



## Consultation on Tax Planning Using Private Corporations

Submission to the Standing Committee on Finance

Submitted by MNP LLP  
Thursday, September 28, 2017

We are pleased to make a submission in response to the July 18, 2017 consultation paper released by the Department of Finance (the “Department”) regarding tax planning using private corporations.

MNP LLP (“MNP”) is a leading national accounting, tax and business consulting firm in Canada. MNP proudly serves and responds to the needs of our clients which include more than 150,000 private enterprise and small business clients, and 16,000 farms throughout Canada. This brief discusses the potential impacts of the three measures proposed in the July 18, 2017 consultation paper on private corporations and small business in Canada.



## Summary and Recommendations

MNP concurs with the Government’s view that Canada needs a tax system that works fairly for everyone, and that Canadians should have confidence that the tax system is serving the needs of everyone. However, it is our view that the July 18, 2017 proposals (the “July 18 proposals”) and accompanying draft legislation amount to a fundamental restructuring of the taxation of private corporations and their shareholders in Canada and are contrary to the fundamental principles of fairness, certainty and predictability in tax planning.

The key points raised in this submission are:

1. Each of the tax measures in the July 18 proposals are highly complex and create uncertainty due to their potentially broad application and lack of clear guidance on administering the measures.
2. The consultation period allowed for the July 18 proposals is far too short and precludes the consideration of alternatives to the proposed changes that are fair to small businesses and the entrepreneurs who risk their livelihood.
3. Contrary to the various public statements made by members of the Government since the release of the July 18 proposals, the proposed tax measures will in fact have a detrimental impact on middle class small business owners and entrepreneurs, which can cause a ripple effect on dampening innovation and the economy overall in Canada.

MNP recommends that the current compressed consultation period be concluded and set aside. The Government should instead undertake a new consultation that includes a comprehensive review of the overall tax system instead of overlaying new measures to address specific provisions. The new consultation must include all potential stakeholders, including members of the small business community. Furthermore, any new tax measures introduced should be simple and administratively executable for small business owners, which will align with the Government’s objective to simplify the Income Tax Act.

By supporting these recommendations, the Government will be taking steps in the right direction to achieve the fairness and neutrality that it strives for.

## 1.) INCOME SPRINKLING

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The income sprinkling measures proposed by the Government target common tax planning arrangements for small business that are permitted under current legislation. If enacted, these measures are expected to increase the overall tax cost of owning a business to an entrepreneurial family, which will mean a reduction of after-tax business profits.

The proposed measures include the introduction of a “reasonableness” test to determine if certain income, referred to as “split income”, of an adult individual is subject to the Tax on Split Income (“TOSI”) rules. While several factors have been provided by the Government to determine if an income amount is reasonable for this purpose, these factors focus on direct labour and capital contributions, which do not realistically capture the total contributions often made by an entrepreneur’s family unit.

In its consultation paper, the Government introduced two neighbouring families - one whose primary income earner (Susan) is an employee, the other’s being a self-employed business owner (Jonah) operating through a corporation. In that illustration, the Government draws attention to the difference in household tax liability between the two families due to income from Jonah’s business being taxed among his family members as dividends.

While the difference between the two families’ tax liability as shown in that single year cannot be disputed, the example does not show a complete picture of the contributions that a small business owner and his or her family likely would have made to make the business profitable. Based on our experience, any one or more of the following common scenarios could have applied:

- Use of personal savings or incurring personal debt to capitalize the business, which resulted in the cost of a reduced standard of living for Jonah and his family.
- Years of operating at a loss while starting up the business, during which Jonah, or his wife and children – who helped out in the business – were not able to draw salaries. This is especially common in the agriculture industry where children are expected to work in the business while in school and often after graduation.
- Loss of employee benefits that Jonah would not have had to self-fund, such as a retirement pension, if he had chosen to remain employed elsewhere instead of starting his own business.
- The opportunity cost of Jonah’s wife having given up her previous employment in order to help Jonah in the business until there was sufficient cash flow to hire other employees.

