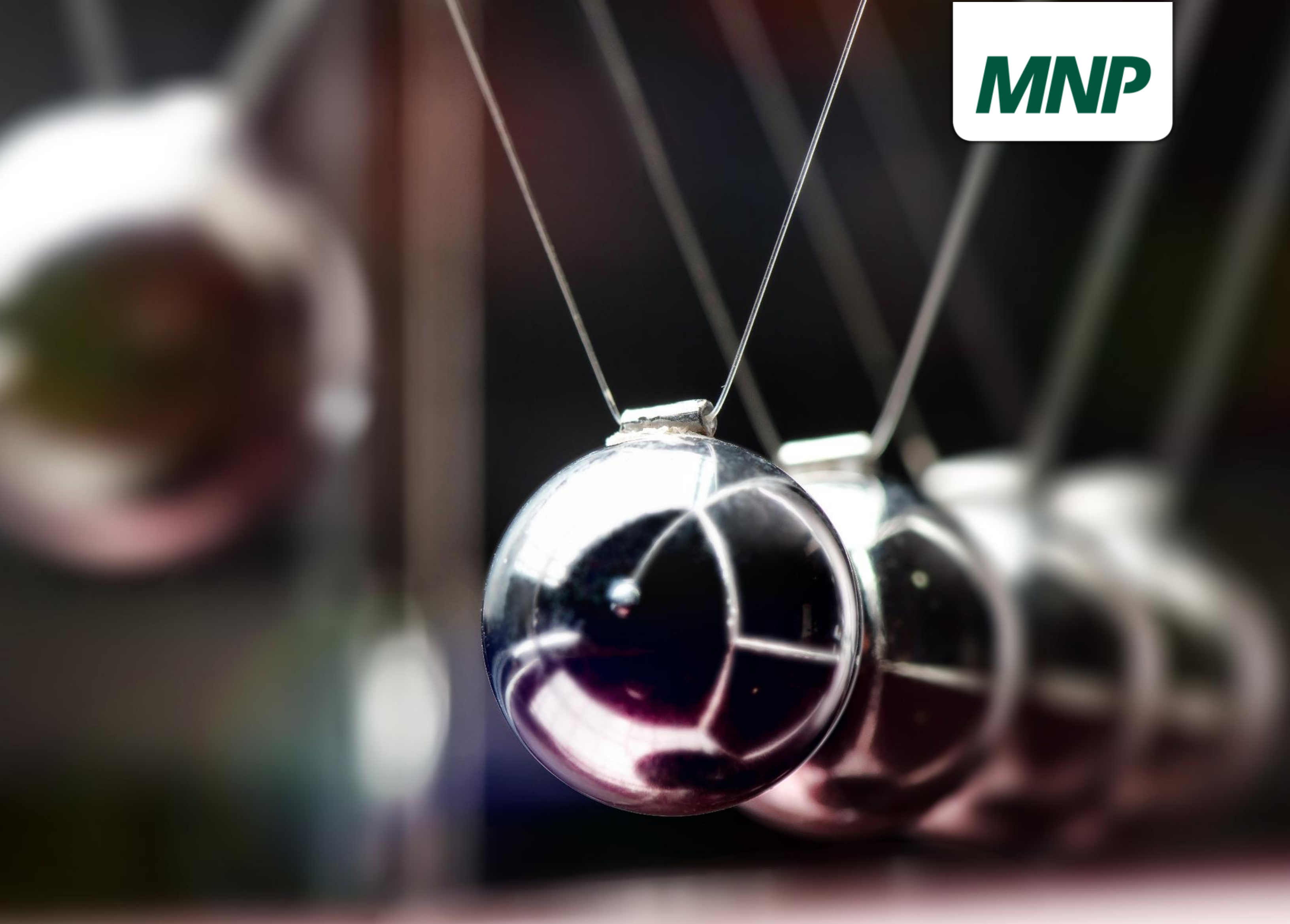


MNP

Fairness and Certainty in Budget 2020

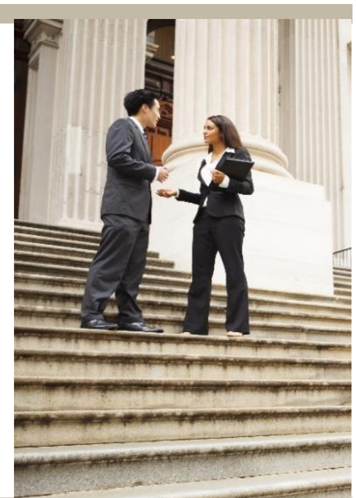
MNP 2020 Submission to the House of Commons Standing Committee on Finance

Thursday, February 6, 2020

We are pleased to make a submission in response to the House of Commons Standing Committee on Finance invitation to share our comments for the 2020 Federal Budget.

