Acorn Partners

Merchant Bankers to Emerging Businesses
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August 11th, 2011

Ms. Guyanne L. Desforges
Clerk of the Standing Committee on Finance
House of Commons
Ottawa, Ontario
K1A 0A9

Re: 2012 Budget Priorities

Ms. Desforges,

The value of small and medium-sized enterprises to the current and future economy of Canada is not in dispute: we can't succeed without them. The Government of Canada's commitment to supporting these enterprises is evidenced in numerous areas, not least of which can be included various tax laws (both for the enterprises themselves and for individuals), various rebate programs (such as the SR&ED program) and even entire government departments (such as the Office of Small and Medium Enterprises within Public Works and Government Services Canada) and there is an evolving recognition that within the SME community, a disproportionate share of the job creation comes from the relative handful of firms that grow sales at more than 20% per year: Gazelles.

In recognition of the importance that small and medium-sized enterprises (SMEs) play, and will continue to play in our economic recovery and future, we have identified three areas in which we could be better serving SMEs, particularly Gazelles. Attached please find 3 issues and accompanying recommendations for your consideration for the 2012 budget. We trust you will consider these proposals and hope that you will endorse them for consideration in the 2012 Budget.

Yours sincerely,

Peter Kemball
Founder and CEO

The Leader in *Sales Driven Financing*™

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EXECUTIVE SUMMARY

The recovery and growth of the Canadian economy will not be achieved without the success of the small and medium-sized enterprises across the country. The Government of Canada has proven its commitment to this sector in many ways, but more needs to be done to provide those firms with the greatest chance to succeed.

OBJECTIVE: TO IMPROVE THE ODDS OF SUCCESS FOR SMALL AND MEDIUM SIZE ENTERPRISES BY IMPROVING ACCESS TO CAPITAL THROUGH THE PROVISION OF AN INCENTIVE FOR PATIENT CAPITAL AND THE REFINEMENT OF EXISTING MEASURES.

RECOMMENDATION #1: To encourage long-term investment in small and medium-sized enterprises (SMEs) and boost the likelihood of success for growing SMEs by encouraging investors to leave their cash in the business for a longer period of time, we recommend that the capital gains inclusion rate which is at 50% be reduced by 5% per year for investments held for a 10 year (or greater) period. In other words, we recommend that there be no capital gains on disposition of any investment in SMEs held for at least 10 years.

RECOMMENDATION #2: Extend the small business deduction (SBD) beyond its existing limit for small business corporations that use retained earnings to finance their own endeavours, instead of bonusing down to meet artificial eligibility criteria for the low small business rate of corporate tax.

RECOMMENDATION #3: Move the administration of the technical and financial eligibility aspects of the SR&ED program to a Government Department, like Industry Canada, where the necessary expertise and administration can be provided in a focussed, and therefore efficient and timely manner to both expedite claims and ensure a proper review.

Implementation of these three recommendations will greatly improve the environment within which SMEs, the drivers of our economy, strive to succeed each day. These changes will improve the odds of succeeding for Canada's SMEs and, by consequence, will provide the most fertile ground from which our nation's economic growth and stability will be sown.

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Submission To: House Of Commons Standing Committee On Finance
August 2011

Objective: To improve the odds of success for small and medium size enterprises by improving access to capital through the provision of an incentive for patient capital and the refinement of existing measures.

This submission to the Standing Committee on Finance responds to the request for input to be considered for recommendation by the Committee to the Minister of Finance in advance of the Federal Budget expected to be presented to the House of Commons in the spring of 2012.

Among the stated top priorities of this Government is to achieve a balanced budget by 2014, increase productivity and not increase taxes. In order to achieve these goals, small business, which is regarded as the engine of the economy, must be able to access the cash flow it requires to sustain itself, increase its productivity and provide jobs. This cash flow is difficult to obtain from conventional financing arrangements through financial institutions but can be accessible by providing some risk incentive and refining existing tax programs.

