October 2, 2017

ITAC RESPONSE TO DEPARTMENT OF FINANCE CONSULTATIONS ON TAX PLANNING USING PRIVATE CORPOARATIONS

The Information Technology Association of Canada (ITAC) appreciates the opportunity to comment on Finance Canada's proposed legislative changes regarding tax planning using private corporations. ITAC is the voice of Canada's information and communications technology sector. More than 37,000 Canadian ICT firms create and supply goods and services that contribute to a more productive, competitive, and innovative economy and society. Two-thirds of ITAC's members are small and medium-sized enterprises, many of which will be directly impacted by the tax changes under consideration by Finance Canada.

Over the past two years, the Government of Canada has made it a priority to support the growth of a more innovative and dynamic economy. The 2017 "Innovation Agenda" budget included several measures designed to help Canadians start and grow innovative companies in the technology space. ITAC had long advocated for many of the measures included in the 2017 budget, and we praised the government for their willingness to take bold steps to grow Canada's ICT sector.

There is anxiety in the industry that some of the tax reforms being proposed by Finance Canada could **inadvertently undermine these efforts**. While the government's objective to reduce illegitimate tax avoidance and create a fairer society has merit, ITAC believes that the proposed approach is overly broad and could discourage businesses or investment activities at the heart of Canada's innovation industries.

Small Businesses are the Core of the Tech Sector

Small business tax benefits and preferential rates are intended to help small companies grow into larger ones. Not all small companies that benefit from preferential rates are focused on growth – most are stable "lifestyle" businesses. However, the **overwhelming majority of tech startups are focused on rapidly scaling their business and creating wealth and jobs**. In no other industry is it possible for a startup to grow into a billion-dollar company in the span of a few years. These are exactly the types of businesses that the government should, and in many respects, is working to support. Care must be taken that policies, especially in sensitive areas like taxation, do not inadvertently hinder growth or drive talented entrepreneurs away.

Following conversations with a significant number of member companies, ITAC has identified four main issues with the proposed tax changes and five recommendations for the government's consideration:

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1. Proposed Changes Could Make Canada a Less Attractive and Competitive Place for Scalable Tech Companies:

The tech industry has an incredibly **entrepreneurial, startup culture** with little restraining talented individuals from turning an idea in to a new company. It is also among the most mobile industries, **with few limitations preventing entrepreneurs from relocating a company anywhere in the world** with a good internet connection. Many tech entrepreneurs start companies knowing that they will make next to no profit for the first several years while the company grows. The eventual payout comes from either scaling the business or "exiting" and selling their company to another organization - which is usually followed by the entrepreneur launching/investing in other startup ventures. The persistence of this cycle makes the tech industry far more vulnerable to changes in capital gains tax than other areas of the economy.

The government has noted that income sprinkling, including tax strategies that leverage the lifetime capital gains exemption (LCGE) of family members go beyond the presumed intention of the law and create an unfair tax advantage. Regardless of the intention, the net effect is that Canadian entrepreneurs have historically been able to exempt significant amounts of capital gains, and the proposed changes will result in a significant increase in tax. If an entrepreneur starts a company knowing they may want to "exit" in 3-5 years, increasing the capital gains tax could make them seriously reconsider whether Canada is the right place to start and grow that business. There are many factors pulling Canadian tech entrepreneurs to places like Silicon Valley and New York. **Increasing the capital gains burden will add additional pressure and push Canadian tech entrepreneurs away**.

Should the government proceed with removing "income sprinkling", measures should be included to make the impacts less dramatic for entrepreneurs. **ITAC would propose the individual LCGE be increased from $800,000 to $1,000,000 to maintain Canada's competitiveness avoid discouraging entrepreneurship.**

Starting a business is also a significant sacrifice for families – many of which put their savings or homes on the line to support the entrepreneurs vision. While all families make sacrifices for their careers, families of entrepreneurs often take greater risks and deliver greater benefits to the Canadian economy. If entire families take risks, it seems fair that they should also realize some benefits. **In recognition of the risks entire families take when starting businesses, ITAC would propose that a limited exemption be allowed for spouses to combine their LCGE.**

2. Proposed Changes would Exacerbated Challenges Around Access to Capital

Accessing capital – whether in the form of a loan or equity investment from an angel investor – can make all the difference in turning a good idea into a great company. Access to capital has been an ongoing challenge for Canadian technology companies for many

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years. While some recent progress has been made, it is still among the top challenges facing early stage and growing Canadian tech companies.

Typically, early stage tech companies cannot access financing from Canadian banks who seldom provide loans to companies creating intangible intellectual property. To access financing, entrepreneurs depend on family, private early-stage investors – often called "angel investors, venture capital firms or government sources (e.g. Business Development Bank of Canada).

Far from "passive," early stage investments in startups are highly risky. Courageous angel investors are an essential element in Canada's tech ecosystem. Not only do angel investors provide capital, they provide guidance and connections that can help the company grow up to their next round of funding. However, according to NACO, "the changes to the taxation of passive investment income would increase the overall effective tax on dividends from 42% to 73% and on capital gains from 26% to 56%, thereby significantly decreasing the return on the few companies that do succeed."[1] By moving to tax "passive investments," Canada will become a much less attractive destination for angel investors to invest their time and capital – and there is no shortage of other jurisdictions courting them.

Tech companies regularly invest in other tech companies through collaborations of capital, ideas and talent so they can develop solutions that will benefit both firms. These are not "passive investments" but important capital outlays that fuel growth and job creation.

