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CHBA Submission on the Federal Government's Proposals for Tax Planning Using Private Corporations

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Executive Summary

- The residential construction and renovation industry is made up mostly of small, family-run businesses. Some 336,000 on-site jobs come from these SMEs.
- The proposed tax changes will make it more difficult to maintain those businesses, especially in slow/lean times. This is of particular concern in our industry as it is cyclical in nature and particularly vulnerable to regional economic conditions
- Combined with recently-introduced federal, provincial and municipal housing interventions and increased interest rates, CHBA projects that housing market activity could be reduced by 10% to as much as 15%.
- **CHBA recommends that the government take the current proposals off the table and launch more in-depth and meaningful consultations** with the business community to address existing shortcomings in tax policy without unfairly targeting small businesses.
- CHBA recommends that tax on split income rules should, at a minimum, exempt a small business owner's spouse or common-law partner. In addition, a threshold should be considered which would recognize various contributions made by family members.
- CHBA fundamentally disagrees with the approach proposed by the government concerning passive investments in private corporations. A fair tax system that accommodates all taxpayers should be built on meaningful dialogue and further consultation with Canadian small businesses.
- CHBA also welcomes an approach that would provide fair tax treatment on a genuine intergenerational business transfer to ensure, at a minimum, it is commensurate with a transfer to a third party.

About the Canadian Home Builders' Association

Since 1943, the Canadian Home Builders' Association (CHBA) has been "the voice of Canada's residential construction industry" - one of the most vital and enterprising industries in Canada. Representing more than 8,500 member firms across Canada, CHBA members come from every part of Canada's housing industry - home builders, renovators, land developers, trade contractors, product and material manufacturers, building product suppliers, lending institutions, insurance providers, service professionals and others.

In 2016, the industry supported over 1 million jobs in new home construction, renovation and repair. It remains one of the largest employers in the country, with tens of thousands of business enterprises engaged. One of every 18 workers in Canada is working in residential construction, either directly on site or indirectly by supplying materials, technologies and services. Total wages paid in 2016 were estimated at $59.4 billion. The construction-related value of new homes, renovations and repairs produced by the industry, including both on- and off-site activities in 2016 exceeded $138 billion.

The Residential Construction Industry is made up of Small Businesses

The residential construction and renovation industry is made up mainly of small, family-run businesses.

According to Statistics Canada, there were 320, 553 residential construction, renovation and associated specialty trade firms engaged in on-site work in June 2017.[i] Of those, just under 40% (125,097) register as having employees (the rest are typically unincorporated individuals, including self-builders.[ii])

Of those 125,097 firms with employees, 83% have 9 or less employees, while 62.5% have 4 or less. This means that small businesses in residential construction, renovation and related small specialty trades businesses (the majority of which are actually micro-enterprises according to Industry Canada's definition) account for in the order of 336,000 onsite jobs, or in the order of two thirds of all on-site employment[iii].

A survey of CHBA members conducted to evaluate the use of private corporations in the residential sector[iv] shows that, of those who do use private corporations, only 17.7% had shareholders that were not related to them, clearly demonstrating that the majority of small-businesses in the residential sector are family-run.

The Minister of Finance has pointed to the increase in Canadian-controlled private corporations (CCPC) as one of the main reasons why these tax changes have been introduced.

This demonstrated that the evolving labour market – with its increase in "precarious employment" and drop in full-time jobs with benefits and pensions – has forced more Canadians into self-employment, which, logically, means more CCPCs. This is consistent with the Minister's observation of job churn and the emerging "gig" economy, and the resultant move by Canadians to secure their own businesses and plan for their own futures through the launching of their own businesses.

The residential construction and renovation industry in particular – due to its cyclical ups and downs, the piecemeal nature of its trade and sub-trade work, and, most importantly, liability issues - has always largely consisted of small companies and incorporated individuals.

An exterior contractor (supply & install) in Alberta observes that "*I cannot trade in my industry without being incorporated, in order to limit risk for all parties involved. The erroneous proposals are the nail in the coffin for our business and 40 families will be looking for work shortly thereafter. It is simply not worth the risk…*"

Impact of the Proposed Changes on Entrepreneurship

Like many other industry associations and chambers of commerce, CHBA is concerned that the proposed changes create a business environment that is not friendly to entrepreneurs wishing to start a business – Canadians who are middle class or striving to join it. The changes will also make it more difficult to maintain a small family-run business, especially in slow/lean times. This latter impact is a particular concern in the residential construction and renovation industry and related trades because of its cyclical activity and particularly vulnerability to regional economic conditions and shifts.

