be wise to think this through thoroughly rather than act hastily, as it seems intent on doing at the moment.

Sincerely yours.

All of us having signed below and having each contributed to this brief on the basis of our expertise and necessary understanding of the issues at stake:

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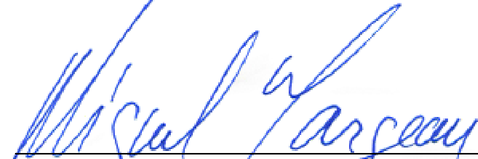

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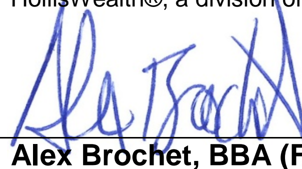

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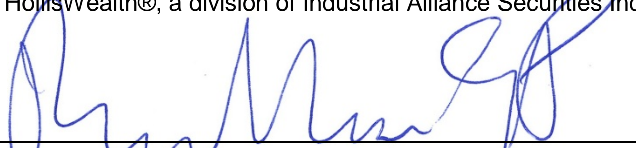

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APPENDIX 1
TABLE 7 – CONSULTATION DOCUMENT

Top marginal tax rate (salary)	50.37%		
Top marginal tax rate (regular dividends)	42.02%		
Corporate tax rate (investment)	19.70%		
Corporate tax rate (active income)	14.40%		
Refundable tax	30.67%		
RDTOH recovery rate	38.33%		
Interest return	3.00%		

	Individual	**Corporation (current rules)**	**Corporation (new rules)**
Startup capital			
Income	100,000	$100,000	$100,000
Corporate tax		(14,400)	(14 400)
Personal tax	(50,367)		
Starting portfolio	$49,633	$85,600	$85,600
Return on investment, Year 1			
Interest (3%)	$1,489	$2,568	$2,568
Non-refundable personal or corporate tax	(750)	(506)	
Non-refundable tax (new rules)			(1,293)
Refundable corporate tax (current rules – RDTOH)		(788)	
After-tax investment income (passive reinvestment)	$739	$1,275	$1,275
Portfolio value after 1 year	$50,372	$86,875	$86,875
Portfolio value after 10 years	$57,539	$99,235	$99,235
Tax refund (RDTOH)		$8,424	
Taxable dividends		107,659	99,235
Personal tax on dividends		(45,235)	(41,695)
Net assets	$57,539	$62,424	$57,539
Total tax paid	$58,390	$65,048	$69,932
Additional tax compared to unincorporated		$6,658	$11,543
Additional money for entrepreneur compared to individual		$4,885	

Appendix 2
Table 7 – Consultation Document, Year by Year

	0	1	2	3	4	5	6	7	8	9	10	Total tax paid	Net end value
Unincorporated													
Business income	$100,000												
Interest income		$1,489	$1,511	$1,534	$1,556	$1,580	$1,603	$1,627	$1,651	1,676	$1,701		
Tax	(50,367)	(750)	(761)	(772)	(784)	(796)	(807)	(820)	(832)	(844)	(857)	(58,390)	
After-tax income	$49,633	739	750	761	773	784	796	808	820	832	844		
Net start value	-	$49,633	$50,372	$51,122	$51,883	$52,656	$53,440	$54,236	$55,043	$55,863	$56,694		,
Net end value	$49,633	$50,372	$51,122	$51,883	$52,656	$53,440	$54,236	$55,043	$55,863	$56,694	$57,539		$57,539
Incorporated													
Business income	$100,000												
Interest income		$2,568	$2,606	$2,645	$2,684	$2,724	$2,765	$2,806	$2,848	$2,890	$2,933		
Tax	(14,400)	(1,293)	(1,313)	(1,332)	(1,352)	(1,372)	(1,393)	(1,413)	(1,434)	(1,456)	(1,477)		
After-tax income	85,600	1,275	1,294	1,313	1,332	1,352	1,372	1,393	1,414	1,435	1,456		
Net start value		$85,600	$86,875	$88,168	$89,481	$90,813	$92,166	$93,538	$94,931	$96,344	$97,779	,	,
Net end value	$85,600	$86,875	$88,168	$89,481	$90,813	$92,166	$93,538	$94,931	$96,344	$97,779	99,235		
Tax upon liquidation											(36,811)		
Total tax (corporate and personal)												(65,048)	
Net value (if liquidated annually)	$49,633	$50,829	$52,043	$53,274	$54,524	$55,793	$57,080	$58,387	$59,713	$61,059	$62,424		$62,424
											Difference	$6,658	$4,885
											Share of added value obtained	57.67%	42.33%

