

The evaluation of current small business tax policy economics essay

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In a sound tax system, all tax measures must adhere to the guiding principles of fairness, neutrality, and simplicity.[1] Since the goal of small business tax policy is to encourage growth, any assessment of small business focussed proposals must be made in consideration of these overriding policy aims, yet must also evaluate the proposal's ability to establish a supportive environment for small firms, for example by providing relief from onerous tax and regulatory requirements or enabling small businesses to be competitive despite any disadvantages in size. A tax system is fair when it impose requirements in an equitable manner.[2] There are two forms of equity: horizontal equity and vertical equity. Horizontal equity is achieved when a policy establishes similar burdens on taxpayers who have similar circumstances.[3] Vertical equity refers to imposing different burdens on taxpayers based on their ability to pay.[4] In the context of small business taxation, this principle implies that business taxes should be imposed at similar rates across all types of business activities. This is due to the fact that businesses can be owned by both rich and poor individuals, and so the ability to pay is best represented at the individual level. Neutrality is achieved in the tax system when tax policies avoid distorting the decisions taxpayers make with regard to the use of their economic resources.

[5] Governments should be cautious when meddling with the tax system since they may unintentionally impede economic growth by incentivising the misallocation of resources. For example, different treatment of types of business organization may distort the choice of legal form. It should be noted that the tax system is just one of a number of public policy tools that governments can deploy to influence economic behaviour. Regulations or

subsidies might be used in lieu of tax measures and may actually be more preferable. Every situation should be assessed individually in order to determine what policy tool might be the most effective in achieving a given goal and in minimizing the distortion of economic decisions. Simplicity in the tax system refers to the ease with which taxpayers understand the rules and correctly comply with those rules in a cost-efficient manner.[6] This is an important goal because complicated rules increase the compliance costs for both taxpayer and government.[7] Complexity increases the costs for firms since they will have to obtain accounting and legal services to navigate the tax system. Complexity also increases costs for the government since it will have to expend more resources to monitor and enforce tax collections. Thus, the tax system should accommodate the difficulties that small firms face in dealing with these compliance costs. This section will assess current small business tax policy in light of the above policy aims through discussion of three important issues: (1) distortions caused by the "notch problem," (2) distortions over the choice of legal form, and (3) the capital gains lock-in effect.

Distortions caused by the "notch problem"

Tax reliefs that attempt to target businesses based on size, by necessity, create thresholds. For example, in order to be eligible for a specific tax relief, a business might be required to employ fewer than a specified number of individuals or earn less than a specified amount of profit. These thresholds have the effect of discouraging growth since if a firm grows beyond a certain limit (in terms of employees, income, or assets), it will lose eligibility for the tax relief it had once benefited from. This result is described by economists

as the "notch problem," and diminishes the neutrality of the tax system.

[8]The "notch problem" can be seen in many of the small business tax measures described in the previous section. For example, the highest R&D tax credit rate is only available to small CCPCs, which may be an important factor in a business owner's decisions concerning growth and investment. However, the tax relief that best exemplifies the economic distortion caused by the "notch problem" is the small business deduction. The wider the gap is between the small business rate and the general corporate rate, the greater the distortion is on business decisions. The small business deduction create a strong incentive to stay below the limits on income and asset size, thereby inhibiting growth at the firm level. On a macro level, long-term economic growth is also negatively affected since business owners would prefer to remain as CCPCs to maintain eligibility for the relief, however CCPCs tend to have relatively little access to capital financing as compared to large businesses.[9]The small business deduction also discourages growth through its interaction with the personal income tax. When a corporation earns income, it is taxed once at the corporate level and again at the individual level when the firm's earnings are distributed as dividends to its shareholders. Although the dividend tax credit system offsets this result to some degree, it does not completely neutralize the effect of double taxation at the general corporate rate.[10]Consequently, under the general corporate rate there is a higher level of taxation on income channelled through a corporation than there would be on income earned directly, for example through salaries. However, since the small business deduction reduces the general corporate rate, the effective tax rate paid on dividend income ends

up being less than, or equal to, the income tax rate for individual income.

