TAX POLICY TRENDS

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SMALL BUSINESS TAX CUT NOT ENOUGH – U.S. TAX REFORMS WILL MAKE U.S. MORE ATTRACTIVE FOR START-UPS

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Big businesses start small. With the proposed Republican tax reform announced on September 28th, small business taxes will be dropped sharply making it attractive for start-up companies to locate and grow in the U.S..

This is in sharp contrast to the recent debate in Canada whereby small businesses will be taxed more heavily under the recent proposals despite a further reduction in the small business tax rate.

In the United States, small C-corporations are taxed at the corporate level on their profits with income paid to investors subject to personal income tax. If the owners hold shares for more than six years in companies in a wide range of industries, capital gains are untaxed. Under the U.S. proposal, both corporate and personal income tax rates would decline.

Small Business Marginal Effective Tax Rates on Investments: Companies either $10 million or $20 million in asset size

	Canada and U.S. Current Tax Rate	Comparing Canada 9% Small Business Tax Rate with Proposed U.S. Tax Reform
$10 Million Asset Size		
Canada	42.2%	41.3%
U.S. S-Corporation	42.1%	28.0%
U.S. C-Corporation	44.3%	36.6%
$20 Million Asset Size		
Canada	47.3%	47.3%
U.S. S-Corporation	47.0%	34.9%
U.S. C-Corporation	44.3%	36.6%

The new U.S. federal corporate income tax rate is proposed to be no higher than 20 per cent compared to most existing corporate rates that are graduated reaching 35 per cent for largest sized companies. With state income taxes remaining deductible, the combined federal-state corporate income tax rate will be 25.3 per cent. Businesses will be also able to fully write off machinery and equipment investment costs from profits rather than depreciating them over time (interest expense associated with these investments would not be deductible). Federal personal taxes on dividends would remain roughly the same 23.8 per cent (plus a 3.8 surtax on dividends as investment income). On the other hand, state personal income taxes may no longer be deductible from federal tax resulting in a higher dividend tax rate.

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S-Corporations as well as limited liability companies in the United States are treated as pass-through entities. In other words, the S-corporation does not pay taxes but profits are attributed to the small business owners and taxed as regular personal income. The Republican plan will lower personal income tax rates with the federal top rate falling from 39.6 per cent (on incomes in excess of $418,000) to 35 per cent (brackets yet to be specified). Most importantly, however, business income earned by investors through their small business will be taxed at 25 per cent at the federal level for a combined federal-state tax rate estimated to be 31.65 per cent (the surtax does not apply to business income).

In contrast, Canada levies a corporate tax rate on Canadian-controlled private corporations at a rate of close to 14.5[*] per cent although it only applies to small businesses with less than $500,000 in profits and $10 million in assets (otherwise the average federal-provincial corporate income tax rate is close to 27 per cent on profits for larger small businesses).

Canada also imposes much higher personal income tax rates with an average combined federal and provincial top rate of 51 per cent on income in excess of about US$160,000).

Canada has much lower sales taxes on capital purchases compared to the United States.

In the table, we provide marginal effective tax rates on capital invested in small businesses taking into account corporate income taxes, personal incomes taxes paid by the small business owner and other taxes related to capital (retail sales on capital purchases being most important). Since U.S. tax law refers to US$60 million asset size for some incentives, we look at two cases: companies with $10 million in asset size and those with $20 million in asset size. Although companies with less than $10 million in asset size are currently taxed at rates close to those applied to similar-sized C-corporation and S-corporations in the United States under the U.S. reform, small businesses would be more heavily taxed in Canada compared to the United States regardless of asset size and type of U.S. business structure. More importantly, those small businesses expecting to grow into larger firms will find the U.S. much more tax competitive to support their growth.

Canadian policy makers need to start preparing now. While most of the world is headed in the direction of lower corporate taxes, Canada is bucking that trend. That will hurt our ability to attract investment and grow our economy.

[*] That rate will fall to slightly below 13 per cent pending the recently announced tax cut.

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