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Policy Brief

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Vibrant Small Businesses Are Crucial to Canada's Economic Prosperity

Introduction

Small businesses[1] are the backbone of communities across Canada, an integral part of the country's economic and social fabric. According to Industry Canada, 98 per cent of businesses in Canada, or just over one million, are small (i.e. have fewer than 100 employees).[2] Approximately five million people work in small enterprises, or almost half of the private sector labour force. Roughly 25 per cent of small firms operate in the goods-producing sector while 75 per cent provide services. Small businesses are active participants in Canada's international trade, accounting for one-quarter of the total value of exports.[3]

As impressive as these statistics are, they do not fully convey the importance of small enterprises in our dynamic economy. Small businesses offer

1 There is no uniform definition of a small business. The size of a business can be defined by the value of its annual sales or shipments, by its annual gross or net revenue, by the size of its assets or by the number of employees. Industry Canada defines a small business as having fewer than 100 employees, a medium-sized business having 100 to 499 employees and a large business having 500 or more employees. See Industry Canada. "Key Small Business Statistics." July 2010.

2 75 per cent of businesses in Canada have fewer than 10 employees and 55 per cent have only one to four employees.

3 Industry Canada. (2011). "Canadian Small Business Exporters." *Special Edition: Key Small Business Statistics*. June.

The Canadian Chamber is committed to fostering a strong, competitive and profitable economic environment that benefits all Canadians. This paper is one of a series of independent research reports covering key public policy issues facing Canada today. We hope this analysis will raise public understanding and help decision-makers make informed choices. The papers are not designed to recommend specific policy solutions, but to stimulate public discussion and debate about the nation's challenges.

a wealth of opportunities for enterprising individuals, are a source of new products and innovations, and play a crucial role in promoting competition and economic renewal.

Recognizing the important contributions smaller enterprises make to the Canadian economy, both the federal and provincial/territorial governments employ a range of preferential tax policies to encourage the formation of small businesses and promote their growth.

Small Business Tax Relief Takes Many Forms

A reduced business income tax rate

Canadian-controlled private corporations (CCPCs) with less than $10 million of taxable capital are eligible for the reduced federal income tax rate of 11.0 per cent on the first $500,000[4] of active business income. The $500,000 small business deduction is phased out on a straight-line basis as a CCPC's taxable capital used in Canada rises from $10 million and $15 million. The federal tax rate jumps to 16.5 per cent[5] once a small business becomes public or its income exceeds the $500,000 threshold.

The provinces and territories also provide preferential tax treatment for small businesses although rates and thresholds differ.

Lifetime capital gains exemption

The federal government provides individuals a lifetime capital gains exemption (from personal income tax) of up to $750,000 for gains from the disposition of qualified small business corporation shares (as well as farm and fishing property). To qualify as a small business corporation, a company must be a CCPC and must have all, or substantially all, its assets used in an active business in Canada. Although the qualifying CCPC can be of any size, most are small companies.

Capital gains rollover provision

In 2000, the federal government introduced a measure that allows individuals to defer the tax on capital gains from the sale of shares in an eligible small business corporation where proceeds are reinvested in another eligible small business in the year of disposition or within 120 days after the end of that year. Specifically, to qualify for the tax-free rollover, the business may have no more than $50 million in assets immediately after the investment.

4 The $500,000 limit must be shared among associated group of companies.

5 The federal general corporate income tax rate is slated to fall to 15 per cent on January 1, 2012.

An enhanced Scientific Research and Experimental Development (SR&ED) Investment Tax Credit (ITC)

Small CCPCs with prior-year taxable income of up to $500,000 and prior-year taxable capital employed in Canada of up to $10 million can receive a refundable tax credit of 35 per cent of up to $3 million in qualifying current and capital SR&ED expenditures carried out in Canada per year. Over the $3 million SR&ED expenditure threshold, the credit rate is reduced to 20 per cent, of which 40 per cent may be refundable. The refund takes the form of a cheque and, therefore, provides an important and predictable contribution to cash-flow.

The 20 per cent non-refundable SR&ED ITC is available to large CCPCs and public or foreign-controlled corporations. For these firms, the tax credit is only marginally effective because it can only be used to offset Canadian federal taxes payable.

Payroll tax exemptions

Several provinces have unique payroll taxes that kick in after payrolls cross a certain threshold. Ontario, for example, levies the Employer Health Tax. Eligible employers are exempt from employer health tax on the first $400,000 of Ontario payroll, and employers with annual Ontario payroll of $600,000 or less can make one lump-sum payment along with their annual returns instead of the monthly installments required of larger enterprises. In Newfoundland and Labrador, employers with payrolls of less than $1.2 million are exempt from paying the Health and Post Secondary Education Tax. Likewise, Manitoba exempts firms with $1.25 million or less in annual remuneration from paying the province's Health and Post Secondary Education Tax Levy.

Small Business Owners Face Unique Challenges

Small business owners and entrepreneurs face special challenges not encountered by larger enterprises:

- The Canadian Federation of Independent Business (CFIB) found that small firms, on a per employee basis, face regulatory compliance costs five times higher than their larger counterparts.[6] Small business owners spend more time complying with red tape and less on ensuring the success of their businesses. This results in less business activity and less job creation.