This submission contains 3 recommendations that we assert are necessary to the viability and sustainability of Canadian controlled private corporations and some listed junior corporations in the technology and service sectors. The recommendations relate directly to the need for external financing from individuals and angel investors, better access to existing government support through the corporate small business deduction for corporate taxes (SBD) and a refinement of the administration of the scientific research and experimental development (SR&ED) tax credit program to ensure a smoother flow of funds and administration by trained experts in the field.

Acorn Partners

Acorn Partners is an Ottawa-based Canadian financial corporation which was founded in 1993. Acorn's clients are small and medium-sized firms across Canada who, because of their aggressive growth strategies, often require assistance in managing their cash flows to fund expansion. Acorn's role is to provide access to funds when it is beyond the normal business of banks to do so and equity capital is neither affordable nor practical.

Acorn's services include financing accounts receivable, refundable SR&ED and other tax credit claims – both prior to and after their filing, as well as purchase order, or contract financing.

Acorn, through its work with both early-stage and rapid-growth firms is well positioned and experienced in assessing the needs of this sector of the economy, which is so vital to securing jobs and enhancing prosperity, a major agenda item for this government.

Issue # 1

The capital gains inclusion rate is set presently at 50%. For those who choose to invest in the small and medium sized enterprises (SMEs) that drive our economy, particularly the fast-growing enterprise, this rate is counter-productive, both for the investor, as well as for the company receiving the investment.

This rate discourages long-term investment in companies that are in desperate need of cash on an almost daily basis by encouraging investors to reclaim, or be repaid their investment, at a time when the business would be much better served by keeping hold of the cash and reinvesting in its own growth.

Recommendation # 1

To encourage long-term investment in these critical enterprises and boost the likelihood of success for growing small and medium sized enterprises by encouraging investors to leave their cash in the business for a longer period of time, we recommend that the capital gains inclusion rate which is at 50% be reduced by 5% per year for investments held for a 10 year (or greater) period. In other words, we recommend that there be no capital gains on dispositions of any investment in SMEs held for at least 10 years.

The capital gains inclusion rate has 2 components – a real gain component and an inflation component.

In prior years, previous governments have introduced incentive measures such as the lifetime capital gains exemption/measures for Canadian-controlled private corporations (CCPCs) that continue to exist today. These measures are focussed to a large degree on estate planning and small business family operated firms. Much of the tax planning is focussed on maximizing the tax benefits with little attention devoted to jobs or productivity.

Our proposal is focussed on the technology companies and service companies that are desperately in need of financing for their high risk ventures where banks and venture capitalists often fear to tread. The individual or angel investor can be made a truly “patient investor” by relieving the capital gain inclusion rate over time. The reward for the risk is at the end of 10 years, when through the financing effort and the ingenuity of the entrepreneur, the firm has increased in value and any capital gain on disposition is then exempt from tax. The benefits that accrue are multi-fold.

First, the company has been financed in Canada and, where successful, has provided jobs, entrepreneurial skill and added to the productivity of the economy.

Government benefits from enhanced payroll taxes, corporate tax, GST and HST, while angel investors have been more firmly encouraged to, and rewarded for, investing their patient capital and, where successful, will reinvest proceeds in more enterprises.

The down-side risk is minimal. Unsuccessful investments don’t generate tax risk and successful investments breed more successful investment. A win-win-win philosophy that does not impact the budget deficit over the years that are critical to Government and takes any potential cost well beyond the 2014 horizon for renewed surplus in budgetary terms.

Issue # 2

The small business deduction (SBD) has an artificial benchmark that forces tax planning in order to remain eligible. It is unnecessary and counter-productive as it incents small businesses to bonus out as deductions, amounts in excess of the small business limit. This practice encourages the removal of necessary cash flow from businesses and perversely restricts their growth potential. Once the funds have been bonused out and personal tax paid on them, it is very difficult to get those funds back into the business and the business suffers, sometimes mortally in the uncertain world of Gazelles.

Recommendation # 2

Extend the small business deduction (SBD) beyond its existing limits for small business corporations that use retained earnings to finance their own endeavours, instead of bonusing down to meet artificial eligibility criteria for the low small business rate of corporate tax.

The existing eligibility criteria to obtain the SBD are the following:

> A corporation which is a CCPC throughout a taxation year may deduct from its tax otherwise payable 17% of its active business income earned in Canada, not exceeding its business limit for the year. For 2009 and subsequent years the business limit is $500,000.00.

