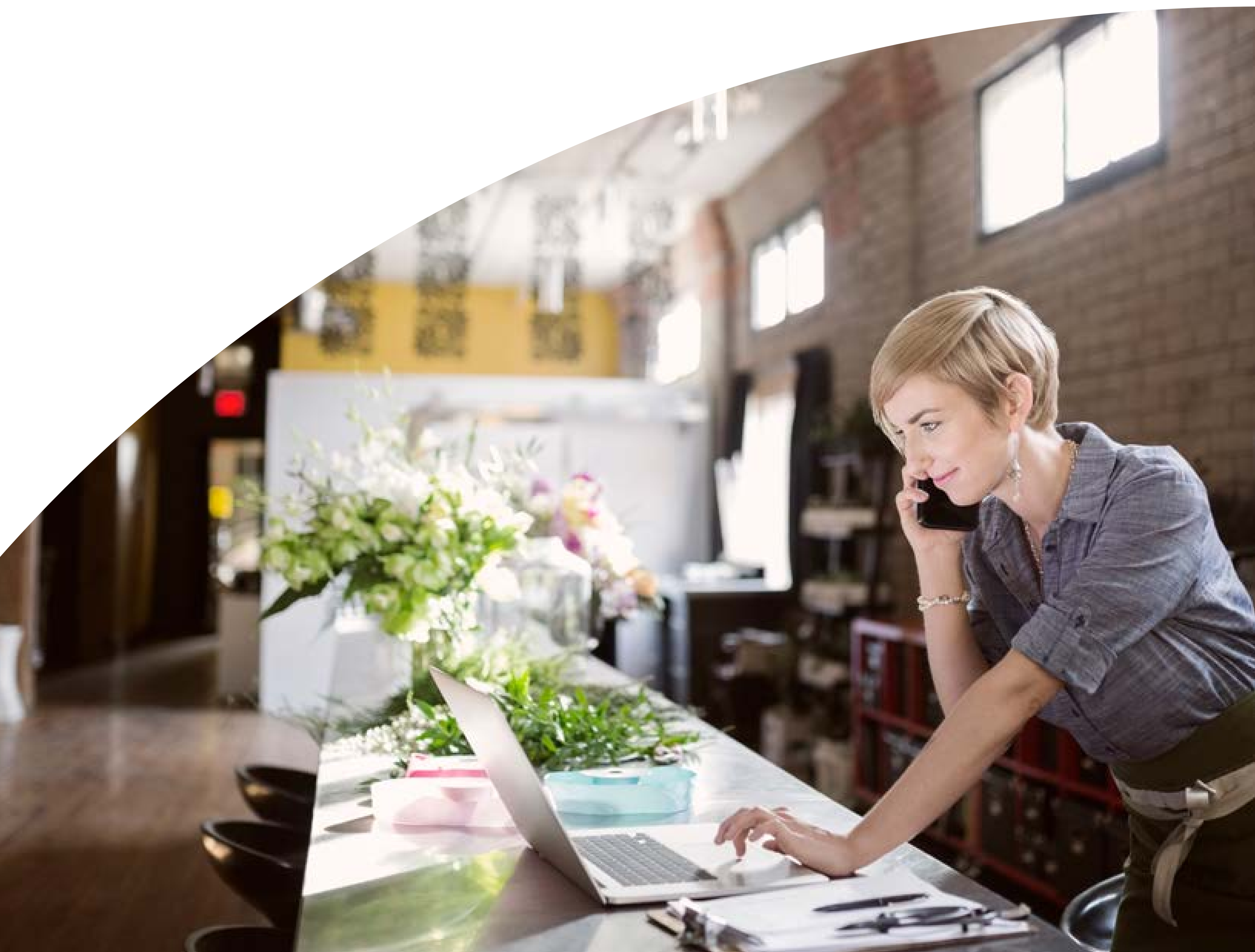
The Grant Thornton Report on Doing Business in Canada

February 2018



Executive summary

The Government of Canada has taken a number of actions over the last year that have had major and wide-spread implications on the ways small and medium sized enterprises (SMEs) in Canada operate. The changes, and subsequent debate over their fairness, has generated major interest among media and stakeholder groups. It is vital that the voice of business leaders across Canada be heard.

