NACO Response to the Tax Planning Using Private Corporations Proposal

October 2, 2017

NACO | National Angel Capital Organization

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The Honourable Bill Morneau, P.C., M.P.
Minister of Finance
House of Commons
Ottawa, ON K1A 0A6

Dear Minister Morneau,

This comment letter is in response to the Legislative Proposals Relating to the Income Tax Act. It is submitted by the National Angel Capital Organization (NACO), a federally registered not-for-profit organization dedicated to professionalizing Angel investment in Canada. NACO has more than 3,300 members, and represents more than 45 Angel member groups.

We applaud the Government of Canada for their efforts in creating a healthy and growing economy where businesses can create jobs, strengthening the economy to ensure that Canadians have confidence in their future. We are encouraged by the government's focus on the Innovation Agenda and its understanding of the need to create a strong ecosystem that supports early-stage entrepreneurs.

Private early-stage investors, often referred to as Angel investors, play a critical role in supporting these entrepreneurs. Angel investors are frequently former or current entrepreneurs, or business professionals, and act as a primary source of financing, mentorship and access to networks for Canadian startups. They help build successful businesses to the point where their revenues and growth make them attractive to venture capitalists and other funding sources (Appendix A). This process often takes many years and rounds of financing. Angels act as the early capital that feeds the pipeline of opportunities for venture capital firms and the early-stage public markets.

We understand the proposed tax changes are an effort to ensure all Canadians are paying a suitably fair share of tax on income, and to eliminate circumstances where private corporations might be used to gain unfair tax advantages. However, NACO would like to ensure that the government is aware of the impact these policies may have on the early-stage ecosystem so that the government's tax and innovation policies are aligned to support the growth of Canadian startups and their continued access to risk capital.

To better inform our comments, NACO surveyed our membership about these proposed changes and how they might affect the availability of capital and active Angel support for entrepreneurs. The resulting data is presented herein and included in Appendix B. We chose to focus primarily on the taxation of private corporations used for investment and the treatment of related parties and "connected" investors under the proposed policies.

Holding Passive Investments Inside a Private Corporation:

It is our understanding that, if an Angel investor holds their portfolio investments within a Canadian Controlled Private Corporation (CCPC), any return generated will be classified as passive investment income and taxed at the new and higher rates (Appendix C). Further, upon disbursement, any investment income within the CCPC will be subject to a higher effective rate, due to the removal of the refundable tax credit on passive investment income.

Possible Outcome: Decreased Incentive and Capital for Angels to Invest

Our survey data shows that up to 88% of investors use private corporations to deploy all or some of their investments into startups, with only 12% of respondents exclusively investing directly as individuals. Regarding the source of funds used to invest, most investors surveyed use multiple sources to generate capital for their investments, with 53% using earnings from an existing operating company, 65% using after-tax dollars and 66% using proceeds from previous investments.

While most investors use private corporations for these investments, few do this as a means to reduce tax liabilities. As it is considered a best practice, many of the most active investors in Canada primarily invest through private corporations when supporting startups or acting as limited partners in a venture fund. Further, risk mitigation and compliance with provincial tax policies also factor into the use of private corporations. In New Brunswick, Manitoba, Alberta and British Columbia, tax credit programs have been used by provincial governments as a capital-efficient way to incentivize Angel investments made through private corporations. In British Columbia and Alberta, Angels have been encouraged to use Venture Capital Corporations (VCCs)[1], a form of CCPC, to structure investments and facilitate the disbursement of the tax credit. In other cases, the motivation for using private holding companies is related to the need to shelter personal assets from the potential negative outcomes that may occur when investing in highly volatile startups using new technologies in emerging markets. Furthermore, since Angel investments are typically high-risk (approximately 70% will fail to achieve a positive return)[2] and can take up to 10 or more years to realize, it is prudent practice to pool these investments and view them in a portfolio context within a CCPC.