MNP LLP (MNP) is a leading national accounting, tax and business consulting firm in Canada. MNP proudly serves and responds to the needs of our clients which include more than 180,000 private enterprise and small business clients, and 19,000 farms throughout Canada.

We made a pre-budget submission in August 2019 to share our recommendations for Canada to remain competitive. We appreciate the opportunity to appear today to offer feedback on two specific tax measures as provided in the Minister of Finance Mandate Letter (Mandate Letter) of December 13, 2019 that raise concern for Canadian businesses. We hope that the Government will take our feedback into consideration in advance of the 2020 Federal Budget.



Fairness and Certainty in Budget 2020
A Balanced Approach to Ease:

1. **Family Business Succession**
2. **Unintended Consequences of Potential Interest Deductibility Limitations**

1. Family Business Succession

The Mandate Letter provides for a specific directive to work with the Minister of Agriculture and Agri-Food on tax measures to facilitate the intergenerational transfer of farms. While we commend the Government on working to facilitate the intergenerational transfer of farms, this is an issue for **all** Canadian private businesses. All private business, whether farms or non-farms, face additional taxes when transitioning the business within the family compared to selling to third parties. We urge the government to treat **all** Canadian private businesses fairly, so that **all** Canadian businesses can implement bona fide succession within a family. This will help private business continue to thrive in Canada.

In May 2019 we asked the Government to continue consultation to ease succession anxiety for entrepreneurs and we introduced the Standing Committee on Finance to the case study of Tracy and Marc. Currently Canadian business owners experience a penalty for succession of a business within their family, such that there is often a double tax component – the vendor parent must pay tax to transition the business and the successor must also have after-tax dollars to fund the purchase. This penalizes family succession planning and can lead to the transfer of a business outside the family unit, or worse yet, lead to no succession of the Canadian business.

Further, preservation of capital gain treatment on any gain that exceeds the lifetime capital gain exemption must be of importance. If the resulting gain on family succession cannot be funded at the corporate level, as would have been the result of the 2017 draft legislation originally proposed, the taxes incurred would make it prohibitive to sell a business to family members.

CASE STUDY

Meet Tracy and Marc

Tracy and Marc run Éclair, a local bakery in Waterloo, Ontario. Prior to purchasing the bakery from her parents in 1982, Tracy had worked in the family business throughout her teenage years and later attended the Culinary Arts School of Ontario. It was while attending this school that she met Marc, and together they returned to Waterloo to work in the family business.

Over time, they worked into management roles and upon her parents' retirement, acquired the business.

The couple has grown the business and now have a staff of 30 people, including their part-time lunch hour servers. Éclair is a specialty bakery with a flair for French pastries, cakes, breads, bagels and desserts. They also have a lunch-time crowd that frequents the bakery for their homemade daily soup and sandwiches.

Today, their two daughters are involved in the business and have both attended culinary school, but they have differing goals with respect to the family business. Their eldest daughter, Adele, is a skilled baker who would rather create beautiful pastries and elaborate wedding and specialty cakes than work on the business. Their second daughter, Jeanette, has a keen business interest and is taking classes working toward a business degree to help grow the family business. Her parents see her as their successor.

Being in their early 60s, Tracy and Marc are considering the transition of their business to their children. Through their succession conversations, they discovered Adele is content working in the business but doesn't want to be bothered with having to buy her parents out. Jeanette intends on keeping the business in the family and together with her partner would like to buy Éclair. Today Éclair is worth between $2.5M to $3.0M.

At the same time, Tracy and Marc have also been approached by Pastry King, a specialty bakery in the Greater Toronto Area (GTA) which has expressed interest in buying Éclair. Pastry King would like to expand their product line into smaller towns outside of the GTA. They figured they could transport the baked goods to Waterloo from their large Mississauga bakery, like they do with all their other GTA locations.

Tracy and Marc have a bias to keep the business in the family but are also concerned with ensuring they have enough after-tax funds for their retirement. Like many small business owners, they have not saved in their RRSP or other tax-sheltered retirement accounts, as they have always been working hard to make the business succeed.