The value of these contributions will vary depending on each entrepreneurial family’s circumstances and as such, it is difficult to establish a standard measure across all Canadian small businesses. However, these contributions cannot be discounted or disregarded altogether, as they are of equal importance as any direct labour or capital contribution.

Another troublesome aspect of the proposals is that historical payments made by a corporation to an individual not previously subject to TOSI can restrict the corporation's ability to pay a reasonable dividend or allocation of income today or in the future. Overall, the factors in the proposed measures are neither practical nor intuitive, and create much confusion in determining current period reasonability.

Many start-up businesses rely on the entrepreneur's family members for start-up capital, and these investors will be disadvantaged under the new TOSI regime.

#### **Illustrative Example 1: Marie**

Marie is a retiree in Lethbridge, Alberta, who was issued preferred shares as part of a family succession plan several years ago when her children took over the family business. Since retiring, Marie has been redeeming a portion of these shares – at a value of \$40,000 – annually to fund her retirement, which she had put in over 30 years of hard work to achieve. Marie is no longer involved in the business. The personal tax liability for Marie under current legislation is approximately \$1,000, plus corporate tax of \$7,000. Under the draft proposals, because she is no longer active in the operations of the business, has little original capital invested in the company and no longer has any risk assumed in relation to the business, her annual tax liability would increase to over \$16,000. Her total annual tax liability under the proposed measures would be over \$23,000; in comparison, an employed individual earning the same \$40,000 would pay less than \$7,000 in taxes.

### **Illustrative Example 2: Steve the Innovator**

Steve is a 23-year-old from Waterloo, Ontario, and a recent university graduate with a degree in computer science. An aspiring software developer, Steve found time to develop various software applications on the side while studying. Now that he has finished school, he wants to start up his own business developing artificial intelligence applications and plans to hire some of his classmates to continue his work. He needs money to cover basic start-up costs like rent, office supplies, and state of the art computers; however, the bank will not lend him the money because he has no credit history nor does he have any collateral. He turns to his mother, who agrees to provide him with \$25,000 in exchange for 50% of the company. If the venture is successful, his mother is hopeful that the proceeds from a future sale of the shares can fund her retirement. Steve sets up a new corporation, and both he and his mother subscribe for shares of the corporation.

It is now 5 years later (2022) and the company has enjoyed tremendous success. Steve recently received an offer from an established software company to purchase all shares of the corporation for \$1,500,000; \$750,000 to each of Steve and his mother.

How will Steve's mother's capital gain be taxed?

#### **Outcome Under Pre-July 18, 2017 Rules**

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Steve's mother would have a capital gain of \$725,000 (\$750,000 proceeds - \$25,000 cost of shares). Under the current rules, this capital gain would be eligible for the lifetime capital gains exemption. As a result, Steve's mother would not pay any tax on the gain, and would have \$750,000 to put towards her retirement fund.

#### **Outcome Under Proposed Rules**

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The treatment of Steve's mother's capital gain is unclear under the proposed rules. She had no involvement in the business other than her initial \$25,000 contribution. To determine the proper tax treatment, she would have to figure out if the capital gain was "reasonable" based on her contribution.

The Government stated in its consultation paper that the policy intention in determining if an amount of a gain is reasonable is that it is "commensurate with what would be expected in arrangements involving parties dealing at arm's length." This is not a comparison that can be made under the current scenario as an arm's length party would not have invested in Steve's start-up. Given that valuations of pre-revenue start-ups are extremely subjective, it is near impossible to determine if a \$25,000 contribution by Steve's mother for 50% of the company is commensurate with what an arm's length party would have paid. It is likely that upon review, a Canada Revenue Agency ("CRA") auditor would view the gain as unreasonable. Steve's mother is receiving proceeds equal to 30x her initial contribution, and has not contributed labour to the corporation. As there is no arm's length comparison available, Steve's mother would not be able to contest this assertion by CRA, and the entire gain would be considered a "Split Portion".

Since the gain is a Split Portion, it would not be eligible for the lifetime capital gains exemption. Furthermore, even though Steve's mother is not a high rate taxpayer, the gain would be subject to tax at the highest marginal rate for capital gains – 26.76% in Ontario. She would pay tax of approximately \$200,000 on the gain.

