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Income Taxation of Small Business:
Toward Simplicity, Neutrality, and Coherence

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I. Introduction

Among the many contributions that Judith Freedman has made to tax law and policy in the United Kingdom and around the world, one of the most sustained and significant involves the regulation and taxation of small business. Beginning with her 1994 *Modern Law Review* article on "Small Business and the Corporate Form"[1] and continuing through numerous subsequent publications on the taxation of small business,[2] Professor Freedman has consistently and persuasively argued for simplicity, neutrality, and coherence in the design of legal rules for the regulation and taxation of small businesses.

In her *Modern Law Review* article, Professor Freedman challenged proposals for a separate legal form for small businesses in the United Kingdom,[3] a theme to which she returned

[1] Judith Freedman, "Small Business and the Corporate Form: Burden or Privilege?" (1994) 57 *The Modern Law Review* 555-84 [hereafter "Small Business and the Corporate Form].
[2] See, e.g., Judith Freedman, "Why Taxing the Micro-Business is Not Simple – A Cautionary Tale from the 'Old' World" (2006), 2 *Journal of the Australasian Tax Teachers Association* 58-77 [hereafter "Taxing the Micro-Business"]; Claire Crawford and Judith Freedman, "Small Business Taxation" in Stuart Adam et. al., *Dimensions of Tax Design: The Mirrlees Review*, (Oxford: Oxford University Press, 2010) 1028-99 [hereafter "Small Business Taxation"]; and Abi Adams, Judith Freedman, and Jermias Prassi, "Rethinking legal taxonomies for the gig economy" (2018), 34:3 *Oxford Review of Economic Policy* 475-494 [hereafter "Legal Taxonomies"].
[3] Freedman, "Small Business and the Corporate Form" *supra* note 1.

in the context of the taxation of small business.[4] In the latter context, she has argued that the taxation of similar economic activities carried on through different legal forms is best addressed not by creating new classifications and complex anti-avoidance provisions to discourage tax-motivated choices among different legal categories, but by structural changes that reduce or eliminate differences between the taxation of similar activities carried on through different legal forms in order to minimize tax-motivated incentives to choose among these legal forms.[5] For this and other reasons, Professor Freedman has also questioned the rationale and effectiveness of special tax preferences for small business, particularly if these are delivered in the form of a reduced rate that is available to all small businesses, however defined.[6]

This article reviews Professor Freedman's contributions to tax law and policy regarding small business, and evaluates Canadian experience with the taxation of private companies and their shareholders in light of Professor Freedman's work. Part II summarizes Professor Freedman's main conclusions regarding the taxation of small business, addressing both the taxation of similar economic activities conducted through different legal forms and the rationale and effectiveness of special tax preferences for small business. Part III examines Canadian experience with the taxation of private companies and their shareholders, illustrating the ways in which Professor Freedman's concerns about structural tax differentials and tax preferences for small business have played out in the Canadian context. Part IV concludes with a few

[4] See, e.g., Freedman and Crawford, "Small Business Taxation" *supra* note 2 at 1061-64 (rejecting the creation of new legal categories for the taxation of small business and concluding that "the best solution will be one that does not rely on defining sub-categories of company or types of shareholder").

[5] See, e.g., Freedman, "Taxing the Micro-Business" *supra* note 2; Freedman and Crawford, "Small Business Taxation" *supra* note 2; and Adams, Freedman and Prassi, "Legal Taxonomies"" *supra* note 2.

[6] Freedman, "Taxing the Micro-Business" *supra* note 2; and Freedman and Crawford, "Small Business Taxation" *supra* note 2.

observations about how best to promote simplicity, neutrality and coherence in the taxation of small business.

II. Judith Freedman on the Taxation of Small Business

Although sometimes viewed as relatively simple and limited in scope, structural issues concerning the taxation of small, owner-managed businesses are, as Professor Freedman's co-authored contribution to the Mirrlees Review emphasizes, highly complex and pervasive in the design of the entire tax system.[7]

Because individuals may conduct similar economic activities either as employees or self-employed independent contractors, and small businesses may be carried on in unincorporated form or through a corporate entity, the existence of these different legal categories poses key questions about the rationale (if any) for differences in the tax treatment of income derived through these different legal forms, as well as important issues regarding the effects of any tax differentials on economic behaviour. As a result, while many individuals have no choice other than to provide their services as employees, and incorporation is often commercially necessary for larger businesses wishing to raise external capital, the choice among employment, self-employment and incorporation is, as Professor Freedman observes, uniquely relevant for "owner-managed businesses at the smallest end of the business sector."[8]

In addition, deliberate use of the tax system to encourage (or compensate) small business through tax preferences raises further questions about the rationales, if any, for such encouragement (or compensation), the effectiveness of specific tax preferences to address these

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[7] Freedman and Crawford, "Small Business Taxation" *supra* note 2 at 1032.
[8] *Ibid*. at 1029.

rationales, and the behavioural impact of these preferences. The following sections summarize Professor Freedman's conclusions on each of these issues, beginning with the taxation of similar economic activities conducted through different legal categories before turning to the rationale and effectiveness of special tax preferences for small business.

(1) Legal Categories, Tax Differentials, and Policy Responses

In the United Kingdom, as in many other countries including Canada, tax rules create key tax differentials between the taxation of employees and self-employed independent contractors on the one hand, and between unincorporated businesses and incorporated businesses on the other.

Employees, for example, are generally highly constrained in their ability to deduct expenses, while deductions for self-employed taxpayers are much more generous.[9] In the United Kingdom, for example, employees must satisfy a strict test of the expense being incurred "wholly, exclusively and necessarily in the performance of the duties of employment",[10] while self-employed taxpayers may deduct expenses incurred "wholly, exclusively and necessarily for the purposes of the trade."[11] In Canada, employees are allowed only those deductions that are expressly allowed under the *Income Tax Act*,[12] while self-employed taxpayers may deduct "ordinary and well-accepted" expenses in computing business profits,[13] subject to a specific

[9] See, e.g., Freedman and Crawford, "Small Business Taxation" *supra* note 2 at 1044-45.
[S] Section 336 of the *Income Tax (Earnings and Pensions) Act 2005* (ITEPA).
[11] In the UK, see s. 34 of the *Income Tax (Trading and Other Income) Act* (ITTOIA), 2005.
[12] *Income Tax* Ac, R.S.C. 1985, c. I-1 (as amended), s. 8(2) [hereafter "ITA"].
[13] *Ibid*., s. 9(1) defines a taxpayer's income from a business as the taxpayer's "profit" from that business. Canadian courts have held that this concept authorizes the deduction of business expenses the deduction of which is consistent with "ordinary principles of commercial trading" and "well-accepted business practices". See, e.g., *Imperial Oil Limited*, [1947] C.T.C. 353, (1947) 3 D.T.C. 1090 (Ex. Ct.); and *The Royal Trust Company v. Minister of National Revenue*, [1957] C.T.C. 32, 57 D.T.C. 1055 (Ex. Ct.).

statutory requirement that the expense is incurred "for the purpose of gaining or producing income from the business".[14] In addition to this important tax differential, income paid to employees is typically subject to social insurance contributions and/or payroll taxes, which are generally less substantial or not imposed on income paid to self-employed taxpayers. As well, while income paid to employees is generally subject to withholding at source, this is typically not the case for income paid to self-employed taxpayers.

As a result, as Professor Freedman has explained, tax law offers a number of incentives to treat those who supply services to an engager's business as self-employed taxpayers rather than employees.[15] Since the boundary between these two legal categories depends on detailed assessments of the facts of the particular relationship,[16] it is not surprising that this determination is among the most disputed tax issues.[17] It is also not surprising that these tax differentials have contributed to a growing shift toward self-employment over the last two decades, particularly with the rise of the so-called "gig economy".[18]

Tax differentials between unincorporated businesses and incorporated businesses are even greater than those between employees and self-employed taxpayers, due to differences in the rates at which income is subject to tax in the hands of individuals and corporations and the

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[14] ITA, *supra* note 12, s. 18(1)(a).

[15] Freedman, "Taxing the Micro-Business" *supra* note 2 at 480.

[16] Freedman and Crawford, "Small Business Taxation" *supra* note 2 at 1044 (referring to "characteristics or 'badges' of employment status"). In Canada, for example, see *Wiebe Door Services Ltd. v. Minister of National Revenue*, [1986] 2 C.T.C. 200, 87 D.T.C. 5025 (F.C.A.), which established a test that looks to "the total relationship" between the parties, considering traditional factors like control, as well as economic factors such as chance of profit and ownership of tools, and the extent to which the taxpayer is integrated into the engager's business when viewed from the perspective the taxpayer.

[17] See the cases discussed in David G. Duff, et. al., *Canadian Income Tax Law*, (Toronto: LexisNexis, 2018) at 211-218.

[18] Adams, Freedman and Prassi, "Legal Taxonomies"" *supra* note 4.

ease with which corporate income facilitates the conversion of what would otherwise be higher-taxed labour income into lower-taxed income from capital.