APPENDIX 3
SUMMARY OF SCENARIOS USING TABLE 7 FROM CONSULTATION DOCUMENT

1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17
										(6-5) + (9-8)	(9-8)	(6-5)	(12/11)	(10-8)	(11-15)	(15/11)
	Scenario	**Corporate rate**	**Personal rate**	**Net value em-ployee**	**Net value current rules**	**Net value new rules**	**Tax em-ployee**	**Tax current rules**	**Tax new rules**	**Added value generated by investments held within corporation**	**Additional tax (current rules vs. employee)**	**Additional net value (current rules vs. employee)**	**Implicit tax rate current rules**	**Additional tax (new rules vs. em-ployee)**	**Additional net value (new rules vs. employee)**	**Implicit tax rate new rules**
1	Table 7	14.40%	50.37%	57,539	62,424	57,539	58,390	65,047	69,932	11,543	6,658	4,885	57.67%	11,543	-	100.00%
2	Quebec	18.50%	53.31%	53,658	57,549	53,045	61,266	68,602	73,106	11,228	7,337	3,891	65.34%	11,840	(613)	105.46%
3	Quebec	18.50%	49.97%	58,067	61,555	56,737	57,997	64,597	69,414	10,087	6,599	3,488	65.42%	11,417	(1,330)	113.18%
4	Quebec	18.50%	47.46%	61,434	64,557	59,505	55,494	61,594	66,647	9,223	6,100	3,123	66.14%	11,152	(1,929)	120.92%
5	Quebec	18.50%	37.12%	75,804	76,958	70,935	44,745	49,194	55,217	5,602	4,448	1,154	79.40%	10,471	(4,869)	186.91%
6	Quebec	18.50%	28.52%	88,368	87,259	80,430	35,267	38,892	45,721	2,517	3,626	(1,108)	144.04%	10,455	(7,938)	415.34%
7	Quebec	22.30%	53.31%	53,658	54,866	50,572	61,266	70,066	74,360	10,008	8,800	1,208	87.93%	,13,094	(3,086)	130.83%
8	Quebec	22.30%	49.97%	58,067	58,686	54,093	57,997	66,246	70,839	8,868	8,249	619	93.02%	12,842	(3,974)	144.82%
9	Quebec	22.30%	47.46%	61,434	61,547	56,730	55,494	63,385	68,202	8,004	7,891	113	98.59%	12,708	(4,704)	158.77%
10	Quebec	22.30%	37.12%	75,801	73,369	67,627	44,748	51,563	57,305	4,384	6,815	(2,432)$	155.47%	12,557	(8,174)	286.46%
11	Quebec	22.30%	28.52%	88,368	83,191	76,680	35,267	41,741	48,252	1,298	6,475	(5,177)	498.91%	12,985	(11,688)	1000.60%
12	Quebec	26.80%	53.31%	53,658	55,379	51,045	61,266	68,109	72,443	8,565	6,843	1,721	79.90%	11,177	(2,613)	130.51%
13	Quebec	26.80%	49.97%	58,067	59,622	54,956	57,997	63,866	68,532	7,424	5,869	1,555	79.06%	10,535	(3,111)	141.91%
14	Quebec	26.80%	47.46%	61,434	62,802	57,887	55,494	60,686	65,601	6,560	5,192	1,368	79.15%	10,107	(3,547)	154.08%
15	Quebec	26.80%	37.12%	75,801	75,937	69,994	44,748	47,551	53,494	2,940	2,803	136	95.36%	8,746	(5,807)	297.53%
16	Quebec	26.80%	28.52%	88,375	86,830	80,035	35,261	36,658	43,454	(148)	1,397	(1,545)	IND.	8,193	(8,341)	IND.
17	Ontario	15.00%	53.53%	53,370	58,478	53,903	61,479	68,808	73,383	12,437	7,329	5,107	58.93%	11,904	533	95.72%
18	Ontario	15.00%	43.41%	66,965	71,142	65,577	51,369	56,143	61,709	8,951	4,774	4,177	53.34%	10,340	(1,388)	115.51%
19	Ontario	15.00%	29.65%	86,690	88,364	81,451	36,537	38,922	45,834	4,059	2,385	1,674	58.76%	9,298	(5,239)	229.05%
20	Ontario	26.50%	53.53%	53,370	56,106	51,717	61,479	67,488	71,877	8,745	6,009	2,736	68.71%	10,398	(1,653)	118.90%
21	Ontario	26.50%	43.41%	66,965	69,028	63,628	51,369	54,566	59,966	5,260	3,197	2,062	60.79%	8,597	(3,338)	163.46%
22	Ontario	26.50%	29.65%	86,690	85,501	78,812	36,537	38,093	44,782	368	1,557	(1,189)	423.42%	8,245	(7,878)	2242.67%