[11]This creates an incentive to keep the firm small so that the small business owner can continue to avail of this financially appealing tax rate. Put otherwise, double taxation is not an issue for qualifying CCPCs. However, this benefit only extends to the first \$500, 000 of the CCPC's active business income. The inevitable result of this limit is that it can again distort business decisions, as business owners will be encouraged to avoid paying higher tax rates on dividend income by paying out any excess business income as salaries or bonuses rather than as dividends. While detailed aggregate accounting data on small business sector performance is scarce, the negative effect that the small business deduction has on growth has been borne out empirically. In one study, data on small business performance demonstrated that the small business deduction appeared to be a strong tax-driven incentive for business owners to keep their firms within the threshold limits of the tax benefit.[12]The longitudinal study looked at data collected on small businesses between 1985 and 1993 and found that the majority of CCPCs were employer firms that earned less than \$200, 000 annually, which was the threshold limit at the time.[13]Further, in any given year, the total small business deduction claimed was around \$1. 5 billion, and roughly one third of this amount went to non-employer CCPCs. [14]Additionally, the study found that less than one percent of CCPCs in a given cohort actually grew beyond the \$200, 000 threshold or made the transition to publically traded company.[15]Thus, the effectiveness of the small business deduction in driving growth appears to be limited to a narrow sliver of claimant firms.

Distortions over the choice of legal form

The different tax treatment of different forms of business organization may cause one legal form to be favoured over another, depending on the circumstances of the small business. Since many of a business' economic activities can be carried out in a variety of legal forms—ranging from employee, to sole proprietor or partnership, to incorporated firm—the availability of specific tax relief for small businesses may distort decisions over legal form, as taxpayers will attempt to structure their activities to qualify for such relief. As a result, the firm will spend more resources on trying to avoid taxes that could have been directed towards innovation or growth. There are a number of tax advantages in choosing to incorporate a small business, specifically as a CCPC, as compared to structuring it in an unincorporated form, such as a sole proprietorship or a partnership. First, using the reduced small business rate, owner-managers are able to shelter income earned via the corporation, since only the reduced corporate tax rate is applicable. This sheltered income can then be switched into capital gains or alternatively, the sheltered income can be paid out as dividends. As discussed above, even after taxing the dividend income, the combined effective tax rate would still be lower than the top marginal tax rate for individuals, thanks to the effect of the small business deduction. The second tax advantage of incorporation is that it gives owner-managers the ability to channel their labour income through a corporation—effectively transforming labour income into income from capital—which means that if the firm is sold, the lower capital gains tax rate would be applicable rather than the higher individual income tax rate. Further, any capital gains taxes could be avoided

through the use of the lifetime capital gains exemption, which is only available for CCPCs. The third tax advantage of the corporate form is that it allows owner-managers the opportunity to split income. Ownership of shares could be spread among family members in lower tax brackets so that dividend income is distributed across individuals and total tax obligation for the family is minimized, as compared to the tax obligation resulting from one shareholder receiving all the dividends. In Canada, the effective combined federal and provincial rate for CCPCs is 20 percent and the dividend tax credit eliminates the effect of this tax from small business dividend income. [16]In contrast, income from employment or from self-employment is taxed upwards of 46 percent.[17]Taken together, this combination of rates results in a lack of horizontal equity among differing legal forms and particularly between individuals who earn income as an employee and owner-managers who earn income through a corporation that offer services that are essentially identical to employees. Consequently, rules have been legislated significantly limiting the use of personal service corporations to minimize taxes.[18]In addition, income from a CCPC is typically shared with family members who own shares but do not contribute much to the company in the way of labour. As a result, the Canada Revenue Agency had repeatedly attempted litigation to restrict this type of income splitting.[19]The legislation targeting personal services corporations has addressed the more blatant tax avoidance schemes, however with appropriate planning and care, taxpayers can still legitimately organize their business affairs to avoid the personal services corporation rules. The litigation directed toward income splitting however has been nowhere near as successful in addressing tax

avoidance, as the Supreme Court of Canada has ruled that income splitting using dividends was an acceptable practice.[20] Thus, it is clear that the appeal of small business tax relief remains significant enough to influence small business owners' choice of legal form.

The capital gains "lock-in effect"

The main weakness of capital gains taxes is the fact that they discourage owners from divesting their shares or property. Consequently, capital gains taxes may impair market efficiency when owners opt to hold onto their investments instead of disposing of their capital and reinvesting their gains into more profitable investments, a result called the "lock-in effect." [21] The lifetime capital gains exemption and the capital gains rollover both help alleviate this problem to a certain degree. The lifetime capital gains exemption eliminates the deterrent effect on divestiture up to a \$750,000 limit. Further, the capital gains rollover allows small business investors to defer capital gains tax obligations, so long as the investor reinvests their capital gains into another small business. This allows investors to avoid capital gains taxes as they shift investments in their portfolios. While these two tax measures provide some relief, they could be broadened and expanded in order to improve overall economic efficiency. The ceiling on the lifetime capital gains exemption has the effect of punishing small business owners if the firm is too successful and the resulting capital gains exceed the \$750,000 limit. Also, the capital gains rollover applies only to reinvestment into another qualifying small business. Thus, the relief does not extend to small business owners who want to reinvest into any type of ventures that

are not small businesses, limiting their ability to adjust their portfolios to include more profitable ventures.