Although corporate income tax rates in many countries were once comparable to the highest marginal rate of income tax for individuals, this is no longer the case as globalization and capital mobility have placed downward pressure on corporate income tax rates at the same time as growing economic inequalities have created political pressure to increase top marginal rates of personal income tax. In Canada, for example, the average combined federal and provincial tax rate on corporate income not that does not qualify for a special "small business" rate was almost 45 percent in 2000, which was only slightly less than the average combined federal and provincial top personal income tax rate at the time.[19] Since then, the average combined federal and provincial tax rate on corporate income not eligible for the small business rate has fallen to 26.8 percent, while the average top marginal federal and provincial income tax rate for individuals has increased to 51.6 percent.[20] Similarly in the United Kingdom, while the general corporate tax rate fell from 35 percent in 2000 to 19 percent in 2017, the top marginal personal tax rate increased from 40 percent to 45 percent over this period. Although the ultimate impact of these tax differentials depends on the taxation of corporate distributions and the taxation of gains on the sale or liquidation of corporate shares, dividends or gains may also be subject to tax at reduced rates, and the ability to defer the distribution of corporate income or the sale or liquidation of corporate shares means that lower corporate tax rates can yield both permanent and temporary tax reductions.

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[19] See, e.g., Department of Finance Canada, *Tax Planning Using Private Corporations* (Ottawa; Department of Finance, 2017) at 12, Chart 5.
[20] *Ibid*.

In addition to the advantage of a lower income tax rate, incorporation also allows owner-managers to convert what would otherwise be income from labour into income from capital that may be distributed in the form of dividends or realized in the form of gains on the sale or liquidation of corporate shares.[21] Since dividends or capital gains may be subject to tax at lower rates than those applicable to business or employment income,[22] and are generally not subject to social insurance contributions and/or payroll taxes,[23] this ability to convert labour income into capital income creates an additional tax advantage for small businesses to incorporate.[24] As well, the conversion of labour income into capital income makes it much easier to split income with non-arm's length persons such as spouses and children who acquire shares in a corporation, creating yet another potential tax benefit to incorporation.[25]

Just as the tax differentials between employees and self-employed taxpayers create incentives for workers to become self-employed, so also do the tax differentials between unincorporated businesses and incorporated businesses create powerful incentives for small owner-managed businesses to incorporate. As a result, it is not surprising the number of corporations increased dramatically in the United Kingdom after the introduction of a nil rate for small companies in 2000,[26] and that the number of small business corporations in Canada

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[21] Freedman and Crawford, "Small Business Taxation" *supra* note 2 at 1049.

[22] This is particularly the case with capital gains, which are subject to entrepreneur's relief in the UK, and also favoured in Canada both by taxing only half the gain and through a "lifetime capital gains deduction" that currently exempts over $860,000 of gains realized on the disposition of "qualified small business corporation shares" over the course of a taxpayer's lifetime. See the discussion at *infra*, text accompanying notes 140-158.

[23] In the United Kingdom, on the other hand, recent changes to dividend taxation appear to have been designed to address this differential to some extent. See Glen Loutzenhiser, "Where next for small company tax reform in the UK?" [2016] *British Tax Review* 674-99.

[24] Freedman and Crawford, "Small Business Taxation" *supra* note 2 at 1049.

[25] *Ibid*.

[26] *Ibid*. at 1054-56.

increased by 50 percent from 2001 to 2014 after the Supreme Court of Canada sanctioned a previously uncertain income-splitting arrangement involving the payment of discretionary dividends by private companies.[27] Nor is it surprising that most of these incorporations have involved owner-managed small businesses with few or no employees,[28] since it is precisely these kinds of businesses that are apt to be most responsive to tax differentials between these different legal categories.

In response to this tax-motivated behaviour, governments often enact complex statutory rules, which as Professor Freedman's co-authored contribution to the Mirrlees Review emphasizes, "attempt, often unsuccessfully, to confine the tax advantages to a subcategory."[29] Alternatively or additionally, revenue authorities may rely on specific or general anti-avoidance rules to challenge tax-motivated arrangements to obtain tax benefits available through specific legal categories.

[27] Department of Finance Canada, *Tax Planning Using Private Corporations*, *supra* note 19 at 11, Chart 4. The case at issue, and the limited legislative response to the decision are discussed later in this article at *infra*, text accompanying notes 39-42 and 159-167. Although the average combined federal and provincial rate of tax on small business income decreased from 20 percent to 14.4 percent during this period, the opportunity to split income was much more significant, particularly when several provincial governments allowed non-medical practitioners to hold shares in professional corporations, thereby effectively offloading part of the cost of negotiating with medical professional on the federal treasury. See also Michael Wolfson and Scott Legree, "Policy Forum: Private Companies, Professionals and Income-Splitting – Recent Canadian Experience" (2015), 63:3 *Canadian Tax Journal* 717-37.

[28] For evidence from the UK, see Freedman and Crawford, "Small Business Taxation" *supra* note 3 at 1056-58, reporting that the number of companies with no employees increased by approximately 50 percent from 2000 to 2006, while those with 1 to 9 employees increased by less than 40 percent and those with 10 or more employees increased by less than 20 percent. For evidence from Canada, see Department of Finance Canada, *Tax Planning Using Private Corporations*, *supra* note 19 at 11, reporting that the number of incorporated self-employed individuals doubled between 2000 and 2016 and the number of professional services corporations tripled during this period.

[29] Freedman and Crawford, "Small Business Taxation" *supra* note 2 at 1061.

In the United Kingdom, for example, the introduction of a nil tax rate on small companies was accompanied by the enactment of personal service company (PSC) rules that are designed to discourage employees from incorporating by subjecting the earnings of these companies to income tax and National Insurance Contributions (NICs) as if the income had been earned directly by the individual performing services.[30] Subsequent rules aimed to deny the benefit of the nil rate to profits that were not reinvested in the business by applying an additional tax on corporate distributions paid out of profits that were taxed at a rate lower than the regular small company rate.[31] Although the latter rules were repealed along with the nil rate in 2006, the PSC rules remain.

Similarly in Canada, where a "small business deduction" reduces the rate of tax on the "active business income" of "Canadian-controlled private corporations",[32] access to this low rate is precluded for personal services businesses (PSBs) in which an "incorporated employee" performs services on behalf of the corporation.[33] Although the Canadian rules do not look through the corporation to tax this income as if it were earned directly by the individual performing the services, other provisions deny the deduction of most expenses incurred by a PSB other than remuneration and benefits paid to the "incorporated employee"[34] and subject income

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[30] *Ibid*. at 1050.
[31] Freedman, "Taxing the Micro-Business" *supra* note 2 at 69; and Susan Ball, "The Non-Corporate Distribution Rate – Section 28 and Schedule 3" [2004] *British Tax Review* 459.
[32] ITA, *supra* note 12, s. 125. See the discussion at *infra*, text accompanying notes 99-138.
[33] *Ibid*., s. 125(7) "personal services business".
[34] *Ibid*., s. 18(1)(p).

that is received by the PSB to a rate of federal income tax equal to the highest federal marginal tax rate imposed on individuals.[35]

In order to challenge income-splitting arrangements involving private corporations, the United Kingdom has generally relied on anti-avoidance rules rather than detailed statutory provisions, invoking the "settlements provisions" in *Jones v. Garnett*.[36] While the taxpayer prevailed at the Court of Appeal and at the House of Lords, the reasons for these judicial decisions differed sharply, leaving some uncertainty as to precisely when these provisions might apply – as borne out at least one subsequent decision by a Special Commissioner.[37] Although the Labour Government of the day introduced draft legislation to address family income-splitting arrangements, implementation of this legislation was postponed and the legislation was eventually withdrawn.[38]

In Canada, on the other hand, where a 1998 decision by the Supreme Court of Canada sanctioned a previously uncertain income-splitting arrangement involving the payment of discretionary dividends by private companies,[39] the government of the day was quick to enact a

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[35] This is accomplished by a number of provisions, beginning with the general corporate rate of 38 percent in *ibid*., s. 123(1), a 10 percent deduction for income earned in a province under *ibid*., s. 124(1), and an additional tax of 5 percent under *ibid.*, s. 123.5. Although provincial corporate and individual rate rates vary, this equivalence generally also applies when provincial income taxes are taken into account.
[36] Glen Loutzenhiser, "Tax Avoidance, Private Companies and the Family" (2013), 72(1) *Cambridge Law Journal* 35-49.
[37] *Buck v. Revenue & Customs Commissioners*, [2009] S.T.C. (S.C.D.) 6, discussed in *ibid*. at 43.
[38] Loutzenhiser, "Tax Avoidance, Private Companies and the Family" *supra* note 36 at 42.
[39] *Neuman v. The Queen*, [1998] 1 S.C.R. 770, [1998] 3 C.T.C. 177, 98 D.T.C. 6297 (S.C.C.), relying on the Supreme Court of Canada's prior decision in *McClurg v. The Queen*, [1990] 1 S.C.R., [1991] 1 C.T.C. 169, 91 D.T.C. 5001 (S.C.C.) to conclude that the payment of discretionary dividends on a class of shares held by the taxpayer's spouse was not subject to the attribution rule in ITA, *supra* note 12, s. 56(2). For a critical review of the decision, see David G. Duff, "*Neuman* and Beyond: Income Splitting, Tax Avoidance, and Statutory Interpretation in the Supreme Court of Canada" (1999), 32 *Canadian Business Law Journal* 345-383.

