Quick comments on the office of the parliamentary budget officer analysis of changes to the taxation of corporate passive investment income

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Not much has happened in the ongoing saga of the Canadian private corporation tax proposals since we last wrote about them. The tax and business community is waiting for the next step which will be the release of the second version of the "income sprinkling" draft legislation – promised to be released before the end of fall – with such legislation to be effective January 1, 2018. We are hopeful V2 of the proposals will be much more objective and simple. Ideally, the new income sprinkling rules would be effective January 1, 2019 rather than rushing to get the law in place for January 1, 2018.

After the income sprinkling matters are dealt with, the next big shoe to drop will be the release of the detailed passive investment proposals in the 2018 federal budget – expected to be sometime in the February – April 2018 timeframe (Canada does not have set dates for the release of its annual budgets). As we wrote in our last blog, we expect such draft legislation to be very complex and broad. Yesterday, the office of the parliamentary budget officer (PBO) released its report: Analysis of Changes to the Taxation of Corporate Passive Investment Income. While the report is an interesting read, we're astounded at some of the assumptions and conclusions that are made. Overall, the following executive summary comment captures the conclusions of the report:

PBO estimates that these changes could increase annual federal revenues by up to $1 billion in the short term (one to two years after implementation), $3 to $4 billion over the medium term (five to ten years after implementation) and up to $6 billion over the long term.

Our analysis suggests that the proposed policy changes could take over 20 years to reach full maturity. We estimate that about 47,000 (2.5 per cent) of CCPCs would be affected by these changes.

While we are not economists nor statisticians, our brief comments follow:

1. *Key Assumptions* – The PBO Report is very short on the key assumptions that underlie the conclusions. For example, it is unclear how unrealized capital gains (that obviously are not reported in tax return data) are treated as a key assumption. The data that the report appears to draw from seems not to be publicly available. The references that are attached to the report include two papers from Professor Wolfson (that have been widely criticized by practitioners for the conclusions that are drawn regarding the reasons why Canadian Controlled Private Corporations (CCPCs) are utilized). As a reminder, Professor Wolfson is credited as one of the inspirations for the Liberal Party's election platform that suggested private corporations were often a platform for the wealthy to save tax.

   On page 3 of the report, the PBO makes the following summary statement: "*We also find that 60 per cent of all passive income is earned by CCPCs with no active business income, suggesting they were set up solely for the purpose of generating passive income*". It is not clear to us why this statement is even relevant and what impact this conclusion had on the overall conclusion of the report. Given the current under-integration of passive income realized by CCPCs across most

provinces, one would be foolish to establish a CCPC solely for the purpose of generating passive income. In other words, there is no current tax planning to be had by simply establishing a CCPC to realize passive income and given so, why is this relevant?

However, to be fair, given the PBO's independent role and assuming it had no inside knowledge about the policy design of the new passive investment rules, the PBO needed to make basic design assumptions about the proposals. That wouldn't have been easy, but ultimately it would be guessing about the design just like the rest of the tax community is. As the report indicates in a number of places, the conclusions drawn by the PBO are sensitive to the ultimate policy design of the new rules.

2. *Behavioural Changes* – The report provides a caveat that the analysis does not account for behavioural changes and the downside risk to the analysis is acknowledged. This is despite the PBO conclusion that they expect individuals to change the amount they invest or to undertake different tax strategies to reduce their tax burden, and that these behavioural changes will compound over time. This is a huge risk to the analysis being flawed. Notwithstanding the new passive investment proposals may not apply to a large number of private corporations – more on that below – there is no doubt that most affected private corporations will do everything in their power to avoid the new flawed confiscatory tax regime. When personal tax rates increased dramatically in 2015 – both federally and in our home province of Alberta – the flight of private capital and planning to avoid the personal tax rate increases has been – and continues to be – large. We have written about this many times, including here. A recent article about New Brunswick's experience with increasing personal tax rates on the "wealthy" is evidence that affected parties will plan accordingly. If the passive investment proposals get passed into law, there is no doubt that affected taxpayers will bend over backwards to avoid the new rules. This will – without doubt – further encourage capital to flee Canada.

3. *The Number of Affected Corporations* – We have difficulty accepting the percentage of affected CCPCs being 2.5%. Many CCPCs are inactive companies or are in place to hold various assets that are not active (such as general partner corporations that exist to simply hold a general partnership interest in a limited partnership). The existence of such corporations – which is difficult to estimate how many there are but we think it is a material amount of CCPCs – would dramatically increase the percentage of affected corporations if such "shell" corporations were eliminated from the calculations. Even if only 2.5% of corporations earn a large amount of passive income in a given year, these are not necessarily the same corporations from year to year.

   Notwithstanding, does such a statistic even matter? If a fundamentally flawed tax policy would apply to even one taxpayer, that is one too many. Even if such a statistic was correct and mattered, the behavioural changes that this group would make would more than likely indirectly impact a much wider group with negative results.

4. *Grandfathering Assumptions* – Footnote 9 of the report states "*We assume that second generation investment income from grandfathered assets would be subject to the new rules.*" Really? Wow. If correct, then that would seem to be inconsistent with the Minister of Finance's October 18, 2017 announcement. I guess we'll have to see if the PBO's assumption is correct when the draft legislation is released in the 2018 federal budget.
5. *Economic Impact* – If we assume that the PBO report is correct and will result in a long-term impact of $6 billion tax increase – presumably applied to a "small group", this will without a doubt

have a negative impact on the Canadian economy. If US tax reform does go forward resulting in lower overall corporate and business tax rates, there is no doubt that Canada will be negatively impacted from a competitiveness standpoint and more planning will be completed to divert capital to the United States as we have previously written about. Could the $6 billion “revenue” figure ultimately become a negative number if capital flees from Canada?

If we were economists or statisticians we would likely have many more comments. However, for now, we remain steadfast that the passive investment proposals – regardless of the ultimate design – is flawed tax policy and will ultimately hurt Canada. Such proposals should be dropped.