Recommendations

The primary goal underlying the following recommendations is to establish tax measures that encourage small businesses to pursue economic growth, and also to avoid any tax measures that unintentionally create barriers to growth. The evidence suggests that current tax measures, such as the small business deduction, create distortions in the tax system that result in support being provided to poorly performing business or businesses that do not even intend on growing. The "notch problem" also has the effect of deterring many small businesses from growing, as they would lose the special tax preferences that they had previously rely on. In place of these flawed tax initiatives, governments should implement tax reliefs that better target and benefit the small businesses that actually intend to grow, without creating any unnecessary threshold requirements. With this guiding principle, the following tax initiatives are recommended: (1) alignment of small business and general corporate income tax rates, (2) alignment of tax rates on labour and capital, and (3) broader capital gains tax deferrals.

Alignment between small business and general corporate income tax rates

Out of all the tax preferences designed to support small businesses, the small business deduction is possibly the most ill-advised since it creates a strong tax incentive to stay small. As discussed above, the current federal small business deduction results in a tax rate of 11 percent while the general corporate rate is 15 percent. Rather than continuing the trend of cutting both

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the reduced and general rate, the focus of any rate changes should be on reducing the gap between both rates. To that end, one alternative would be to eliminate the small business deduction altogether and implement a 14 percent flat rate on all corporate income, regardless of size. The federal government calculated the cost of the small business deduction to be \$4.4 billion in 2008, based on a gap of 9 percentage points between the general rate and the small business rate.[22]Based on this figure, the cost was \$488 million for every percent point difference. Therefore, if the small business rate were raised from 11 to 14 percent, the government would see an increase in tax revenues of roughly \$1.46 billion. As for the corporate income rate, government estimates showed that a drop of one percent of the corporate rate costs \$1.45 billion in lost tax revenue.[23]Consequently, if the small business deduction was discarded for a flat general corporate rate of 14 percent, the change would actually result in a marginal increase in tax revenues of \$10 million. Notably, this simple calculation does not take into account a number of other beneficial effects. First, and most importantly, a 14 percent flat corporate tax would remove the financial incentive for firms to stay small. Second, a 14 percent flat tax creates a simpler tax system that benefits small businesses who no longer have to incur expenses on costly accounting services and tax avoidance strategies.[24]Third, a lower general rate would reduce the impact of double taxation on foreign investors who do not qualify for the dividend tax credit, thereby making Canada a more attractive tax jurisdiction for foreign investment.

Alignment between tax rates on capital and labour

Differences between tax rates on capital and labour income result in a lack of horizontal equity between taxpayers of different legal forms—employees, non-incorporated businesses, and incorporated businesses—thus influencing the choice of legal form. The trend towards reduced corporate rates, both generally and for small businesses, taken together with the progressive rate of tax on labour, further reinforce this distortion. In the context of small businesses, elimination of this distortion calls for alignment between tax rates across all types of legal forms, whether the income are generated from labour or capital. One approach to removing distortions in the system would be to ignore legal differences between different types of income and levy taxes based on economic substance. Essentially, all or part of the income from an unincorporated business or CCPC would be recharacterized as labour income and then taxed at the rate for individual income. This is the approach used in Scandinavian countries like Norway, where corporate income and labour income are combined into a "dual-income tax" that is calculated using a low flat rate for income from capital, equivalent to the corporate income tax rate, and a progressive rate on income from labour.[25] To eliminate the incentive to transform labour into capital income, the design for small business taxation in the Nordic system has two important features: (1) an election for unincorporated firms to have part of their income taxed at lower corporate rates and (2) a tax on shareholder income determined by a rate of return allowance.[26] Unincorporated firms can make an election to have a portion of their income be subject to the lower rates on income from capital.[27] In order to determine the portions of income attributable to the

use of capital and from labour, it would be necessary to monitor the working hours of the self-employed. To address this logistical impossibility, an imputed return on business assets is calculated.[28]The imputed return is subsequently taxed using the lower rate on income from capital and the remainder of the firm's income is taxed at the higher progressive rates as income from labour.[29]Under the Nordic system, closely held corporations are also subject to similar application of both capital and labour income tax rates, however for these corporations the scheme is mandatory.[30]This scheme allows for the reduced tax obligations for normal returns to capital while also aligning the effective tax rates for corporate income and labour income for any excess returns.[31]The system uses an imputed normal rate of return for income from capital to determine how much of a shareholder's dividend income should exempt from the tax system.[32]The reasoning behind the exemption is that since the rate of return allowance amount has already been subject to the capital income tax rate, it therefore should not be taxed further. On the distribution of a dividend, only dividend income above this allowance will be taxed, and the rate used would equate to the top marginal tax rate for individuals.[33]This mirrors the effect of the treatment for unincorporated firms, where the imputed return on assets is subject to the lower tax rate on capital and any excess is taxed at the higher rate for labour. The Nordic system is appealing for a number of reasons, the most important being the resulting restoration of horizontal equity. Since the same flat tax applies to all sizes of business, the "notch problem" would be eliminated. Further, the low tax on capital income—applicable to corporate income, capital gains, interest, and dividend income—would be beneficial for