As a purpose-driven firm that works to help SMEs manage challenges they face and realize opportunities, Grant Thornton decided to undertake the *Grant Thornton Report on Doing Business in Canada* to hear first-hand from business owners their thoughts on the policy shifts.

The report, based on the feedback of SME leaders across Canada, delves into the highest-profile issues facing business in Canada today, and how government decisions have impacted the core of Canada's economy.

The participants

74% of survey respondents reported that they are owners of their company, with 15% serving as Presidents or CEOs. These respondents are intimately familiar with the daily challenges of running a small or medium sized business, and have a deep grasp of the consequences of policy changes and its effect on Canada's competitiveness.

This report gives unique insight into the needs of business owners, and how policies of the federal government can help Canadian businesses to compete and innovate.

Federal tax changes

Canada's federal government has recently overseen several significant changes in the way businesses and their owners in Canada are taxed. Federal Minister of Finance Bill Morneau stated that the changes were implemented to "ensure a level playing field for the middle class." The debate has frequently been framed as removing unfair advantages for high-net worth Canadians.

Business leaders are highly aware of the effort on the part of the government – approximately 72% of respondents reported being aware of the changes.

This high rate of awareness is not a positive condition. In fact, a strong majority of respondents reported that the tax changes will negatively impact their businesses. While both SMEs feel that there will be a negative effect, leaders of smaller businesses were even more highly concerned, with 67% reporting that they will be negatively affected by the changes.

Intensity of response

Respondents spoke with deep frustration to the current environment, citing a belief that they were being unfairly pitted against middle-class Canadians. Several characterized the changes as the government was "going after" or "attacking" small businesses and their owners.

Others described the government's message of tax fairness as "misconceived", writing that the changes will render business "unable to reinvest earnings into the business, which will cripple the economy."

The responses reveal a passion and intensity held by business leaders in opposition to changes that they largely feel were unhelpful to Canadian competitiveness.

Areas of research

Grant Thornton identified areas that affect the viability of SMEs, and involve areas of federal government jurisdiction. Those five main categories are:

- Changes to the taxation of passive income;
- Changes to income splitting;
- Effectiveness of business tax rate changes;
- Innovation and accessibility of research and development funding; and
- Diversity in the workplace.

Each area was probed in the survey to understand how they affect business, and how they can be used to improve innovation and investment by Canadian businesses.

> "Small business owners will not be able to reinvest earnings into the business, which will cripple the economy."

Passive income changes

SMEs are the cornerstone of Canada's economy, accounting for a significant share of Canada's GDP and employment base, yet they are more vulnerable to cyclical downturns and unexpected events than their larger counterparts. Many use income from passive investments to mitigate these risks and grow their businesses.

In October, the government confirmed it would be moving forward with measures to limit the tax deferral opportunities related to passive investments. No legislative language was offered, instead the federal government promised to consider the input received during the consultation period in crafting legislation that will be released as part of the 2018 budget.

It is difficult to assess the full impact of these changes without knowing the details, but business owners fear changes will impede their ability to innovate, protect employees from cyclical shortfalls or invest in new growth.

Startup, innovation and business growth involves substantial financial risk

Individuals who start and run Canada's SMEs commit substantial personal financial capital to do so. They often assume direct and personal liability for financial debts and risks the business may incur in order to innovate and grow.

Underlying policy direction is the notion that there is an unequal playing field when it comes to taxation – that business owners enjoy advantages and opportunities not available to other individuals. Yet, this perspective fails to take into account the extraordinary financial risks that accompany business ownership, as well as the unique challenges facing smaller enterprises. The current rules regarding passive investment can balance the scales by providing an incentive for individuals to undertake these risks, supporting this engine of Canadian economic growth.

SMEs have limited tools to survive cyclical downturns

Passive asset retention provides a measure of protection for these businesses – allowing them to continue operations and pay their employees and suppliers when times are lean. Without this tool, these community-based businesses face greater threat of failure or acquisition by a larger competitor.

Competing with the world's best on their own terms

Promoting Canadian business development and competitiveness is essential to maintaining a healthy economy. Unfortunately, the proposed changes to the treatment of passive investment income would only affect Canadian business owners, not non-resident owned and controlled businesses, potentially placing Canadian companies at a significant competitive disadvantage to publicly traded or foreign controlled corporations.

The ability to retain passive assets allows business owners to finance their own growth and innovation without needing to rely on third party sources. It allows business owners to take a long term view rather than a shorter term perspective driven by tax policy.

