
Compliance Issues: Small Business and the Corporate Income Tax System

Plamondon & Associates Inc.
Ottawa

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Prepared for the
Technical Committee on Business Taxation

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Abstract

The corporate income tax system is functioning reasonably well for small business in Canada, with no dramatic flaws or overwhelming irritants. While there is room for improvement, this is the overall conclusion of this report to the Technical Committee on Business Taxation. The report focusses on the nature and extent of incremental compliance costs, specific irritants in the system, and revenue-neutral initiatives that the government could undertake to improve and simplify the system for Canada's entrepreneurs. The data in the report was generated primarily from a discussion panel of six accountants who deal exclusively with small business. Given the absence of any field work with individual small businesses, the representations and opinions should not be viewed as definitive. While noting that the incremental compliance costs for completing a basic corporate tax return for most small-businesses is between \$200 to \$500, the panel recommended: a short-form corporate tax return to promote an understanding of the system; a simpler and fairer system for capital assets; elimination of separate provincial corporate tax administrations; less frequent tax installments; a less costly method of dealing with inactive corporations; more certainty and fewer changes in the system; and, greater consultation with individual small businesses concerning compliance costs and the functioning of the system. The panel also observed: the proper functioning of the Small Business Deduction; tax planning that focusses on income splitting and reorganization of share capital; clearly legitimate claims for R&D credits not being made; the use of estimating techniques to comply with non or partial deductibility of expenditures; the complexity of provisions concerning company vehicles; and, the high level of professionalism and level of assistance given to small business by Revenue Canada.

Table of Contents

1.	Executive Summary	1
2.	Objectives	3
3.	Methodology	4
3.1	Defining Small Business for this Study	4
3.2	Data Gathering	4
3.3	Panel Preparation and Organization	5
3.4	Identification of Issues	5
3.5	Post-panel Review	6
4.	Issues	6
4.1	Completing the Corporate Tax Return	6
4.2	Integration	8
4.3	Tax Planning.....	10
4.4	Compliance.....	10
4.5	Research and Development Tax Credits	11
4.6	Capital Acquisitions	13
4.7	Allocation of Income to Multiple Provinces	13
4.8	Manufacturing and Processing Profits	14
4.9	Non- or Partially Deductible Expenses	14
4.10	Automobiles	15
4.11	Non-harmonized Provinces	16
4.12	Tax Instalments	16
4.13	Filing Deadlines	17
4.14	Penalties for Late Filing or Payment.....	18
4.15	Inactive Corporations	18
4.16	Revenue Canada	18
4.17	Other Issues.....	19
5.	Strengths and Limitations of the Research	20
6.	Areas for Further Study	20
7.	Research Team	21
	Appendix A: Agenda for Panel Discussion	23

1. Executive Summary

The corporate income tax system is functioning reasonably well for small business in Canada, with no dramatic flaws or overwhelming irritants. While there is room for improvement, this is the overall conclusion of this report to the Technical Committee on Business Taxation, established in the 1996 budget to review Canada's business tax system.

While the Committee's primary objective is to determine how the tax system can contribute more to the creation of jobs, the Committee is also examining related issues such as complexity, compliance costs and overall level of fairness of the system. This report is in support of the Technical Committee's work and examines one aspect of business taxation: small business and the corporate income tax system. In particular, this report focusses on the nature and extent of incremental compliance costs, specific irritants in the system and revenue-neutral initiatives that the government could undertake to improve and simplify the system for Canada's entrepreneurs.

The data in the report were generated primarily from a discussion panel of six accountants who deal exclusively with small business. The panel centred its discussion around companies with annual revenues of less than \$2 million to focus on those businesses that must grapple with the tax system without the benefit of "in-house" expertise. Other insights were gained from having panelists review their client files and an extensive post-panel review of the report.

Given the absence of any field work with individual small businesses, the representations and opinions contained in this report should not be viewed as definitive. However, the value of this work need not be understated since the panelists work with thousands of small businesses from across Canada and have first-hand experience about how the system operates – or fails to operate.

Specifically, the panel offered the following specific observations and recommendations concerning small business and the corporate income tax system:

1. Small business relies on specialists to complete the corporate tax return. The system is too complex, the return too lengthy and the efficiencies of using a specialist too great to do otherwise.
2. The incremental costs of completing a basic corporate tax return for most small businesses are between \$200 to \$500. This amount does not vary significantly by the type or size of small business. This cost estimate assumes that small businesses maintain core accounting systems that produce management information, including the year-end financial statements that are not "incremental" to the production of the corporate tax returns. The incremental costs, therefore, include the cost of computer input, adjustments from the financial statements on the T2S(1), preparation of accompanying schedules (e.g. capital assets), and, in most cases, a second review by another partner in the accounting firm. Costs associated with tax planning are also excluded for the \$200 to \$500 estimate.

3. Despite the fact that small-business owners certify the completeness and accuracy of the return, they rarely review its contents because of its length and complexity. A short-form small-business corporate tax return was advocated by the panel.
4. The integration concept with the small-business deduction (SBD) working as intended without significant complexity. There was no consensus on whether the SBD limit should be raised or changed to permit a larger low-cost pool of investment capital for small business.
5. Much of the tax planning that occurs in a small business relates to income-splitting, reorganization of corporate share capital, and establishment of family trusts. A prevalent attitude among small-business owners is that, given the risks and uncertainty that comes with self-employment, they are entitled to organize their affairs to pay less tax than someone who enjoys the comfort of a regular salary. The more sophisticated measures of tax planning are a response, in part, to the elimination or reduction of many other deductions for items such as meals, the use of home offices and company vehicles.
6. The tax advisor plays a critical role in how a business owner approaches tax-planning opportunities. They also have a positive influence on compliance with the tax system.
7. The compliance costs associated with making a single claim for research and development (R&D) tax credits are in many cases greater than the level of credit available to most small businesses. Consequently, many clearly legitimate claims for R&D credits are not being made. There is also concern over an emerging industry that makes R&D claims on behalf of clients on a contingency fee basis.
8. The treatment of capital assets could be simplified by reducing the number of asset categories. The system could also be made fairer by permitting a claim for terminal losses when an asset category is substantially depleted.
9. Most small businesses deal with issues of non- or partial deductibility of expenditures by employing estimating techniques (e.g. for meals and entertainment). This approach reduces the overall level of compliance costs and does not necessarily result in a material difference in the amount of tax that would have been assessed had more precise methods of tracking been employed.
10. The provisions of the *Income Tax Act* concerning company vehicles are so complex that most business owners acquire their own cars and charge a "reasonable allowance" to the company for their use. It was suggested that even junior-level Revenue Canada auditors have difficulty computing the taxable benefit on company cars.
11. The existence of separate corporate tax administrations in Ontario, Quebec and Alberta add about 50 percent to the incremental cost of completing tax returns for small businesses in these provinces. Complexity and cost were also noted in maintaining two tax instalment accounts. Given the very minor differences in tax policy, the panel did not see the benefit of sustaining separate bureaucracies.