legislative response in the form of a separate "tax on split income" (TOSI) which subjected most private company dividends received by individuals under the age of 18 to tax at the top marginal rate of personal income tax.[40] Since this provision applied only to individuals under the age of 18, however, income-splitting through private corporations continued to be available for spouses and adult children, contributing to a 50 percent rate of growth in the number of Canadian-controlled private corporations over the following 15 years, with much higher rates of growth for self-employed individuals and professional corporations.[41] The government returned to the issue in 2017, proposing to extend the TOSI rules to adult individuals receiving dividends from and capital gains from the disposition of shares of private companies over which a connected individual exercises significant influence, unless these amounts are reasonable in the circumstances taking into account contributions of labour and capital.[42] After considerable controversy, a substantially revised and considerably more complex version of these rules was enacted effective for the 2018 taxation year.

Reflecting her consistent emphasis on simplicity and neutrality in tax rules, Professor Freedman has been sharply critical of these responses to differences in the tax treatment of similar economic activities carried on through different legal forms. Of the PSC rules, for example, she has written that they are "complex and uncertain" in their application, relying on the same fact-based tests that are used to distinguish employees from self-employed taxpayers, and that they impose "a cost and burden on a greater number of business owners than are ultimately

[40] *ITA, supra* note 12, s. 120.4. In order to prevent share sales designed to avoid the provision, it was subsequently extended to capital gains from the sale of private company shares to non-arm's length persons.
[41] Department of Finance Canada, *Tax Planning Using Private Corporations*, *supra* note 19 at 11.
[42] *Ibid*. at 23-28.

subject to the provisions, because many people need to seek advice."[43] Similar criticisms might be levied on the PSB rules in the Canadian ITA, which also rely on the same fact-based determinations that are used to distinguish employees from self-employed taxpayers.[44]

Professor Freedman has also questioned the use of anti-avoidance provisions to challenge income-splitting arrangements involving private corporations, arguing that this approach "has created serious uncertainty for many small businesses and a general sense of persecution", and denouncing this response as "a lazy approach to policy making because the problem is perceived as being too hard to tackle with specific and structural legislation."[45] At the same time, she has also criticized the proposed legislative response to *Jones v. Garnett*, maintaining that these provisions were "complex and fact dependent, leading to justified criticisms that [they] would be heavy in compliance and administrative costs and yet would probably raise little revenue."[46] Here too, similar criticisms may be directed at Canada's TOSI rules, which are extraordinarily complex and also dependent on fact-based determinations, notwithstanding the existence of specific safe harbours that inevitably add to the complexity.

Rejecting these limited legislative and judicial responses to the existence of tax-differentials among similar economic activities carried on through different legal forms, Professor

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[43] Freedman, "Taxing the Micro-Business" *supra* note 2 at 72, adding that: "This is a source of a great deal of angst for business people, which causes considerable annoyance beyond those in fact subject to the legislation. It also creates a great deal of work for professional advisors, but work which they would perhaps prefer not to have as it is not especially productive or lucrative." See also Loutzenhiser, "Tax Avoidance, Private Companies and the Family" *supra* note 36 at 43-44.

[44] See the definition of "personal services business" in ITA, *supra* note 12, s. 125(7), which turns on whether the incorporated employee "would reasonably be regarded as an officer or employee of the person or partnership to whom or to which the services were provided but for the existence of the corporation".

[45] Freedman, "Taxing the Micro-Business" *supra* note 2 at 74,

[46] Freedman and Crawford, "Small Business Taxation" *supra* note 2 at 1053.

Freedman has instead favoured structural changes that reduce or eliminate these tax differentials themselves – arguing that the optimal policy response to tax-motivated responses to these tax differentials is "to align the tax payable by each group as far as possible, such that the boundaries matter less or, if possible, not at all, for tax purposes."[47] For this reason, she has argued that "if it is desired to tax income from incorporated firms as labour income, then it would be preferable to achieve this through structural changes to the tax system" instead of through complicated provisions like the PSC rules that aim to re-characterize corporate income as employment income.[48] For the same reason, she has also argued that responses to the use of private corporations to split income with related individuals should be addressed "in a holistic way, looking at the rules on family taxation, small business taxation and capital transfers between spouses" as a whole,[49] recognizing that the "fundamental issue" involves the re-characterization of income from labour as income from capital.[50] In principle, therefore, her preferred approach would be that "[i]ndividuals who are identical in every way except their legal form should not face radically divergent tax incentives."[51] For this reason, her co-authored contribution to the Mirrlees Review suggests that a possible solution to the existence of tax differentials for small businesses carried on through different legal forms "might be to treat employees through to companies across the whole small business spectrum in exactly the same way for tax purposes, taxing them on the same receipts at exactly the same rate."[52]

[47] Adams, Freedman and Prassi, "Legal Taxonomies"" *supra* note 2 at 486.
[48] Freedman and Crawford, "Small Business Taxation" *supra* note 2 at 1052.
[49] Freedman, "Taxing the Micro-Business" *supra* note 2 at 74.
[50] Freedman and Crawford, "Small Business Taxation" *supra* note 2 at 1054.
[51] Adams, Freedman and Prassi, "Legal Taxonomies"" *supra* note 2 at 484.
[52] Freedman and Crawford, "Small Business Taxation" *supra* note 2 at 1032.

Notwithstanding this conceptual ideal, however, Professor Freedman has recognized that practical and theoretical considerations may justify some tax differentials for income obtained through different legal forms. Explaining that receipts "vary in nature" and that "an employee's wage cannot be equated with the receipts of a business", for example, Professor Freedman's co-authored contribution to the Mirrlees Review suggests that a taxpayer's income from employment must be computed differently from that of a self-employed taxpayer, for whom the computation of business income requires "the application of rules from which it is possible to derive a profit figure."[53] As well, observing that globalization and capital mobility have created downward pressure on corporate income tax rates,[54] Professor Freedman also acknowledges the enduring presence of tax differentials between labour income and capital income, suggesting however that these differentials are best addressed by structural reforms that prevent the conversion of labour income into capital income.[55]

As a result, although Professor Freedman seems to suggest that rules for computing the income of employees and self-employed taxpayers might reasonably differentiate among allowable deductions,[56] she maintains that tax differentials on income derived through these different legal forms should be reduced by aligning NICs on income earned by employees and self-employed taxpayers and requiring tax and NIC contributions to be deducted on payments to self-employed taxpayers.[57] Similarly for income derived through incorporated businesses,

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[53] *Ibid*.
[54] *Ibid*. at 1064.
[55] *Ibid*. at 1033.
[56] Although Professor Freedman is not clear on this point, it appears to be a reasonable inference from the suggestion in her co-authored contribution to the Mirrlees Review that "an employee's wage cannot be equated with the receipts of a business." *Ibid*. at 1032.
[57] Adams, Freedman and Prassi, "Legal Taxonomies"" *supra* note 2 at 493.

Professor Freedman has suggested that tax differentials are best addressed by aligning effective tax rates "after taking into account capital investment"[58] by distinguishing labour income from capital income and subjecting the former to NICs and taxation at the higher rates applicable to individuals. To this end, her co-authored contribution to the Mirrleess Review proposes that the United Kingdom should adopt a dual income tax similar to that in the Nordic countries, including an allowance for corporate equity (ACE) in computing corporate income that would exclude the normal rate of return on corporate assets while taxing other corporate income at higher rates that apply to individuals.[59] Correspondingly, unincorporated businesses would pay the capital income tax rate on an imputed return on business assets, with the remainder taxable at higher rates of tax applicable to labour income.[60] Although this approach would not eliminate the ability of owner-managers to split their income with non-arm's length persons, it would reduce the resulting tax advantages by taxing income other than the normal return to capital at the labour income tax rate.[61] Similar proposals have been made for a dual income tax in Canada,[62] but these recommendations have yet to be adopted in the Canada or the United Kingdom.