The family had their accountant run a few planning scenarios and they discovered that if they sold to Pastry King, they would have an effective tax rate of approximately 10 percent after using their lifetime capital gain exemption. They were shocked to realize that if they sold to Jeannette, she would be obligated to repay their loan with personally taxed dollars, a significant penalty compared to a sale to Pastry King (rendering the effective tax rate to vary between 27 percent and 67 percent - see below). They had a family meeting to discuss the options and were seriously considering selling the business outside the family, as they did not want to burden their daughter with a tax obligation that would inhibit her ability to make a living and grow the business.

On the sale of shares of Éclair, Tracy and Marc should be indifferent to selling shares to their daughter or to Pastry King. Their daughter should not be penalized for purchasing shares from her parents and should be able to fund the purchase with corporate funds, as she would if she were to purchase a business from an unrelated party. This allows children to become entrepreneurs, continue to grow local businesses and diversify their local economies while protecting existing jobs.

Illustration of Tracy and Marc Selling Bakery Business to Child vs Third Party (using 2020 Ontario rates)

	Sell to Child Personally	Sell to Child's Corporation	Sell to Third Party	2017 Draft Legislation *
Proceeds	2,750,000	2,750,000	2,750,000	2,750,000
Use Lifetime Capital Gain Exemption	Yes	No	Yes	Yes
IMPACT TO PARENT				
Tax Paid	271,983	736,175	271,983	271,983
Cash Available for Retirement	**2,478,017**	**2,013,825**	**2,478,017**	**2,478,017**
IMPACT TO PURCHASER				
Tax Paid	1,584,025	-	-	2,512,151
Corporation's Cost to Fund Purchase	**4,334,025**	**2,750,000**	**2,750,000**	**5,262,151**
TOTAL TAX				
Parents	271,983	736,175	271,983	271,983
Purchaser	1,584,025	-	-	2,512,151
Total Tax	**1,856,008**	**736,175**	**271,983**	**2,784,134**
Effective Tax Rate as Percentage of Proceeds	67.49%	26.77%	9.89%	101.24%

*** Sale to child personally under ITA s. 84.1 as previously proposed; however the Government of Canada has indicated that it would not proceed with these changes.**

Recommendation:

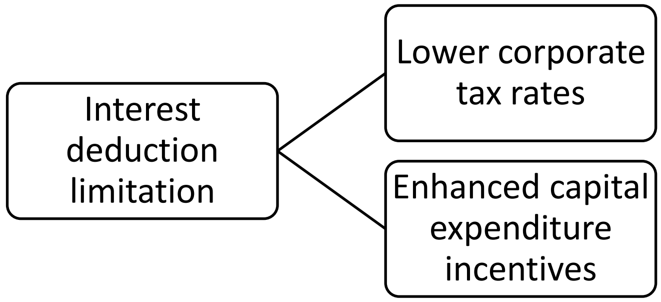
We recommend the Government amend and / or expand the existing provisions of the Income Tax Act (ITA) to allow **all** privately owned companies access to the lifetime capital gain exemption when engaging in bona fide succession and transition of existing businesses. In addition, individuals should be able to preserve capital gains treatment when transitioning their ownership interests to family members where full succession is gradual or in excess of the lifetime capital gain exemption.

This will allow business owners and purchasing family members to be in the same position as they would be if selling to / purchasing from a third party. We further acknowledge that amendments to this specific provision cannot be considered in isolation — other provisions such as Section 55 of the ITA must also be considered to avoid any unintended consequences.

2. Unintended Consequences of Potential Interest Deductibility Limitations

The Mandate Letter provides for a specific directive to *close corporate tax loopholes that allow companies to excessively deduct debt to artificially reduce the tax that they pay*. No specific details have been outlined on how the Government plans to implement such a directive. Documentation provided by the Parliamentary Budget Office relating to the Liberal Election Campaign Proposal (Proposal) (September 29, 2019) suggests that companies will be limited from deducting interest from their taxable income to no more than 30 percent of their earnings before the deduction of interest, taxes, depreciation and amortization (EBITDA). The Proposal advises that the limitation will not apply to net interest expenses less than $250,000 to exempt most small businesses. Further it suggests that Canadian Controlled Private Corporations (CCPCs) with less than $10 million in assets or less than $500,000 in active business income will not be impacted.