With respect to the startup companies themselves, other federally funded programs require the use of CCPCs. The Scientific Research and Experimental Development tax incentive program (SR&ED) is a prime example. As well, returns on passive investments also affect an entrepreneur's ability to ensure sufficient capitalization of the business in the case of unexpected growth or an unfortunate development or economic downturn. Discouraging entrepreneurs from establishing prudent reserves by taxing the returns on such funds incentivizes a culture of continual fundraising instead of business plan execution and stable growth. This runs contrary to the best practice of encouraging young companies to have ample capital reserves.

1 http://www2.gov.bc.ca/gov/content/employment-business/investment-capital/venture-capital-programs/venture-capital-corporation

2 Angel investment returns data collected by the Angel Resource Institute in 2016 suggests that approximately 70% of Angel investments failed to achieve a positive return. http://angelresourceinstitute.org/research/report.php?report=101&name=2016%20Angel%20Returns%20Study

Tax credit programs have offset some of the risk of Angel investing and made Angel investment a more accessible activity for newer and less experienced Angels. However, 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. Since Angels often rely on returns from a few excellent companies to offset losses in the majority of their portfolio, this change would have a major adverse impact on the net portfolio return and result in a corresponding increase in the level of risk associated with startup investment. It is therefore no surprise that 76% of respondents to our survey indicated that they would decrease investment, with 64% indicating that they would significantly decrease their investment activity in startups as a result of these provisions.

Unless clarity is provided on the intent and scope of these changes, and on how or to which private corporations they will affect, the proposed changes may have a foreseeable and significant impact on the willingness of investors to deploy risk capital in the future, resulting in a material decrease in available funding for startups.

Recommendations:

- Should you proceed to pursue passive investments in CCPCs as indicated, please avoid including high-risk, early-stage investments or make appropriate provision to exclude them from the scope of these new rules.
- Specify which types of private corporations are to be targeted by the proposed changes to ensure the impact of these changes is limited to the intended targets and not all CCPCs, with a view to aligning with the various provincial and other federal initiatives.
- Enact exemptions or counterbalancing provisions to offset the impact of the changes on early-stage investors and startups, so as to ensure that entrepreneurs continue to have sustained access to the required funding.

On Income Splitting and Sprinkling:

The government's proposal seeks to expand the rules governing the treatment of split income to prevent the transfer of income from high-earning individuals to lower-earning related parties by taxing such income at the highest marginal rate. While a reasonableness test would be applied to determine if a party is subject to the new rules, expanding the definition of a "connected individual" to include a measure of equity, earnings or investment influence[3] could foreseeably capture an investor who has a significant stake in a company, or who is acting as a strategic advisor or Board member to a company. Thus, family members, friends and Angels (the traditional first sources of funding) may now face substantially greater tax rates. This will likely serve to curtail availability of such critical early funds, as 61% of respondents indicated the changes would decrease their investments at a time when the Innovation Agenda specifically wishes to accomplish the opposite.

Potential Outcome: Decreased Access to Early-Stage Capital

The survey data suggests that 72% of respondents have made investments into startups that would fall under one of the criteria within the new definition of a "connected individual." The additional scrutiny created by this proposed change led to 61% of respondents indicating that this provision would decrease their investment activity, with 37% of those respondents indicating that it would significantly decrease their appetite to invest in startups.

While a decrease in investment may not mean that investment would cease overall, it would suggest that the 67% of investors who indicated they have made investments for ownership interests of greater than 10% would limit their future investments to remain below that threshold. The data suggests that many investors would also be hesitant to mentor or take on an active role within their portfolio companies, or to invest in the businesses of their friends or relatives, in order to avoid the new rules.

Overall, this would impact startups by increasing the difficulty involved with closing early rounds of investment through the traditionally proven sources.

Recommendations:

- Consider reviewing the definition of "connected" so as not to affect arm's-length investors who provide critical access to funding for startups, or to inadvertently penalize those who play a more active mentorship role in their portfolio companies.
- Consider the historical and appropriate relationship of family members as first investors in new entrepreneurial businesses.
- Consider specifically targeting the measure towards individuals who are withdrawing salaries from businesses versus those who are investing risk capital into a company.

