Small Business Deduction

The largest financial tax incentive provided to privately held small business corporations in Canada is the Small Business Deduction ("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.

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 (and expanded) the benefit of the SBD to maintain the sector's health and foster 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 bright line test of what was considered to be a small corporation and a large corporation in Canada. In 2004 the LCT was effectively eliminated for most Canadian corporations, and the taxable capital limit 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 the 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.

In addition, with the introduction in 2006 of the Eligible Dividend regime and the General Rate Income Pool, private companies will retain more profits within the corporation. While this is a positive change, it will increase a private company's taxable capital and serve to exaggerate the limitation of the SBD.

Recommendation

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