These family-run businesses help build the communities they operate and live in, many of them over several generations. These small companies also employ many more Canadians through subtrade relationships, many of whom are also small family-owned corporations.

As businesses in our industry are community-based, they also support local charities, local sports teams, and are active volunteers in a wide range of community activities.

The government contends that it's only fair to tax income levels the same, but it ignores the multiplier effect of a small business:

- The company generates sales, resulting in GST paid to government.
- The company also employs two or three people, who also pay taxes.
- The company pays business and property taxes.
- The company expends on capital assets for growth, which helps grow the economy.

It is clear that the small business owner is typically generating more tax revenue than an employee.

As a builder in Kelowna notes, "*we are not simply "sitting" on our hard earned money just to save taxes. More often than not, the "money" sits in our corporations while we take smaller paychecks than our peers working as employees, so that we can grow and build our businesses.*

"Should our businesses fail there is the potential loss of personal assets and we are not entitled to collect unemployment insurance. As small business owners, we do not get pensions or other benefits. The money we leave in our companies is not only the capital we need to expand, grow and pass onto future generations, but also the money we will rely on after years of financial uncertainty and sacrifice that we are saving for our retirement. Employees in private firms, large corporations or government simply do not face these pressures as they are guaranteed monthly paychecks, benefits and pensions."

Overall, rather than recognizing risk-taking entrepreneurs (many of whom are working hard to join the middle class) and their supportive families, these tax changes will treat all Canadians as if they were employees who never have to feel the pressure of making a payroll, keeping the bank happy or worrying about their accounts receivable.

These changes have the potential to undermine entrepreneurship and business ownership that power the Canadian economy. They pose a direct disincentive to entrepreneurs to take on the risk/reward challenge that starting and owning a business entails, and they will actively disadvantage those who look to start their own business in order to join the middle class. Furthermore, they vilify success, taking away key motivators to entrepreneurship and innovation. At a time when Canada needs all cylinders in the economy firing, and needs to innovate to succeed on the international stage, it is hardly the time to discourage the hard work and entrepreneurship that can lead Canada to a stronger economy.

Income Sprinkling

The proposed changes to income sprinkling could make it harder for families that devote so much of their collective energy and resources to their small business and depend on its success for their livelihood. That family will see their tax burden increase no matter what level their household income may be.

A renovator from Nova Scotia told CHBA that: "*My wife and 2 adult children assists in my company and don't take any compensation for their participation in trade shows, industry events, sales and marketing, cleaning job sites, and many other tasks. One of the biggest reasons why small business owners can run their company is because of the support of their families. I don't know of any small businesses that don't have family support, involvement and sacrifice. Being able to distribute income to family members is*

a benefit of small business and helps in a small way to compensate the family members for everything they do to support the enterprise."

In a survey, 66% of CHBA members who use private corporations confirmed that changes to income sprinkling would impact how they manage their business income, with another 10% unsure of how negative the effects would be.

Many respondents also indicated that the changes will impact them in the future as their children age and (they hoped) begin working for the family business. Several lamented that this could cause them to step away from the business and forego the family legacy.

As a builder in BC related, "*sharing the income with my wife, who also works in the business is helpful to us. We have had some very bad years in business and have fought to keep our staff working. Part of our solution was to reduce what we paid ourselves in order to keep other staff employed with us. The government needs to see the WHOLE picture here.*"

The income sprinkling proposals will also remove a source of start-up capital for a significant number of new businesses – family members. This is because a related party who is not active in the business, but helps fund start-up costs, and accordingly receives distributions from the corporation, may now be considered to receive "split income" and thus will be taxed at the highest marginal tax rate. This situation was illustrated by a builder in Saskatchewan: "*My mother and sister have made significant sacrifices to help allow this business to start and grow. Even though they don't work in the business day to day, they are very much a reason that it can continue to be active.*"

Passive Investment Income in Private Corporations

In contrast to a salaried employee, incorporated entrepreneurs and professionals have to provide for their own pensions and benefits, retain earnings for cash flow in slow times, and face both the myriad of risks and expenses related to running a business.