[3] https://www.fin.gc.ca/activty/consult/tppc-pfsp-eng.pdf

Converting Income Into Capital Gains:

In an effort to prevent the tax benefit achieved when corporate surplus is converted from dividends or salary into capital gains, the proposed rules contain, in part, the expansion of an existing anti-avoidance rule in section 84.1 to include situations where the step up in cost base of the shares of a corporation sold to a non-arm's-length individual or trust (an estate, for example), which would otherwise be increased in a taxable transaction, would be reduced to the original cost base prior to the sale of the shares.

This expanded anti-avoidance rule would reduce the entire step up in cost base, not just the amount equal to the lifetime capital gains exemption claimed at the time of the sale of the shares, which was originally the case. As a result, the proposed expansion of the anti-avoidance rule is punitive in two ways.

First, it eliminates the ability of an estate to implement the long-accepted pipeline strategy to avoid double taxation; specifically, the immediate tax on the deemed disposition of the shares of the corporation at the time of death and the future inherent tax liability on the fair market value of the assets held within the corporation. In some situations, the proposals could result in double or even triple taxation with an overall tax rate of between 73% and 93%. Second, a legitimate succession transfer of a family business will now be taxed at a substantially greater rate (an additional 39% to 45%) than would be the case selling to a third party.

These outcomes are of obvious concern for entrepreneurs and their investors. As Angel investments are usually illiquid and long-term, any forced premature sales to satisfy new tax obligations will likely be on distressed terms. Further, as many such investee companies will still be looking for additional funding, such forced secondary sales activity will likely negatively affect early-stage entrepreneurs by adversely impacting the valuation of their companies and crowding out potential funding sources.

By targeting legitimate family succession situations with an increased tax burden, the government will be incentivizing sales to third parties (including foreign purchasers) and possibly curtailing the growth of some of our stronger emerging Canadian companies.

Recommendations:

- Consider the impact of these changes on a company's succession plan so as not to force the distressed sale of equity in young Canadian companies.
- Consider the impact of these provisions on an aging population of business owners and how this may decrease the number of large companies in Canada.
- Consider the possible outcome of such sales on the transfer of ownership and taxable profits from Canadian businesses into foreign hands.

Conclusion:

As stated earlier, Angel investors are a critical source of funding to the startup ecosystem. They invest personal funds, time and their networks to provide Canada's most promising companies access to the sustained mentorship and financial resources they need.

It is important to recognize that Angel investors are prepared to take extraordinary risks to support the development and growth of Canadian companies for the benefit of the Canadian economy, often with little chance of return. In essence they are a unique segment of the population that is actively supporting innovation and economic growth by deploying hard-earned income that could otherwise rest on the sidelines of the economy or be invested in other asset classes or foreign markets.

Without the incentive of appropriate returns, we believe that Angel investors will be less inclined to make these often lengthy and high-risk investments. It should be possible to achieve both goals of innovation and tax fairness in the economy by bearing in mind the impact of the proposed legislation on the early-stage ecosystem and thus avoiding the unintended consequences that might otherwise adversely influence the flow of funds and resources to Canadian entrepreneurs.

Should you wish to discuss any of these matters further, we would be delighted to assist in whatever manner you feel appropriate.