(2) Tax Preferences for Small Business

Consistent with these proposals for structural changes to reduce or eliminate tax differentials for similar economic activities carried on through different legal forms, Professor Freedman has also rejected special tax preferences for small business – particularly if these are

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[58] Freedman and Crawford, "Small Business Taxation" *supra* note 2 at 1030.
[59] *Ibid*. at 1067.
[60] *Ibid*. at 1068.
[61] *Ibid*. at 1069.
[62] See, e.g., Kevin Milligan, *Tax Policy for a New Era: Promoting Economic Growth and Fairness*, (Toronto: C.D. Howe Institute, 2014).

delivered in the form of reduced rates such as the short-lived nil rate in the United Kingdom or the small company rate that was eliminated in 2015. Although recognizing that market failures may justify tax incentives for certain kinds of behaviour, such as research and development, and that some such incentives might reasonably differentiate between small and medium-sized enterprises (SMEs) and larger corporations,[63] Professor Freedman has challenged each of the three leading arguments in favour of broad-based tax preferences for small businesses: first, that they are necessary to address structural challenges that small enterprises experience obtaining finance; second, that they compensate for structural issues in being small such as the regressive impact of compliance burdens and an inability to set off losses against profits; and more generally that small businesses are important engines of economic growth and job creation, which itself justifies support through the tax system.[64]

Beginning with the last of these arguments, there is little evidence to support the claim that small business is crucial to economic growth or job creation. Although studies suggest that incorporated businesses are more likely to grow than unincorporated businesses,[65] it is unclear whether incorporation is a cause or effect of growth, since businesses that wish to grow are likely to incorporate at some point,[66] while other businesses that do not wish to grow may incorporate primarily for tax reasons.[67] Nor are all small businesses effective vehicles for job creation, since

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[63] Freedman and Crawford, "Small Business Taxation" *supra* note 2 at 1078-80, noting that smaller enterprises may have fewer opportunities to balance costs against profits from other activities. For this reason, Canadian tax assistance for research and development carried on by private companies is generally provided in the form of refundable tax credits. ITA, *supra* note 12, s. 127(10) and 127.1(1).
[64] *Ibid*. at 1074.
[65] See, e.g., David J. Story, *Understanding the Small Business Sector*, (Abingdon: Routledge, 1994) at 140.
[66] Freedman, "Taxing the Micro-Business" *supra* note 2 at 64.
[67] *Ibid*., characterizing many of these small businesses as "life-style businesses" that are carried on for non-tax reasons, but incorporated for tax reasons.

many closely-held corporations have no employees and only a minority of small enterprises create jobs.[68] Where small businesses do create jobs, moreover, these jobs may not endure, as studies suggest that only a small percentage of SMEs last for more than ten years.[69] As a result, Professor Freedman concludes, tax preferences that are conferred on small businesses in order to encourage growth and job creation are apt to be poorly targeted and ineffective, encouraging the tax-motivated incorporation of small businesses more than the economic outcomes that these tax preferences are intended to promote.[70]

Nor is there strong evidence of any pressing market failure in the financing of SMEs. Although it is reasonable to conclude that many new businesses find it more difficult to raise capital than established enterprises,[71] Professor Freedman rightly explains that an effective policy response to this market failure would target newly-established businesses, not small businesses as a whole, many of which may not wish to expand and have little or no need for finance.[72] Indeed, by withdrawing tax benefits as new enterprises grow, tax preferences targeted at small businesses may create a barrier to this growth instead of removing one.[73] According to one study, for example, by encouraging economic activity through SMEs rather than larger corporations, Canada's small business deduction may contribute to lower productivity in Canada than in other developed countries.[74] As a result, instead of enhancing economic efficiency by

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[68] Freedman and Crawford, "Small Business Taxation" *supra* note 2 at 1038 and 1075.
[69] Kenneth Hendricks, Raphael Amit and Diana Whistler, *Business Taxation of Small and Medium-Sized Enterprises in Canada*, Working Paper 97-11, Prepared for the Technical Committee on Business Taxation (October 1997) at 1, reporting that only 20 percent of SMEs existed ten years later.
[70] Freedman, "Taxing the Micro-Business" *supra* note 2 at 64.
[71] *Ibid*.
[72] Freedman and Crawford, "Small Business Taxation" *supra* note 2 at 1078.
[73] *Ibid*. at 1080.
[74] Duanjie Chen and Jack M. Mintz, "Small Business Taxation: Revamping Incentives to Encourage Growth" (2011), 4:7 *School of Public Policy Research Papers* 1-29 (University of Calgary School of Public Policy).

counteracting a market failure, tax preferences for small businesses may actually impede economic efficiency.[75]

In contrast to a lack of evidence to support arguments that small business is essential to economic growth and job creation and systematically disadvantaged in raising finance, there is considerable evidence indicating that small businesses experience a disproportionate burden to comply with tax rules and other regulatory obligations by virtue of their size alone.[76] It is also reasonable to conclude that SMEs may be more constrained than larger enterprises in their ability to set off losses against profits. As Professor Freedman's co-authored contribution to the Mirrlees Review notes, however, this constraint is more likely to apply to new enterprises than more established enterprises, and is probably best addressed by permitting some pass-through treatment for corporate losses, particularly new corporations, than by a broader tax preference for all small businesses in the form of a reduced rate of tax.[77]

Although disproportionate compliance costs may justify some relief provisions, such as reduced reporting requirements or income thresholds for VAT registration,[78] it is also not obvious that this structural disadvantage is best addressed by a reduced rate of income tax for all small businesses. On the contrary, Professor Freedman cautions, since a low corporate tax rate for small business is apt to be accompanied by detailed anti-avoidance rules to prevent abuse, a tax

[75] Freedman, "Taxing the Micro-Business" *supra* note 2 at 61, concluding that tax preferences for small businesses "may distort the market in unintended ways by, for example, resulting in the allocation of resources to small firms in circumstances where larger firms could be used more efficiently."
[76] See, e.g., Chris Evans, Ann Hansford, John Hasseldine Philip Lignier, Sharon Smulders and Francois Vaillancourt, "Small business and tax compliance costs: A cross-country study of managerial benefits and tax concessions" (2014) 12:2 *eJournal of Tax Research* 453-82.
[77] Freedman and Crawford, "Small Business Taxation" *supra* note 2 at 1084.
[78] *Ibid*. at 1081-82.

preference along these lines can add to the complexity of the tax system, thereby increasing compliance burdens for enterprises wishing to benefit from the preference.[79] In addition, complexity and compliance costs are often compounded by the fact that these anti-avoidance rules are often revised and extended to address novel forms of abuse.[80]

In the United Kingdom, for example, where a nil rate of tax on the first £10,000 of corporate income was introduced in 2002, complicated anti-avoidance rules were subsequently enacted in order to increase the corporate tax rate on distributions paid out of profits taxed at less than the general corporate tax rates, thereby negating the advantage of the nil rate on these profits.[81] Likewise in Canada, where a small business deduction reduces the rate of corporate tax on the first $500,000 of active business income of a Canadian-controlled private corporation, numerous and increasingly complicated anti-avoidance rules aim to prevent the multiplication of this deduction through "associated corporations" and other arrangements.[82] It is ironic, therefore, that those defending the Canadian deduction often point to the costs that businesses bear in order to comply with tax rules as a central rationale for the preservation of a tax preference that greatly contributes to these compliance costs.[83]

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[79] *Ibid*. at 1082-83, characterizing this outcome as a form of "complex deregulation".

[80] Freedman, "Taxing the Micro-Business" *supra* note 2 at 65-67, explaining that compliance and administrative costs are increased not only by the complexity of legal rules, but by frequent changes in legal rules.

[81] *Ibid*. at 69, citing one commentator who described these anti-avoidance provisions as "bordering on the surreal".

[82] See, e.g., the associated corporation rules in ITA, *supra* note 12, s. 256, and recently-enacted rules denying the small business deduction for income from the provision of services or property to a private corporation where the corporation, one of its shareholders or a person who does not deal at arm's length with the corporation or one of its shareholders holds a direct or indirect interest in the private corporation to which the services or property are provided. *Ibid*., s. 125(1)(a) and 125(7) "specified corporate income" and "specified partnership income".

[83] See, e.g., Ted Mallet, "Policy Forum: Mountains and Molehills – Effects of the Small Business Deduction" (2015), 63:3 *Canadian Tax Journal* 691-704.

In addition to the complexity associated with a low corporate tax rate for small business, moreover, experience suggests that this kind of tax preference can be extremely costly in terms of foregone revenues. In the United Kingdom, which offered a reduced corporate tax rate for small companies until 2015, the cost of this tax preference was estimated at £1.585 billion in 2013-14.[84] In Canada, the annual cost of the small business deduction in terms of foregone federal income tax revenue was estimated at $3.75 billion in 2016, an amount that is projected to increase to $5.585 billion in 2019 – making it the second most costly corporate tax expenditure after the partial taxation of capital gains.[85]

Finally, studies indicate that a low corporate tax rate for small business provides the most benefit to high-income shareholders and family members who are able to obtain the greatest advantage from the deferral and income-splitting opportunities that are available when income is derived through private corporations. According to one Canadian study, less than 5 percent of tax filers in the lower half of the income distribution own CCPC shares versus 65-80 percent of tax filers in the top 0.1 percent of the income distribution.[86] Another study documents the extent to which CCPCs have been used for income-splitting purposes, particularly by high-income professionals.[87] For these reasons, it is not surprising that a prominent Canadian economist has

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[84] Her Majesty's Revenue and Customs, "Estimated costs of principal tax reliefs" available at https://www.gov.uk/government/statistics/main-tax-expenditures-and-structural-reliefs.

