Canada's tax system needs a proper overhaul

By Ian McGugan
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The near hysterical debate over the small-business taxation demonstrates a simple truth: Canada's tax system has become mind-numbingly complicated. Maybe, just maybe, it's time to consider more-complete reform.

The current system is plagued by huge differences in how different types of income are taxed. It's riddled with complexities and inequities. Taken together, those problems are driving the current rush among Canada's big earners to incorporate themselves.

Ottawa is absolutely right to take issue with this trend. Among other absurdities, the current rules allow the owner of an incorporated small business to pay substantially less tax than the owner of an identical small business that isn't incorporated, even though both earn the same amount of money.

This is not the way taxation is supposed to work in Canada. You shouldn't get a big reward from the taxman simply for doing the same thing but inside a different economic wrapper.

But the government's attempts to crack down are ham-handed. And that reflects how difficult it is to tinker with a system that has grown into a labyrinth designed to discourage anyone except the bravest tax accountant.

Consider, for instance, income sprinkling – the entirely legal practice in which the owner of a Canadian-controlled private corporation passes on income to other adult family members by paying them dividends. If those other family members don't have much in the way of earnings – if they're university students or a stay-at-home spouse, for example – they pay very little tax on the money they receive.

Ottawa wants to rein in the practice, most notably by looking at whether the amount received is reasonable compensation for what the family member has contributed to the business. But determining what constitutes reasonable compensation would pose endless problems, observes Kevyn Nightingale, a partner at the accounting firm MNP LLP.

What would happen, for instance, if a woman comes up with a brilliant idea for a business, her sister executes it, while a brother figures out how to make the product substantially more efficient? Or if parents lend their tech-genius kid a vital few thousand dollars that enables him to start a company that unexpectedly turns into a huge success?

Making the problem even worse is that the whole point of income sprinkling is to spread out earnings to low-income, lightly taxed family members. This means the amounts involved typically aren't huge. "How does one reasonably determine that a person's contributions are worth $30,000, $40,000 or $50,000?" Mr. Nightingale asks.

The questions become even more complex in the case of Ottawa's two other proposed reforms. Government wants to reduce the incentive to use private corporations as tax-sheltered piggy banks for large amounts of passive investments that aren't directly tied up in running a business. In addition, it aims to make it tougher for the owner of a private corporation to enjoy a lower tax rate simply by converting regular income into capital gains.

Both proposals are eminently reasonable in concept, but they come with enough ambiguities to fuel years of debate and litigation. "This is adding a huge amount of complexity onto a system that is already complex," Jack Mintz of the University of Calgary told a conference this week.

What’s the payoff for all that angst? The government says it does not know the exact figure. But the impact on federal revenues is likely to be small; the income-sprinkling measure, for example, is expected to yield only $250-million. Stacked up against Ottawa’s $315-billion annual budget, the potential rewards seem inconsequential to many analysts. “These proposals involve a great deal of added complexity and uncertainty for a small gain in equity and revenue,” Mr. Nightingale says.

Others disagree. Kevin Milligan of the University of British Columbia argues that it’s important for the tax system to maintain neutrality – in other words, for government not to push people to package their economic activities into different shapes simply as a way of avoiding tax.

Prof. Milligan and others point out that the private-company structure delivers the greatest benefit to high earners. It deviates from the guiding principle that people who earn the same amount should pay the same amount of tax. Left unchecked, the current trend toward incorporation risks creating a two-tiered system – a flexible, low-tax one for people who can take advantage of incorporation and a much sterner, higher tax one for those who can’t.

But all of that brings us back to the case for wider reform.

At the moment, Canadian-controlled private corporations pay a special, low rate of tax on their first $500,000 in active business income thanks to what is known as the Small Business Deduction. This results in an effective combined federal-provincial tax rate of 10.5 to 18.5 per cent – which just happens to be the lowest such rate in the G7.

Other business income is taxed at a general rate that is much more onerous – 26 to 31 per cent. But even that looks like a mad bargain next to personal tax rates. Levies on the biggest earners have surged in recent years and top marginal rates now nudge 54 per cent in Ontario and several other provinces.

Given this pyramid of pain, there has been a growing and overwhelming motivation for people to arrange their affairs so that as much income as possible is taxed at the small-business rate rather than at the personal rate. This has resulted in a boom in incorporation – and also increasing concern that the growing swarm of private corporations are being used primarily as tax shelters rather than for their intended purpose of providing an effective vehicle for a growing business.

An ideal system would simplify the tax code and remove the need for elaborate manoeuvres designed to shuffle dollars from one income bucket to another. Most importantly, it would provide incentives for companies to grow.

The boldest idea would be to abolish the small-business deduction. Having only a single corporate tax rate with no preferential rate for smaller enterprises might infuriate Canada’s small-business lobby, but it would go a long away to simplifying Canada’s byzantine tax structure.

It would also remove a disincentive to growth. At the moment, companies that are nudging up against the $500,000 income limit have a strong motivation to split into smaller units to avoid paying a higher tax rate. This can result in a proliferation of small companies that are too tiny to ever achieve economies of scale. They’re primarily tax shelters rather than growth vehicles.

A move to a single corporate tax rate could be sweetened by reducing personal or corporate tax rates. The small-business deduction now costs the government $4.1-billion a year. Eliminating it would give Ottawa room to bring down rates elsewhere or to introduce incentives aimed at small companies that are actually growing.

To be sure, moving to a single tax rate for all corporations may be a fantasy in the current political climate. Dr. Milligan argues that, for now, policy makers have to focus on making the current proposals work by finding ways to reduce their administrative burden.

He suggests balancing the reforms with measures that would do more for companies that actually want to grow. For instance, firms could be allowed to immediately expense a certain amount of capital investment annually rather than deferring the depreciation deductions. “This gives an advantage to smaller firms, and the advantage is directly targeted where we want it: incentives to grow investment,” he said.

For his part, Dr. Mintz believes several alternative policies would have been preferable to Ottawa’s current proposals. For instance, he would have favoured moving to a single corporate tax rate, such as Britain introduced in 2015. But he argues that even more sweeping changes are needed to address issues ranging from double taxation of savings to how the tax system handles risk. “These reform proposals should have been put in the context of major reform,” he told the Calgary conference.

Exactly. The most positive thing to emerge from the current firefight would be a commitment to a wider rethinking of a system that has grown too messy, too complex, for anyone’s comfort.