12. The operation of tax instalments should be simplified by eliminating the requirement for small businesses to make monthly payments. Quarterly payments were recommended, since this frequency coincides with the filing of the Goods and Services Tax (GST) return and payment. Small businesses, however, would prefer a system where they continue to remit separate cheques for different taxes.
13. It should be less onerous and less costly to complete tax returns for inactive corporations. It was recommended that a letter or form signed by the business owner certifying that a business is inactive should satisfy any requirements of Revenue Canada.
14. Generally favourable comments were given about the professionalism and level of assistance given to small business by Revenue Canada.
15. Uncertainty and the frequency of change to the tax system are issues that raise compliance costs. The panel also noted that compliance costs do not appear to be given sufficient consideration when the tax system is being changed. It was thought that greater direct consultation with those who work exclusively with small business would avoid many problems, such as the difficulties associated with the recent change to calendar year-ends for unincorporated businesses.

2. Objectives

As part of the 1996 federal budget, the Minister of Finance, the Honourable Paul Martin, announced the establishment of a Technical Committee to consider ways in which Canada's business taxation system could contribute more to the creation of jobs.

The focus of the Committee's work is to improve the tax system to help create jobs, spur economic growth, simplify the system for business, reduce compliance costs for business and administrative costs for government and enhance fairness. The Technical Committee is to table a report to the Minister, after which public consultations will follow.

The broad objective of this report is to assist the Technical Committee primarily with corporate income tax issues that are of particular concern to small business in Canada. Particularly, the objectives are to respond to the following questions:

- Which compliance issues in the corporate income tax system are of particular consequence to small business?
- What is the range of incremental costs that small businesses incur in complying with the corporate income tax system?
- What specific initiatives might the government enact to minimize compliance problems for small business?

3. Methodology

3.1 Defining Small Business for this Study

While there is no generally accepted definition as to what constitutes a small business in Canada, most studies place an upper limit of an annual revenue below \$5 million.¹

For purposes of the *Income Tax Act*, a preferential tax rate is granted to Canadian-controlled private corporations on the first \$200,000 of taxable income. This level of income could be generated from a business with revenues of slightly over \$200,000 (assuming limited expenses) to businesses with revenues in the millions of dollars.

It is reasonable to assume that businesses with revenues in excess of \$2 million would ordinarily have some in-house accounting expertise that would make them better able to address compliance issues.

Since the focus of this research is to consider "small-business" issues, it is prudent to ensure the focus is on those businesses that do not have "in-house" expertise – those who must deal with the requirements of the *Income Tax Act* on their own or with the assistance of an external advisor. Accordingly, the report will speak primarily about those businesses with revenues below \$2 million.

3.2 Data Gathering

A number of constraints and considerations affected the selection of research methodology for this project, including the following:

- The project duration, from inception to final report, was six weeks;
- Financial resources are limited; and
- Small-business owners themselves are generally not knowledgeable about corporate tax issues and rely on tax specialists to assist them with tax planning and compliance. Their direct involvement in the research, therefore, was unlikely to answer the key research questions.

After consultation with the client and tax practitioners, it was determined that the most efficient, effective and timely manner of gathering data was through the use of a specialist panel. The panel would be knowledgeable about small businesses in general, and specifically how they deal with the corporate income tax system.

¹ This limit has been used by Statistics Canada in a 1986 study profiling small business in Canada.

A panel of accountants has been successfully employed by the research team on three projects, all of which concerned tax policy.² The panel for this project comprised partners in accounting firms that specialize in serving small business.³ The partners would typically serve hundreds of small business clients representing all sizes of businesses and all industries. The panelists also represented different regions of Canada, coming from Vancouver, Toronto, Ottawa, Montreal and Halifax.

3.3 Panel Preparation and Organization

The panel discussion took place on July 5, 1996. Included in the day-long session were six practising accountants, Robert Plamondon as the moderator and representatives of the Technical Committee Secretariat and the Business Income Tax Division of the Department of Finance.

Panelists were forwarded a copy of the discussion guide before the meeting and instructed to spend one half day to consider the issues identified; think about other relevant issues; and review client files (in particular to assess the incremental cost of completing corporate income tax forms).

The day was guided by an agenda that permitted an open and free-ranging discussion to promote an in-depth exploration of the issues under consideration.⁴ The day began with introductions and an overview of the work of the Technical Committee by John Sargent.

Panelists were encouraged to be vocal throughout the day and to challenge each other if they had a difference of opinion. They were instructed to represent themselves, their clients and the small-business community as a whole. No specific client was mentioned, and all confidences were strictly observed. Further, no specific comments would be attributed to any of the participants.

3.4 Identification of Issues

While the mandate of the Technical Committee is to examine issues related to the business tax system, jobs and economic growth, the directed focus of this work was the compliance burden and specific irritants experienced by small business related to the corporate income tax system.

The issues were initially identified by the research team and reviewed by the Technical Committee. Almost all of the issues discussed during the panel discussion were identified and included in the agenda circulated before the meeting.

² For example *GST Compliance Costs for Small-Business in Canada* by Plamondon & Associates Inc., December 1991.

³ A listing of panelists is included in section 7 of this report.

⁴ See Appendix A for a copy of the agenda.

Some other considerations were made in issue identification, such as the need to maintain the same general level of tax revenue and the requirement that tax policy be co-ordinated with provincial governments.