[85] Canada, Department of Finance, *Report on Federal Tax Expenditures – Concepts, Estimates and Evaluations 2019* (Ottawa: Department of Finance, 2019) at 29 [hereafter Canada, *Report on Federal Tax Expenditures*], available at https://www.fin.gc.ca/taxexp-depfisc/2019/taxexp-depfisc19-eng.pdf.

[86] Michael Wolfson, Mike Veall, Neil Brooks and Brian Murphy, "Piercing the Veil: Private Corporations and the Income of the Affluent" (2016), 64:1 *Canadian Tax Journal* 1-30.

[87] See, e.g., Michael Wolfson and Scott Legree, "Policy Forum: Private Companies, Professionals and Income-Splitting – Recent Canadian Experience" (2015), 63:3 *Canadian Tax Journal* 717-737.

reported that 60 percent of the tax benefit from the small business deduction goes to households with more than $150,000 in income.[88]

Given these criticisms, it is perhaps surprising that several countries, including Canada and the United Kingdom, have provided preferential corporate tax rates for small business, and that these tax preferences have persisted over many years.[89] As Professor Freedman's co-authored contribution to the Mirrlees Review notes, the explanation for this result is largely political, as the small business community is vocal, well-organized and broadly supported by the media and the general public, leading to "the introduction of reliefs which then become entrenched into the system and are hard to remove even if found unhelpful."[90] Nonetheless, this study continues, experience with the United Kingdom's nil corporate tax rate in the early 2000s demonstrates that "business will broadly support simplifying measures where the reliefs have become very complex."[91] Indeed, it is testament to the influence of the Mirrlees Review's recommendation that the general corporate rate should be aligned with the small business rate,[92] that the United Kingdom eliminated the preferential rate for small business in 2015 by reducing the general corporate rate to the lower rate applicable to small business. In Canada, on the other hand, recent efforts to limit the use of private corporations for tax planning produced

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[88] Jack Mintz, quoted in Bill Curry and Steven Chase, "Tories to table tax-cut-heavy federal budget plan", *Globe & Mail* (April 21, 2015).

[89] For an excellent, though now somewhat dated, survey of small business taxation in Australia, Canada, the United Kingdom and the United States of America, see Neil Brooks, "Taxation of Closely-Held Corporations: The Partnership Option and the Lower Rate of Tax" (1986), 3:4 *Australian Tax Forum* 381-509.

[90] Freedman and Crawford, "Small Business Taxation" *supra* note 2 at 1086.

[91] *Ibid*.

[92] *Ibid*. at 1066 and 1071.

a political backlash that ultimately led the federal government to actually increase the differential between the general corporate rate and the small business rate.[93]

III. Canadian Experience with the Taxation of Private Companies and Their Shareholders

As noted earlier, Canada provides a preferential corporate tax rate for small business, which is delivered in the form of a "small business deduction" that reduces the federal tax rate on the first $500,000 of active business income earned in a taxation year by a Canadian-controlled private corporation (CCPC).[94] It also maintains a preferential regime for capital gains, only half of which are subject to tax,[95] and exempts over $800,000 of capital gains from the disposition of "qualified small business corporation shares" that are realized by resident individuals over the course of their lifetimes.[96]

Together with other tax benefits resulting from incorporation, such as the ability to convert labour income in to capital income and the ability to split income more easily with related persons, these provisions create strong incentives for resident individuals to incorporate otherwise unincorporated enterprises, and for these shareholders to access corporate surpluses in the form of capital gains from the sale or liquidation of shares, rather than the distribution of dividends which are generally taxable at personal tax rates.[97] Instead of pursuing the kinds of structural reforms that Professor Freedman advocates in order to reduce or eliminate these tax differentials, however, Canadian governments have relied on increasingly complicated statutory

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[93] See the discussion at *infra*, text accompanying notes 134-138.
[94] ITA, *supra* note 12, s. 125.
[95] *Ibid*., s. 38, generally limiting the taxable amount of a capital gain and the allowable amount of a capital loss to one-half of the capital gain or loss.
[96] *Ibid*., s. 110.6(2.1).
[97] As explained more fully below, these dividends are subject to a gross-up and tax credit mechanism designed to integrate corporate and individual income taxes. *Supra* note 139 and accompanying text.

provisions and anti-avoidance rules in order to limit the scope of these tax preferences. The following sections review Canadian experience with the taxation of private companies and their shareholders, illustrating how Professor Freedman's concerns have played out in the Canadian context.

(1) Taxation of Private Companies

The key elements of the small business deduction date from 1972, when the federal government replaced a two-tiered rate structure for all corporate income that had existed since 1949.[98] Although the Canadian Royal Commission on Taxation (Carter Commission) rejected arguments for a preferential small business rate in its 1967 Report,[99] and the federal government's 1969 White Paper recommended that that the dual rate structure should be abolished,[100] political opposition led the government to replace the lower corporate rate with a tax credit that effectively reduces the federal corporate tax rate for qualifying income of eligible corporations.[101] When first introduced in 1972, this credit reduced the corporate tax rate by 25 percent from a general rate of 50 percent to a small business rate of 25 percent.[102] With long-term reductions in the corporate tax rates, however, this rate differential had decreased substantially by 2011, by which time the general federal corporate tax rate was 15 percent and the federal small business rate was 11 percent.[103]

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[98] See Brooks, *supra* note 89 at 422-25.
[99] Canada, Royal Commission on Taxation, *Report*, vol. 4 (Ottawa: Queen's Printer, 1967) at 270-73.
[100] Hon. E.J. Benson, Minister of Finance, *Proposals for Tax Reform* (Ottawa: Queen's Printer, 1969) at 27, paras. 4.15 to 4.18.
[101] See Brooks, *supra* note 89 at 434-37.
[102] *Ibid*. at 437.
[103] This rate differential is greatly increased, however, by provincial corporate income taxes, for which general corporate rates current range from 11 to 16 percent and small business rates range from 2 to 6 percent. Although all provincial and territorial governments levy their own income taxes, provincial

In order to target the small business deduction to small businesses, the original provision included three features which remain to this day. First, the credit is available only to private corporations, not public corporations or corporations controlled by one or more public corporations – presumably since private corporations cannot raise capital by issuing shares to the public.[104] Second, the credit is limited to a maximum amount of qualifying income for each taxation year (originally $50,000 but now $500,000), which must be shared among CCPCs that are "associated" with each other in the year.[105] Finally, the credit applies only to the corporation's income from an "active business carried on" by it in Canada so as to exclude its use to reduce the rate of tax on income from passive investments held by a private corporation.[106]

In addition to these elements, the original legislation included two other features intended to target the incentive to new small businesses that would use the tax savings to invest in their businesses. First, in order to limit the incentive to new small businesses, the legislation included a "total business limit" that limited the maximum amount of qualifying income that could benefit from the credit to an aggregate amount.[107] Second, in order to discourage qualifying corporations from using the tax savings to accumulate passive investments, the legislation included a special refundable tax on "ineligible investments" that effectively eliminated the benefit of the credit when a qualifying corporation made an investment that was

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income taxes are generally collected by the federal government under tax collection agreements whereby the provinces agree to adopt the same definition of taxable income as the federal income tax, while maintaining freedom to set their own rates.

[104] The credit is further limited to corporations that are not controlled by one or more non-residents in order to ensure that the benefit flows primarily to residents of Canada. ITA, *supra* note 12, s. 125(7) "Canadian-controlled private corporation".

[105] *Ibid*., s. 125(2).

[106] *Ibid*., s. 125(1)(a).

