Small Business Deduction

The largest financial tax incentive provided to privately held small business corporations in Canada is the small Business Deductions ("SBD"). The SBD allows these companies to pay taxes on their first $500,000 of profit at a significantly lower rate of tax. This mechanism has been a long standing tool to promote growth of small businesses in Canada by allowing for more capital to be reinvested back into the business.

Small businesses are well known to be the drivers of employment and economic growth in Canada. Accordingly, both the Government of Canada and the provinces have recognized the sector's importance and have provided the benefit of the SBD to maintain the sector's health and encourage growth.

Commencing in 1994 the Large Corporations Tax ("LCT") was enacted to generate additional revenues for the federal government. The LCT was a tax on a corporation's "taxable capital" (essentially the value of a company's debts and retained earnings) in excess of $10 million. The taxable capital threshold established a clear division between small and large corporations in Canada. In 2004 the LCT was eliminated for all Canadian firms except for financial institutions and insurance corporations and the taxable capital was raised from $10 million to $50 million.

However, for the SBD purposes the $10 million taxable capital threshold has remained unchanged and is still used as the upper limit for qualification. Once the threshold is exceeded the SBD benefit is reduced on a straight-line basis and is eliminated for corporations with taxable capital in excess of $15 million.

This approach to limiting SBD is punitive and fosters inequality between business and industries in Canada. Corporations and/ or industries that are highly leveraged due to the cost of the equipment used in business or the high cost of inventory that must be maintained (e.g. an automobile dealership) are put at an unfair disadvantage. Accordingly, it would be possible for two similarly profitable companies in similar industries to have significantly different tax burdens entirely based on how they financed their growth.

Prior to 2016, the Government of Canada had laid out plans to further increase the benefits of the SBD by lowering the tax rate on that $500,000 from 11% to 9% by 2019. As of 2016, this rate fell to where it currently sits at 10.5%[1] according to that plan, but has been frozen at this value by the current government since then.

In addition, with the introduction in 2006 of the Eligible Dividend regime and the General rate income pool, private companies retain more profits within the corporation. While this has been a positive change, it will have the unintended consequence of increasing a company's taxable capital and serve to only exacerbate the growth disincentive that is created by the current limitations of the SBD.

Recommendation

That the federal government remove the $10 million taxable capital limitation to the Small Business Deduction.

[1] http://www.taxplanningguide.ca/tax-planning-guide/section-1-businesses/the-small-business-deduction/