Residential construction firms, in particular, need to carry considerable equity in assets that can be liquefied quickly – commonly GICs - to take advantage of business opportunities, such as purchasing land.

A developer from BC notes that "*I use GICs or make loans that earn interest as a way to continue to grow the capital in the company between making investments in new business ventures*" while a developer in Ontario observes that "*We use GICs as a cash management tool for both security of Letters of Credit and to get a return on un-deployed capital while waiting for land opportunities*."

In a survey of CHBA members who use private corporations, 74% of respondents said that they use passive investments in their corporation to manage business income and opportunities.

There is no tax revenue loss to the government under the current passive investment system and in fact, the current corporate tax rate for investment income is already in excess of 50% in many provinces. A portion of the overall tax may be deferred if excess cash is left in the corporation but in exchange for this deferral, the corporation retains more capital to invest so that it can be ready for that next opportunity when it arises. This is the essence of the entrepreneurial spirit of our membership.

The proposed changes mean that a builder will face a much higher rate of taxation for capital retained and passively invested within a private corporation, reducing their ability to fund business growth and capitalize on business opportunities. This will lead to reduced economic activity and less job growth in our industry. In addition, business owners who are saving for retirement responsibly will have less money.

Converting Income into Capital Gains

79% of CHBA members with private corporations said that changes to the ability to convert a private corporation's regular income into capital gains would affect them, especially when it comes to transitioning the business, while another 10% were unsure.

As many residential construction firms are family-owned, often with multiple generations working in the company, the proposed rule changes will mean that the tax consequences of selling a family business to your child will be greater than when the sale is made to non-family members. This represents a clear tax bias against family-owned businesses.

Individuals with CCPCs in the residential construction and renovation industry rely heavily on the ability to sell their business to the next generation in order to fund their retirement.

61% of CHBA members with private corporations said that selling the shares of their corporation to a third party and possibly claiming the capital gains exemption(s) was part of their exit strategy. 22% of respondents were unsure of their exit strategy.

When asked “What percentage of your retirement savings is held in your business?” the average answer was 67%, while the median answer was 75%.

Our industry just does not understand why the government feels the need to hinder the continuation of a family-based business from one generation to the next and strongly urges the government not to proceed with these injurious measures.

Applicability to CCPCs

The government has asserted that the proposed changes will have negligible impact on anyone making less than $150,000 per year because "under this amount there is very little benefit from the loophole because you could simply max out your RRSP and TFSA."[v]

Much of our membership make less than $150,000 per year and they do not even have surplus funds to make RRSP and TFSA contributions. However, they will certainly be impacted by these new proposals as their overall family income will be reduced.

The proposed changes penalize a spouse by preventing them from receiving equal compensation from the business if they do not work in the business on a full-time basis, even though that spouse has equal responsibility for the debts and obligations of the company as a shareholder.

Impact on Housing Markets and Jobs

The negative impact of the proposed tax changes to the productivity and competitiveness of firms in the residential construction and renovation industry cannot be considered in isolation.

Combining recently-introduced federal, provincial and municipal housing interventions (including the Office of the Superintendent of Financial Institutions B-20 Guideline restrictions) and increased interest rates, CHBA projects that housing market activity could be reduced by 10% to as much as 15%.[vi]

This would have significant economic impacts across the country that need to be factored into consideration of the proposed tax changes:

- Resale transactions could be reduced by 50,000 to 75,000 units per year, resulting in the loss of 18,500 to 27,700 jobs.[vii]
- Housing starts could be reduced by 20,000 to 30,000. A 10% (20,000) reduction in housing starts would result in 42,500 fewer jobs and a 15% (30,000) drop in starts would reduce employment by 63,800 jobs.
- In combination, employment in Canada could be reduced by 61,000 to 91,500.

Furthermore, reduced sales activity would impair price growth (causing slower growth in some communities and price reductions in others). This would assuredly reduce the "housing wealth effect", an important driver of consumer confidence and spending, and thus an important factor for job creation.

While the direct economic effects of resale market activity occur quite rapidly, the impacts from housing starts occur more gradually, and the impacts of the wealth effect are even more prolonged.