Sincerely,

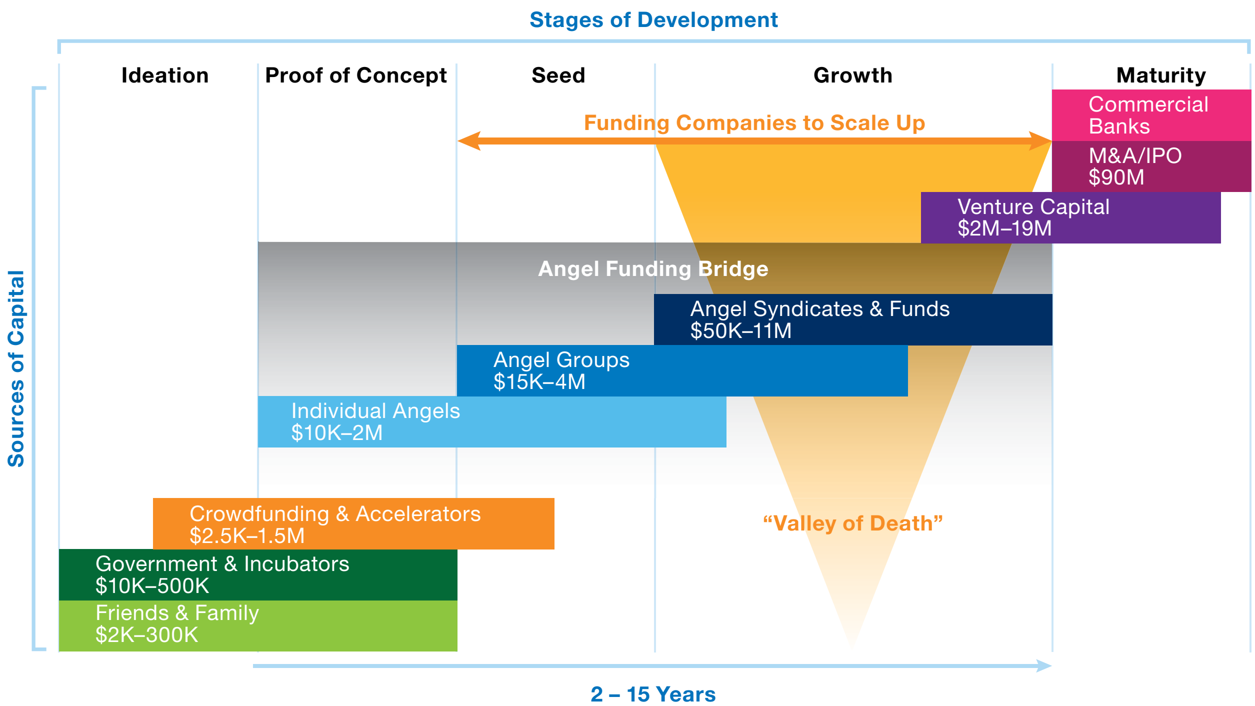
Yuri Navarro
CEO & Executive Director
National Angel Capital Organization

Ian Bandeen
Chairman
National Angel Capital Organization

cc: Hon. Navdeep Bains, Minister of Innovation, Science and Economic Development Canada
cc: Hon. Bardish Chagger, Minister of Small Business and Tourism
cc: Paul Rochon, Deputy Minister of Finance
cc: John Knubley, Deputy Minister of Innovation, Science and Economic Development Canada

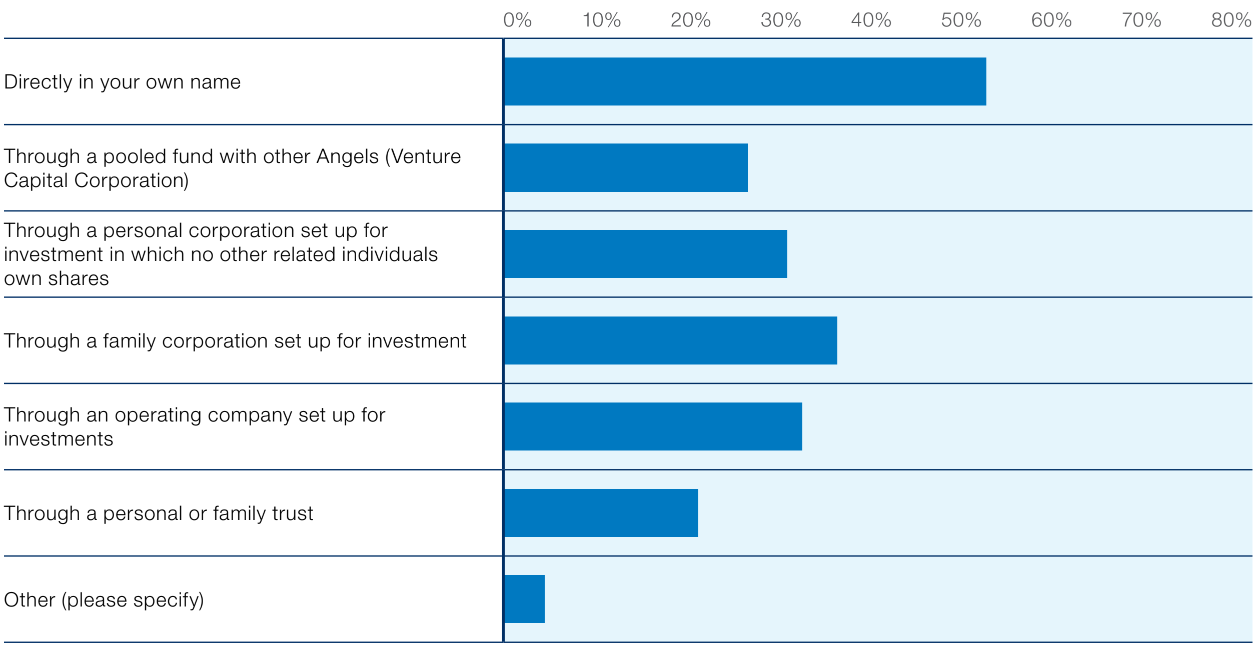
Appendix A:
The Innovation Funding Continuum