The proposed changes create a disincentive to invest in the business ventures of family members. Since contributions from family are often the only source of capital for start-up businesses, this will have a significant impact on investment in innovation in Canada.

## 2.) HOLDING PASSIVE INVESTMENTS INSIDE A PRIVATE CORPORATION

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The Government is proposing that the perceived tax advantage of taxpayers that hold passive investments through a private corporation be eliminated by amending the rules under the current tax regime to normalize savings opportunities for both the employed and self-employed. The Government is generally advocating that everyone should save through a Registered Retirement Savings Plan (“RRSP”) or Tax-Free Savings Account (“TFSA”). The methods contemplated in the consultation paper eliminate the refundable taxes on investment income earned on such passive investments so that an individual is indifferent to holding these investments personally or through a corporation.

Since the July 18 proposals were introduced, there have been many quantitative analyses showing that a private corporation with passive investments does not have a significant investment advantage over an employee doing so through a registered portfolio. In some cases, the private corporation is actually at a disadvantage when comparing the after tax, fully distributed return on investment to that of an employee.

The proposed measures do not seem to contemplate reasons beyond the dollar-for-dollar comparison between corporate and personal passive investments, thus ignoring the many bona fide reasons why a business owner might be required to accumulate funds in a corporation, including:

- Meeting bank financing terms – corporations that have obtained bank financing commonly must adhere to certain financial ratios (debt-to-equity requirements, debt service, working capital, etc.) which require surplus funds to be retained in the corporation.
- Angel investors – start-up enterprises not able to obtain bank financing rely on angel investors, which are often private corporations that have accumulated excess funds not immediately required in their business, the income from which is used to help other start-ups.
- Fluctuations in the economy – businesses require strong working capital to cover operating costs, including staff costs, during less profitable times.
- Capitalization decisions – some businesses that do not want to rely on bank financing or incur additional interest costs require the ability to save for future expansions or even to maintain its existing capital structure.
- Retirement Savings – small business owners generally do not have a pension for retirement, and many cannot utilize RRSPs or TFSAs personally as they are required to maintain a certain amount of capital in their corporation. Corporate investments are often the only way small business owners can start saving for retirement.

### **Illustrative Example 3: Peter's Pizzeria**

Peter owns a small pizzeria in Ottawa, Ontario. Over the last 10 years, Peter has built up a loyal customer base using his famous wood-burning oven. This year, the pizzeria made a profit for the first time. It is expected to continue earning a pre-tax profit of \$100,000/year before paying a salary to Peter.

Next year, Peter's famous wood-burning pizza oven breaks, which will cost him \$40,000 to replace. As his restaurant is considered a high-risk enterprise, the bank will not lend him the money to replace the oven.

#### **Outcome Under Pre-July 18, 2017 Rules**

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Peter was advised to take a salary of \$50,000/year, which would cover his living expenses. The remaining \$50,000 could be left behind in the corporation, on which tax of \$7,500 would be paid, leaving the corporation with \$42,500. His advisors explained that it is wise to leave excess funds in the corporation in case future unexpected business expenses arise. They also let him know that he can invest the \$42,500 in the corporation, allowing him to meet two goals: plan for unexpected expenses, and begin saving towards retirement.

Fortunately for Peter, when the pizza oven broke, he had liquid investments of \$42,500 in the corporation. He was able to sell these investments and use the proceeds to buy a new pizza oven.

#### **Outcome Under Proposed Rules**

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Peter heard on the news that investing in passive assets within his private corporation would now result in tax rates on investment income as high as 73%. Fortunately, he also heard a quote from the Department of Finance that these proposals would only affect individuals making more than \$150,000/year. Since he makes less than \$150,000, the Department of Finance stated that the best strategy is for him to pay himself a salary and maximize his RRSP and TFSA.

Peter took this advice and paid himself a salary of \$100,000. With this, he was able to contribute \$18,000 to his RRSP, and paid personal income tax of \$18,600. After covering his living expenses, Peter was left with \$22,200 of excess cash to put towards his retirement in either his TFSA, or taxable accounts.