entrepreneurship since owners would be able to retain more of their gains and reinvest in their businesses. Admittedly, this is a radical proposal and it is not suggested that these schemes could be easily implemented in Canada. Nevertheless, the Nordic system does offer value in providing an alternative way of thinking about, and addressing, equity issues in small business taxation.

Broader capital gains tax deferrals

Improving access to capital is one of the main rationales for providing tax preferences to small businesses. Changes to the treatment of capital gains may improve the incentives for capital investments in the small business sector. One approach recommended by Mintz and Wilson is the creation of a "capital gains deferral account" (CGDA).[34] Using a CDGA, investors would be able to defer capital gains tax obligations by rolling over investments in the account until the investments are sold and funds withdrawn. Unless those funds are used to make another investment in the account, the capital gains tax would apply.[35] Any assets capable of producing a capital gain, such as securities or real property, would be permitted to be used in the CDGA.[36] To reduce the fiscal cost of the incentive and prevent unlimited deferral of capital gains tax, a number of limitations could be imposed on the CDGA. For example, the CDGA could be limited to eligible small business owners and there could be both annual and lifetime limits on the amount that an investor could contribute to the CDGA.[37] By limiting the amount an investor is able to invest in a CDGA, this incentive better targets small business owners and small investors.

Conclusion

There is no doubt that small businesses play an important role in the growth and performance of the Canadian economy. The data collected on the small business sector demonstrates that small businesses serve as a revitalizing force on the economy, driving change and innovation in a variety of industries, and accounting for nearly half of the country's GDP and half of the country's private sector employment. The contributions that small businesses make to the country's economy propel much of the broad political support for the government's enactment of policies to help support the small business sector. There are a number of rationales justifying the provision of tax relief for the small businesses. Chief among these justification is the existence of market failures that inhibits the creation and growth of small businesses. An oft-cited market failure of this kind would be imperfections in the capitals markets that prevent small firms from accessing the financing needed to grow. Another important rationale for small business tax relief is to counter the disadvantages small firms face due to their size. Smaller firms bear relatively higher compliance costs compared to larger companies since they lack economies of scale. Tax measures might be one tool with which governments can correct market failures, however they would need to address the root causes of any imperfections in the capital markets. Caution must be exercised in designing reliefs and incentives. The policy aims of fairness, neutrality, and simplicity should be considered in designing any tax measure. Ideally, basic economic considerations, not tax policy, would be the driving principles when a business owner makes decisions regarding firm organization, investment, and growth. This

fundamental principal has been contravened by many of the tax preferences provided by the federal and provincial governments. Analysis of current small business tax benefits suggests that it is difficult to justify many of the current reliefs both on equity and neutrality grounds. Small business tax benefits lighten the tax burden on business owners, but in doing so, they weaken the progressivity of the personal income tax system. Moreover, the design of current tax measures impedes growth by placing size limits for qualification, thereby creating an incentive for businesses to stay small in order to maintain eligibility. The available data on small firms strongly suggest that the small business sector's economic activities appears to be tax driven. The data also suggests that small business creation and growth are not sufficiently constrained by market failures to justify special tax preferences. The unnecessary impairment of the tax system's neutrality dulls the country's economic dynamism, as business owners are effectively discouraged from growing their firms. Changes to the tax system should be assessed to ensure that market failures are addressed without causing any economic distortions or spurring tax-driven business decisions. From the perspective of small business taxation, providing more generous small business tax relief in its current form will likely not result in any further economic growth, but instead may create more distortions in the tax system: taxpayers will be further enticed to incorporate in order to avoid taxes and tax reliefs will provide more support to poorly performing firms. Economic theory maintains that efficiency gains produced by income tax reduction are maximized when the taxes do not distort decisions regarding production and organization within firms and all returns to capital are taxed at the same

rate. The policy recommendations outlined in this paper would have a dramatic effect with regards to addressing the disincentives to growth that currently afflict small business tax system. By eliminating the incentives for firms to stay small, Canada's economy will become more competitive overall. It should be noted however, that tax preferences for small firms will be of little use if a firm benefitting from the relief is not aiming to grow. Thus, the policy recommendations in this paper attempt to strike the right balance between supporting the small business sector and encouraging innovation and growth.