Through the combined direct and indirect economic effects, a 10% to 15% reduction in housing activity would likely cause employment in Canada, in three years, to be about 100,000 to 150,000 lower than it would otherwise be.

This decline in housing activity, coupled with the proposed tax changes that will decrease builders' "rainy day" funds and the ability to buttress themselves professionally and personally, will mean an increase in the number of firms in the industry that fail and possibly to an increase in personal bankruptcies, plus thousands of jobs lost for the people they employ.

Reducing Affordable Rental Housing

The proposed tax changes regarding passive investment income will discourage builders from utilizing completed but unpurchased units as rental units (explored later in *Builder/Landlord Scenario*).

These units are an important source of affordable rental units in a community – especially in struggling housing markets and smaller centres – and contribute to the growth of mixed-income developments.

Growth in the Underground Economy

The residential construction and renovation industry struggles everyday against underground 'cash' operators, especially in Atlantic Canada, Northern Canada and rural areas.

Statistics Canada estimates under-the-table trade accounts for $45.6 billion a year, or 2.4% of the economy.

The underground economy in residential construction accounted for $12.5 billion (28% of the total underground economy in 2012, the latest figures available).

While it is clear that homeowners pay cash for under-the-table jobs because they feel they are getting a deal, cash operators are doing more than not paying HST/GST on materials and labour – they are also avoiding income tax, licensing, WSIB, etc.

The proposed tax changes will increase the number of cash operators by increasing the incentives for such business behavior, dramatically reducing any perceived revenue increase the government would get from these tax changes.

Industry-Specific Scenarios

The proposed changes offer significant impediments and disruptions to regular residential construction industry practices. To illustrate this, CHBA has outlined the following scenarios:

A. Developer Scenario:

- A real estate developer operating in the GTA has unrelated shareholder/partners, each of which have their own private corporations.
- When an opportunity arises, the shareholders/partners have an extremely limited time, often one week, to assess the proposal and commit to a contribution of funds.
- Some proposals may be split equally, others might not include all the shareholders/partners, and others still may have different proportions of shareholder/partner investment.
- For the real estate developer to seize on these opportunities, each incorporated shareholder/partner must have considerable equity at the beginning of the venture. Therefore, the shareholders/partners each must hold assets that can be liquidated quickly. This commonly means GICs.

Although the government did not provide draft legislation with respect to the proposals to change the way it taxes income on passive investments held inside a private corporation, the Department of Finance did indicate that a corporate tax deferral should not be used to accrue passive investments inside a corporation, discussing several options to eliminate this perceived benefit including removing the refundable tax regime.

If this were done, it would have the effect of increasing the overall tax rate on certain investment income earned in a corporation to in excess of 70% in some cases, once the funds are ultimately paid out to the shareholder.

The proposals have already created a great amount of uncertainty within the industry concerning what amount of cash/investments are acceptable in the company for valid business opportunities and what amounts may be considered to be surplus cash subject to the new passive investment income proposals.

As in this example, some businesses within the industry are very cyclical and generate a significant amount of cash in a few months. While this cash may not be needed right away, it is certainly required to get through periods where revenue generation is very slow or to react to emerging business opportunities. It is not clear right now whether any income generated on this cash is active business income or passive investment income subject to the new proposals.

In addition, there is great concern in the industry about the gap between what the government says is the "intent" of the changes and the eventual execution through Canada Revenue Agency (CRA).

How does the government intend to measure what level of cash/investment assets are acceptable to hold in a company (in its own description) "in order to grow, find more customers and hire more people?" CRA audit staff require clear parameters when applying tax rules, and it remains completely unclear what these will be.

The government must recognize the need for businesses within the residential construction industry to hold significant liquid assets in order to operate efficiently and effectively, and they must be explicit in their language recognizing and respecting the operating necessities of the industry.

Additionally, it should be noted that cash reserves are often required to meet industry or regulatory guidelines (e.g. Tarion). It is our hope that the government is prepared to explicitly state that this cash would be considered an active business asset and any interest on that cash be active business income.

B. Renovator Scenario:

- A related two-person team (e.g., couple or siblings) run a renovation business in Ontario.
- On the advice of their accountant they set up a corporation and receive dividends as opposed to salary.
- The company retains very little money year over year – just enough for capital requirements such as tools and a company vehicle.