[107] This aggregate limit was originally set at $400,000, but was increased to $500,000 in 1974, $750,000 in 1976 and $1 million in 1982. Brooks, *supra* note 89 at 439.

not for the purpose of gaining or producing income from the business.[108] Although these features arguably made the small business deduction a relatively well-designed tax subsidy,[109] the refundable tax on ineligible investments was retroactively repealed in 1973 before it came into force,[110] and the total business limit was repealed in 1985.[111]

Judicial decisions further undercut the target-effectiveness of the subsidy by interpreting the (originally undefined) concept of an "active business" expansively to include most activities carried on by a corporation, including investment in income-producing property.[112] Although the federal government responded to these decisions in 1979 by defining the concept of an "active business" to exclude a "specified investment business" the "principal purpose" of which is "to derive income (including interest, dividends, rents and royalties) from property,"[113] this statutory test has been subject to considerable litigation in which courts must engage in a fact-based inquiry to determine whether the taxpayer's core business activity involves the provision of property or the provision of services.[114] This is also the case with an exclusion for a "personal

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[108] *Ibid*., former Part V
[109] Brooks, *supra* note 89 at 441.
[110] S.C. 1973-74, c. 14, s. 60(1)(2). According to the Minister of Finance at this time, the refundable tax was not only complex but also unnecessary since "small corporations … will, in fact, use these tax savings to expand their businesses, to improve their technology and to create more jobs for Canadians." Canada, *House of Commons Debates*, 19 February 1973, at 1433 (*per* Finance Minister, Hon J. Turner).
[111] S.C. 1984, c. 45, s. 40.
[112] See, e.g., *The Queen v. Rockmore Investments Ltd*., 76 D.T.C. 6156 (F.C.A), *The Queen v. M.R.T. Investments Ltd.*, 76 D.T.C. 6158 (F.C.A.), and *E.S.G. Holdings Ltd. v. The Queen*, 76 D.T.C. 6158 (F.C.A.), in which interest income on mortgages held by the taxpayers was characterized as income from an active business; and *The Queen v. Cadboro Bay Holdings Ltd.*, 77 D.T.C. 5115 (F.C.T.D.) at 5123, in which the court held that any quantum of business activity giving rise to income in a taxation year is sufficient for the income to be characterized as income from an active business.
[113] ITA, supra note 12, s. 125(7) "specified investment business".
[114] See, e.g., *072443 B.C. Ltd. v. The Queen*, [2015] 1 C.T.C. 2123, 2014 D.T.C. 1208 (T.C.C.), aff'd 2015 D.T.C. 5115 (F.C.A.), in which the court determined that the principal purpose of a self-storage business was to derive income from the provision of rental space rather than the provisions of services. See also *Rocco Gagliese Productions Inc. v. Canada*, [2018] T.C.J. No. 102, [2019] 3 C.T.C. 2154, 2018 D.T.C. 1099

services business" which turns on whether an incorporated employee "would reasonably be regarded as an officer or employee of the person or partnership to whom or to which the services were provided but for the existence of the corporation"[115] – thereby relying on the same fact-based determinations that are used to distinguish employees from self-employed taxpayers.[116]

Other elements of the small business deduction have also been subject to frequent litigation and recurring legislative amendments that increase complexity as well as compliance and administrative costs. Although the distinction between a private and a public corporation is easily drawn,[117] the concept of corporate control is less clear and is often disputed.[118] This is particularly the case with concept of *de facto* control, on which the statutory definition of a Canadian-controlled private corporation has relied since an amendment to this effect was added to the ITA in 1988.[119] Following contradictory interpretations of this concept,[120] moreover, the ITA was further amended in 2017 to require courts to "take into consideration all factors that are

(T.C.C.), in which the court held that the taxpayer's principal purpose was to earn income from composing music, notwithstanding that its main source of income was from royalties.

[115] ITA, supra note 12, s. 125(7) "personal services business". This exclusion was originally introduced in 1979 as one of various "non-qualifying businesses" (including professional corporations and management service corporations) that were eligible for a reduced credit. The reduced credit for personal services businesses was eliminated in 1981 and the exclusion for other non-qualifying businesses was eliminated in 1985. See Brooks, *supra* note 89 at 443-49.

[116] See, e.g., *Dynamic Industries Ltd. v. Canada*, [2005] 3 C.T.C. 225, 2005 D.T.C. 5293 (F.C.A.).

[117] See the definitions of "private corporation" and "public corporation" in ITA, *supra* note 12, s. 89(1).

[118] See, e.g., *Duha Printers (Western) Ltd. v. Canada*, [1998] 3 C.T.C. 303, 98 D.T.C. 6334 (S.C.C.); and *Silicon Graphics Ltd. v. Canada*, [2002] 3 C.T.C. 527, 2002 D.T.C. 7112 (F.C.A).

[119] ITA, *supra* note 12, s. 256(5.1), stipulating for the purposes of the ITA that a corporation is "controlled, directly or indirectly in any manner whatever" by a person or group of persons were "the controller has any direct or indirect influence that, if exercised, would result in control in fact of the corporation."

[120] See, e.g., *Transport M.L. Couture Inc. v. Canada*, [2003] 3 C.T.C. 2882, 2003 D.T.C. 817 (T.C.C.), aff'd 2004 D.T.C. 6636 (F.C.A.); and *McGillivray Restaurant Ltd. v. Canada*, [2015] 3 C.T.C. 2205, 2015 D.T.C. 1030 (T.C.C.), aff'd [2017] 5 C.T.C. 103, 2016 D.T.C. 5048 (F.C.A.).

relevant in the circumstances" in determining *de facto* control,[121] ensuring that the statutory test depends on a detailed fact-based inquiry.

The concept of corporate control is also relevant to the associated corporation rules, which had accompanied the pre-1972 dual-rate corporate tax and were retained in order to prevent businesses from increasing the amount of income that is eligible for the credit by incorporating multiple entities.[122] Subject to numerous deeming rules[123] and a targeted anti-avoidance rule enacted in 1988 which deems two or more corporations to be associated where "it may reasonably be considered that one of the main reasons for the separate existence of those corporations in a taxation year is to reduce the amount of taxes that would otherwise be payable",[124] these provisions have been a frequent topic of litigation.[125] In order to further prevent multiplication of the small business deduction, moreover, recent amendments have introduced complicated rules that generally deny the small business deduction for income from the provision of services or property to a private corporation where the corporation, one of its shareholders, or a person who does not deal at arm's length with the corporation or one of its shareholders, holds a direct or indirect interest in the private corporation to which the services or property are provided.[126] Yet other amendments have aimed to better target the incentive to

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[121] ITA, *supra* note 12, s. 256(5.11).
[122] *Ibid*. s. 256.
[123] See, e.g., the deemed control and share ownership rules in *ibid*., s. 256(1.2) to (1.4) and the deemed association rule for corporations associated with a third corporation in *ibid*., s. 256(2).
[124] *Ibid*., s. 256(2.1).
[125] See, e.g., *Brownco Inc. v. Canada*, [2008] 5 C.T.C. 2123, 2008 D.T.C. 2591 (T.C.C.); *Taber Solids Control (1998) Ltd. v. Canada*, [2010] 1 C.T.C. 2290, 2009 D.T.C. 1343 (T.C.C.); *Maintenance Euréka Ltée v. Canada*, 2011 D.T.C. 1319 (T.C.C.); *Jencal Holdings Ltd. v. Canada*, 2019 D.T.C. 1019 (T.C.C.); and *Prairielane Holdings Ltd. v. Canada*, 2019 TCC 157 (T.C.C.).
[126] ITA, *supra* note 12, s. 125(1)(a) and 125(7) "specified corporate income" and "specified partnership income". For a useful explanation of these rules, see Kenneth Keung, "New Small Business Deduction

small businesses by reducing the amount of income eligible for the deduction to the extent that the equity of the corporation and associated corporations exceeds $10 million,[127] and to discourage the use of tax savings to accumulate passive investments by also reducing the amount of income eligible for the deduction to the extent that investment income of the corporation and associated corporations exceeds $50,000 annual and eliminating the deduction completely if annual income from passive investments reaches $150,000.[128]

As explained earlier, the annual cost of the small business deduction in terms of foregone federal income tax revenue was $3.75 billion in 2016 and is projected to increase to $5.585 billion in 2019 – making it the second most costly tax expenditure after the partial taxation of capital gains.[129] Evidence also suggests that the deduction provides the most benefit to high-income shareholders and family members who are able to obtain the greatest advantage from the deferral and income-splitting opportunities that are available when income is derived through private corporations.[130] Finally, for the reasons that Professor Freedman has identified, a reduced rate for incorporated small businesses is a poorly-targeted tax incentive that greatly increases tax complexity for small businesses, as well as compliance and administrative costs.[131]

For these reasons, Canada would be well-served to heed the advice of the Mirrlees Review and to follow the example of the United Kingdom by eliminating any differential between the general corporate tax rate and the small business rate. In fact, this possibility seemed

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Rules Under Section 125" in *Report of the Proceedings of the Sixty-Eights Tax Conference*, 2016 Conference Report (Toronto: Canadian Tax Foundation, 2017), 27:1-26.

[127] ITA, *supra* note 12, s. 125(5.1)(a) [generally applicable to taxation years after June 1994].

[128] ITA, *supra* note 12, s. 125(5.1)(b) [generally applicable to taxation years after 2018].

[129] Canada, *Report on Federal Tax Expenditures*, *supra* note 85 at 29.

[130] *Supra* notes 86-88 and accompanying text.

[131] *Supra*, text accompanying notes 65-83.

tantalizingly close in 2015 when the differential in federal corporate tax rates was only 4 percent, and a new government was elected on a platform that promised to review all tax expenditures benefitting top income earners[132] and (unlike the other two major political parties) did not promise to reduce the small business rate.[133] Instead of addressing the rate differential directly, however, the government eventually proposed various measures to limit opportunities for tax planning using private corporations, including new provisions to discourage income-splitting through private corporations,[134] a specific anti-avoidance rule to prevent the conversion of taxable dividends into tax-preferred capital gains,[135] and other provisions to discourage the use of private corporations to accumulate passive investments.[136] In the fact of fierce criticism from professionals and the small business sector, the government ultimately withdrew the specific anti-avoidance rule to prevent the conversion of dividends into capital gains, adopted a much weaker provision to discourage the use of private corporations to accumulate private

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132 Liberal Party of Canada, 2015 Election Platform, *A New Plan for a Strong Middle Class* (2015) at 73, available at https://www.liberal.ca/wp-content/uploads/2015/10/New-plan-for-a-strong-middle-class.pdf.