Unfortunately, when the pizza oven broke, Peter now only had access to \$22,200 to put towards its replacement. He met with his advisors to determine how to fund the difference. Peter could withdraw the \$18,000 out of his RRSP; however, this had two consequences:

- I. He would have to pay tax of about \$7,800 on the withdrawal at his marginal tax rate (43.4%). This means he would only have cash of \$32,400 to put towards the pizza oven, which is still \$7,600 short.
- II. Withdrawing the \$18,000 from his RRSP would permanently reduce his RRSP contribution limit, meaning he would significantly reduce his ability to save towards retirement in a registered plan.

Peter is confused as to why the proposals impacted him, as he had heard in the news that individuals making less than \$150,000 per year would not be affected by the proposals. As he cannot afford to replace the oven, which is a vital component of his business, he will likely have to shut down his business.

Corporate passive investments allow a business owner to provide for retirement and manage risks that are not otherwise assumed by employees. RRSPs are not a viable savings vehicle for business owners.



### 3.) CONVERTING INCOME INTO CAPITAL GAINS

While the Government’s position in targeting “surplus strip” transactions and certain non-arm’s length transactions not occurring at fair market value (“FMV”) are logical, the proposed changes are expected to impact a much broader scope of transactions, including bona fide FMV intergenerational business transfers and long-standing estate planning transactions.

Current tax legislation permits planning for small business owners to transfer their business to a family member, whether upon their death or as part of their retirement plan, such that any income arising on the transfer is not subject to double taxation. Under proposed legislation, the resulting tax liability on a FMV sale of a business from one family member to another can be 45% to 70% of the accrued value of the business, which is an illogical result when compared to a sale of the same business to a third party, which can actually result in an effective tax rate of 0% . This may force business owners to look to a third-party sale instead of being able to pass on a family business to their children, and can also have the undesirable effect of lessening competition in the Canadian marketplace.

#### Illustrative Scenario #4: Mr. & Mrs. John Farmer

Mr. and Mrs. Farmer, second generation farmers, have run a successful farm in their corporation, Farmco, for 30 years. They have two children, one is a teacher and one intends to take over the farm. Their farmer child has recently completed high school and the family feels it would be diligent to send him to university to obtain a bachelor of agriculture degree before handing over the reins to their entire retirement nest egg. To help fund education and allow for estate planning, they have set aside 30% of the equity growth in the farm into a family trust for the benefit of their children.

Like many family farms, the business was incorporated to allow the family farm to grow, expand, repay debt and access corporate tax rates to manage the risk of the business. Mr. and Mrs. Farmer own the original home quarter and the nearby pasture land personally, as this was gifted from Mr. Farmer’s parents. All land they acquired since incorporating has been purchased in the company.

As part of their succession plan, they are balancing a concept of fairness and equality, but want to ensure the family farm can survive. They have few assets other than the farm, and intend to sell one piece of land to their daughter from the company, and have the rest of the land transition to the farming child.

During their son’s university years, it is expected that the son will spend significant time working on the farm, substantially impacting the profitability of the farm, but likely not substantial enough to meet the new tax on split income rules.

Once the son has completed his degree, Mr. and Mrs. Farmer expect they will slowly transition the family farm to him, and in time, he will be in position to take over the farm fully. However, as there is significant capital required and the risks of running a farm, Mr. and Mrs. Farmer will transition the business over several years. When they have fully transitioned the farm, they will purchase a house in town and sell the home quarter to their son. At that time, they will require \$500,000 in cash to purchase a home in town. They have estimated they will need after-tax income of \$130,000 per annum to fund their retirement once they have transitioned the farm.

FMV of Farmco Shares	\$1,500,000
FMV of Personally Held Farmland	\$1,000,000

Mr. and Mrs. Farmer intend to receive funds for this transition, albeit some up front and some over time. They will not utilize the intergenerational rollovers.



### **Outcome Under Pre-July 18, 2017 Rules**

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The son's post-secondary education will be financed through dividends from the farming company to the son via the family trust. This is expected to cost a total of \$100,000, a cost the farm is capable of bearing.