In addition, many smaller businesses make effective use of passive investments in order to build retirement savings. Removing this option could impede their competitiveness today and hurt Canada's economy in the future.

Report findings

Passive income

Respondents believe that the Government of Canada's plan to take away tax deferral opportunities related to passive income has limited the flexibility, security, and ability of our SMEs to grow and innovate.

Finance Minister Bill Morneau initially stated that these changes would not impact businesses earning less than $150,000 a year.

Our 2018 business survey finds that a significant number of SMEs expect that these changes will create further challenges.

According to our findings, over one-third of SMEs believe that the changes to passive investment income rules will hurt their business. While this does not reflect the majority, it represents a significant contingent of businesses that will face increasing headwinds in an already tumultuous international business climate.

Grant Thornton's experience working with a range of SMEs demonstrates that best practices for saving and investing vary significantly among industry participants. Small business owners rely on flexibility in often-cyclical environments.

In some cases, this flexibility is what allows small business owners to insulate profit margins for unexpected personal or business expenses. One business owner reported: "I will never enjoy the safety net of paid vacation, sick days, pensions, etc. Passive investment income is a way for me to build a nest egg for when I retire."

The report also indicates a prevailing distrust in the government's approach, an approach which does not reflect the need for private businesses to possess these tools. One respondent indicated that, "they think that private businesses should be taxed the same way as private citizens."

Furthermore, the report indicates that revisions to the federal government's initial plans, which are expected to be fully communicated in the upcoming budget, have not been positively received or even widely recognized by our business community. Over two-thirds of those who were aware of the changes indicated that the government had not gone far enough in responding to business feedback. And only four-in-ten SMEs indicated that they were aware of the changes at all.

In October, when Prime Minister Trudeau announced these revisions alongside cuts to the small business income tax rate, he stated that small businesses are the "heart of the economy." The results of the report demonstrate that the government must meaningfully equip Canadian businesses with the tools they need.

For the government to address tumultuous international conditions, Canadian competitiveness, and attract investment, it will be critically important for the budget to respond to this strong feedback.

"Corporate investment is a salary replacement plan during low cashflow periods. Also a legitimate retirement solution for business owners with no pension/benefits."

Income splitting

Changes proposed last summer to how income distributed from businesses will be taxed has generated uncertainty and anxiety among Canada's small business community.

Many business owners have told us that these changes will limit their ability to expand and innovate – that limiting income splitting options will force poor business decisions to fit a flawed tax rule.

Limiting options for business owners to manage risk, invest in innovation

Canada's business owners take on substantial personal financial risk. The overwhelming majority of business owners that would be affected by the proposed restrictions are middle-class Canadians who rely on the savings from income splitting to mitigate the financial risks associated with the business, and ultimately to invest more into expansion and innovation. These owners are concerned that stripping away such an important tool will hurt their ability to grow their businesses.

Recent revisions bring a degree of clarity, but significant questions remain unanswered

The federal government announced a number of revisions to its proposals regarding income splitting in December. These revisions add a measure of clarity – for example, in outlining when income from corporations can be excluded from the new rules. These exclusions apply to spouses of retired business owners, adults over 18 who have materially contributed to the business and adults over 25 who have a 10% or greater ownership stake.

Many questions remain, however, and the legislation continues to be very complex and difficult for business owners to interpret. As an example, service based businesses are not eligible to take advantage of the exclusions noted above, but there is little clarity as to what constitutes a service business. If the broadest definition of "services" is applied, that would mean a substantial portion of the small business sector would be ensnared by the new requirements but it is unclear why those businesses would be impacted but other non-service based businesses are not.

Tax policy changes could drive flawed business decisions

Furthermore, the ownership tests that are part of the proposed modifications to income splitting rules could prompt business owners to make structural changes to their organizations – structural changes that may not be prudent from a business perspective -- simply to fit within the proposed exclusion clauses. Business decisions should be driven by what's in the best interest of the business, i.e., growth, employment creation and innovation…not tax law.

Report findings

Income splitting

Our findings indicate wariness amongst Canada's SMEs about the Government of Canada's changes to income splitting rules.

While the government announced revisions to its initial proposal in October, the report highlights lingering confusion and resistance from the Canadian business community, particularly from small businesses who expect to feel the pain from these changes most acutely.