- The CFIB[7] estimates it costs businesses $12.6 billion annually to comply with their tax obligations, the lion's share of the burden ($11.4 billion) carried by small- and medium-sized enterprises. The smaller the business, the higher the tax compliance cost per employee. Average tax compliance costs range from $3,928 per employee for very small firms (i.e. those with fewer than five employees) to an average of $481 per employee for firms with 50 to 499 employees. Contributing to tax compliance costs are a large amount of paperwork, the complexity of the tax system, frequent changes in tax legislation, different rules across jurisdictions and with multiple audits (federal and provincial/territorial). Complying with sales tax rules is a top frustration of many small business owners.

- Small firms face constraints on their ability to raise capital. Access to capital may be particularly challenging for young technology companies with new or unproved products and start-ups that typically lack cash-flow and tangible assets to satisfy a commercial bank's collateral requirements. Indeed, new firms have little experience or history from which to assess their operating performance making information on which to base credit evaluations sparse or non-existent. One challenge of running a small business "is dealing with the feast-or-famine nature. That's not just about the flow of business, but also the flow of cash."[8] Financial difficulties may arise from taxes that are not related to profitability, most notably payroll and property taxes. Profit-insensitive taxes disproportionately burden smaller businesses.

- The formation and growth of small entrepreneurial firms and technology companies may also be hindered by the lack of venture capital funding in Canada. The amount of venture capital financing, relative to the size of our economy, is smaller than that of the United States, as is the typical size of venture capital investment per company. "As a result of these factors, some potentially high-growth companies may fail to develop in Canada, with entrepreneurs having to abandon their ideas or taking their ventures to the United States."[9]

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6 Canadian Federation of Independent Business. (2009). "Prosperity Restricted by Red Tape." *2nd Edition*. November 19.

7 Canadian Federation of Independent Business. (2008). "The Hidden Tax Burden: A Business Perspective on the Cost of Complying with Taxes." *CFIB Tax Research Series*. Report 1. August.

8 Anthony, Joseph. "6 Ways to Improve Your Cash Flow." Microsoft: SME Business Centre. http://www.microsoft.com/business/smb/en-ca/

9 Klyuev, Vladimir. (2008). "Show Me the Money: Access to Finance for Small Borrowers in Canada." *IMF Working Paper 08/22*. Washington: International Monetary Fund. January.

Helping Small Businesses Realize Their Full Potential

Creating a business environment favourable to entrepreneurship, enterprise formation and small business growth requires a broad range of mutually reinforcing and supportive policies:

- Minimizing regulatory and administrative burdens as part of a broader regulatory quality agenda so business owners can dedicate more time to their business and less time to compliance. In this regard, the Canadian Chamber of Commerce eagerly awaits the release of the findings and recommendations of the Red Tape Reduction Commission.
- Promoting inward foreign direct investment which can serve as a vehicle for smaller businesses to access international markets indirectly by joining the supply chains of multinational enterprises.
- Lowering the barriers faced by smaller firms who wish to expand into global markets and become more export oriented.[10]
- Making the tax system simpler, more transparent and easier to understand and follow.
- Improving the administrative management of the SR&ED program to ensure SR&ED investment tax credits are being delivered in a predictable, timely and cost-effective manner to make it easier for smaller enterprises to invest in research and development.
- Providing formal education and training to support small business owners.
- Facilitating access to capital through a wide scope of partners to foster the creation of small businesses, ensure their survival and growth, and encourage investment in productivity–enhancing machinery and equipment and new technologies and processes.
- Exploring ways to facilitate the succession planning process.
- Working to attract immigrants whose skills levels match those needed by employers of all sizes.

These policy recommendations would not only help small businesses grow, they would also benefit large–size businesses—directly and indirectly. After all, neither small business nor large business operates in a vacuum. Each is deeply embedded in the overall Canadian economy, with extensive connections to each other.

10 Free trade agreements can help slash red tape, reduce transaction costs, streamline rules, simplify customs processes, reduce tariff and non-tariff barriers, provide arbitration procedures and increase transparency for businesses of all sizes. They are particularly important for smaller businesses that lack the resources and foreign business partners to navigate and successfully participate in foreign markets.

Conclusion

The vibrancy and competitiveness of our small business sector is crucial for the economic prosperity of our nation. Small enterprises account for a significant share of jobs, serve as a vital source of economic renewal, inject technological innovation and competition, and provide valuable goods and services to consumers and other businesses. Many Canadians owe their livelihood to successful small businesses or to bigger companies that started out small.

Many small businesses face special constraints and barriers that large ones do not that may impede the entry of new small entrepreneurial firms or greatly diminish the chances of survival of existing firms. The challenge for policymakers is to select the best policy tools to address them.

"By building on the strength of our entrepreneurs their vibrancy, optimism and talent—we can ensure they become Canada's path to prosperity."[11]

11 Nixon, Gordon. (2002). "Canada's Path to Prosperity: Growing our Small and Medium-sized Enterprises." *Presentation to the Queen's Centre for Enterprise Development, Queen's School of Business, Queen's University*. Toronto: RBC Financial Group. October 7.

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