The government's proposed changes have introduced uncertainty to the industry concerning what level constitutes "reasonable" dividends paid to the individuals.

The draft legislation proposes a subjective reasonability analysis that includes three factors:

(i) The labour contributions of the individual receiving the dividend;
(ii) The individual's capital contributions to the business;
(iii) Whether the individual receiving the dividend is between ages 18-24 or if they are aged 25 and older.

Individuals aged 18-24 must be "actively engaged on a regular, continuous and substantial basis in the activities of the business" for the dividend to be deemed reasonable. However, an amount could still be deemed unreasonable if it exceeds a legislatively prescribed maximum rate of return on assets contributed to the business by the individual.

Individuals aged 25 and older will need only to have been involved in in the activities in the business. That involvement, however, need not be on a regular, continuous and substantial basis. There will be no legislatively prescribed maximum rate of return, but the individual will need to have contributed assets or assumed risk in support of the business.

Guidelines for how CRA plans on administering this “reasonability test” are not clear. Therefore, in addition to the uncertainty faced by companies due to these tax changes, the government has also increased the paper burden on small businesses as they now have to thoroughly document duties and contributions of each shareholder in the event a dividend paid to a family member is challenged by CRA.

In an era where Canada is seeking increased productivity, increasing the paper and red-tape burden is detrimental and counter-productive.

As a CHBA member from Kamloops noted in a letter to their MP, “*My wife has invested in our company, is an equal shareholder and we both draw salaries and dividends from the company. She does all the annual bookkeeping, wage cheques, contractor payments, and remittances each month, does all interior decorating for the dwellings I build, shares equally in the risk and sometimes draws a larger salary then I do. To think she will have to pay a tax penalty because she is my wife is outrageous and damning. The only way she can avoid this prejudice is to sell her shares to a distant third party or divorce me.”*

C. <u>Builder/Landlord Scenario:</u>

- A builder has a home that goes unsold in a development; either a sale fell through or there was not enough market interest.
- The builder has a choice; either the unsold stock sits vacant and incurs carrying costs or it is rented out to provide some needed revenue into the business.
- The builder chooses to retain the product and hold it as rental stock to keep from going under in a falling market.

Income derived from the rental of real property may be considered passive investment income. Under the new proposals, this rental income could be subject to an overall tax rate in excess of 70% once the income is paid out to the shareholders.

However, there is great uncertainty as to whether this income would be subject to the passive investment income proposals as specific rules exist under the Income Tax Act that may deem rental income of this nature to be active business income.

Under the Income Tax Act, active business carried by on a corporation means any business carried on by a corporation other than a specified investment business or a personal services business.

A specified investment business means a business, the principal purpose of which is to derive income (including interest, dividends, rents and royalties) from property but does not include a business carried on by the corporation in the year where the corporation employs in the business throughout the year more than 5 full-time employees or any other corporation associated with the corporation provides in the course of carrying on an active business, management, administrative, financial, maintenance or similar services to the corporation in the year and the corporation could reasonably be expected to require more than 5 full-time employees if those services had not been provided.

Accordingly, if renting properties is a primary business and the company has the equivalent of more than 5 full-time employees working to generate that rental income, the income will be deemed to be active business income and not passive business income.

However, builders who are generally not in the business of renting properties but are simply trying to make the best of a bad situation, may be penalized.

As well, the CRA definition of a full-time employee for holding property disqualifies most businesses in the industry, as they hold units in rental stock but, as they need to use a property management company to deliver services to renters, they do not meet the more than five employee threshold.

D. Retirement Scenario:

- A custom home builder/contractor in Vancouver is 61 years old with a business that he has been growing for 40 years. His spouse is also a shareholder in the company.
- He has accumulated about one third of needed assets for retirement within his corporation.
- He is concerned that the proposals for taxing income on passive investments held inside a private corporation would reduce this retirement income and that the punitive tax rates now contemplated on income from such assets would postpone his retirement.
- He's tempted to reduce his work and number of employees, and wonders if at this point it would better to just shut his business down and walk away. *"If I get to keep less of my income due to the tax changes, why take the risk?"*

While there is no current draft legislation on passive investments held inside a private corporation, the Department of Finance is discussing several options to eliminate this perceived benefit including removing the refundable tax regime. If this were done, it would have the effect of increasing the overall tax rate on certain investment income earned in a corporation to greater than 70% once the funds are ultimately paid out to the shareholder.