133 Conservative Party of Canada, 2015 Election Platform, *Protect our Economy* (2015) at 19, available at http://s3.documentcloud.org/documents/2454398/conservative-platform-2015.pdf; New Democratic Party of Canada, 2015 Election Platform, *Building the country of our dreams* (2015) at 15, available at http://s3.documentcloud.org/documents/2454378/2015-ndp-platform-en.pdf.

134 Department of Finance Canada, *Tax Planning Using Private Corporations*, *supra* note 19 at 18-31.

135 *Ibid*. at 55-60.

136 *Ibid*. at 32-54.

investments,[137] and lowered the federal small business rate to 9 percent,[138] thereby increasing the differential between this rate and the general corporate tax rate.

(2) Taxation of Shareholders

As Professor Freedman rightly notes, the extent to which a tax system encourages individuals to incorporate a small business is influenced not only by reduced rates for corporate income but also by the ability to convert labour income into lower-taxed income from capital and by the ability to split this income with related persons. Although Canada taxes dividends received by individual shareholders at personal tax rates, subject to a gross-up and tax credit regime designed to integrate corporate and individual income taxes,[139] tax preferences for capital gains and the ability to split corporate income more easily than labour income create additional incentives to incorporate otherwise unincorporated businesses and an incentive for individual shareholders to convert otherwise taxable dividends into capital gains from the sale or liquidation of shares. As with the small business deduction, Canadian governments have relied on complex statutory provisions and anti-avoidance rules to limit the extent of these tax benefits, instead of pursuing structural reforms that would reduce or eliminate the tax differentials resulting from different kinds of income.

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[137] ITA, *supra* note 12, s. 125(5.1)(b), which reduces the amount of income eligible for the small business deduction to the extent that investment income of the corporation and associated corporations exceeds $50,000 annually, eliminating the deduction completely when investment income is $150,000 per year – thereby allowing passive investments of $1 million with an assumed annual return of 5 percent without any reduction in the small business deduction and eliminating the small business deduction if passive investments with an assumed annual return of 5 percent are $3 million.
[138] S.C. 2018, c. 12, s. 20(1), amending ITA, *supra* note 12, s. 125(1.1).
[139] ITA, *supra* note 12, s. 82(1) and s. 121. Until 2005, this gross-up and credit system was designed to integrate corporate and individual income taxes only for corporate income subject to the small business deduction. Since then a separate gross-up and tax credit for "eligible dividends" integrates corporate and individual income taxes subject to tax at the general corporate rate.

(a) Dividends and Capital Gains

Like the small business deduction, the gross-up and tax credit mechanism for dividends was introduced in 1972, at which time the general corporate tax rate in Canada was 50 percent, the small business deduction reduced this rate to 25 percent, and the gross-up and tax credit for individual shareholders offset corporate tax at the small business rate.[140] Under this regime, individual shareholders subject to tax at a marginal rate of 50 percent paid an effective rate of $33^1/_3$ percent on the cash amount of the dividends paid out of corporate income.[141] Since one-half of capital gains were taxable at the time, these rules created an incentive to realize corporate surplus in the form of capital gains, which would be taxable at effective rate of only 25% for individual shareholders subject to tax at a 50 percent marginal rate.[142]

Because Canada did not tax capital gains before 1972, it had considerable experience with "surplus stripping" transactions designed to convert otherwise taxable dividends into non-taxable capital gains, and had enacted various rules deeming proceeds from the sale or

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[140] Brooks, *supra* note 89 at 437.

[141] Assuming $100 of corporate income subject to tax at the 25 percent small business rate, an individual shareholder taxable at a 50 percent marginal tax rate who received a dividend of $75 would gross-up the cash amount of the dividend by $25 ($33^1/_3$ percent of $75), and receive a tax credit of $25 against tax otherwise payable of $50 (50 percent of $100), resulting in an effective rate of tax on the cash amount of the dividend of $25/$75 = $33^1/_3$ percent. If the corporate income were subject to the general rate of 50 percent, the individual receiving a dividend of $50 would gross-up the cash amount of the dividend by $16.67 ($33^1/_3$ percent of $50), and receive a tax credit of $16.67 against tax otherwise payable of $33.33 (50 percent of $66.67), resulting in an effective rate of tax on the cash amount of the dividend of $16.67/$50 = $33^1/_3$ percent.

[142] Assuming that the value of a corporation is increased by the amount of after-tax income retained by the corporation, shareholders of a corporation earning $100 of income subject to tax at the 25 percent small business rate would realize a gain of $75 on the sale or liquidation of their shares, resulting in a taxable capital gain of $37.50 and tax of $18.75 (25% of the gain) for individuals subject to tax at a 50 percent marginal rate.

liquidation of shares to be dividends in specific circumstances.[143] While the taxation of capital gains reduced the incentive to engage in these transactions, the difference in effective tax rates on dividends and capital gains meant that these rules were retained in 1972.[144] Although subsequent amendments in 1990 synchronized the effective rates on capital gain and dividends paid out of corporate income subject to the small business rate by reducing this rate to 20 percent and increasing the capital gains inclusion rate to three-quarters,[145] this equivalence was not established for corporate income that was subject to the general corporate tax rate, and capital gains became generally more attractive than dividends after 2000 when the capital gains inclusion rate was reduced to one-half.

In 1985, moreover, the federal government increased the incentive for surplus stripping by enacting a lifetime capital gains exemption that exempts a specific amount of capital gains

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[143] See, e.g., s. 81(1) of the *Income Tax Act*, R.S.C. 1952, c. 148, which deemed funds or property distributed or appropriated in any manner whatever to or for the benefit of one or more shareholder on a winding-up, discontinuance or reorganization of a corporation's business to be a dividend to the extent of the corporation's undistributed income on hand; *ibid*., s. 81(2) which deemed a dividend to have been received on the redemption of a share to the extent of the shareholder's undistributed income on hand ; and *ibid*., s. 138A(1), which deemed amounts received or receivable by a taxpayer as a consequence of a disposition or exchange of property to be a dividend where it could reasonably be considered that "one of the purposes" of the disposition or exchange was "to effect a significant reduction of, or disappearance of, assets of a corporation at any time in a manner such that the whole or any part of any tax that might otherwise have been or have become payable … in consequence of any distribution of property of a corporation has been or will be avoided." For a useful discussion, see H. Heward Stikeman and Robert Couzin, "Surplus Stripping" (1995), 43:5 *Canadian Tax Journal* 1844-1860.

[144] ITA, *supra* note 12, s. 84(2), 84(3) and former 247(1) (which was repealed in 1988 when Canada's general anti-avoidance rule (GAAR) came into effect).

[145] Assuming $100 of corporate income subject to tax at the 20 percent small business rate, an individual shareholder taxable at a 50 percent marginal tax rate who received a dividend of $80 would gross-up the cash amount of the dividend by $25 (25 percent of $80), and receive a tax credit of $20 against tax otherwise payable of $50 (50 percent of $100), resulting in an effective rate of tax on the cash amount of the dividend of $30/$80 = 37.5 percent. Alternatively, if the after-tax income were retained by the corporation, resulting in a gain of $80 on a disposition of the shares, the shareholder would pay tax of $30 (50 percent of $60, being three-quarters of the gain), also resulting in an effective tax rate of 37.5 percent.

realized by resident individuals over the course of their lifetimes.[146] Although this exemption was capped in at $100,000 in 1987 and repealed in 1995, a more generous exemption for capital gains from the disposition of "qualified small business corporation" shares was introduced in 1988 and remains in place.[147] Originally limited to $500,000, this amount was increased to $750,000 in 2007 and $800,000 in 2014, when this amount was indexed for inflation, as a result of which the value of the exemption had increased to $866,912 in 2019.

Extremely complicated,[148] with multiple limitations,[149] and a targeted anti-avoidance rule that disallows the exemption where among other things "it can reasonably be concluded, having regard to all the circumstances, that a significant part of the capital gain is attributable to the fact that dividends were not paid on a share,"[150] the lifetime capital gains exemption was also accompanied by specific anti-avoidance rules aimed at surplus stripping through non-arm's length transactions,[151] and through the purchase by a public corporation of shares distributed in the form of a stock dividend.[152] Although the anti-avoidance rule for public corporations has not resulted in any litigation, the anti-avoidance rule for non-arm's length transactions has been subject to considerable litigation, which is not surprising for a provision that depends on the

[146] *Ibid.*, s. 110.6(3) [repealed in 1995]. As originally enacted, the exemption was to be phased in from $20,000 in 1985 to $50,000 in 1986, $100,000 in 1987, $200,000 in 1988, $300,000 in 1989 and $500,000 in 1990.