3.5 Post-panel Review

In addition to preparation and participation in the discussion, all panelists were given a draft copy of the report for their comments. In particular, they were asked to spend an additional one half day to confirm the reporting of the discussion, add additional relevant material and provide illustrations to underscore some of the points and issues raised during the discussions.

4. Issues

4.1 Completing the Corporate Tax Return

4.1.1 By Whom

It was the unanimous view of the panel that virtually all individual businesses do not prepare their own corporate income tax returns as, in all cases, the tax return is completed by an external accountant. This is not the case just for small business, but for many larger businesses as well that have full-time in-house professionals and revenues of over \$50 million.

Businesses seek outside assistance for three reasons. First, they believe they lack the technical knowledge to complete the tax return. Second, they are concerned about changes to the system with which they may not be familiar. Third, they save time and money by having accounting specialists complete the return in the most efficient manner.

Interestingly, even accounting firms have specialists who complete or review corporate tax returns. Partners in the firm who deal with a broad range of issues find it difficult to stay current with the detail of the *Income Tax Act* and regulations. Entry-level staff do not have the requisite experience. It is mid-level staff members, typically with 3 to 10 years of experience, who complete the return. Their specialization makes them very familiar with both the details of the *Income Tax Act* and the computer program that generates the return.

It was noted that the larger and more sophisticated clients prepare most of the background information and schedules that form part of the return. However, for most small businesses without accounting or tax expertise, it is the external accountant who compiles the supporting data and schedules.

When exploring other reasons why specialists are required, the panel noted the frequent and significant changes that are made to the tax system. There is a deep concern that unless someone is dedicated exclusively to tax issues, there is a risk that some issues will be overlooked. The frequent changes, or at least the fear of change and its consequences, are what drives many large corporations to seek outside help, and many accounting firms to use specialists.

4.1.2 How Returns are Completed

Virtually all corporate income tax returns are completed with the use of computer software programs. The programs themselves are relatively inexpensive to acquire, with staff training representing the more significant cost. Focussing the training on only a few individuals within an accountant's office adds to the efficiency of the process.

4.1.3 Incremental Costs

Surprisingly, the panelists reported that the incremental cost to small businesses in having a corporate tax return completed is relatively low – ranging from \$200 to \$500 for most returns. This cost estimate was derived by having the panel review a number of corporate income tax files from their client base and by discussing the issue with the specialists in their offices who complete the returns. All panel members agreed that the \$200 to \$500 range represented a reasonable estimate of incremental costs.

The definition of "incremental" compliance costs requires elaboration. It is assumed that, in every business, there exists a core accounting system that is used to produce information for management: including the year-end financial statements. Thus, the cost of maintaining the accounting records and the production of financial statements are not "incremental" to the production of the corporate tax returns. Once the statements are produced, the accountant uses this data as the foundation for the preparation of the tax return. The incremental costs, therefore, include the cost of computer input, adjustments from the financial statements on the T2S(1), preparation of accompanying schedules (e.g. capital assets), and, in most cases, a second review by another partner in the accounting firm. The costs do not include expenses related to personal or corporate income tax planning, including decisions regarding the salary-dividend mix or the payment of income to family members who are involved in the business.

The cost does not vary significantly by size of business or industry. This means that as a percentage of business revenue or profit, the cost of the return is proportionally much higher for small firms than for larger companies.

The contents of a basic tax return do not vary much from business to business. Even a very small company with a limited number of transactions still has to pay the \$200 to \$500.

The presence of specialized information increases compliance costs. As will be noted later in this report, completing claims for research and development (R&D) tax credits can cost from \$1,500 to \$5,000 in scientific and professional fees.

The panel was asked if the need to compile data on such issues as the partial deductibility of meals and the use of company vehicles added significantly to the level of compliance costs. They reported that most companies take short-cuts and use estimates to deal with many of these issues. They believe that any difference between the estimate and precise data would not result in a material difference in the assessment of tax. Consequently, most businesses and their accountants

are not prepared to invest the time to be precise in their calculations. Even large firms do not keep detailed records on items that require adjustment on tax returns.

4.1.4 Other Issues on the Corporate Tax Return

In open discussion, the panel raised other concerns with the corporate tax return. First, the return was thought to be too long, with too many pages and calculations. Most of the T2 jacket contains nil calculations that have no application to an active small business. As a result, most business owners do not even bother to examine the return and simply rely on their accountants to do the work. It is somewhat discomfoting, therefore, that business owners are certifying the accuracy and completeness of returns when they are so unfamiliar with their contents. It was suggested that a "short-form" return be prescribed that would be available for use by small business with exclusively active business income. The panel attributed some of the problem of lengthy and complicated returns to computer programs that can efficiently spew reams of pages and calculations with little cost or effort. Reading and understanding the return, however, is a different matter.

4.2 Integration

A key feature of the corporate income tax system is the small-business deduction (SBD) that provides a preferential rate of tax on the first \$200,000 of active business income for a Canadian-controlled private corporation. The concept surrounding this issue combined with the dividend tax credit is often referred to as "integration," since the system is designed to generate an approximately equal tax burden between income ultimately received from a corporation rather than from a proprietorship or partnership.

Any business with a taxable income in excess of \$200,000 pays a substantially higher rate of tax, and the integration objective is not achieved. Accordingly, most small businesses ensure that their incomes are below the threshold, usually by accruing bonuses sufficient to bring their taxable incomes below the \$200,000 level. These bonuses must be paid out as wages within six months of the corporate year-end.

A key issue for the panel to consider was the functioning of the small-business deduction and any complexity and compliance costs that resulted. In discussion, it was clear that this part of the tax system works fairly well. Most accountants have developed some easy-to-use rules of thumb, such as:

- pay wages to ensure maximum use of the RRSP;⁵
- use dividends to the point where corporate taxable income remains below \$200,000; and
- give bonuses on any excess income to ensure taxable income is \$200,000 or less.

⁵ If income does not meet the earnings required to achieve the maximum RRSP deduction, the base earnings for CPP could represent another threshold for earnings.