42% of small business respondents expect that these changes will negatively impact their business.

In addition to real impact to their bottom line, the report indicates that these changes have caused a wave of confusion as **nearly two-thirds of respondents have sought advice about the impact of these changes on their business practices**.

On a more qualitative level, respondents indicated that their family's contributions are being impacted. For example, one respondent wrote: "This rule will make it harder for [my spouse] to get paid what she deserves. It's not a choice we made as one born out of necessity. It's unfair to punish small business owners that survive on family support."

This feedback is particularly revealing when coupled with broader concerns about the government's suite of tax reforms' impact on families.

60% of respondents indicate that their ability to save for family needs has been negatively impacted.

In some cases, respondents referred to the flexibility resulting from income splitting as a necessary offset to the risks inherent when starting a small business. One respondent commented: "My family will pay higher taxes. Income splitting allows you to offset some of the enormous risks that business owners take when starting a business."

Additional comments focused on increased red tape, growing challenges associated with passing on businesses to family members and disruption of existing plans.

Most revealingly,

81% of respondents believe that the Government of Canada should repeal or remove the changes that it made to income splitting provisions.

While the Government of Canada has already scaled back income splitting rules from its initial proposal, the near unanimity of opposition to these changes indicate immediate reconsideration is needed.

(Changes to income splitting)

"Makes it more difficult to legitimately share business income and reduce overall taxes for the family as a whole."

Taxes and a competitive business environment

Reductions to the small business tax rate, to be phased in over two years, will provide a measure of welcome relief. These rate reductions are supported by business owners, but they are unlikely to offset the increased tax costs for SMEs triggered by changes to passive income and income splitting rules.

Supportive of Canadian businesses, although the practical impact is limited

Lowering the small business rate can help keep more money within the communities where small and medium sized businesses operate. On its own, a rate reduction can boost the competitiveness of Canadian companies in the international arena.

While business owners support the move, its impact is minimal. The maximum amount a business could save in the first year is $2,500, or just over $200 per month. When fully implemented in 2019, the lower rate (9%, down from 10.5% in 2017) is expected to provide a maximum annual tax savings of $7,500.

Reviving the rate reduction in an attempt to balance other measures

These measures were not part of the package of small business tax changes the federal government proposed in July 2017. In fact, this government had frozen a previously-legislated phased reduction of the small business rate in 2016, and these cuts effectively bring us to the same place we would have reached under the earlier plan.

Rather, the rate reductions were brought in at this time as a partial offset to the other changes in taxation policy first announced in July, including new limits on income splitting and the treatment of passive income.

Net result still likely to leave small businesses challenged

As a standalone measure, a tax rate reduction would be a net positive for Canada's SMEs. However, proposed changes in the tax treatment of passive investment income and income splitting could remove important strategies these businesses rely on to survive cyclical downturns – while also limiting their ability to expand and innovate.

This reduction will be insufficient to offset the negative consequences of the changes in passive income and income splitting rules – leaving them facing many new challenges.

Report findings

Taxes and a competitive business environment

While business owners certainly appreciate tax rate reductions, context is everything. Changes in the ability of SMEs to income sprinkle and in taxation of passive income assets significantly offset any gains made by a reduction.

Business leaders believe that the changes made will harm their business.

66% expressed concern that there will be a significant negative on their businesses.

As one respondent noted, "the adjustments being made to income splitting and tax thresholds really make the effort involved in running your own business not worth the risk and investment." Another actually characterized the changes as "an attempt to make small business owners pay more tax."

When asked about what will affect their businesses, respondents identified a number of factors. That includes:

59% reporting that the tax changes have negatively impacted their profitability;

55% reporting that the changes have negatively impacted their investment in hiring and training;

57% saying their succession planning has been negatively affected; and

75% saying that their saving for retirement will be hindered;

60% reporting that their ability to save for family needs has been negatively impacted.

Some media coverage of recent US tax reform has suggested that it would have a significant effect on Canadian business. However, a robust 71% of SMEs did not feel that US tax reform would affect their businesses.

Business leaders showed considerable concern that the ratification of NAFTA was in jeopardy. 77% of SMEs owners expressed concern about the state of the agreement, with almost half (47%) saying that the failure of NAFTA negotiations would have a negative impact on their business.

Viewed holistically, the reduction of the small business tax rate does not mitigate the concerns of the government's broader moves on taxation on SMEs, and the competitive international environment provides additional concern.