The Innovation Funding Continuum – Angels Fund Companies to Scale Up

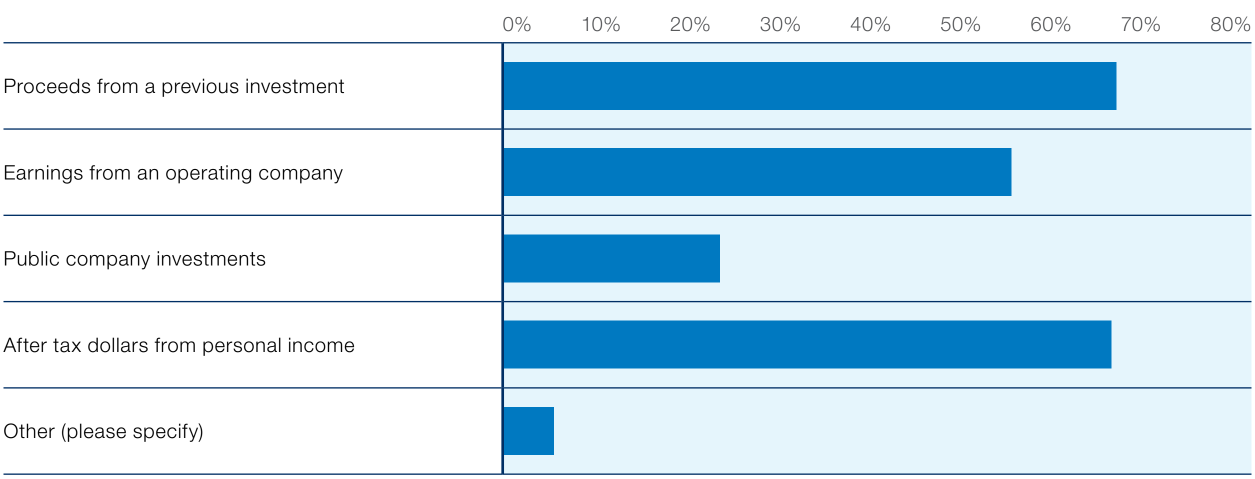


Appendix B:
Results From the NACO Member Survey on Related-Party Investment