While some Organization for Economic Co-Operation and Development (OECD) countries have implemented interest deduction limitation rules, they typically use a three-pronged approach:



Budget 2019 introduced several measures to make Canadian businesses more competitive. While the Mandate Letter continues its focus on fostering technology and innovation by providing incentives, introducing measures that limit interest deductions for Canadian businesses is counter intuitive, especially given our high corporate tax rates and current economic environment.

The impact of the Proposal is far reaching, and its effect will have unintended results. Highly leveraged companies such as leasing companies, real estate and construction businesses (including home builders), automobile dealerships and even large farming operations will be adversely affected. Most notably, start-ups and capital-intensive businesses (from technology-based to manufacturing to resource companies) will be hardest hit as they incur large amounts of debt when earnings in the early years are low. Businesses in economic downturn will be impacted as falling earnings will limit the interest expense even further. Ultimately this can change how businesses operate, whether they survive or if they even choose to do business in Canada.

From a policy perspective, interest deductibility concerns mainly stem from ensuring profits are not shifted outside of Canada without the requisite tax imposed. Canada already limits foreign companies from deducting thinly capitalized interest paid to related non-resident parties via its thin capitalization rules. To the extent that the Government wishes to limit cross-border hybrid debt mismatch arrangements that exploit differences in jurisdictional tax laws, it should focus its efforts specifically to combat this.

Businesses simply do not borrow money for the sole purpose of taking an interest deduction. It may be difficult for many businesses to capitalize with equity instead of debt. The rules contemplated in the Mandate Letter and Proposal target pure domestic companies and can result in an increase in the effective corporate tax rate paid for many Canadian businesses.

Introducing an interest deduction limitation in isolation can have adverse consequences and can increase the overall taxes businesses pay. Canada implemented partial capital expenditure incentives in 2018 in the form of accelerated depreciation. Canada should not just follow the OECD model partially without a full review of the impact such a measure will have on Canadian competitiveness.

The Proposal attempts to carve out small businesses by providing thresholds for net interest expense less than $250,000 and CCPCs with less than $10 million in assets or less than $500,000 in active business income to be precluded from these rules. These thresholds are not sufficient. The $10 million taxable capital limit has been in place since 1989 and has never been indexed to inflation. Certainly, businesses today are not the same as they were 30 years ago.

CASE STUDY

Meet Marie and Jacques

Marie and Jacques own a family farm corporation operating a 600-cow dairy operation in rural Saskatchewan. Marie and Jacques have two children, Elaine (aged 26) and Peter (aged 28). Both children have recently completed university degrees in Agriculture and Bioresources and decided their entrepreneurial passion lies with the family farm. The group has determined that the dairy farm is not large enough to support three families and Elaine and Peter have decided to expand through the start-up of an organic grain division to compliment the dairy operation. They are excited to introduce new farming technology strategies to Canadian farmers that create more agricultural sustainability, as the production of organic grains have been slow to take off.

The family has determined that the optimal size for the organic grain division would be 5,280 acres. They have been advised to purchase the land instead of renting since organic standards require that farmland must be managed using organic practices for a minimum of 36 months prior to harvesting the first organic crop.

The estimated start-up costs are as follows:

Land	$13,200,000
Equipment and Storage:	$2,900,000
Total investment:	$16,100,000

As the dairy operation is somewhat mature and has available equity, it will contribute $3,220,000 (20 percent) of funding for the new venture, with the remaining $12,880,000 being financed with bank debt. The average interest rate will be 4.50 percent, resulting in an annual interest cost of approximately $580,000.

In working through the business plan and cash flow projections, Elaine and Peter were advised of the possibility that the interest on their bank debt could be capped at 30 percent of EBITDA.

With a transition period for organic production, the children are expecting an average net profit of $50 per acre for the first 5 to 10 years, resulting in EBITDA of $1,199,000 per year.