Innovation agenda

It is critically important for the government to make innovation funding more easily accessible in order to encourage Canadian businesses to innovate and invest in new technologies, while also improving their competitiveness on the global stage.

Canadian business owners recognize the need to innovate to remain competitive in today's global marketplace, and many leverage government grants and tax credits for their business innovation efforts. These grants reduce investment risk by offsetting costs, and therefore spur increased levels of investment.

The innovation economy and effects of budget 2017

Last year's federal budget emphasized three programs to promote innovation: the Strategic Innovation Fund of $1.26 billion to be spent over 5 years, the $400 million Venture Capital Catalyst Initiative, and the Innovation Supercluster Initiative. As we approach the unveiling of this year's budget, it is worth noting that all three of last year's initiatives have been implemented, paving the way for the government to address new innovation challenges and opportunities in 2018.

Will budget 2018 push Canada's innovation economy even further?

The Scientific Research and Experimental Development tax credit program provides incentives for Canadian businesses to invest in research and development – however, compliance requirements, particularly for small business owners, have increased – making it overly complex to access the funding.

Inconsistent funding levels and increasing red tape

Government funding for research and development has been cyclical, with grant programs sporadically launching and ending once funding is depleted. Knowing where and how to access funding has been a major challenge for many Canadian businesses. Additionally, the federal government's criteria for funding has become so burdensome that it makes it highly unrealistic for small businesses to apply for it.

By making funding difficult to access, the Government has put Canadian businesses at a disadvantage on the international stage, limiting their ability to innovate in the face of rapidly changing market forces and heightened competition from both traditional and emerging economies.

Improved access and consistent funding will spur innovation and growth

A renewed funding focus on research and development will encourage businesses to take risks and grow more rapidly. It will also help build our talent economy through training and retention of highly skilled workers within Canada.

Boosting funding levels will be an advantage for Canadian business by ensuring access and reduced compliance costs of the programs. A more accessible Scientific Research and Experimental Development tax credit will enable Canadian businesses to innovate and expand, growing the economy, creating jobs and increasing the country's competitiveness in the global marketplace.

Report findings

Innovation agenda

While innovation plays an important role in an economy reaching its potential, our findings indicate a number of barriers limiting Canada's SMEs from participating in government innovation incentive programs.

While only 21% reported not being aware of tax deductions and 14% reported not being aware of federal government grants, the majority of the report's respondents have not applied for grants. This input is consistent with a decrease in claims over the past five years.

Only 3 in 10 respondents have applied for federal government grants or tax deductions. Of these respondents:

15% have applied for grants or tax breaks for hiring or training employees;

8% have applied for grants or tax breaks for conducting research and development, innovating or developing a product or service;

6% have applied for grants or tax breaks to reduce pollution or improve efficiency; and

5% have applied for grants or tax breaks for developing the local economy and exporting into new markets.

The most common response from applicants who have not applied cited that, "government programs are often really complicated and likely time consuming to apply for."

As Budget 2018 moves to implement innovation commitments from last year's budget, like innovation superclusters, reducing these barriers will be paramount to fostering an innovative, productive economy.

A second revelation from the report is that medium sized businesses have more awareness of the impact of emerging, disruptive technologies than their smaller counterparts.

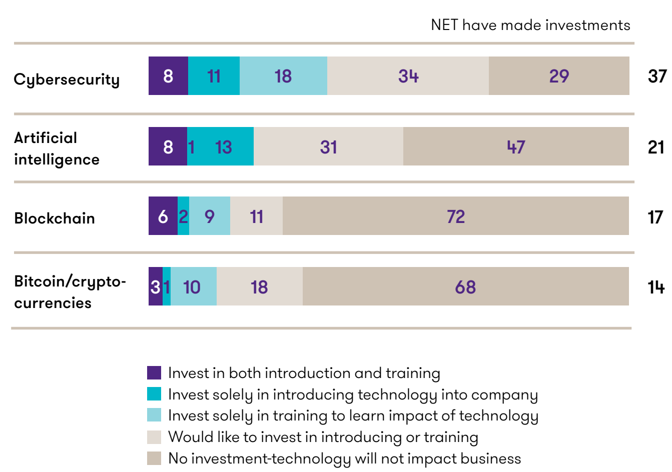
Likely informed by high-profile reports in the past years, nearly half of respondents were aware of the impact that cyber security measures are expected to have on their companies with 43% believing their company will be impacted.

