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Are The Proposed Tax Changes Really Fair?

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On July 18, 2017, the Liberal government released a consultation paper "Tax Planning Using Private Corporations". In this paper, the government proposes three changes to Canada's current taxation system:

1. Eliminating income sprinkling
2. Discouraging holding passive investments inside a private corporation by disallowing the use of Refundable Dividend Tax On Hand (RDTOH) and Capital Dividend Account (CDA)
3. Converting capital gains into taxable dividends using section 84.1 of Income Tax Act

Income Sprinkling

From the example in the consultation paper, Jonah and Jonah's family purchased Jonah's corporation shares and then using the shares to pay out bonuses to Jonah and dividends to Jonah's family to reduce the tax payments for the whole family. This is what the government called, Income Sprinkling technique. There's one thing I'd like to point out. All these years, people purchase shares and invest into different corporations to earn investment incomes such as dividends and capital gains. Some people have very good luck and put very little money into buying start up corporations' shares that, after few years of time, receiving dividends due to the profitability of the start up corporations. From the government's example, I don't see that the government has problems for these investors receiving dividends from these corporations. Just because, the investors are family members of these corporations, all the investment gains from the corporations become so unreasonable.

Besides, for a business to grow, the business owner needs to spend tremendous of time building the business. In doing so, his spouse must step in and support the business owner by building and maintaining the family. How should the spouse be compensated? Maybe you would say that an employee's family also has sacrifices because of his job. But these employees would get compensated with overtime pays. Would the business owner be compensated with overtime pays? Honestly, I never heard of it. In addition, as we all know, there used to be income splitting between family members, but it was eliminated by current government starting 2016 tax year.

Holding passive investments inside a private corporation

On one hand, the government provides small business deduction to small businesses with active business incomes less than $500,000 per year. On the other hand, the consultation paper wants to discourage the small businesses to save their corporate money for future uses by taking away RDTOH and CDA. The reason provided in the paper indicates that these small businesses have tax advantages using the small business deduction from its active business income to earn passive income.

So, per Table 7 and Table 8 of the consultation paper, they show that, due to less corporate tax rate for small businesses, business owners can put more money into investments in corporations and earn more money. As a result, the government takes away CDA and RDTOH so the business owners would get the same after-tax investment money as the one with individual taxpayers. However, comparing with individual taxpayers' tax rates, the business owners have to pay 10% more under Table 7 while with Table 8, the business owners have to pay 4% more taxes. When the business owners are doing both types of investments, the business owners have to pay 7% more taxes.

Converting Income into Capital Gain

At the beginning of section D of the consultation paper, the government indicates that "Individual shareholders with higher incomes can obtain a significant tax benefit if they successfully convert corporate surplus that should be taxable as dividends, or salary, into lower-taxed capital gains." The paper then goes on explaining Section 84.1 of Income Tax Act and the additional measure in changing Section 84.1 so the section would apply to non-arm's length transactions by converting capital gains transactions into taxable dividends.

Let's put it this way. On one hand, an arm's length person wants to do some investments. When an arm's length person buys corporate shares, no matter how big or small, people call it "legitimate investment transactions". When this person sells the shares for cash, these shares are categorized as "capital gains" by the government and the person pays lower taxes. On the other hand, a business owner wants to retire. His adult son wants to invest into his father's business and continues his father's legacy. When an adult son buys his father's corporation's shares, no matter how big or small, people call it "tax cheating". When the father sells the shares for cash, these shares categorize as "dividends" by the government and the business owners pays higher taxes. In the end, as Appendix A shows, when the business owner wants to sell his shares to his family member for retirement, he is heavily taxed by the government by paying additional 27% more than individuals who put their money into regular investments.