	Regular Market Conditions		Market Volatility	
	No Interest Limitation	With Interest Limitation	No Interest Limitation	With Interest Limitation
EBITDA	1,199,000	1,199,000	1,067,000	1,067,000
Less: Depreciation	(355,000)	(355,000)	(355,000)	(355,000)
Less: Interest Allowed	(580,000)	(360,000)	(580,000)	(320,100)
Taxable Income	**264,000**	**484,000**	**132,000**	**391,900**
Taxes (27%)	(71,280)	(130,680)	(35,640)	(105,813)
After-Tax Profits	**192,720**	**133,320**	**96,360**	**26,187**
Effective Corporate Tax Rate	27.00%	49.50%	27.00%	80.00%
Interest Deduction Carryforward		(220,000)		(259,900)

If interest deductions for tax purposes are capped at 30 percent of EBITDA, this will result in a denial of interest costs of $220,000 annually. The effective tax rate on the profit generated from the new organic grain division will consequently increase from 27 percent to 50 percent annually. In years of market volatility, profit per acre could easily plummet to $25 per acre and the effective tax rate could potentially increase to approximately 80 percent.

As cash flow will already be problematic in the start-up phase, the proposed interest deductibility limitation would impede the ability to start a new organic grain farm.

Recommendation:
The Government should propose a consultation with various stakeholders to ensure there are no unintended consequences of the Proposal. Introducing interest deductibility limitations are extremely broad and complex and do not take into consideration the range and diversity of businesses that will be impacted. They also need to be considered in tandem with lowering the corporate tax rate and introducing enhanced tax incentives to ensure that Canadian businesses are not at a competitive disadvantage. We continue to highlight the need to lower the combined corporate tax rate to a more competitive rate of 20 percent.

Concluding Remarks

Budget 2020 must include measures to ensure Canada remains competitive in the global marketplace. The Government needs to ensure that tax policy and legislation promotes and protects Canadian entrepreneurs, small business and individual taxpayers.

Specifically:

1. **We recommend the Government amend and / or expand the existing provisions of the ITA to allow all privately owned companies access to the lifetime capital gain exemption when engaging in bona fide succession and transition of existing businesses.**

2. **We recommend the Government propose a consultation with various stakeholders as the interest deductibility limitation proposals are broad and complex.**

We reiterate that any amendments to legislation must be balanced and cannot be considered in isolation to avoid unintended consequences.

MNP is pleased to continue to work with Parliament and the Government to further discuss our comments and recommendations in this submission with Finance if required.

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Am is the Senior Vice President of Tax Services with MNP. As the leader of MNP's Tax Group, Chair of MNP's Tax Executive Committee and a member of the firm's management team, she oversees all facets of the firm's tax practice providing management and strategic guidance to tax specialists across Canada.

Am has extensive expertise in Canadian taxation, providing a wide range of tax planning and compliance services to mid-market organizations and their shareholders. Working one-on-one with clients, she delivers effective advice and strategies for corporate and personal tax planning, estate and succession planning and corporate reorganizations, as well as merger and acquisition planning. Am strives to fully understand her clients and their businesses, allowing her to tailor solutions to their objectives.

Am has been involved in and presented at numerous tax conferences hosted by CPA Canada and the Canadian Tax Foundation. She is also active in the tax education community, previously serving on the CPA Canada Education Committee, the Advisory and Planning Committee for CPA Canada's National Conference on Income Taxes and on the CTF British Columbia Tax Conference Program Committee. Currently Am is an active member of the CPA Canada Tax Advisory Committee.

Am is a Chartered Professional Accountant (CPA), qualifying as a Chartered Accountant (CA) in 2001. She received a Bachelor of Commerce degree from the University of Northern British Columbia in 1998. Am previously served as a Director on the MNP Board.