Observations:

Column	Comment
11	The additional return generated by leaving more money in the corporation
12	The additional tax the entrepreneur pays compared to the employee under the current rules
13	The additional assets of the entrepreneur compared to the employee under the current rules
14	The implicit tax rate the entrepreneur pays on the increased value of their assets under current rules
15	The increase in tax under the new rules compared to the employee
16	The increase (or decrease) in the entrepreneur’s assets compared to the employee under the new rules. The assets are even lower if the entrepreneur is not taxed at the top personal rate. The tax increase (column 15) accounts for this decrease in the entrepreneur’s assets (compared to column 13).
17	The implicit tax rate the entrepreneur pays under the new rules

APPENDIX 4
TABLE 11 FROM CONSULTATION DOCUMENT
(AND CONTINUING TO PERSONAL TAXES)

Top marginal tax rate (salary)	50.37%		
Top marginal tax rate (regular dividends)	42.02%[6]		
Top marginal tax rate (assessable dividends)	32.29%		
Corporate tax rate (investments)	19.70%		
Corporate tax rate (active income)	14.40%		
Refundable tax	30.67%		
RDTOH recovery rate	38.33%		
Dividend rate of return	4.00%		

	Individuals	Corporation (current rules)	Corporation (new Rules)
Startup capital			
Income	100,000	100,000	100,000
Corporate tax		(14,400)	(14,400)
Personal tax	(50,367)		
Starting portfolio	49,633	85,600	85,600
Return on investment, Year 1			
Dividends (4%)	1,985	3,424	3,424
Non-refundable personal tax	(641)		
Non-refundable tax (new rules)			(1,313)
Refundable corporate tax (current RDTOH rules)		(1,313)	
After-tax investment income (passive reinvestment)	1,344	2,111	2,111
Portfolio value after 1 year	50,977	87,711	87,711
Portfolio value after 10 years	64,839	109,219	109,219
Tax refund (RDTOH)		14,682	
Dividend breakdown			
Regular dividends		85,600	109,219
Eligible dividends (109,219+14,682-85,600)		38,301	-
Personal tax on dividends		(48,333)	(45,891)
Net assets	64,839	75,568	63,328
Total tax	57,618	62,733	74,973
Additional tax compared to unincorporated		5,115	17,355
Additional money for entrepreneur compared to employee		10,729	(1,511)

[6] The formula for calculating the regular corporate dividend rate is the same as that used in the consultation document. The dividend rate is based on the percentage of additional capital at work within the corporation compared to the capital at work available to the individual, i.e., 42.02% (85,600 – 49,633/85,600). Also see Note 17 on page 44 of the consultation document.