As a result, no income is taxed at the high rate of tax. These rules of thumb may become more complex to apply if the rates of payroll taxes continue to grow and if there is uncertainty over entitlement to the Canada Pension Plan. In this environment, small businesses may lean more toward more compensation from dividends that do not attract payroll tax. Despite the relatively smooth application of the small-business deduction, a number of potentially complicating issues were noted. First, by paying out bonuses to stay below the \$200,000 limit, there are fewer resources available in the business for reinvestment. It would be typical of most businesses in this situation to pay out bonuses, remit the personal tax and lend the balance back to the company as a shareholder loan. However, these businesses need a cash flow to pay bonuses, which is often not available since earnings are often tied up in accounts receivable, inventory and capital assets.

Some panelists argued that the SBD has not kept pace with inflation or the growth in the importance of small business. By increasing the SBD, small businesses would have access to a larger low-cost pool of capital. There was no doubt that they would reinvest more funds if the SBD were increased. Some worried, however, that small businesses would take on a "Treasury Bill" mentality and the rules concerning what is "active business income" would become more complex and abused.

Others suggested that a mid-level tax rate – say for taxable income between \$200,000 and \$400,000 – would be appropriate. However, because a change of this sort carries revenue implications for the government and would add complexity (in particular with associated companies), the suggestion was not pursued in any detail.

It was noted that not all small businesses with high income levels bonus-down to the \$200,000 level. Because the regular corporate income tax rate is lower than the highest marginal personal income tax rate, tax-deferral advantages remain when taxable income is above \$200,000. Funds taxed at the high rate would likely have to stay invested in the business for 10 years or more before it became "economically" advantageous over the long term. Few businesses, however, have the sophistication to perform the cost-benefit analysis or the predictability of cash-flows to make this type of decision. As a result, the overwhelming majority of businesses ensure that their taxable income is below the \$200,000 level.

The nature of small-business ownership also plays a role in the integration of corporate and personal income. In a family-run business, with the active participation of many family members, there is more flexibility and opportunity to split income and avoid the high corporate tax rate. The whole concept of income splitting in a small business is a major issue among family-run businesses, and is dealt with in greater detail later in this report.

There were a few areas of complexity noted about the SBD, such as when a shareholder is a non-resident and management services are rendered. Revenue Canada could argue that a bonus or management fee was not reasonable compensation for services provided and deny the corporate deduction.

In conclusion, the panel thought that the operation of the SBD worked well and did not materially add to compliance costs or complexity in the corporate tax system. Also, there did not appear to be a strong push among the panelists to have the SBD raised or modified.

4.3 Tax Planning

The first issue raised was about the attitude held by small businesses toward minimizing their taxes and the extent to which they were prepared to take steps to lower their tax burden.

The panel thought that much of the planning effort today is focussed on income splitting within a family. The first approach is to split the income as evenly as possible among as many family members, which has the effect of lowering the overall income tax rate. This happens in virtually every small business that is owned by an individual who is married, living common-law, or has dependants.

More sophisticated forms of planning may involve establishing trusts, gifting arrangements, and reorganization of corporate share capital. These present opportunities for income splitting, use of the capital gains provisions as well as estate planning. There may be significant up-front costs associated with these planning techniques, which raised the issue of how much money business owners are prepared to spend or invest to save tax dollars. The view was that for most, and especially younger taxpayers, any net savings are worth pursuing. The age issue is relevant because once a tax-saving vehicle is established, it requires only a minimal ongoing cost to sustain. Most accountants treat specialized tax-planning arrangements as separate engagements to enable their clients to measure the cost and benefits of a particular tax manoeuvre.

The growth in the more sophisticated forms of tax planning was explained in this manner: many of the long-standing tax advantages associated with being an entrepreneur – such as the deductibility of entertainment expenses, use of a home office, company vehicles – have been so substantially eroded that the appetite for tax savings simply finds another form. There is a belief in the small-business community which was shared by the panel, that since they are taking risks, making investments, providing jobs and have limited security of earnings, they are "entitled" to pay less tax than those enjoying the comfort of a regular salary in a less pressurized environment.

In discussions among panelists, it was clear that the tax advisor plays a substantial role in decisions made by clients to save tax. An aggressive and persuasive advisor could well have the majority of small-business clients in a "family trust" arrangement, where a more cautious advisor would make limited use of this vehicle.

4.4 Compliance

4.4.1 Unintentional Non-compliance

The panel reported many instances of non-compliance with the *Income Tax Act* simply out of ignorance of its provisions. Typical are items where an expense is either not deductible or only partially deductibles; examples include club dues, life insurance premiums, Christmas gifts, and meals and entertainment.

While in many cases non-compliance is unintentional, the panel viewed many of these items as immaterial to the overall tax burden, taking the view that business owners "could not be bothered" keeping informed of the details of the Act or the specifics of any transactions that required special tax treatment.

It was noted that the presence of a tax professional was a positive factor in promoting compliance with non or partially deductible expenses. Many of the required adjustments are only identified by the accountant in reviewing the year-end financial statements.

Small businesses are also very responsive to Revenue Canada audits. This means that once advised by Revenue Canada of the need to keep track of a particular item for adjustment on a tax return, the taxpayer usually becomes fully compliant from then on. In this regard, the panel thought that initial or periodic site visits to a new corporation would assist small businesses in being compliant with the law.

4.4.2 The Underground Economy

The panelists themselves appeared to have limited exposure to the underground economy. As professionals, they cannot be associated with anything they know or ought to know is false or misleading, and they argue, would disassociate themselves from clients who were clearly cheating on their taxes.

Panelists think the underground economy is much more pronounced among those who operate totally outside of the tax system, or who are unincorporated and complete their own tax information.

Panel members generally welcomed the initiatives undertaken by Revenue Canada to address the problem of the underground economy.

4.4.3 International Issues

While not an issue of large proportion, the panel reported that international transactions are becoming more significant even among small businesses. For non-resident shareholders, integration does not function because the dividend tax credit is unavailable. Efforts, therefore, are made to avoid the withholding tax to non-residents and to convert any payments into a deductible expense to the corporation. While not a big issue at this time, the provisions of the North American Free Trade Agreement (NAFTA) regarding mobility will likely make the non-resident issues more important in the years to come.

