Government's tax changes would hurt small businesses and innovation

It is completely reasonable for the government to ask for comments on the proposed tax changes in the Department of Finance's July 18th consultation paper. Hopefully, Finance Minister Morneau will consider the issues raised and reconsider these proposals.

The government's concern is that many businesses, including small family businesses, choose to incorporate, which it believes limits its tax revenues. So, it is proposing a number of very complex and onerous rules to increase taxes on these business owners and their families. There are three areas of changes being proposed that will limit the ability of business owners to;

- Provide income from the business, or capital gains to family members (what it calls "income sprinkling" but which as shown below, is mostly compensation paid to spouses),
- Holding passive investments inside the business (which might be done for a variety of reasons, including helping deal with an economic downturn),
- Convert the corporation's income to a capital gain (e.g. an owner may wish to sell a business over time and receive a set amount every year.).

Small businesses, including entrepreneurs, professionals, physicians, plumbers, tech start-ups and farmers are crucial to the economic health of the country and to our competitiveness, which continues to lag (currently ranked 15th in global competitiveness according to the World Economic Forum and only 24th in innovation).

These changes are not minor and are more than just a public relations problem for the government, as some in the media have suggested. The consultation paper refers to the lower tax paid by someone who owns a private business compared to someone who works as an employee. What it doesn't mention is that the business owner likely has no health benefits, no maternity leave, no pension, no CPP/QPP and no income security, (including no access to EI). If not incorporated, the business owner is also personally liable if someone takes them to court, which could wipe them out financially. Hopefully, he or she has at least purchased disability insurance, as an injury or illness could result in significant financial difficulty. To provide retirement income of say forty thousand per year, a business owner would need to have saved two million dollars at current GIC rates of two percent, and that doesn't account for inflation. A successful business owner probably saw very little return and poor wages for years to build the business and had to deal with the risk that about half of new businesses fail in the first five years.

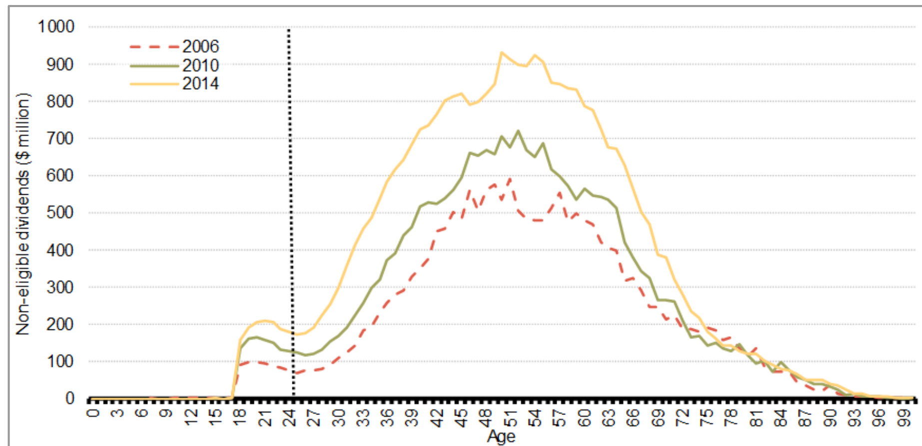
Often the people who are prepared to take the risks to start a business are young, intelligent and highly mobile. With steps like this, the government is just going to encourage them to look to other places which will probably welcome them with open arms. It certainly will not make it attractive for those who have already left Canada to return and there are estimates of over 350,000 Canadians working in Silicon Valley *(Globe & Mail, Canada continues to lose tech talent to Silicon Valley, Feb 9, 2014*).

If young people who start a business wish to get married or have children, they need tremendous support from their families and especially from spouses in a family business. There are already rules limiting children's involvement, so this really seems to be about spouses. By diminishing the potential of a spouse to participate financially in the success of a business, when he or she is prepared to share in the risks and commitment required, the government will reduce our ability as a country to attract and keep the people we need to build future businesses and our economy. With these changes, it seems it would be easier for a spouse to invest in a U.S stock than in their spouse's business. That way they would avoid being subjected to the proposed tests of "connectedness", "reasonableness" and whether he or she is classified as a "specified individual".

As the following chart, taken from the government's consultation paper shows, the average age of those receiving what it calls "non-eligible" dividends is about 51 years old, yet the government misleadingly suggests that it is those18-24 years of age that represent a particular advantage for "sprinkling" income. It is much more likely that it is a spouse and that he or she is being compensated fairly as a co-owner of a family business.

Why Non-Eligible? Why "sprinkling"? With an average age of 51 could most beneficiaries just be co-owners of a family business?

Non-Eligible' Dividends Reported on T1 Returns, By Age of Filers ($million)-Government's Chart



These proposals simply seem short sighted and are not targeting the very wealthy as the government promised in the last election. They are targeting middle income, hardworking Canadians and their families and will discourage innovation and young people from ever starting businesses. This also seems like a potential wedge issue, which could be viewed as purposely divisive for political purposes that most people probably hoped this government would avoid.

The fact that the number of small businesses incorporating has increased could be viewed as a positive thing. If businesses grow and are successful, incorporating makes sense. During the financial crisis of 2008, probably very few businesses were looking to incorporate as they were struggling just to stay afloat. Interestingly, at that time, anyone with stable employment income and a pension clearly was doing much better than any small business owner whose businesses or savings were decimated. Apparently the Minister believes a small minority of well to do business owners are just stoking opposition among those who won't be affected *(Macleans, Morneau shows a flash of temper,September 28, 2017).* It is more likely that those who are not incorporated yet will just see this as more government interference that will hinder the growth of their businesses and their ability to incorporate in the future. The proposals certainly are not consistent with Elon Musk's advice that governments should do everything they can to support small businesses *(Business Insider, Interview with Elon Musk and Sir Ricard Branson, Aug 8, 2013).*

The government's current estimates are that the proposals regarding sharing of income and capital gains will generate $250 million in extra tax. The actual amounts will probably be less, given the complexity of the rules and the potential costs to collect and audit these new sources of tax revenue. Given that this represents less than 1 tenth of one percent of the total budget of $330 billion, and the political cost, it's difficult to see why these proposals were made. The government does not yet have estimates of the potential tax it will collect from the other two proposals, but the amounts will likely be even more miniscule.

If the government wishes to improve its finances, perhaps it could consider going after off-shore tax havens or other provisions used by large businesses and the truly wealthy. It will also soon have tax revenue from cannabis sales which should help with the deficit. Of course, the government also has the option of operating more efficiently, as most small business have to do, to balance its budget.

Longer term though, hopefully it will also look at ways to make it easier to start businesses in Canada and to stimulate innovation and Canadian competitiveness.

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