The end of the Small Business Deduction?

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On June 13, 2016, the Organisation for Economic Co-operation and Development (OECD) released its Economic Survey of Canada. There were some interesting comments and criticisms about Canada's overall economy. However, as it relates to small business taxation, the following quote should be noteworthy for Canadian private client tax advisors:

Small business dynamism and productivity would also benefit from focusing small business programmes more clearly on reducing market failures. The programme with the largest budget cost, the preferential tax rate for companies under a threshold size based on taxable capital (known as the Small Business Deduction [SBD]), is not so focused. The aim of this arrangement is to leave them with more money to invest, effectively making it a financing programme. However, the economic literature on capital market failures does not establish a case for subsidising SMEs based on their size alone – such market failures can result in too much or too little finance (Boadway and Keen, 2006; Braido et al., 2011; Boadway and Sato, 1999). In the Mirrlees Review of taxation in the United Kingdom (Mirrlees et al., 2010), it was concluded that there was no evidence of any general capital market failure affecting small firms (Crawford and Freedman, 2010). Accordingly, there was no case for a reduced small business corporate tax rate – this tax preference was abolished on 1 April 2015.

This is certainly not the first time that the small business deduction (SBD) has been roundly criticized by well-known economists and think-tanks. Well-loved by private clients and their advisors, it is often utilized by successful private businesses to retain larger amounts of after-tax capital to reinvest or deploy. The SBD has a long history in Canadian taxation. Elements of the SBD or lower rate taxation for small businesses have been around since at least 1949.

In my 25+ years of tax practice, I often spent my early days devising plans to ensure that the SBD was multiplied or maximized given the high rates of overall taxation that entrepreneurs faced. As time progressed, Canadian income tax rates were significantly reduced—both corporate and personal—which made planning to multiply and maximize the SBD of lower value to the average private client. Recently, with newly elected left-leaning governments at both the federal and provincial levels in Canada, such tax rates have swung back in time which brings multiplying and maximizing the SBD back into vogue.

However, as my colleagues recently wrote, the Federal government has introduced rules to prevent the multiplication and utilization of the SBD in many cases. Such new rules are far reaching and dramatically change the landscape for private clients and their tax advisors.

Canada has a long history of adopting the OECD's tax policy recommendations. For example, Canada recently adopted the OECD's common reporting standard and introduced draft legislation to implement it. If the Canadian government accepts the invitation of the OECD to eliminate the SBD, would that harm Canadian small business? In my view, yes. Small business owners are currently suffering tax fatigue with significantly increased income taxes. In Alberta, at the high end, entrepreneurs are now faced with a dramatic 9 per cent increase in personal income taxes compared to just two years ago. With a depressed economy, there has been no shortage of tax increases from other areas as well such as increased property taxes, municipal business taxes, the soon to be implemented carbon tax in Alberta, etc. What many fail to consider is that increased taxes—whether it comes with a simple increase in the rate or the removal of certain long-standing tax preferences such as the SBD—causes behavioral changes. For example, I have had more meetings and engagements with respect to wealthy entrepreneurs who want to leave Canada in the last six months than I have had in the last 25 years of my entire career. What's the collective net worth of those people that I have been meeting? Billions. And the primary reason for those people wanting to leave Canada? Tax fatigue.

Yes, I can already hear the high tax proponent people retorting to the above by saying "let them leave." It's not that simple. Entrepreneurs create jobs and when such entrepreneurs leave, jobs often leave with them. And, of course, their income and some of their assets will be removed permanently from the Canadian tax ecosystem and the economy in general. That is not good for anyone in Canada. What's more is that a low corporate tax rate for small businesses is designed to create a disincentive against owners withdrawing profits from the corporation and from my experience of meeting with thousands of entrepreneurs over the years and being one myself, any surplus cash built up from these retained earnings are almost always plowed back and re-invested in order to grow the business. That was how Canada has built its corporate titans and champions in the past, and in this day and age, that is what Canada needs more of.

With respect to Canada's recent increased personal income tax rates for the wealthy, the OECD report had the following to say:

The other main redistributive measure is a middle-class income tax cut to be financed mainly by increasing the tax rate on high incomes to an average federal- provincial combined rate of over 50%. <u>It would have been less costly to finance this tax cut by increasing taxes with lower efficiency costs, such as Goods and Services Tax (GST)</u> – both through broadening the base (the VAT revenue ratio, shown in Figure 14, Panel A, suggests that Canada's base may be marginally less comprehensive than the OECD average), and raising the standard rate (Panel B), although cross-border shopping possibilities restrict the extent to which rates can exceed sales tax rates in neighbouring US states) and by applying environmentally related taxes (especially taxes on energy), which are limited…[emphasis added]

In general, I agree with the above. Financing a tax reduction for the "middle class" by significantly increasing tax rates for the "wealthy" is poor tax policy, and it causes unintended behavioral responses as discussed above.

Given all of the above, would I support the elimination of the SBD if there was a return to more modest taxation rates? Absolutely. That would make economic sense. However, if the Federal government were to follow the recommendation of the OECD without alleviating the current high tax rate environment, my fear is that many businesses will simply wind-up or exit Canada like many entrepreneurs are already considering. That is not good for anyone… especially Canada. Going forward, our governments must carefully consider the risk that high tax policies could erode Canada's tax base, as jobs and capital depart for greener pastures.