The proposed rules around "income sprinkling" also do not seem to consider the important historical role families and other "connected individuals" play as the earliest investors in new companies. By expanding the definition of "connected individuals," family members could be dissuaded from taking more than 10% equity in a company to avoid the new rules.

The government's argument that individual incomes should not be taxed as corporate incomes has merit. However, **to account for the potential loss of early stage capital available to startups, the government should provide additional incentives for individuals and corporations to invest in early stage companies**. **For instance, any new passive investment rules should not apply to portfolios where a certain percentage is invested in early stage or scaling companies in high growth sectors.**

[1] Capital gains rate based on British Columbia while the dividend rated is based on Ontario rates. See National Angel Capital Organization, *Response to the Legislative Proposals Relating to the Income Tax Act.* 2017

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3. Proposals Could Negatively Impact Defensive Corporate Arrangements

Businesses that create and produce intellectual property, especially software and technology, face the serious and persistent threat of litigation for patent infringement. There is an industry of non-practicing entities, or "patent trolls," who aggressively target successfully growing companies that have the funds to pay court settlements. Regardless of whether an actual patent violation took place, the threat of years of costly litigation, often in plaintiff friendly courts, is enough to force companies to pay egregious licensing fees.

One of the best defenses companies can adopt to these threats is creating a corporate structure where assets are split between the operational company and one or more shell corporations, so a lawsuit against one will not sink the entire business. Funds in the shell corporation may be saved to fund eventual expansions, transferred in salary to employees, or invested into markets or startups.

It is unclear how these necessary, defensive tax arrangements would be impacted by the proposed tax reforms. Specifically, clarity is required on whether businesses would be barred from passively investing through a shell and then transferring funds between corporations or from the shell corporation to employees without facing a significant tax penalty. Before proceeding with the proposed reforms, **ITAC recommends Finance Canada review how the proposals will deal with defensive corporate structures and ensure the proposals do not force technology companies to choose between an overwhelming tax burden and potentially fatal litigation risks.**

4. Could Dissuade Business Growth and Dilute Taxpayer IP Investments

Canada has a shortage of large companies with their head offices in Canada compared to similar sized economies.[2] Large companies are important because they are more productive and generate more revenue (and tax dollars) than smaller ones. Government should be encouraging technology companies in the right circumstances to grow into long-term sustainable businesses. However, by making it costlier to transfer assets between generations (by disallowing use of the LCGE for inter-generational transfers), the proposed tax measures could deter entrepreneurs from building enduring companies that they can one day pass down to their children.

Some analyses have shown that the death of an owner could result in a combined tax burden of over 67%– creating a strong incentive to sell the businesses to the highest bidder while the owner is still alive.[3] Often, the company that purchases a successful

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[2] See Deep Centre, *Canada's Billion Dollar Firms: Contributions, Challenges, Opportunities*, 2014.

[3] Figure based on death on tax which could be subject to double tax where the deceased holds a greater than 10 percent investment in the shares of a corporation and passes that corporation to a related family members. This would discourage intergenerational transfers and promote sales to unrelated purchasers, including foreign buyer and public companies.

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Canadian tech company will not be Canadian – meaning that the business, jobs and Canadian tax-payer funded intellectual property could flow out of the country. Budget 2017 announced that the Government is creating a new strategy on intellectual property. There is concern in the ICT industry that the proposed tax measures could undermine this initiative.

ITAC understands that the government has heard similar concerns around intergenerational transfers from a range of sectors. We appreciate that Finance Canada is taking these seriously and is looking for avenues to ensure all intergenerational transfers are not impacted by tax measures intended to address a small percentage of Canadians. **ITAC recommends the government work with a range of industries, including the ICT sector to ensure tax measures do not discourage entrepreneurs from building longstanding, intergenerational companies.**

Additional Issues

Beyond the aforementioned issues, ITAC members have shared their concerns that the proposed requirements will add unpredictability, complexity and cost to the tax regime. Administrative items like the proposed "reasonable test" seem likely to create long-term confusion and uncertainty. The lack of any grandfathering for existing structures also ignores the substantial investments many companies have made to establish heretofore legal and prudent tax structures.

Several industry groups have been highlighting the impacts of the proposed changes on independent contractors. IT contractors play an important role in the ICT industry because they can be deployed as required to help businesses adopt, align and optimize their technology purchases. Removing tax planning tools will increase operating costs for these businesses, which could increase the cost and potentially slow the pace of technology adoption for organizations across the economy.

ITAC would be happy to further discuss the impacts of the proposed tax measures for Canada's ICT industry at your nearest convenience. We would also be happy to connect Finance Canada with industry thought leaders who can provide first hand details and examples of the impacts they would expect for their business.

Summary of ITAC Recommendations:

1. ITAC recommends the individual lifetime capital gains exemption (LCGE) be increased from $800,000 to $1,000,000 to maintain competitiveness avoid discouraging entrepreneurship.

2. In recognition of the risks entire families take when starting businesses, ITAC recommends an exemption be allowed for spouses to combine their LCGE.

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3. To account for the potential loss of early stage capital available to startups, the government should provide incentives for individuals and corporations to invest in early stage companies. For instance, any passive investment rules should not apply to portfolios where a certain percentage is invested in early stage or scaling companies in high growth sectors.

4. ITAC recommends Finance Canada review how the proposals will impact defensive corporate structures and ensure tax changes do not force technology companies to choose between facing an overwhelming tax burden and potentially fatal litigation risks.

5. ITAC recommends the government work with a range of industries, including the ICT sector to develop measures which reduce illegitimate tax avoidance while not discouraging entrepreneurs from building longstanding companies.

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