Without question, in this example, the homebuilder will have to alter his retirement plans in order to compensate for the loss of retirement income due to the government's proposals.

As well, the proposed changes to the income splitting rules would not allow him to pay dividends to his spouse any longer and this would effectively reduce the after-tax cash available to the couple in retirement.

E. Buyout Scenario:

- Two parents own shares in a general contracting company.
- The parents and their only child, age 25, work for the company.
- The parents wish to retire and have their adult child buy their interest in the company.

If the adult child buys the shares personally from his parents and the shares otherwise qualify as shares of a qualified small business corporation, it is assumed that the parents should be able to claim their capital gains exemption on the sale. This would be the case if the shares were sold to an arm's length person.

However, if the parents claim their capital gains exemption on the sale, the adjusted cost base of the shares to the adult child (being the amount he paid for the shares), would not be a "hard" basis to him and he could not extract this amount from the company on a tax-free basis at a later time (e.g. if he transferred the shares to a new corporation).

Often times, to not penalize their child, the parents will not claim their capital gains exemption on the sale and will pay tax at a capital gains rate (e.g. 26.76% in Ontario). However, under the new proposals, even if the parents did not claim their lifetime capital gains exemption, if the son subsequently transfers the shares to a new corporation, he would be deemed to have received a dividend for income tax purposes and possibly be subject to tax at a rate of approximately 45%.

The new proposals make it more favourable to sell a business to a third party and may force business owners to look to a third-party sale instead of being able to pass on a family business to their children.

Conclusion and Recommendations

Firms in the residential construction and renovation industry are overwhelmingly small and family-owned.

Contrary to the perception of some, these firms are not tax havens for the wealthy, but are the realm of the middle-class entrepreneur, and their ongoing sustainability is threated by the government's proposed tax changes. As one custom home designer in Alberta comments: "*[I] have supported my family for the past 11 years with my business. My business is successful, but I still live paycheque to paycheque mostly and do not have large reserves of disposable income … [t]he proposed tax changes would threaten the overall wellbeing of my company, including the staff of 9 long-term employees I have*."

Overall, rather than recognizing and supporting risk-taking entrepreneurs and their families (who contribute beyond the day-to-day), these tax changes will treat all Canadians as if they were an employee who never has to worry about making a payroll, keeping the bank happy or collecting their accounts receivable.

For the residential construction industry the changes will mean a reduction in capacity, economic activity and jobs. A developer in BC observes that: *"If the government insists on pushing these changes I will have no choice but to reduce or eliminate the capital investment into new residential housing projects. Unfortunately, I take all the risk of investing my own capital without a return on my investment for up to 2 years while providing dozens of well paid jobs from labourers to skilled consultants all the while without a regular paycheck as we survive from the savings in our company. The proposals will directly affect the "middle class" Canadians who are currently actively employed in the residential construction industry."*

To address concerns of both the government and industry, CHBA recommends that the government take the current proposals off the table and launch meaningful consultations with the business community to address any shortcomings in tax policy without unfairly targeting small businesses.

Increasing, rather than decreasing, business certainty should be the goal of any tax policy changes.

In particular, the government needs to consider the following:

Income Sprinkling

In practice, the application of Tax on Split Income ("TOSI") and the "Reasonableness Test" will result in inconsistent application, as the Reasonableness Test requires a subjective self-assessment after considering labour and capital contributions.

Consider the practical difficulties with labour contributions that will arise in the following situations:

- Both spouses are involved in the home construction business on a regular and continuous basis. However, at different points during their life, their involvement is limited because of health reasons or maternity reasons.

- All family members are involved on a regular and continuous basis in the business (adult children and parents). Similar to the example above, each family member would have differing levels of involvement at different times and each family member would have unique contributions.

- In some cases, a household will be required to decide on the division of labour. The division of labour would consider both inside and outside duties resulting in one family member being less active in a business for period of time or permanently because he/she is directly supporting inside duties so that the other spouses' involvement can exceed what would normally be required of an employee's duties.