The basic federal corporate rate is 38%, so that after the 10% federal abatement for provincial taxes and the SBD, the effective rate for active business income for a CPCC is 11%.

The business limit has been increased several times in recent years. Before 2003, the limit was $200,000 and it was scheduled to increase over 4 years, to $300,000, by January 2006. Budget 2004 accelerated that cap to 2005. Budget 2006 further increased the limit to $400,000 beginning in 2007 and then to $500,000 beginning in 2009.

There are other limitations with regard to associated corporations and corporations with taxable capital in excess of $10M with a total elimination of the SBD at $15M of taxable capital (a measurement of large). That measurement of taxable capital should be sufficient, on its own, as the benchmark for SBD eligibility. Forcing small businesses to bonus out, as deductions, amounts in excess of the small business limit only eliminates necessary cash flow from businesses and severely restricts their growth potential.

Securing funding for on-going business growth at the lowest cost of capital with the fewest restrictions is imperative for the sustainability and viability of the small and medium enterprises in any country, but particularly in Canada, where we compete to export with countries with substantially different cost structures. Artificial benchmarks, such as the existing business limit for the SBD, force companies to engage in wasteful tax planning in order to remain eligible. This activity is counter-productive to the best interests of this sector.

The capital limits are sufficient to differentiate between small and large CCPCs and removing the business limit would enable small business to self-finance itself in a self-sustaining and viable way.

Issue # 3

The administration of the technical and financial eligibility aspects of the SR&ED program by the Canada Revenue Agency (CRA) is inefficient, under-resourced (in terms of necessary expertise), and at cross-purposes with dominant CRA objectives. As a result, the current administration of the eligibility for the SR&ED program is damaging to the very small and medium-sized enterprises that use and rely on the program to fund their growth, and for whom the program is intended to provide the greatest benefit, Gazelles.

Recommendation # 3

Move the administration of the technical and financial eligibility aspects of the SR&ED program to a department, like Industry Canada, where the necessary expertise and administration can be provided in a focussed, and therefore efficient and timely manner to both expedite claims and ensure a proper review. This would leave CRA with its traditional responsibility: to audit and determine taxpayer compliance.

It is important that the SR&ED tax program, which is one of the largest tax support programs of the government ($3B annually) be administered by a group with expertise and whose sole objective is the certification of eligibility for tax support. CRA does not have so clear and simple a mandate, rather, it has numerous objectives, including audit programs to curtail costs.

CRA is not well suited to administer SR&ED claims. While auditors may be adept at reviewing and ascertaining the quantum of expenditures, they do not have the technical expertise and know-how to review the technical merit of scientific research and experimental development. CRA's acknowledgement of this is evidenced by the fact that it has seconded private sector individuals from the high tech sector to aid in the administration of the program. While the individuals no doubt contribute for a limited time, these positions are short term and the expertise does not last.

Furthermore, this recommendation is not precedent setting as the Government has already acknowledged and endorsed, in a number of different vital but technical areas of the economy, the merits of separating the decisions on a project's technical eligibility from the decisions on financial compliance.

For example, in the film industry, tax support for Canadian-produced film and television productions that receive investment tax credits are certified as meeting eligible criteria by the Canadian Audio-Visual Certification Office (CAVCO), which was established by the Department of Canadian Heritage specifically for that purpose. CRA still has the responsibility for auditing the numbers and checking the invoices, but CAVCO certifies eligibility for the program.

Similarly, many of the Government's green energy initiatives delivered through the tax system rely on Natural Resources Canada (NRCan) to review and certify eligibility criteria for Canadian Renewable and Conservation Expenses (CRCE). Once again, CRA has the responsibility to audit and determine taxpayer compliance, but NRCan determines eligibility because that is where the expertise is.

Moving the eligibility decisions for the SR&ED program to a department such as Industry Canada, would only improve the efficiency of the program for those who rely on it to fund their growth. Making the move would not only alleviate concerns over conflicting mandates for CRA, but it would also make the Government's approach to programs such as SR&ED more consistent, as it did with CRCE.