Conclusion

Is it really fair? To be fair, all individuals, no matter they are business people, employees or investors, should have the same tax rates. To be fair, all individuals should share the same risks and benefits. In other word, when an employee works 12 hours per day, the employee gets to have overtime to compensate his working hours. Same should be for the business owner as well. When a business owner works 12 hours per day, the government should pay the business owner overtime to compensate his working hours as well. In the worker's paycheque, the worker pays only 1 out of 2.4 for EI and 1 out of 2 for CPP, the rest has to be paid by the corporation owned by business owners. When the worker losses his job or when the worker is on maternity leave, he gets to have EI. The same should go to business owner as well. In the owner's paycheque from his own corporation, he should pay for EI as well for his future protection. And the EI and CPP should contains the same portion as employee's: 1 out of 2.4 for EI and 1 out of 2 for CPP, the rest should be paid by the government since the owner owns the corporation.

When the owner losses his corporation or when the owner is on maternity leave, he should get to receive EI as well.

Are these happening? No! So, what is fair? Look at the tax dollars the government will be collecting from these business owners just by using the government's numbers. I can definitely conclude that this so call "fairness of the tax system" is just a disguise the government wants more money and they are targeting the small businesses this time.

Appendix A
Combined Treatment of Passive Incomes Based on Government's Consultation Paper

	Capital Gain (Per Table 8)			Interest Income (Per Table 7)			Total		
	Individual	Corporation		Individual	Corporation		Individual	Corporation	
		Current System	Proposed System		Current System	Proposed System		Current System	Proposed System
Source capital									
a. Income	100,000	100,000	100,000	100,000	100,000	100,000	200,000	200,000	200,000
b. Federal personal or corporate tax	33,000	10,500	10,500	33,000	10,500	10,500	66,000	21,000	21,000
c. Provincial personal or corporate tax	17,367	3,900	3,900	17,367	3,900	3,900	34,734	7,800	7,800
d. Starting portfolio (a - b - c)	**49,633**	**85,600**	**85,600**	**49,633**	**85,600**	**85,600**	**99,266**	**171,200**	**171,200**
Return on investment, realized in Year 10									
e. Capital gains (6 per cent/year) (using gov't info)	39,252	67,697	67,697				39,252	67,697	67,697
f. Taxable portion of capital gains (e x 50%)	19,626	33,848	33,848				19,626	33,848	33,848
g. Non-refundable personal or corporate tax (using gov't info)	9,885	6,668					9,885	6,668	
h. Federal (using gov't info)	*6,477*	*2,708*					*6,477*	*2,708*	
I. Provincial (using gov't info)	*3,408*	*3,960*					*3,408*	*3,960*	
j. Non-refundable taxes (new system) (f x 50.37%)			17,048						17,048
k. Refundable Taxes (RDTOH) (f x 30.67%)		10,380						10,380	
l. After-tax investment income (e - g - j - k)	29,367	50,649	50,649				29,367	50,649	50,649
Return on investment after year 10*									
m. Interest (3 per cent per year) (per schedule)				15,928	27,471	27,471	15,928	27,471	27,471
n. Non-refundable personal or corporate tax (o + p)				8,022	5,412		8,022	5,412	
o. Federal (f x 33% ; f x 8%)				*5,256*	*2,198*		*5,256*	*2,198*	
p. Provincial (f x 17.36%; f x 11.7%))				*2,766*	*3,213*		*2,766*	*3,213*	
q. Non-refundable taxes (new system) (m x 50.37%)						13,836			13,836
r. Refundable taxes (RDTOH) (m x 30.67%)					8,424			8,424	
s. After-tax investment income (re-invested passively) (m - n - q - r)				7,906	13,635	13,635	7,906	13,635	13,635
t. Portfolio value after 10 years (d + l + s)	**79,001**	**136,249**	**136,249**	**57,539**	**99,235**	**99,235**	**136,539**	**235,483**	**235,484**
u. Refund of pre-paid tax (RDTOH) (same as k)		10,380			8,424			18,804	
v. Distribution of capital dividends (e x 50%)		33,848						33,848	
x. Distribution of taxable dividends (d + f - g + m - n)		112,780	136,249		107,659	99,235		220,439	235,484
y. Personal income tax on dividends (x * 42.02%)		47,387	57,248		45,235	41,696		92,622	98,944
z. Net worth (t + u - y)	**79,001**	**99,242**	**79,001**	**57,539**	**62,423**	**57,539**	**136,539**	**161,666**	**136,540**
aa. Total Income earned from both ordinary Income and investment income (a + e + m)	139,252	167,697	167,697	115,928	127,471	127,471	255,180	295,168	295,168
ab. Total Taxes Paid (b + c + g + j + n + q + y)	60,252	68,455	88,696	58,389	65,047	69,932	118,641	133,502	158,628
ac. Tax percentage (aa / ab)	**43.27%**	**40.82%**	**52.89%**	**50.37%**	**51.03%**	**54.86%**	**46.49%**	**45.23%**	**53.74%**
Difference: Personal Tax Rates vs. Business Owner Tax Rates			9.62%			4.49%			7.25%
Net Assets / Net Worth (same as z)	79,001	99,242	79,001	57,539	62,423	57,539	136,539	161,666	136,540
Capital Gain (same as z)		99,242	79,001		62,423	57,539		161,666	136,540
Lifetime Capital Gain Exemption		-99,242			-62,423			-161,666	
ad. S. 84.1 Dividend (same as z)			79,001			57,539			136,540
ae. Personal Tax Rate on Dividend			42.02%			42.02%			42.02%
af. Tax Payable (ad x ae)		0	33,196		0	24,178		0	57,374
ag. Total Income Earned (same as aa)	139,252	167,697	167,697	115,928	127,471	127,471	255,180	295,168	295,168
ah. Taxes Paid (ab + af)	60,252	68,455	121,892	58,389	65,047	94,110	118,641	133,502	216,002
ai. Effective Tax Rate (ah / ag)	43.27%	40.82%	72.69%	50.37%	51.03%	73.83%	46.49%	45.23%	73.18%
Difference: Personal Tax Rates vs. Business Owner Tax Rates			29.42%			23.46%			26.69%