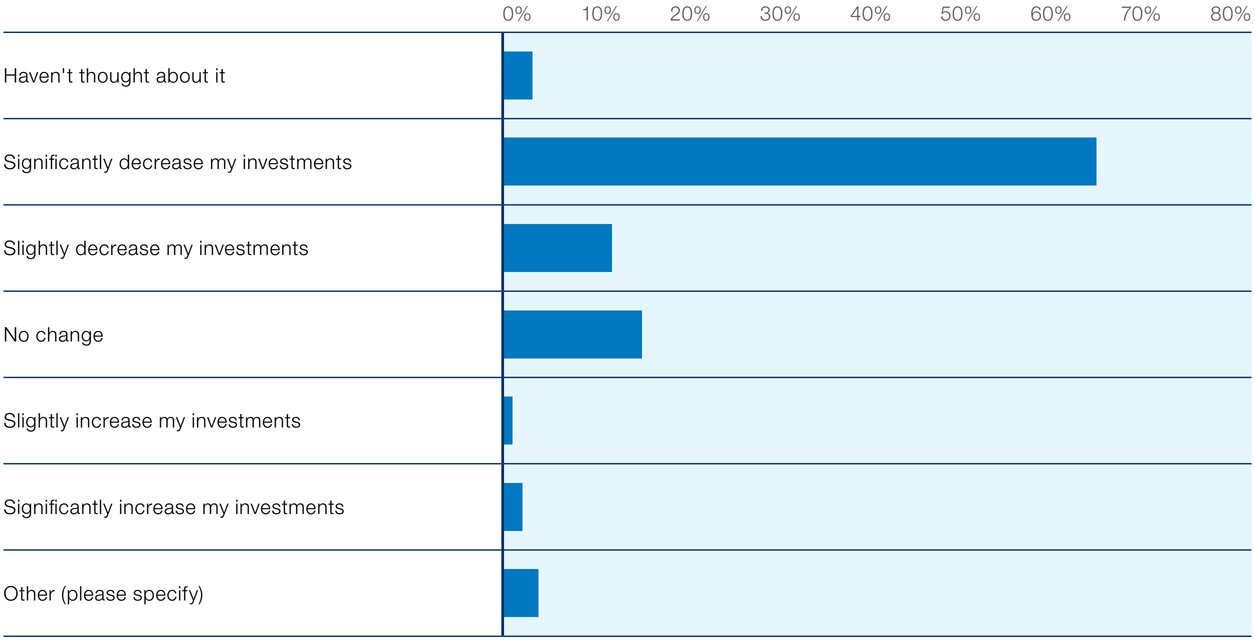
How do you structure your investments? (select all that apply)



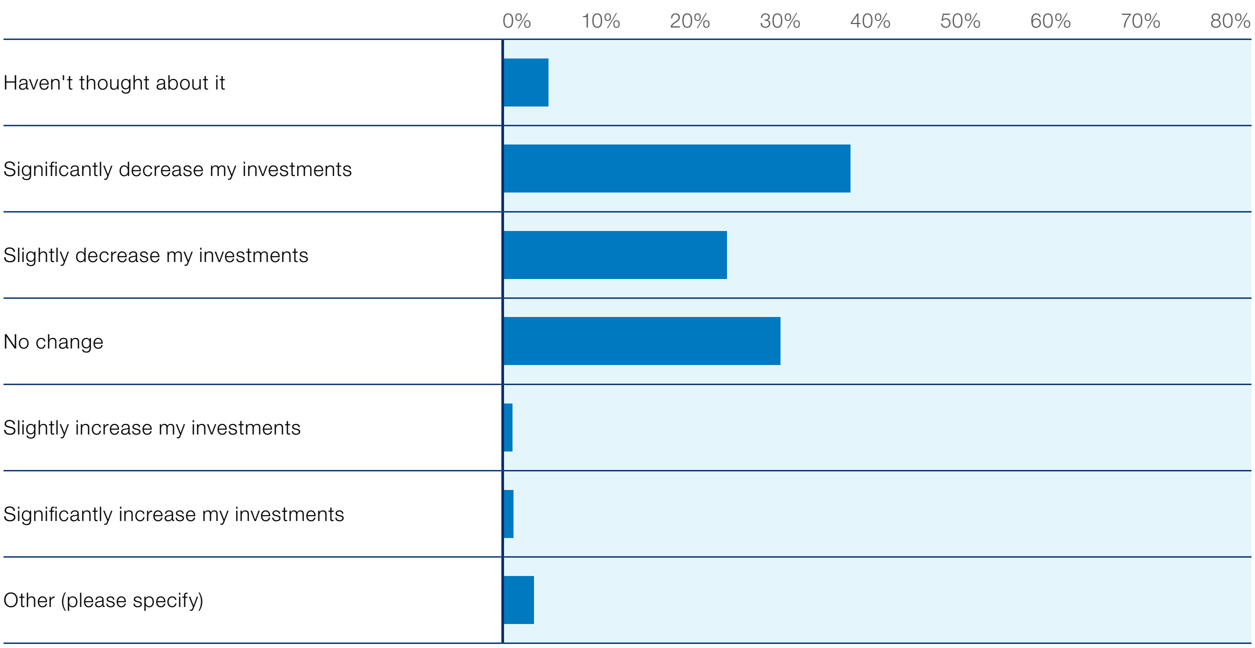
What is the source of the capital you invest? (select all that apply)