[147] *Ibid.*, s. 110.6(2.1).

[148] See, e.g., the definition of "qualified small business corporation share" in *ibid.*, s. 110.6(1), which includes ownership and asset requirements "at the determination time" and for 24 months preceding this time.

[149] See, e.g., the concept of a "cumulative gains limit" in *ibid.*, s. 110.6(1), which reduces the amount that may be deducted under the exemption in a taxation year to the extent of the taxpayer's "cumulative net investment loss" at the end of the year.

[150] *Ibid.*, s. 110.6(8). Potentially quite broad, this provision is limited in scope by an exception for "prescribed shares".

[151] *Ibid.*, s. 84.1.

[152] *Ibid.*, Part II.1.

factual determination of a non-arm's length relationship between an individual who sells shares and a corporation that purchases the shares.[153] The lifetime capital gains exemption has also been subject to numerous cases involving the Canadian general anti-avoidance rule, which was also enacted in 1988.[154]

Consistent with Professor Freedman's admonition, therefore, Canadian tax preferences for capital gains have been accompanied by complex statutory provisions that "attempt, often unsuccessfully, to confine the tax advantages to a subcategory"[155] and by reliance on specific and general anti-avoidance rules to challenge tax-motivated arrangements to obtain tax benefits resulting from specific legal forms. In addition to their complexity, these tax preferences are extremely costly in terms of foregone revenues,[156] uncertain in their economic impact,[157] and disproportionately benefit high-income taxpayers.[158] Here too, therefore, Canada would be well-

[153] See, e.g., *Brouillette v. Canada*, [2005] 4 C.T.C. 2013, 2005 D.T.C. 1004 (T.C.C.); *Côte –Létourneau v. Canada*, 2007 TCC 91, 2010 D.T.C. 1116 (T.C.C.); and *Poulin v. Canada*, [2016] 6 C.T.C. 2206, 2016 D.T.C. 1129 (T.C.C.).

[154] See, e.g., *McNichol v. Canada*, [1997] 2 C.T.C. 2088, 97 D.T.C. 111 (T.C.C.); *Geransky v. Canada*, [2001] 2 C.T.C. 2147, 2001 D.T.C. 243 (T.C.C.); and *McMullen v. Canada*, [2007] 2 C.T.C. 2463, 2007 D.T.C. 286 (T.C.C.).

[155] Freedman and Crawford, "Small Business Taxation" *supra* note 2 at 1061.

[156] Canada, *Report on Federal Tax Expenditures*, *supra* note 85 at 30 and 34, estimating the annual cost of the lifetime gains exemption in terms of foregone federal income tax revenue as $1.5 billion in 2016, which is projected to increase to $1.81 billion in 2019, and the annual cost of the partial inclusion of capital gains as $12.91 billion in 2016, which is projected to increase to $17.115 billion in 2019.

[157] See, e.g., Kenneth J. McKenzie and Aileen J. Thompson, "The Impact of the Capital Gains Exemption on Capital Markets" (1995), 21 *Canadian Public Policy* S100 at 2113, concluding that "[i]t is … difficult to draw strong conclusions about the effect of the capital gains exemption on the cost of capital, and, therefore, on investment."

[158] David G. Duff, "Canada" in Michael Littlewood and Craig Elliffe, *Capital Gains Taxation: A Comparative Analysis of Key Issues*, (Cheltenham, UK: Edward Elgar Publishing, 2017) 141 at 156-57 and 163, reporting that capital gains are constitute a much larger share of income reported by high-income taxpayers than middle- and low-income taxpayers and that the tax benefit from the lifetime capital gains exemption is enjoyed overwhelmingly by high-income taxpayers.

served to heed Professor Freedman's advice to reduce or eliminate the tax differentials resulting from these tax preferences.

(b) Income-Splitting

The incentive to incorporate a small business for tax reasons is also driven by opportunities to split income with related persons. Although Canada has a lengthy history with attribution rules that limit opportunities to split income with spouses and related minors through transfers of property for consideration less than fair market value,[159] and the revenue authorities have successfully relied on a provision limiting deductions to amounts that are "reasonable in the circumstances"[160] in order disallow the deduction of excessive salaries paid to related employees,[161] opportunities to split income through private corporations were greatly facilitated by a 1998 Supreme Court of Canada decision allowing the diversion of corporate income to the taxpayer's spouse through a separate class of shares on which dividends could be paid at the discretion of the company's directors.[162]

Although the government of the day responded to this decision with a provision taxing most private company dividends received by individuals under age 18 at the top marginal rate,[163] this tax on split income (TOSI) did little to discourage the tax-motivated incorporation of small businesses since it did not apply to spouses or adult children. Indeed, in the fifteen years after the TOSI came into effect in 2000, the number of Canadian-controlled private corporations

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[159] For the current version of these rules, see ITA, *supra* note 12, s. 74.1 to 74.5.
[160] *Ibid*., s. 67.
[161] See, e.g., *Grant Babcock Ltd. v. Minister of National Revenue*, [1985] 2 C.T.C. 2181, 85 D.T.C. 518 (T.C.C.); and *Maduke Foods Ltd. v. Minister of National Revenue*, [1989] 2 C.T.C 284, 89 D.T.C. 5458 (F.C.T.D.).
[162] *Neuman*, *supra* note 38.
[163] *ITA, supra* note 12, s. 120.4.

increased by 50 percent, the number of incorporated self-employed individuals doubled, and the number of professional services corporations tripled.[164]

When the government returned to this issue in 2017, it did not – as Professor Freedman would have suggested – address the problem of income-splitting "in a holistic way" considering both the conversion of labour income into capital income and "the rules on family taxation … and capital transfers between spouses,"[165] but instead proposed to extend the TOSI rules to include all resident individuals receiving dividends or capital gains from the disposition of shares of a private corporation over which a "connected individual" exercises significant influence.[166] After considerable controversy and opposition from professionals and the small business sector, a substantially revised and considerably more complex version of these rules was enacted effective for the 2018 taxation year.[167] Here again, therefore, Canada would have been better served if it had heeded Professor Freedman's advice.

IV. Conclusion

Over the course of a distinguished academic career, Judith Freedman has consistently and persuasively argued that the taxation of similar economic activities carried on through different legal forms is best addressed by reducing or eliminating the tax differentials among these legal forms, instead of through complicated statutory provisions and anti-avoidance rules that attempt to confine the tax advantages associated with particular legal forms to subcategories of these

[164] Department of Finance Canada, *Tax Planning Using Private Corporations*, *supra* note 19 at 11.
[165] Freedman, "Taxing the Micro-Business" *supra* note 2 at 74.
[166] *Ibid*. at 18-31.
[167] S.C. 2018, c. 12, s. 13(5) to (7), amending ITA, *supra* note 12, s. 120.4.

forms. For this and other reasons, she has also questioned special tax preferences for small business, particularly through a reduced corporate tax rate for small business.

Canadian experience with the taxation of private companies and their shareholders illustrates why Professor Freedman's contributions to tax law and policy regarding small business are so convincing. Instead of minimizing tax differentials among different legal forms, Canada provides a preferential tax rate for small businesses and tax preferences for capital gains, which encourage the tax-motivated incorporation of otherwise unincorporated businesses, the conversion of labour income into capital income and dividend income into capital gains, and income-splitting with related persons. In order to limit the scope of these tax preferences, moreover, Canada relies on complicated statutory provisions which are subject to frequent amendment as well as specific and general anti-avoidance rules to challenge perceived abuses. The result is a complex and often uncertain legislative framework the economic merits of which are doubtful, the tax advantages of which are enjoyed disproportionately by high income taxpayers, and the cost of which in terms of foregone revenues and increased compliance and administrative costs are substantial.

As Professor Freedman notes, the reason why these kinds of tax preferences persist had more to do with politics than policy, since the small business community is vocal, well-organized and broadly supported by the media and the general public.[168] At the same time, experience in the U.K. suggests that business may support simplifying reforms when tax rules become extremely complex, [169] and that it is possible to align corporate tax rates for small and large

[168] Freedman and Crawford, "Small Business Taxation" *supra* note 2 at 1086.
[169] *Ibid*.

business – though it is important to note that this result was accomplished by reducing the general corporate rate to the small business rate instead of by increasing the small business rate, which would have been much more challenging politically.

Most importantly, perhaps, experience in the U.K. suggests that thoughtful tax policy analysis, particularly when provided through an expert and impartial medium like the Mirrlees Review, can have a positive impact on actual tax policy. Indeed, Professor Freedman's contributions to tax law and policy regarding small business are testament to her conviction that "in the long run a clear policy based system that can be explained to taxpayers and shown to be equitable and simple to operate may be more successful politically than one which responds to lobbyists and creates complexity, resulting in anti-avoidance provisions and confusion amongst users about the objectives of the system."[170]

[170] *Ibid*.