Mr. and Mrs. Farmer will cause Farmco to sell one parcel of land to their daughter at FMV of \$200,000 with a taxable capital gain of \$100,000. They must sell one of the pieces in the company as the personally held land is pertinent to the operations of the farm. There will be a capital gain in the company, which creates a capital dividend account (CDA) of \$100,000. The parents intend to pay out the CDA and gift the proceeds to their daughter as part of their estate plan. The daughter paid \$200,000 for this parcel of land. They pay combined corporate and personal tax of \$50,000 on this disposition.

As they transition to their son, the bank is requesting that they sell the farmland to the company. This is being recommended so he can repay principal with corporate-taxed dollars versus personal-taxed dollars. As such, Mr. and Mrs. Farmer will sell their personally held land to the company and use their LCGE on the transfer for \$500,000 of cash and a promissory note for the balance of the sale price. They intend to sell the Farmco shares to him at FMV. As a result, the parents pay tax at 24% on the Farmco shares sold for FMV. The gain on the farmland will be sheltered by the LCGE.

Their son will likely be approved for \$1,500,000 in bank financing, the maximum financial institutions feel will be viable given the size of the farm and the risk in the industry, provided he uses a corporation. As such, it will be necessary to extract funds from the company to pay Mr. and Mrs. Farmer.

Mr. and Mrs. Farmer will receive immediate cash of \$1,500,000. They will spend \$500,000 on their new home, will be required to pay tax on the sale of the shares of \$360,000, and will set up a portfolio of \$640,000. Further, they will have a promissory note from the company of \$1,000,000. This \$1,640,000 will be required to fund their retirement.

The son has tax-paid shares of the company, and will be required to extract \$1,500,000 from the company to pay his parents. His parents paid tax on the \$1,500,000 capital gain on the shares, thus he can sell these shares to a new company and be able to fund the purchase price with after-tax dollars.

### **Outcome Under Proposed Rules**

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#### **Sale of Farmland to Daughter:**

Mr. and Mrs. Farmer and their daughter are shocked to realize that the new rules under section 246.1 mean the gain on the transfer of their farmland to the daughter cannot create CDA on the FMV sale. The personal tax on the sale will increase by \$41,000 on the sale, resulting in a tax rate of almost 50% on the capital gain. There is no tax-free cash to be extracted, and the daughter will not receive a gift from her parents, which will negatively impact their overall estate plan.

### **Transition to Son:**

The family is shocked to realize that it will cost them an additional \$41,000 in tax to fund their son's post-secondary education due to the new TOSI rules, and the fact that the son cannot meet the definition of "actively engaged on a regular, continuous, and substantial basis" while he is away in school. Mr. and Mrs. Farmer advise their son that he will need to fund his own education as the farm cannot afford this added expense.

As a result, the son decides he does not need further education, and at age 18, requests to start the succession of the farm immediately. Initially, Mr. and Mrs. Farmer agree to this request, and arrange a meeting with their business advisor.

The family is confused when they learn that the new section 246.1 could be applied to cause all repayments of their proceeds on the sale of the farmland being recharacterized as a dividend, and creating tax of another \$410,000 for Mr. and Mrs. Farmer even though they also used their capital gain deduction on the sale. This is because there has been a significant disappearance of assets of a private corporation.

They also learn that the changes to section 84.1 mean the tax-paid adjusted cost base on the shares of Farmco cannot be sold by the son to his company for a promissory note without attracting further tax. As he owes his parents \$1,500,000, he will be required to extract \$2,540,000 as a dividend and pay tax of \$1,040,000 to be left with \$1,500,000 to repay them.

Mr. and Mrs. Farmer are not impressed with the potential loss of family equity, feel their risk has increased due to the lack of education, and consequently insist that the son finance this loss, which creates discord within the family.

The total tax on this transition is now \$1,491,000 to transition a farm worth \$2,500,000. Under the pre-July 18, 2017 regime, the tax is \$360,000. This is a 314% increase.

