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Canada Persists With Plan to Punish Private Corporate Passive Reinvestment

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To the Editor:

Stephanie Soong Johnston's recent article ("Government to Set Income Threshold for Taxing Private Corporations," *Tax Notes Int'l*, Oct. 23, 2017, p. 323) about a development related to the July 18 controversial Canadian government proposal to punitively tax passive reinvestment by Canadian private corporations of after-tax active business profits brings to mind an important background factor that postdates our September 4 commentary on the controversy ("Unexpected Canadian Private Company Tax Proposals: A Critique and International Comparative," *Tax Notes Int'l*, Sept. 4, 2017, p. 997). This factor is bound up in the unusual expression "dead money" that Canadian Finance Minister Bill Morneau used to explain the government's proposal.

In our prior commentary, we expressed two fundamental concerns about the government's proposal on passive reinvestment. First, we challenged the government's underlying proposition that the current tax system is unfair to employees. Employees must pay up to approximately 53 percent of tax on employment income before they can invest the after-tax balance, whereas a Canadian-controlled private corporation that is carrying on an active business pays only roughly 15 percent on the first C $500,000 on profits (available to small and medium-size enterprises) and around 27 percent on the rest. So the government posited that it is unfair that the employee has less than 50 cents on a dollar of after-tax employment income available to invest while a privately owned business corporation has as much as 85 cents on the dollar to invest. To "fix" this perceived unfairness, the government has proposed not to lower the tax rate on employment income but rather, quite unusually, to effectively apply a form of penalty tax to the private corporation's passive investment income to reduce the ultimate combined after-tax investment income, after dividend taxes are paid on its distribution, to that of the employee.

In our September 4 piece, we argued that there is a basic problem with this "fairness-driven" equation: The circumstances surrounding the earning of employment income and undertaking the risks and challenges of running a business are so different (including the practical necessity of using a corporation to limit exposure to the risk of liability associated with conducting business) that it is without merit to ignore these differences in designing tax policy.

Our second basic objection to the government's proposal stemmed from a 16-country informal survey[1] we carried out for the September 4 article that showed the government's proposal would put Canada out of step on an international comparative and competitive basis. Fourteen of the countries surveyed simply had no rule that penalizes passive reinvestment of business profits. The U.S. has long had an "accumulated earnings tax" that is basically inapplicable to private U.S. business activities because they are generally carried out through transparent entities (for example, "non-check-the-box" partnerships and LLCs). Only Israel has recently adopted this type of rule, but it applies only if a series of objective and subjective conditions are satisfied, including a five-year retention period, a minimum retention amount, and an avoidance purpose.

Johnston's article stated that on October 18, the government had announced that despite the enraged reaction and opposition to the July 18

[1] Argentina, Australia, Belgium, Brazil, Denmark, France, Germany, Israel, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Sweden, the United Kingdom, and the United States.

announcement, it was persisting and would legislate a punitive tax regime for passive reinvestment, but that in an attempt to placate the rightful anger of small businesses, the new rules would not apply to preexisting investments or to those made in the future that produce no more than C $50,000 of annual investment income.

In the foregoing context, including the absence of even limited specifics of the penalty tax or the various exceptions (including steps to avoid discouraging high-tech start-up investments) that will be made, we come to the "dead money" factor alluded to above. In early October, the government floated a previously unannounced rationale for the proposal. This is the "dead money" notion originally coined by the former head of the Bank of Canada, Mark Carney, several years ago. The notion was used by him to reflect a complaint that large public Canadian corporations were building war chests in passive investments — this being the "dead money" — either for share buybacks or some undefined future acquisitions and were not deploying this alleged dead money to grow their businesses.

In early October Morneau resurrected this notion in respect to private corporations. In an interview with the editorial board of *The Globe and Mail* (one of Canada's two national newspapers), Morneau put forward the proposition that not only were passive investments by corporations of no use to the economy (even though every share or bond or real estate investment is financing some business activity), but the government had the right to coerce private corporations through tax policy to use this "dead money" to expand their businesses, even though the businessperson had decided there was no need for further reinvestment in the business.[2] In other words, the government not only subscribes to the international norm that positive tax incentives can be used to induce deployment of capital in ways that the government would like, but the government also believes that taxpayers should be punished for not doing so. We express alarm in view of such an approach. Outside the context of Pigouvian or so-called sin taxes, these writers have never seen such an approach, which defies all norms of proper tax policymaking.

The government's October 18 announcement said detailed draft legislation will not be issued until the 2018 federal budget next spring. It is hoped that between now and then, the government will adopt the October 2 recommendation of the Joint Taxation Committee of the Canadian Bar Association and the Professional Chartered Accountants, Canada, that there be no such legislation "unless and until" there has been a thorough study by an independent commission or advisory panel. ■

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[2]For a discussion, see David Parkinson, "Unlocking Productivity Is Crucial to the Tax-Reform Debate," *Globe and Mail*, Oct. 5, 2017, who notes that:

> Of course, he used the term "dead money," which gave small-business owners already upset at him a whole new reason to be upset with a minister who had already painted many of them (intentionally or not) as a bunch of unrepentant tax-avoiders. They don't see money invested passively through their companies to secure their family's financial future, to save for retirement, as "dead."