Also consider the practical difficulties for small business owners when assessing reasonable capital contributions:

- Both the taxpayer and the CRA will be required to evaluate a proper rate of return and assess "risk" assumed in respect of capital contributed to a private corporation. It is a well-known fact that independent data or proxies are not readily available when assessing "risk" assumed in respect of private company investments.

In the case where a spouse and/or all family members invest in the business and are involved on a regular and continuous basis, practical difficulty will constantly arise when attempting to ascertain with any degree of precision or certainty reasonable compensation in the circumstances.

In many cases, a homebuilder's spouse will choose not to enter the work force as a second income earner on the basis that it is not economically viable when the day-to-day realities of managing a business, raising a family and planning for the future are considered. Consider the division of labour in the context of a new homebuilder who has a family and who is required to manage every aspect of a new business. Home sales often occur during the evenings and on weekends and this requires many hours away from the family.

Constraining income splitting will in some cases cause hardship for families that have maximized their division of labour on the basis that the family would fully support the homebuilder's activities. Maximizing the division of labour between spouses translates into business owners being more available to grow businesses. If the economics concerning the division of labour within and outside of the household are seriously

altered, many small business owners could be motivated to work less and refocus their division of labour.

Income splitting is a legitimate corporate transaction recognized by the Supreme Court of Canada. Besides legitimacy, income splitting is viewed by some to indirectly recognize the division of labour within a household. In addition, it is arguable that income splitting also provides for one's loss or reduction of future earning power when it is decided to focus on the household itself.

Dividends are paid to shareholders as a return on their investment in the corporation. Since the distribution of the dividend is not determined by the quantum of a shareholder's contribution to the corporation, it is illogical to use contribution or labour as the criterion that determines when dividend income will be subject to Tax on Split Income.

A small business is dynamic and contributions to a family business are required at different times, by different people requiring differing amounts of effort. Documenting and measuring the many different contributions will undoubtedly create problems because a business owner and their spouse are often inextricable when it comes to valuing contributions to a business.

Because of the complexity created by the proposed legislation; the Tax on Split Income rules should, at a minimum, exempt a small business owner's spouse or common-law partner. In addition, a threshold should be considered which would recognize various contributions made by family members. A threshold would also alleviate significant amounts of complexity and judgment for small business owners and it would ensure that some small businesses are in fact not impacted by these proposed changes.

Passive Investments in a Private Corporation

Investing passively in a private corporation has been a legitimate long-standing practice for many generations of Canadian business owners. Investing passively within a corporation accommodates business owners who assume risk and responsibility not otherwise assumed by employees. A few important accommodations are noted below:

- Investing passively provides a business owner with efficient access to capital so that opportunities that arise can be seized, creating growth and employment for our economy.

- Business owners are more likely to accept risk and make investments if they have access to more capital.

- Investing passively allows a business owner to manage risks assumed when one goes into business for themselves. These risks are not otherwise assumed by employees.

- Investing passively allows a business owner to diversify risk by investing in assets that are very different than private corporation shares.

- Investing passively allows a business owner to provide for retirement and other unforeseen circumstances that may need to be self-funded. Self-employed individuals do not have pension plans, paid holiday, benefits or sick days like an employee.

Many small business owners have legitimately organized their affairs by investing passively in their corporation and have not contributed to RRSPs. Fundamentally changing the tax system will in some cases require small business owners to:

- Work longer in life in order to save for retirement with after tax dollars;

- Cause some to evaluate whether Canada's tax system is competitive with other economies;

- Cause some small business owners to retire early, not work at all or work less;

Applying a 50% permanent income tax rate in the corporation to passive income assumes that all small business owners are high rate tax payers. This is not the case and this assumption would inadvertency punish many small business owners (including many CHBA members) who are not subject to the highest rates of income tax. In some cases, applying a high rate of personal income tax to corporate income that has already been subject to tax at 50% will result in a combined income tax rate in excess of 70%.

Canada's tax system is already complex and the proposed methods of accounting for passive income will, in all cases, add further complexity, increasing the costs of taxpayer compliance. Tracking and pooling sources of income to account for investments will be both time consuming and costly.

The proposals concerning passive income in a private corporation represent a significant change in tax policy. If implemented in any way as proposed by the government, the proposed changes could act as a disincentive for those looking to invest in small business which in turn creates jobs.