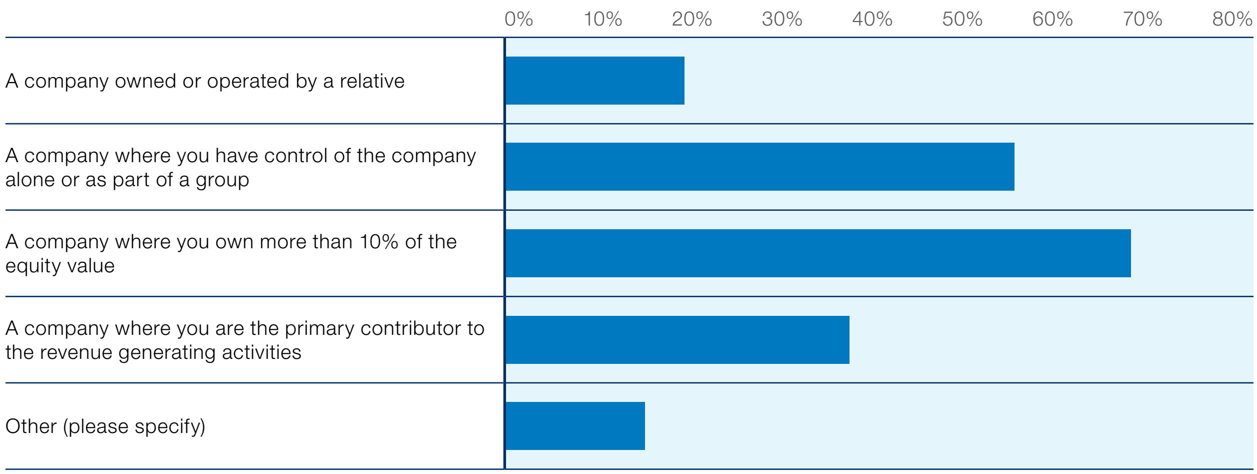
Do you anticipate that the proposal to tax investments made through private corporations as passive investment will impact your ability or willingness to Angel invest?



Do you anticipate that the changes to income-splitting/sprinkling will impact your ability or willingness to Angel invest?



Have you made investments into companies that would be considered 'connected' or related? (select all that apply)



Appendix C:
Impact of Proposed Taxation of Capital Gains and Dividends From a Canadian Controlled Private Corporation

Treatment of Investment Returns Inside a Private Holding Company Current and Proposed

Private Corporation	Capital Gain Current	Capital Gain Proposed
Capital Gain	100,000	100,000
Tax (50% capital gain inclusion rate)	(24,850)	(24,850)
Refundable Amount – Dividend	15,335	—
Available to Distribute	90,485	75,150
Capital Dividend Account	50,000	—
Taxable Dividend	40,485	75,150
Personal Income Taxes	(16,579)	(30,774)
Net After-tax Amount	**73,906**	**44,376**
	26%	56%

** British Columbia Income Tax Rates 2017

Total Tax of Reinvested Income Inside a Private Operating Company

Private Operating Company	Non-Capital Gains Passive Income Proposed System
Income	100,000
Federal Corporate Tax	10,500
Provincial Corporate Tax	3,900
Net Income	85,600
Starting Portfolio	85,600
1 Year Investment Income (3%)	2,568
Proposed New Non-Refundable Tax	(1,293)
Net After-tax Investment Income	1,275
Dividend	1,275
Tax on Dividend at 45.31%	(578)
Net Return on Investment	697
Total Investment Income	2,568
Total Effective Tax (73%)	(1,871)

* Based on numbers presented in Table 7 (p. 44) of the Department of Finance Canada, Tax Planning Using Private Corporations which use a blended tax rate of all Canadian Provinces.