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Canada

Meeting the Challenge of the 1985 Budget

A Guide for Small Businesses



Government
of Canada

Regional Industrial
Expansion

Minister of State
Small Businesses

Gouvernement
du Canada

Expansion Industrielle
régionale

Ministre d'État
Petites entreprises

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It should be noted that this document outlines the budget proposals of May 23, 1985. In case of conflict between this document and relevant legislation, the legislation will govern.

The characters, businesses and examples depicted within this publication are purely fictitious and are used for illustrative purposes solely.

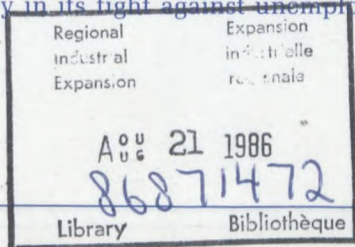
A Message from the Hon. André Bissonnette Minister of State for Small Businesses



On February 8, 1985, the Honourable Sinclair Stevens, Minister of Regional Industrial Expansion, and I released jointly the *Consultation Paper on Small Business*. The paper served as the basis for extensive public consultations which I conducted across Canada during February and March of this year. The views of hundreds of small business owners, entrepreneurs, representatives of national and regional small business associations, financial institutions, labour organizations and academics were heard.

One of the biggest problems facing small business owners and entrepreneurs was identified as the lack of adequate access to funds for business start-ups or expansions. The small business community unanimously expressed a desire for the government to create an economic climate that would encourage both growth and job creation.

In recognition of the important role we believe the small business community can play in bringing about economic renewal and job creation, I am pleased to inform you that your government has listened and has reacted. The Budget of May 23, 1985, contains measures to make funds more accessible to you. It includes amendments to the Income Tax Act which will free up Pension Funds and personal Registered Retirement Savings Funds for investment in small businesses. Major financial incentives will be put in place to encourage individuals, such as friends, family and personal contacts as well as small and large financial institutions, to invest in your business. Imagine if each of the 750,000 or so small businesses in Canada responded to the challenge of the 1985 Budget by creating one new permanent job. It would bring the nation a long way in its fight against unemployment.



This brochure gives you ideas about what the budget can do for you. My aim is to provide you with information that will help you and your business take the fullest advantage of the benefits and opportunities that we hope will flow from the improved climate for small businesses. The consultative process has been meaningful and responsive. Through the budget we are giving you opportunities to innovate, create and build.

The next step is up to you. Your government is confident you will respond to the challenge and it will keep on finding ways that respond to your needs.



Hon. André Bissonnette

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Some Small Business Problems . . .

George Neufeldt, 45, works as a warehouse foreman in a metal foundry in southern Ontario and earns a salary of \$28,000. He has wanted to start his own custom woodworking business for many years but has never taken the plunge. Now he thinks that business conditions are right for his venture, but *George* has heard that it would be virtually impossible to get the \$100,000 needed to start the business.

Technologies Unlimited is a young western-based high technology firm that has discovered a new technology for controlling the temperature in homes and businesses. This could result in substantial energy cost savings, and could be marketable worldwide. About \$250,000 is needed to take the discovery from the drawing board to the working prototype stage. The company approached two Canadian venture capitalists who appeared impressed with the technology, but did not take discussions further. *Technologies Unlimited* may be forced to give up and sell the technology to foreign interests.

For three years *Monique Nadeau*, 35, has operated her own successful catering business in Montreal, attracting new customers all the time. *Monique* is finding that the business is constantly experiencing a "cash crunch" in spite of her success. She has asked her banker to extend more credit, but has been told that she will have to increase her equity by \$50,000 before more credit can be extended. She has approached some friends and some local business people but nobody seems able to help her.

Paul and Jennifer Gardner have operated their souvenir manufacturing business in Moncton, New Brunswick, for almost 30 years. They are planning to retire in a few years, but are concerned about the tax consequences of selling the business. It is only in the last few years that they have been able to make the maximum allowable contributions to Registered Retirement Savings Plans. Other than the equity in their business, they have put aside very little for their retirement.

Most entrepreneurs have experienced one or more of these problems. This guide is intended to help you understand how the recent federal budget can help resolve some of these problems. In particular, it is intended to show how the budget will make more capital available for start-up, growth and diversification, while enabling business owners to keep more of the money they have earned. Through the small business consultation process, we listened to your concerns. Now we are acting.

How the Budget Helps Small Businesses

There are a number of measures in the budget specifically designed to:

- free up substantial capital for small businesses;
- help small businesses improve their cash flow; and
- help entrepreneurs achieve financial security when they retire.

Making Adequate Capital Available to Your Business

For many years some of the largest sources of investment capital such as pension funds and registered plans were not available to small businesses. There were few mechanisms to allow funds from a local community to be invested in local small businesses. To add to the problem, the income tax system created few incentives for individuals to invest in small businesses.

Freeing up capital for your business

1. \$500,000 Tax Free

By 1990 individuals will be permitted to make lifetime capital gains of up to \$500,000 tax-free. This measure will be phased in over six years, starting in 1985.

How This Incentive Works

The following table shows you how the after-tax return on a \$50,000 investment made in 1986 in the equity of a small business will be affected by the capital gains exemption, if the investment is sold for \$80,000 in 1990. This is contrasted with the return that would be obtained by putting the same amount of money in a savings account yielding \$30,000 in interest over the same period:

	Return on Savings Account	Return on Investment in Small Business	
		Before 1985 Budget	After 1985 Budget
Original investment	\$50,000	\$50,000	\$50,000
Interest income	30,000	—	—
Tax on interest ¹	(15,000)	—	—
Capital gain	—	30,000	30,000
Tax on capital gain ¹	—	(7,500)	—
Total return	\$15,000	\$22,500	\$30,000
Annual rate of return	6%	9%	12%

¹Assumes 50% tax rate.