4.5 Research and Development Tax Credits

Because of the size of operations and level of investment, it is atypical for small businesses to have clearly defined research and development operations or the management information systems to readily generate an R&D claim. This does not mean, however, that R&D is not taking place.

The largest impediment to small business in making an R&D claim is compliance costs. Since all claims are carefully scrutinized by Revenue Canada, the application must provide substantial scientific authority to satisfy a government audit. The costs of preparing such a report for a small dollar-value claim are disproportionate, and in fact may exceed the value of the available tax credit. It usually falls to the owner of the small business to complete the application – and given the substantial and varied demands on their time, the R&D claim does not rate a high priority. The result is that many legitimate R&D claims are not being made by small business. Typically, small businesses would only organize themselves to submit a claim if their R&D expenditures were of a recurring nature.

The panel thought a special pre-screening process for R&D claims for small business by Revenue Canada would help them deal with the learning curve. Others noted that Revenue Canada was very helpful in processing R&D claims, offering seminars and genuinely demonstrating an interest in making the system work. On the other hand, there is a fear among small business that simply making an R&D claim would trigger a comprehensive audit.

The system works best if a small business has recurring R&D activity. This provides the incentive to establish the tracking systems, justifies the expenditures of the initial application and makes it worthwhile to endure the first audit. It was noted that once an application is accepted, subsequent claims tend to flow through the system more rapidly since, typically, the scientific merit of the claim has already been accepted.

Comparisons were made between a generalized tax incentive versus a direct granting process. Some expressed concern that moving to a discretionary granting process leads to abuse and favouritism – if not patronage.

There is a very interesting and growing development in the claiming of R&D credits. Companies have recently been formed to help business complete R&D claims on a contingency-fee basis. The fee is typically 50 to 60 percent of the tax credit received in the first year the claim is made. The R&D consultants come from two sources: from companies that sought out refunds under the former Manufacturer's Sales Tax, which have sought a new market for their services; and a few former Revenue Canada staff members who worked in an R&D section. These consultants have no affiliation with professional accounting firms. Their business approach begins with a cold-call and a no-risk contingency offer in which they assume responsibility for all preparation costs. As far as small-business owners are concerned, this constitutes "found money" and they are typically very receptive. The accountants who maintain an ongoing relationship with the small business say they are surprised that some of the claims submitted through the "contingency" firms are accepted by Revenue Canada. It appears that the quality and presentation of the application can often be as important as the underlying research.

Despite the compliance cost problems and concerns with firms operating on a contingency-fee basis that need to be scrutinized, the panel thought that existing policies foster the continuation of R&D investment.

4.6 Capital Acquisitions

The primary issue in this area is distinguishing between capital and operating expenditures.

For small business, the accounting and tax treatments almost always parallel each other. Consequently, the accounting concept of materiality, which does not have equal application in taxation, results in many expenditures being categorized as operating, whereas a strict interpretation of the *Income Tax Act* would suggest capital treatment.

Among small business, there is little appetite for capitalizing expenditures below \$1,000. When considering a statutory provision of this magnitude however, concern was expressed about the segmentation of a large acquisition into component parts to avoid capitalization, as could easily be done with a computer purchase. The panel, however, thought that was an unlikely outcome and generally favoured a more relaxed approach to the expensing of acquisitions.

The treatment of capital assets can be complex because of the large number of asset classes. The three different rates for building were cited as an example of unnecessary complexity. Combining asset categories was favoured by the panel.

Many companies, including small businesses, have acquired computers for use by their employees in their homes. While primarily intended for business use, it is obvious that there would be an element of personal use as well. Since this personal use component is difficult or impractical to measure, it is not to be treated as a taxable benefit to staff members.

Because a capital cost allowance (CCA) is recorded on a declining balance basis, an acquired asset is never completely written off. The panel considered whether there should be a limit at which an undepreciated capital cost could be totally written off – say \$1,000. While this proposition carried some favour, the annual recording of a CCA was not considered burdensome, and the proposal would not result in a meaningful or even noticeable reduction in compliance costs.

A larger issue was the recording of terminal losses. The panel felt that a terminal loss should be allowed when an asset category is substantially depleted. An example given was leasehold improvements where an amount was capitalized for the lease term plus one renewal period. In this example, the renewal was not exercised, and the company had only a very small interest in another leasehold. However, because the category was not void of assets, the company had to continue to write off leasehold costs over an additional five years when they were not occupying the facility.

4.7 Allocation of Income to Multiple Provinces

Most small businesses, due to the size of their operations, operate in only one province. As a result, allocating corporate income to multiple provinces is not an issue for the overwhelming number of small businesses in Canada.

The question of a permanent establishment may come into play when a small business has marketing or sales representation in another province. However, it is typical that the salesperson would have a contractual rather than employment relationship. Some panelists noted circumstances where sales agents were employees but worked from their homes, which were not considered to be permanent establishments.

It was reported that the mid-sized businesses with establishments in multiple provinces typically organized their accounting data – in particular on wages and revenues – by province. This made the computations of income allocation a relatively straightforward exercise.

4.8 Manufacturing and Processing Profits

Businesses in manufacturing and processing (M&P) industries enjoy a reduction in the corporate tax rate. This rate, however, does not apply to the first \$200,000 of income and, accordingly, has limited application in the small-business community.

The panel noted that qualifying businesses typically segment their accounting data to isolate manufacturing activity, therefore the determination of qualifying income does not impose a significant compliance burden. The issue for most of these businesses is to ensure that the maximum percentage of their earnings is attributable to M&P activity to help lessen their tax burden.

4.9 Non- or Partially Deductible Expenses

For most small businesses, the type of expenditures that are non- or partially deductible are for meals and entertainment, club dues, parking tickets, life insurance, and interest and penalties on account of corporate taxes. As was discussed earlier, the panel thought the compliance costs associated with these items were not particularly burdensome for three reasons. First, in many cases they are not material to the business and are not adjusted for. Second, when an adjustment is made for meals, it is typically a "ball-park" estimate that does not involve a significant investment of time. Third, many of these adjustments are made by the accountant at year-end when the accounting and tax data are readily accessible.