The impact of artificial intelligence is understood by a majority of medium sized businesses (52%) and a lower number of smaller businesses (38%).

Both small and medium sized businesses reported limited awareness of the disruptive impact of blockchain or cryptocurrencies in the coming year, with only two in ten respondents expressing expectations that these technologies will impact them.

The lack of awareness in these areas, especially among small businesses, demonstrates that the Government of Canada must look for ways to make its innovation agenda more engaging and accessible, reducing barriers so that Canadian SMEs can build awareness and capacity.

% Among all small and medium sized businesses



Gender diversity in the workplace

A healthy business ecosystem enables and encourages participation from all areas of the Canadian business community. In particular, there is evidence that female owners, executives and employees can provide competitive advantages for their companies. Canadian women are already contributing significantly to the economy, but barriers remain to unlocking their full potential.

Diversity can drive profit growth, innovation and sustainability

Women bring new perspectives to companies both as leaders and as employees, and this point of view can provide advantages from sparking innovation to enabling long-term growth and prosperity. Diversity in the workplace can help their business grow.

This is backed by hard data: research by the Conference Board of Canada suggests gender diversity can increase a businesses' competitiveness, while a recent global survey by the Peterson Institute for International Economics found that publicly-traded companies in which at least 30% of the executives were women earned up to 6% more in net profits.

Diversity helps businesses mitigate risks

Research conducted by Grant Thornton also reveals that men and women perceive risk and opportunity in different ways, and that they act differently as a result. When these diverse approaches are brought together, they facilitate more effective risk strategies for the sustainable growth of dynamic businesses.

A gender equality strategy that works for Canadian business

Further opportunities exist in federal policy to encourage diverse hiring options, including universal daycare and extending more training opportunities to ensure a highly-trained workforce.

Practical results will require more than new policies – they will require that business leaders themselves champion the cause. The first step, which is taking place across Canada now, is getting businesses to talk about the issue.

Changes in the global economy, ongoing technological innovations and disruption makes this issue more important than ever. The challenges will be different for each organization, and companies should be encouraged to develop their own gender equality strategies, setting targeted goals that work within their competitive environment.

There is no single initiative that will boost gender equality, but it's ultimately up to businesses and the government to work collaboratively to create more gender diversity in the workplace.

Sources for data:
Conference Board of Canada: https://www.conferenceboard.ca/e-library/abstract.aspx?did=8336
Petersen Institute for International Economics: https://piie.com/publications/wp/wp16-3.pdf

Report findings

Gender diversity in the workplace

Gender diversity can be a boon to SMEs.

57% of surveyed business leaders agree that employing women fundamentally improves the success of a business. Only 7% disagree.

Many have taken proactive steps to attract women to their business, including implementing formal strategies. However, 48% disagree with the idea that companies in their sector aren't doing enough to ensure there is good representation of women in the workplace.

Efforts by the government to increase the hiring of women has little recognition among business leaders. Only 24% of these business leaders are aware of efforts, though it is higher among medium sized businesses.

When pressed if there are policies that the federal government should be implementing to increase diversity in the workplace or, if there is a role for the government to play, the opinions of business leaders are similarly split. 34% agreed, while 37% disagreed.

There are a number of methods that could see an increase in the number of women hired by companies. Grant Thornton asked business leaders about their general support for these measures, which was also generally split:

55% support extended periods of Employment Insurance for women on maternity leave;

54% support more government training programs for women in the areas where women are currently under-represented (e.g., technology and finance);

52% support improved financing of maternity leave through tax breaks; and

48% support universal daycare.

Consistently, medium sized businesses were more likely than small companies to support these measures. They also supported tangible policy measures significantly more than leaders of small businesses.

Methodology

Two hundred small and medium-sized businesses (SMEs) were surveyed online:

- 100 small businesses nationwide (5-99 employees).
- 100 medium-sized businesses nationwide (100-499 employees).

Those who completed the survey were members of the executive team (C-suite) or the leadership team within the business.

Fully 74% of survey respondents report that they are owners of their company. Another 15% of respondents are the CEO or President of their firm.

Almost all of the companies who participated (92%) report that they are privately owned.

The research was completed over a two-week period: from February 9 to February 21, 2018.

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