Kim Drever, CPA, CA

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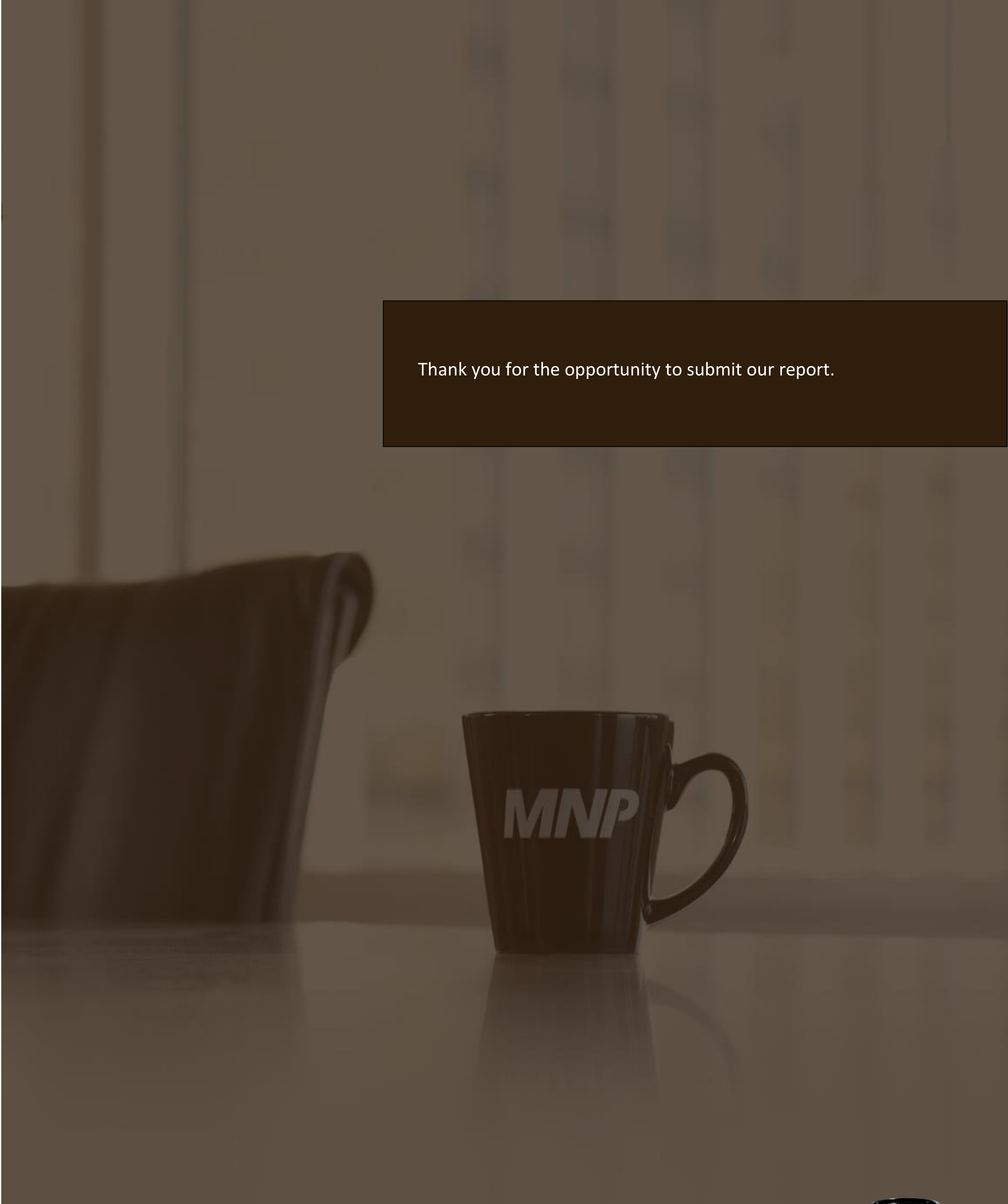
Kim is a Partner and the Regional Leader of MNP's Tax Services group for the Edmonton Region. Working out of Edmonton, Kim helps clients of all sizes throughout the region by delivering innovative tax, structure and reorganization solutions tailored to their specific needs.

Working one-on-one with her clients, Kim delivers strong advice and guidance that helps clients with Canadian corporate reorganization tax planning. She plans appropriate business structures while preserving wealth and ensuring the family needs are considered. In addition to internal reorganizations and succession planning, Kim assists in tax and structure planning for purchase and sale of businesses. She has experience with businesses in a broad range of industries, including oilfield services, forestry, construction, hospitality, agriculture and professional practices.

Kim develops and delivers tax education throughout the firm to MNP's specialty tax group and its partners. She also speaks to numerous business groups and is invited to participate in tax or financial panels for conferences. Kim has presented at the Canadian Tax Foundation Prairie Provinces Tax Conference and tutored with CPA Canada for advanced tax courses. Most recently, she is facilitating the CPA Canada In-Depth Level 2 course.

Kim is a Chartered Professional Accountant (CPA), qualifying as a Chartered Accountant (CA) in 2001, and graduated Beta Gamma Sigma with a Bachelor of Commerce from the University of Calgary in 1999. Kim is involved in her community, previously serving as co-chair Finance for the Arctic Winter Games 2010 and currently the chair for the Grande Prairie Regional Hospital Foundation. She is also a member of the MNP Tax Executive Committee and is a Director on the MNP Board.



Thank you for the opportunity to submit our report.