INFOR Financial Believes that Proposed Tax Changes Harm Canadian Entrepreneurs

Make no mistake about it, the federal Liberal's tax proposals represent one of the most damaging attacks on Canadian entrepreneurs and growth companies in the history of our country. The effects have the potential to be disastrous for the enterprises that are the growth engines of our economy.

At our firm, investment bank INFOR Financial, we were surprised that few Bay Street commentators and the big banks have not been more critical of Prime Minister Justin Trudeau and Finance Minister Bill Morneau's tax package. But the more we study the proposal, the more we understand the reason for this silence. The proposals have virtually no impact on those that work on Bay Street, the banks or their employees. They are squarely focussed on entrepreneurs, small business owners who are critical to the future of Canada, but are largely ignored in corporate finance circles.

We know, because at INFOR, our team has arguably been involved in funding more Canadian growth companies than any other independent investment banking advisory group, particularly those involved in the technology and mining sectors. In the last year alone, we have been the lead financial advisors for four companies that have achieved a market capitalization of greater than $1 billion from a standing start over the last decade. Today, they collectively employ over 10,000 people.

There is a good chance that some of these businesses – and countless others we have advised – would not have been established under the proposed tax regime. How is that a good outcome for Canada?

What the federal government is really trying to do, from a tax perspective, is put entrepreneurs on a level playing field with every other worker when it comes to taxation. It doesn't take a degree in economics to see that this is not good policy. But a close study of the proposals demonstrates that they would actually disadvantage entrepreneurs relative to the rest of the workforce; business owners will be second class citizens when it comes to paying tax. This is simply outrageous.

To date, the government has shown little interest in consulting entrepreneurs and seems hell bent on forging ahead regardless of the consequences. On the chance the Prime Minister and the Finance Minister are actually listening, we offer three perverse outcomes which would follow from the proposals:

Limiting spousal income splitting for entrepreneurially run private companies

In this case, let's compare a married couple employed by Revenue Canada working 40 hour weeks, each making $100,000 a year, enjoying defined benefit pension plans, six week weeks of vacation and unemployment insurance, as well as many other perks, including a generous severance package; with an entrepreneurial couple who employee 10 people in their technology company, where the wife makes $200,000 a year and works 80 hour weeks in the business while the husband looks after their four children.

The entrepreneurs have no pension plan, no access to unemployment insurance, no paid vacation and no severance if their business fails. Yet they pay approximately 42% more in income tax than the Revenue Canada couple. One way to mitigate this is to split income. Under the Trudeau/Morneau proposals, even if the entrepreneur can show that her spouse is involved in the business, the Government plans to audit this closely, increasing the cost of oversight and compliance on the entrepreneur who is likely already being crippled by government bureaucracy. One can easily see why the entrepreneur might opt to close her business, and opt instead for a job at Revenue Canada.

Taxing passive income for Canadian controlled private corporations at the highest marginal rate

Let's assume in the first three years of the business, our entrepreneur made no money, in year four the business made $500,000 and in year five the business lost money again. Knowing that her business would be lumpy, she considered investing her year four profits in income-producing securities hoping the income would provide a cushion for the business in down years.

But now income from this investment would be taxed at the highest marginal rate, incenting her to take profits out of the business. After year five, with no cushion to offset the losses, our tech entrepreneur is forced to close the business. Our Revenue Canada couple would have a government-sponsored pension plan compounding tax free over the same period. It is hard to see why a properly informed and rational economic person in this circumstance would choose to be an entrepreneur over becoming a government employee.

Limiting capital gains exemptions

Finally, let's consider the plight of our tech entrepreneur in the event she achieves a modest degree of success and is able to sell her business. Early on, her parents and parents-in-law invested and she counted on the help of her husband and the parents, without whom the business would not exist. The proposals would limit the lifetime capital gains exemption on the sale to the entrepreneur's stake only. All other investors would be taxed at the top marginal capital gains rate. Given this, one could imagine that the parents might not provide capital to their daughter's Canadian controlled corporation, and instead decide to hold a portfolio of bank stocks for which the capital gains treatment would be identical.

Now imagine these decisions playing out over and over again across the country. Maybe slowly at first, but compounding each year. It would be a disaster for entrepreneurs and our economy!

It is particularly galling that both Mr. Trudeau and Mr. Morneau have tried to cast this argument as one of "rich" vs "poor." Why not, for instance, review the tax rules related to trust funds and generational wealth transfer schemes that Mr. Trudeau and Mr. Morneau have each benefitted from personally, or public company stock options granted to overpaid corporate executives, or indeed examine government pension plans which compound tax free or pay a defined benefit, truly a public sector anomaly.

All of these would be better targets than hardworking entrepreneurs who are the engine of Canadian growth. To target and demonize this group is just plain wrong.