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Presentation to the Standing Senate Committee on National Finance

Study of the proposed changes to the *Income Tax Act* respecting the taxation of private corporations

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Thank you, Mr. Chair, members of the Committee. As mentioned, my name is Ian Russell and I am President and CEO of the Investment Industry Association of Canada. With me today is Mr. Jason O'Halloran, a partner at S+C Partners LLP and Tax Advisor of the IIAC, who will be fielding any technical tax questions you may have.

It gives me great pleasure to come before this Standing Senate Committee to present the views of the IIAC as you continue with your study on the proposed changes to the *Income Tax Act* with respect to the taxation of private corporations. We commend the Committee for undertaking this study, and appreciate the invitation to appear before you today.

As some of you may know, the IIAC represents 130 member firms in Canada's securities industry. Our member firms are the key intermediaries in Canadian capital markets, accounting for the vast majority of financial advisory services, securities trading and underwriting in public and private markets for governments and corporations.

I will focus my comments on the proposed tax treatment of passive investment income in private corporations and its negative impact on access to capital for small companies and capital formation in the country.

At present, Canadian Controlled Private Corporations (CCPCs) based in Ontario, for example, pay tax at a rate of 50.17% (federal-provincial combined) on passive investment income, such as interest on savings accounts and foreign income, including foreign dividends. The taxation rates in other provinces are similar. This tax rate includes a refundable portion of 30.67%, which gets refunded to the corporation when dividends are paid to individual shareholders. The goal of the current taxation rules is to ensure that individuals pay approximately the same amount of tax whether the income is earned personally, or by a CCPC. Other private and public corporations currently pay 26.5% tax on similar income (assuming Ontario tax rates).

Under existing tax law, CCPCs are also more inherently likely to reinvest their earnings into other businesses. A withdrawal of these funds would be subject to taxation as dividends received by the shareholders at a rate of 39.34% for eligible dividends and 45.3% for non-eligible dividends (in Ontario, for example). Conversely, if the Canadian corporation is owned by a U.S. parent corporation, then the similar intercompany dividend would only be subject to a 5% withholding rate under the tax treaty. As such, a shareholder of a CCPC is motivated to reinvest these earnings inside the corporation

to avoid the relatively high tax cost, while a foreign-owned corporation does not have this cost and has easy access to the capital for other purposes outside of Canada.

Under one option in the new proposals, the refundable portion of the tax (30.67%) would not be refundable when income is paid out to the shareholder. This could result in a combined (corporate and personal) effective tax rate of over 70% on passive income. Moreover, this tax regime applies only to Canadian private corporations and not public companies or foreign-owned private corporations, creating an uneven playing field.

The proposals, if implemented, will have serious, unintended consequences. While the latest changes improve some aspects of the original proposals, they do not address the fundamental problem of changing business behaviour, or the distortions they introduce.

Approximately $27 billion (2015) in passive income is earned through small business corporations annually. This income and the related assets (estimated between $200 billion and $300 billion) are put to use in a variety of ways. For example:

- Corporate savings give businesses resources to draw-on during economic downturns (when profits fall), enabling them to continue to operate and maintain employment levels. The proposed tax treatment of passive investment income will make it more difficult for Canadian entrepreneurs to

succeed and weather downturns in their business. Many small businesses will simply wind up operations.

- Given the excessive tax rates, many successful entrepreneurs and their capital may leave Canada altogether.
- Businesses also keep liquid assets on hand to purchase equipment, invest in property or land, or expand their operations requiring additional working capital. The proposed rules will discourage reinvestment in Canadian enterprises.
- It is important to emphasize that passive income held by private corporations is one of the more significant sources of capital for private equity and public venture companies in the country. Many businesses in the technology sector, for example, use the passive income and the related assets to invest in new and emerging businesses and, at times, provide funding right through to the IPO stage. The proposed tax changes, will discourage Canadian entrepreneurs from taking on the risk of new business ventures, constricting the already scarce flow of capital to new and emerging enterprises.

The proposed corporate tax changes could not come at a more inopportune time for small business and the Canadian economy.

First, the flow of equity capital to small business has collapsed in recent years, partly reflecting a weak and uncertain business climate, and structural adjustments that

have reduced investor participation in small business markets. Additionally, structural changes in institutional and retail markets have restricted capital flows to domestic and small cap markets. Overall, small business financing transactions have fallen one-third over the last ten years, particularly worrisome in an expanding economy. The number of financing transactions on TSX Venture Exchange fell more than 40 percent, while the number of Canadian private equity financing transactions trended up slightly.

Second, despite buoyant growth in the first half of the year, economic momentum is likely to falter later this year, placing more importance on support from a growing small business sector.

Third, a strengthening U.S. economy, boosted by the likelihood of tax reform, will draw Canadian capital south of the border as well as reduce the capital flows of U.S. venture funds to the Canadian small business markets.

Members of the Committee, the Canadian economy needs steadily expanding capital to drive capital formation, innovation, job creation and economic growth. The tax proposals pertaining to the taxation of passive investment income mean Canadian business will have less resources to meet legitimate, strategic business objectives, and place additional burdens on Canadian businesses.

The IIAC recommends that the government take these proposals off the table. The taxation of passive investment income in privately held Canadian companies has been well understood, fair and worked effectively for more than four decades. The government's proposals introduce unneeded complexity, serious unintended consequences, and a disincentive to business investment and entrepreneurship in Canada.

Thank you for your attention. My colleague, Jason O'Halloran, would be pleased to answer any questions you have relating to tax considerations on these issues.