* Please see Supplement to Table 7 - Interest Income Calculation For 10 Years for calculation

Supplement to Table 7 - Interest Income Calculation For 10 Years

Individual

Principal	Interest	Tax Deducted	Federal	Provincial	Net Interest	Balance
49,633	1,489	750	491	259	739	50,372
50,372	1,511	762	499	263	750	51,121
51,121	1,534	773	506	267	761	51,882
51,882	1,556	784	514	271	772	52,654
52,654	1,580	796	521	275	784	53,438
53,438	1,603	808	529	279	795	54,233
54,233	1,627	820	537	283	807	55,040
55,040	1,651	832	545	287	819	55,859
55,859	1,676	844	553	291	831	56,690
56,690	1,701	852	559	293	849	57,539
	15,928	8,022	5,254	2,767	7,906	

Current Corporate Tax System

Principal	Interest	Tax Deducted	Federal	Provincial	RDTOH	Net Interest	Balance
85,600	2,568	506	205	301	788	1,274	86,874
86,874	2,606	514	208	305	799	1,293	88,168
88,168	2,645	521	212	310	811	1,313	89,481
89,481	2,684	529	215	314	823	1,332	90,813
90,813	2,724	537	218	319	835	1,352	92,165
92,165	2,765	545	221	324	848	1,372	93,537
93,537	2,806	553	224	328	861	1,393	94,930
94,930	2,848	561	228	333	873	1,413	96,343
96,343	2,890	570	231	338	886	1,434	97,778
97,778	2,933	577	234	343	900	1,457	99,235
	27,471	5,412	2,197	3,215	8,424	13,635	

Proposed Corporate Tax System

Principal	Interest	Tax Deducted	Net Interest	Balance
85,600	2,568	1,293	1,275	86,875
86,875	2,606	1,312	1,294	88,169
88,169	2,645	1,332	1,313	89,482
89,482	2,684	1,352	1,333	90,815
90,815	2,724	1,372	1,353	92,168
92,168	2,765	1,392	1,373	93,541
93,541	2,806	1,413	1,393	94,934
94,934	2,848	1,434	1,414	96,348
96,348	2,890	1,455	1,435	97,783
97,783	2,933	1,481	1,452	99,235
	27,471	13,836	13,635	