Of the three expenses noted above, the inability to deduct interest costs associated with corporate taxes was the most significant irritant. While recognizing why government would want to employ every effort to collect taxes, the cost to small businesses is particularly high because they do not have the sophistication to manage their instalments properly, and are more likely to be assessed interest costs.

There are other non- or partially deductible expenses that affect only a small number of businesses. The panel noted that legal fees associated with a reorganization became a concern of small business when many undertook to crystallize their capital-gains exemption. Some small businesses in Toronto were assessed for deducting "foreign advertising" in a publication printed in Chinese – for the local community – but which included foreign content. In this case, the panel

thought Revenue Canada was overzealous in tracking down what was mostly small businesses for small sums, involving an issue where it was unreasonable to think they would have known of the tax consequences of their action.

The panel also noted that Revenue Canada appears quick to threaten to assess gross negligence penalties under Section 163(2) during the audit process, when the intent of the party was not a deliberate avoidance of tax. It was thought that the threat of these penalties was being "thrown around" too readily and was being used as a scare tactic by Revenue Canada.

One complication for corporations in Quebec is the limit that meal and entertainment expenses can only be deducted to the extent they are less than 1 percent of gross revenue. It was noted that many businesses in Quebec are actively finding ways to circumvent this provision, particularly those where substantial entertaining is an industry norm.

4.10 Automobiles

No issue raised as much unanimity and frustration as the provisions of the Act pertaining to company-owned automobiles. The clear message is that the rules are so complicated that no one – not the business operator, the accountant or the Revenue Canada auditor – is able to properly apply and enforce the law. The law in this case refers both to the *Income Tax Act* (standby charge) and the *Excise Act* (for the Goods and Services Tax – GST). An attempt to make a proper interpretation, precise calculations (such as kilometre logs) and explore alternative treatments offered in law is very costly and typically beyond the financial resources or technical ability of small business.

To cope with the current situation, many small-business owners are no longer acquiring their cars through the business. They find it much simpler to buy their cars personally and charge a "reasonable" allowance to the company for their use. The panel thought this applied to about 90 percent of the cars being used by small-business operators.

Some business operators with company cars do not make the taxable-benefit computations suggesting it is less costly to have Revenue Canada make the calculations in an audit. Further, it is thought that "giving" Revenue Canada a clear violation to discover will help them achieve their audit "recovery quota," making them less likely to delve into other areas.

Independent accountants are frustrated with the law because they know it is not being observed, and they cannot persuade their clients to take the time to maintain detailed records or to pay them the necessary fee to make accurate calculations.

Because the large majority of small businesses have now reorganized themselves to "get out of the car business," the panel thought the complexity problem was becoming academic.

4.11 Non-harmonized Provinces

Separate corporate tax administrations are maintained in Quebec, Ontario and Alberta. This poses an additional compliance burden on businesses with operations in these provinces simply because of the need to complete an additional corporate income tax return and send a copy of the federal return to the province.

Even though the returns and system are separate, there is considerable information sharing between the federal and provincial return. For these reasons, the panel thought the additional incremental cost of the second return was likely 50 percent of the cost of completing the federal return.

The panel did not see any material benefit to the provinces that maintain separate administrations, particularly since the differences between federal and provincial tax policy were described more as a "nuisance" than substantive and meaningful.

Many panelists reported the frustration of having to deal with two sets of auditors on the same issues. Tax planning is complicated because of different CCA rates that could affect loss carry-forwards.

Capital tax is growing in importance and the panel thought it could become a more important issue for small business. The accountants noted that some larger businesses are already taking steps to shift assets to provinces with low capital tax rates.

Finally, having two administrations and two tax accounts complicated the instalment process. Business owners frequently make mistakes about the amounts of their instalments and to whom they should be sent. Governments often make mistakes about the tax year in which these instalments should be credited. In one instance, it was reported that cheques payable to the province of Ontario were sent to the federal government by mistake – and then cashed. Having two administrations simply adds a burden to an already complex situation.

4.12 Tax Instalments

While there are minimum limits under which instalments are not required (\$1,000 federal; \$2,000 in Ontario), most small businesses are required to make income tax instalments.

The first issue that arose is why the government would make instalments a monthly requirement. Quarterly was thought to be more appropriate, particularly since it coincides with the GST payment for most businesses. As an alternative, the government could suggest quarterly payments – in advance – advising that a full interest credit would be granted for payments made in advance of the due date.

A complication for determining instalments is that tax returns are not due until six months after the end of the fiscal year – yet the proper instalment payments must begin much earlier. This means that business owners could be fully compliant with submitting tax returns yet receive non-deductible interest charges if their instalments have not met the prescribed amounts.

Small-business owners do not have the sophistication to properly manage their instalments. For example, many do not realize that in a year of low profitability their instalments can be reduced to meet their expected tax liability. Since their accounting systems may not be current or precise, they are more inclined to remit instalments based on the previous year's taxes, even though they could and should remit much less.

Some panelists thought the system would be simpler if small businesses sent in a series of post-dated cheques to cover their instalments. Others were concerned about Revenue Canada misapplying the instalments – either losing the cheques, applying the cheque to the wrong tax account or taking the cheques to cover other taxes, some of which may be in dispute. In this regard, the panel warned of a potential accounting "nightmare" if small businesses were ever asked or required to submit a single cheque for payment of a variety of tax accounts – e.g. GST, payroll deductions and corporate tax.

Many small businesses consider the government as a source of financing and do not make tax instalments. The panel thought this approach would change if small businesses realized the after-tax effective interest rate that they are paying on deficient instalments.

4.13 Filing Deadlines

For most businesses, the corporate tax return is due six months after the end of the fiscal year-end, while any tax owing is due three months after the year-end. The panel generally thought that these deadlines were fair and reasonable.

Despite the reasonableness of the policy, it is inevitable that many businesses will not meet the filing deadline. The panel reported that penalties can be avoided by filing a return with estimated data while providing the precise amounts through an amended return to be filed at a later date.

It was noted that there were advantages to filing the return as late as possible, even though it might be ready as early as one month after the year end. Delaying the return provides some flexibility to change the statements (i.e. bonus accrual) to take into account changing circumstances. Since there are restrictions on what can be accomplished through an amended return, many businesses routinely submit their returns "at the deadline" to provide a wider and more flexible window in which to make changes.