Their bank does not believe the farm could service the debt required to fund the transition and the tax, especially since the son has no post-secondary education to rely on. The son is discouraged by these results, and after consulting with farm advisors, feels it will be a non-viable farm. As a result, he decides to abandon his farming dreams and instead work for a farm machinery dealership.

The parents decide to sell the farmland and the shares of their company through a local farm bidding site, giving them the ability to use their lifetime capital gains exemption to eliminate all taxes on the sale. They have proceeds of \$2,500,000 and a combined LCGE of \$2,000,000 and pay total tax of \$120,000 after using their LCGE.

Mr. and Mrs. Farmer, their son, and Mr. Farmer's parents are confused. They had heard that the recently proposed tax changes would not have a significant impact on family farms. Now, their dreams of a third, fourth or even fifth generation of the family farm have been crushed.

As illustrated above, the new non-arm's length asset transfer rules will increase family succession costs and also encourage sales to third parties. While the Department has indicated it is considering alternatives to distinguish genuine intergenerational transfers from those that may be perceived as abusive to the tax system, the "hallmarks" proposed in the consultation paper to do so are subjective and impractical as many farms transition from parents to children over time.

The proposed surplus-stripping rules also eliminate planning opportunities currently available to mitigate potential double taxation on death of a taxpayer where the deceased taxpayer and the estate are both taxed on property held at the time of death. It is our understanding that the Department intends to address this issue in a future iteration of the proposed legislation. We look forward to seeing what the Department implements to provide such relief.

## **Our Recommendations**

Based on the above discussion and illustrative examples, it is evident that the proposed measures can impact taxpayers that these measures may not have been intended for. Many of the concepts introduced in these measures lack clarity and as a result, the proposed measures can be punitive in certain situations to small businesses operating through a private corporation in Canada. While most of the illustrations show the impact of each of the proposed measures in isolation, there are many – including that of Mr. and Mrs. Farmer – that will be negatively affected by two or even all three of the proposed measures. If fairness and neutrality in the Canadian tax system is what we are truly striving for, it will not be achieved through the proposed measures as currently drafted.

### **We strongly urge the Department to:**

- 1. Set aside the current proposals.**
- 2. Undertake a new consultation process that provides a comprehensive review of the overall tax system, involving all stakeholders that will allow sufficient time for a more substantive and collaborative analysis of the changes required for an effective tax system.**

If the Department is unwilling to start anew, we respectfully request that our recommendations for each of the proposed measures, as detailed in MNP's separate submission on the July 18 proposals, be given serious consideration. As expressed in our meeting with representatives from the Office of the Prime Minister on Tuesday, September 19, MNP is committed to taking a lead role with the Department on the proposals and offer our expertise to the consultation process.

We would be pleased to further discuss the technical merits of our comments and recommendations in this submission with the Department if required.

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

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

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

Kim holds the Chartered Professional Accountant (CPA) designation, qualifying as a Chartered Accountant (CA) in 2001, and graduated Beta Gamma Sigma with a Bachelor of Commerce from the University of Calgary in 1999. She has completed CPA Canada's In-depth Tax Courses I, II and III. Kim is involved in her community, previously serving with the Kinette Club of Brooks, as co-chair Finance for the Arctic Winter Games 2010 and currently as the vice-chair for the Grande Prairie Regional Hospital Foundation.

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Eddy has a broad range of experience advising private companies and their shareholders on a variety of domestic and international taxation issues. He has advised on acquisition / divestiture strategies, cross-border expansion strategies, alternative financing arrangements, executive compensation arrangements, and maximizing shareholder wealth. Eddy specializes in advising privately held companies within the real estate sector, which includes a number of professional consulting engineering organizations.

Eddy holds a Master of Business Administration from York University and is a Chartered Professional Accountant (CPA) and Chartered Accountant (CA). A frequent speaker and lecturer on taxation matters, he has also been a lecturer for CPA Canada's In-Depth Tax courses for the past 13 years. Eddy is a member of the Canadian and Ontario Institutes of Chartered Accountants, and sits on various charitable boards and committees.

Thank you for the opportunity to submit our report.

