Intelligence MEMOS

From: Rosalie Wyonch, Bill Robson, and Alex Laurin

To: The Honourable Bill Morneau, Minister of Finance

Date: February 28, 2017

Re: **Why the Small Business Deduction Should be a Young Business Deduction**

The federal corporate income tax provides a small business deduction that taxes the first $500,000 in active business income of Canadian-controlled private corporations at a lower rate than the regular corporate tax. While justifiable as a measure to lower costs and improve returns for start-ups, providing a concessional rate to every business that is small creates problems.

Incorporated professionals and "lifestyle" small businesses reap much of the benefit, and it can discourage growth and encourage tax-driven income and asset shuffling to avoid tax at the higher normal rate. These distortions hurt Canada's economic performance: small firms, on average, are less productive than larger ones, and unambitious firms are almost by definition less productive.

Moreover, the revenue cost of the small business deduction – estimated at more than $4 billion in 2017 – is substantial. So Ottawa effectively finances it with lower spending or higher taxes elsewhere. Not a winner on fairness grounds, and not effective in promoting growth and jobs.

A better approach would target start-ups – young, growth oriented firms. As recommended in our recent federal Shadow Budget, orienting the deduction to firms that are just starting out would remove the incentive for firms to stay small that the existing deduction creates, and reduce tax-planning opportunities for high-income individuals whose decisions to incorporate reflect only tax considerations.

One way to structure a tax provision targeting young businesses would be to link it to their capital assets. At five-year intervals the threshold level of capital assets that qualifies for the tax preference would rise, and the tax-rate advantage would fall, until it converges with the standard corporate tax rate.

As a transition measure, mature small businesses could be treated like new firms, giving them time to adapt. The reform would pose enforcement problems: it would need anti-avoidance safeguards to prevent businesses restarting their deduction clocks by rolling their assets into a new company at regular intervals, as well as measures to discourage fragmentation of business activities.

The prospect that people would try to game the new system is not a decisive argument against it, because the current regime is rife with gaming. Your 2016 budget cancelled previously legislated reductions to the small business tax rate, and introduced measures to reduce access to the small business deduction for incorporated professionals with the objective of limiting the use of the deduction to lower tax rates outside its intended purpose. The challenge of effective administration is worth confronting for the sake of a tax change that would stop rewarding businesses for staying small, but instead push them toward success.

William B.P. Robson, Alexandre Laurin and Rosalie Wyonch are the co-authors of the recently release C.D. Howe Institute report, "Getting Real: A Shadow Federal Budget for 2017"