The panel much prefers the Canadian approach with firm deadlines to the U.S. model with frequent filing extensions.

It was also noted that the current system, along with the recent changes regarding year-ends for unincorporated businesses, has concentrated and compressed much of their professional work in a shorter time frame. Some accounting firms have taken to offering lower billing rates to corporate clients who do not have calendar year-ends.

4.14 Penalties for Late Filing or Payment

While the filing deadlines were judged to be fair and reasonable, the application of penalties appeared to be particularly punitive toward small business.

For example, some penalties (such as those for late T-4s) are a flat charge that is assessed regardless of the number of staff or the tax remitted. This obviously bears more heavily on small businesses. It was noted that Revenue Canada frequently shows some flexibility and judgment on this issue, which is appreciated by small business.

There appears to be some unwritten "grace" provisions for the late filing or paying of taxes. Some thought these policies should be clearly identified to ensure fair and consistent application; others thought the grace policies would then be abused to the limits of what was available.

Some noted that there should be no penalties for non-filing of returns that have no real tax consequence, such as the issuance of T-5s for intercorporate dividends.

4.15 Inactive Corporations

As noted previously, the preparation of any corporate tax return – even those with no activity – attracts a fee of between \$200 and \$500. The filing of a complete return, it was thought, must also be a costly exercise for Revenue Canada to process.

The whole process for filing tax returns for inactive companies can be substantially streamlined. There should be no need for a return, perhaps a letter or tick-off box could suffice.

Problems were also noted in moving a corporation from an inactive to a dissolved status. It was reported that governments have requested articles of dissolution as proof that the company will not resume activity. The reality is, that when a company is "dead," its owner is loath to spend the additional time and money to obtain what is in effect a death certificate. This simply will not happen.

4.16 Revenue Canada

The panel gave high marks to Revenue Canada as an organization that is professional, flexible, and generally exhibited good judgment. The highest praise was given to senior officials and rulings officers who had the most knowledge about the tax system. It is this group that accounting professionals deal with most often if problems are encountered with junior-level auditors.

The cost of an audit was considered to be an unavoidable irritant – although unnecessarily frustrating when audits for different governments and different taxes are not co-ordinated.

The "fairness package" has gone a long way in making Revenue Canada a more "approachable" organization. However, there appears to be a difference in attitude regarding the fairness issue between Revenue Canada Taxation and Revenue Canada Excise (GST). The GST auditors appear to exercise less judgment and show less flexibility than their Taxation colleagues. It is obvious which approach engenders more support, and, ultimately, compliance.

One specific irritant was the computer-generated demands for information from Revenue Canada. The panel reported that in many cases, if more judgment were exercised, the requests would never have been sent – and their clients would not have had to spend the time and money to prepare and submit a response. One panel member reported receiving a monthly request for payroll information for the past eight years although the company has long since been inactive.

4.17 Other Issues

In a free-ranging discussion at the conclusion of the day, panelists raised a number of other issues and concerns, which are reported in this section.

In contrasting the Canadian and U.S. systems the issue of "preparer penalties" was raised. The United States has provisions in its legislation that can make the tax preparer financially responsible if a return is inaccurate. The panelists strongly oppose this approach. First, accountants in Canada are held to high ethical professional standards that prohibit them from being associated with anything that is false or misleading. The panelists observed they are far more fearful of a professional conduct committee than the prospect of a fine from Revenue Canada. Second, the evidence suggests that professionals actually help to make the tax system work as it was designed. Finally, there is a concern that preparer penalties would drive up compliance costs, particularly for small business.

The panel argued that the capital-gains exemption and deemed-dividend provisions of Section 84.1 unfairly prejudice against fair-market value buy-out arrangements between related individuals. That is, a common arrangement for unrelated individuals is to buy shares through a holding company. For related individuals, the capital gains exemption cannot be used in this process, thereby greatly increasing the after-tax cost of a business transaction at fair-market value terms between related individuals.

Uncertainty and the frequency of changes to the tax system are two issues that raise compliance costs. For example, because of wide speculation about modifications to the capital-gains exemption for small business, many businesses spent thousands of dollars reorganizing their affairs to "crystallize" their exemption. Had the government made a clear pronouncement before the 1996 Budget that these provisions would not be modified, then much of this costly activity would have been avoided.

The panel noted that small-business compliance costs not appear to be given sufficient consideration when the tax system is being changed. It was thought that greater consultation with those who work exclusively with small business would avoid many problems. The recent change regarding calendar year-ends for unincorporated businesses was cited as an example where consultation would have been helpful.

Tax policy by press release and the retroactive provisions of tax changes were widely criticized by tax specialists. These actions tend to undermine confidence in the system and results in a higher compliance-cost burden as businesses seek protection from retroactive provisions.

5. Strengths and Limitations of the Research

The findings of this research have the following limitations:

1. There was no direct contact with individual small businesses (other than the panelists who operate businesses of their own) and therefore findings are based on the opinions of others regarding the target population. There is no certainty that the panel fully represented the target population.
2. The number of panelists was small (six) and did not represent all areas of Canada.
3. This research report does not include a literature review and an analysis of any statistical data that is available from Revenue Canada and Statistics Canada.
4. Not all incorporated small businesses deal with a professional accountant. These businesses are not directly represented by the panel, although there is nothing to suggest their concerns would be substantially different from those raised in this report.

The strengths of the research can be described as follows:

1. The use of a panel of knowledgeable accountants who specialize in small-business issues provided a forum for an in-depth discussion about the problems experienced by small business, the source and impact of these problems, and possible solutions.
2. The pre-and post-panel review of the report provides additional support to the views and recommendations contained therein.

6. Areas for Further Study

This research focussed on compliance issues related to the corporate income tax system for small business in Canada. Other relevant and important issues for further research include the following:

1. The panel provided a very useful methodology to generate important insights into the primary research questions. To add confidence to the findings, to reveal other areas of concern and to address emerging issues, a regular program of consultation with small-business specialists could be instituted. It would be useful to have as many as 10 participants per session.
2. Small business has compliance concerns with the entire tax and regulatory burden. Studies of this sort could be extended to cover compliance of the Canada Pension Plan, Employment Insurance, personal tax deductions at source, capital tax, T-4 Summaries and Supplementaries, GST and requests for information from Statistics Canada.