A fair tax system accommodates taxpayers who assume different levels of risk and is flexible enough to allow taxpayers to manage various circumstances. From a policy perspective, there are many examples of accommodation or incentive such as the

Lifetime Capital Gains Exemption and the Small Business Deduction that accommodate a self-employed individual's realities when compared to an employee.

Passive income is already taxed at rates of almost 50% to discourage investing passively in a corporation and when passive income is distributed to individual shareholders, investment income is appropriately taxed.

Making radical changes to legitimate tax structures that have been in use for 45 years requires very careful consideration, material stakeholder involvement, consideration of appropriate grandfathering provisions and the appropriate amount of time to plan and implement around any changes. CHBA fundamentally disagrees with the approach proposed by the government concerning passive investments in private corporations. A fair tax system that accommodates all taxpayers should be built on meaningful dialogue and further consultation with Canadian small businesses.

Converting Income into Capital Gains

The proposed changes in ITA section 84.1 are especially troublesome for those nearing retirement and who have planned for their final estate tax liability under the current income tax regime.

For example, assume an owner of a home building firm passes away in Ontario and the shares are not inherited by a spouse. If the private company shares have a fair market value of $2,000,000 with minimal adjusted cost base, the estate's final income tax liability will increase by approximately $360,000 if the fair market value of the private corporation must be realized as a dividend rather than a capital gain as contemplated by proposed subsection 84.1(2).

The additional income tax burden assumed by estates will ultimately reduce assets available for distribution. This will result in less money being donated to charities, hospitals and other entities that serve the public's interest. In addition, there would be limited opportunities for retired or near-retirement business owners to acquire life insurance or otherwise reorganize their affairs.

Lastly, the proposed changes would effectively require each estate to wind up the affairs of a private corporation within a very short period of time (12 months) to avoid double tax. If the private company owned by the estate is not wound up within 12 months, income in the estate will be subjected to double taxation.

Subsection 164(6) of the Act should be extended to coincide with the graduated rate estate rules which were recently introduced. On this basis, an estate would have three years to properly wind up the affairs of a private company, realize a capital loss and carry it back to the terminal return of the shareholder to alleviate paying income tax two times.

It is extremely common for firms within the residential construction and renovation industry to transfer their companies to the next generation. In fact, some of the most prominent companies in our industry are 2nd or 3rd generation owners. CHBA therefore welcomes an approach that would provide fair tax treatment on a genuine intergenerational business transfer to ensure, at a minimum, it is commensurate with a transfer to a third party.

Endnotes

[i] Statistics Canada. Table 552-0006 and 553-0006 - Canadian business counts, location counts with and without employees, by employment size and North American Industry Classification System (NAICS), Canada, June 2017, semi-annual (number). Included in the totals are all residential building firms, and all specialty trades firms that work in construction. Many of the latter do both residential and non-residential projects.

[ii] According to Statistics Canada, the data for firms without employees include all active Canadian locations with a business revenue greater than $30,000 or that are incorporated.

[iii] As per the tables referenced above, if the average 0-4 person firm has two employees, and the average 5-9 person firm has 7 employees, the total at these multipliers is 336,127 employees. The total number of on-site jobs for 2016 calculated by Will Dunning Inc. Economic Research for the Canadian Home Builders' Association is in the order of 504,000. His estimates are based on 2016 data from Canada Mortgage and Housing Corporation and Statistics Canada.

[iv] Survey conducted September 11 – 18, 2017 of all CHBA members.

[v] Source – August 23, 2017 Canadian Press article https://globalnews-ca.cdn.ampproject.org/c/globalnews.ca/news/3711319/bill-morneausmall-business-tax-plan/amp/

[vi] According to a review of potential economic impacts of amendments to OSFI Guideline B-20, completed by Will Dunning Inc. for CHBA in August, 2017. It is not feasible at this stage to determine more precisely what economic impacts of the proposed corporate tax changes are likely to be.

[vii] The CREA research report can be found here: http://www.crea.ca/wp-content/uploads/2016/02/Altus-Report-Economic-Impact_OS_En.pdf. Research conducted for the Canadian Real Estate Association indicates that an average sales rate of 464,363 sales per year during 2012 to 2014 resulted in 171,650 jobs per year, or 0.37 jobs per sale.