7. Research Team

Robert Plamondon
Plamondon & Associates Inc. – Ottawa

Doug McLarty
McIntyre & McLarty – Ottawa

Brent Hiscoe
McIntyre & McLarty – Ottawa

Grant Galbraith
Nauss Simpson Cole Galbraith – Halifax

Stanley Clamen
Fuller Landau – Montreal

Joel Levitt
Fuller Jenks – Toronto

Steven Reed
Manning Jamison – Vancouver

Appendix A: Agenda for Panel Discussion

- 9:00 - 9:15** Introduction
- 9:15 - 9:25** Objectives of the Technical Committee – *John Sargent*
Mandate of the Committee
Work to date
Reporting and follow-up
- 9:25 - 9:30** The Task of the Small Business Panel – *Bob Plamondon*
Impact of the Corporate Income Tax System on Small Business
Focus on problems that are unique to small business
Format for the day
Represent yourselves, your clients, the business community as a whole
Confidentiality
Report from the panel
- 9:30 - 10:15** Issues:
Corporate tax return
 Completed by
 How – computer software; staff level required
 Incremental costs – by element (include tax planning)
- 10:15 - 10:30** Coffee break
- 10:30 - 12:00** Issues: (cont'd)
Integration
 Issues re the \$200,000 small-business limit (planning, investment, growth)
 Salary-dividend mix
Compliance
 Unintentional non compliance
 Tax avoidance
 Knowledge of the system
- 12:00 - 1:00** Lunch
- 1:00 - 2:30** Research and development tax credits – use and compliance costs
Capital acquisitions: Compliance – complexity – alternatives
Allocation of income to multiple provinces
Manufacturing and processing profits
Non- or partially deductible expenses
Non-harmonized provinces (separate administrations)

- 2:30 - 2:45** Coffee break
- 2:45 - 4:30** Tax installments
Filing deadlines
Penalties for late filing
Inactive corporations
Revenue Canada
Specific industry concerns
Positive comments about the system
Other
- 4:30** Wrap-up

Technical Committee on Business Taxation

The Technical Committee was established by the Minister of Finance, at the time of the March 1996 federal budget, to consider ways of:

- improving the business tax system to promote job creation and economic growth,
- simplifying the taxation of businesses to facilitate compliance and administration, and
- enhancing fairness to ensure that all businesses share the cost of providing government services.

The Technical Committee will report before the end of 1997; consultations with the public will follow the release of the report.

The Technical Committee is composed of a panel with legal, accounting and economic expertise in the tax field. The members are:

Mr. Robert Brown
Price Waterhouse
Toronto, Ontario

Mr. James Cowan
Stewart McKelvey Stirling Scales
Halifax, Nova Scotia

Mr. Wilfrid Lefebvre
Ogilvy Renault
Montreal, Quebec

Professor Nancy Olewiler
Department of Economics
Simon Fraser University
Burnaby, British Columbia

Mr. Stephen Richardson
Tory, Tory, Deslauriers & Binnington
Toronto, Ontario

Professor Bev Dahlby
Department of Economics
University of Alberta
Edmonton, Alberta

Mr. Allan Lanthier
Ernst & Young
Montreal, Quebec

Professor Jack Mintz (Chair)
Faculty of Management,
University of Toronto (on leave)
Clifford Clark Visiting Economist
Department of Finance
Ottawa, Ontario

Mr. Norm Promislow
Buchwald Asper Gallagher Henteleff
Winnipeg, Manitoba

The Technical Committee has commissioned a number of studies from outside experts to provide analysis of many of the issues being considered as part of its mandate. These studies are being released as working papers to make the analysis available for information and comment. The papers have received only limited evaluation; views expressed are those of the authors and do not necessarily reflect the views of the Technical Committee.

A list of completed research studies follows. They may be requested from:

Distribution Centre
Department of Finance
300 Laurier Avenue West
Ottawa, Ontario K1A 0G5
Telephone: (613) 995-2855
Facsimile: (613) 996-0518

They are also available on the Internet at <http://www.fin.gc.ca/>

Technical Committee on Business Taxation Completed Research Studies

- WORKING PAPER 96-1**
Comparison and Assessment of the Tax Treatment of Foreign-Source Income in Canada, Australia, France, Germany and the United States
Brian Arnold (Goodman Phillips & Vineberg)
Jinyan Li and *David Sandler* (University of Western Ontario)
- WORKING PAPER 96-2**
Why Tax Corporations
Richard Bird (University of Toronto)
- WORKING PAPER 96-3**
Tax Policy and Job Creation: Specific Employment Incentive Programs
Ben Cherniavsky (Technical Committee Research Analyst)
- WORKING PAPER 96-4**
The Effects of Taxation on U.S. Multinationals and Their Canadian Affiliates
Jason Cummins (New York University)
- WORKING PAPER 96-5**
The Integration of Corporate and Personal Taxes in Europe: The Role of Minimum Taxes on Dividend Payments
Michael Devereux (Keele University)
- WORKING PAPER 96-6**
International Implications of U.S. Business Tax Reform
Andrew Lyon (University of Maryland)
- WORKING PAPER 96-7**
The Economic Effects of Dividend Taxation
Ken McKenzie (University of Calgary)
Aileen Thompson (Carleton University)
- WORKING PAPER 96-8**
Capital Tax Issues
Peter McQuillan and *Cal Cochrane* (KPMG Toronto)
- WORKING PAPER 96-9**
Compliance Issues: Small Business and the Corporate Income Tax System
Robert Plamondon (Ottawa)
- WORKING PAPER 96-10**
Study on Transfer Pricing
Robert Turner (Ernst & Young, Toronto)
- WORKING PAPER 96-11**
The Interaction of Federal and Provincial Taxes on Businesses
Marianne Vigneault (Bishop's University)
Robin Boadway (Queen's University)
- WORKING PAPER 96-12**
Taxation of Inbound Investment
Gordon Williamson (Arthur Andersen, Toronto)