The gain increases substantially and makes investment in small businesses more attractive than ever before

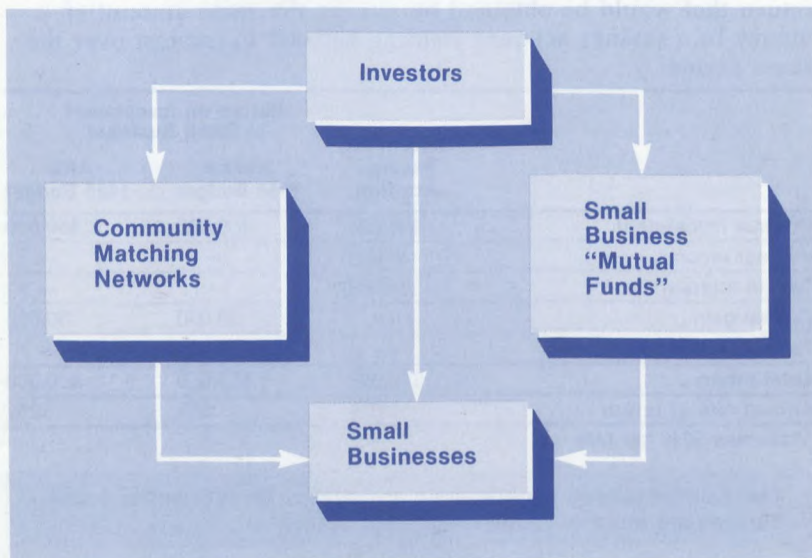
The government is providing Canadians with incentives to invest in small businesses instead of savings accounts. Friends, family and personal contacts, already a source of small business investment, should be much more willing to invest in your business.

What Small Business Owners Should Do

George Neufeldt needs \$100,000 to start up his business. *Monique Nadeau* needs \$50,000 to improve her cash flow. It is now up to *George* and *Monique* to persuade their circles of contacts that their business plans are sound and worthwhile supporting. With these budget measures, *George* and *Monique* have a better chance of getting the funding they need.

But what about *Technologies Unlimited*? Realistically, that company cannot expect to raise \$250,000 from within its immediate circle. To help businesses like *Technologies Unlimited*, new ways are being developed to match businesses with investors other than family, friends and contacts. Community organizations are establishing "networks" to bring together people with money and people with ideas. Investment companies and venture capitalists are establishing small business "mutual funds" to pool investments in a number of small businesses within a community.

Technologies Unlimited should approach the local Chamber of Commerce and locally-based venture capital companies with its business plan. The capital gains tax exemption creates a strong incentive for those with money to find those with good business plans. We believe that people in communities across Canada will make it work.



Matching People with Ideas and People with Money

2. \$20 Billion Now Accessible to Small Business

Registered Retirement Savings Plans (RRSPs) and Registered Retirement Income Funds (RRIFs) together represent a capital pool estimated at \$40 billion. Before the budget, this capital was virtually inaccessible to small businesses. This constraint has now been removed and there are new opportunities available to gain access to a portion of these funds. It is now possible for owners of RRSPs and RRIFs to invest up to 50 per cent of these funds in small businesses. Some \$20 billion is potentially available for investment in small businesses.



If only 10 per cent or \$2 billion is used, 40,000 small businesses could receive an investment of \$50,000

Owners of RRSPs and RRIFs can invest in small businesses in two ways:

- by directly investing at arm's length in small businesses; or
- through organizations such as investment funds, banks and credit unions that manage RRSPs and RRIFs, creating Small Business Investment Limited Partnerships to invest in small businesses.

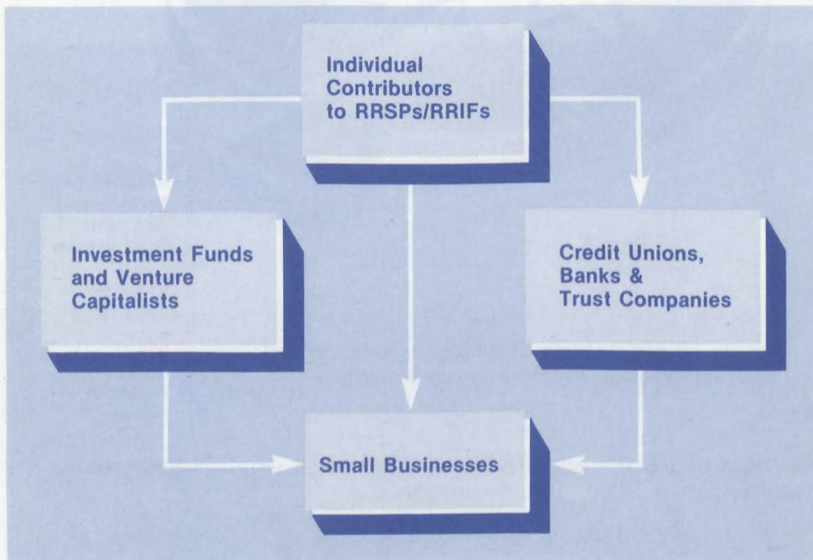
Why These Investments Will be Made

Consider an investor who is presented with an opportunity to invest \$5,500 in shares of your small business. He will now be able to use funds from an RRSP, and will be much more likely to make the investment because:

- RRSPs may be his only source of funds available; and
- the investor will obtain a tax deduction for the full cost of the investment. If the investor's tax rate is 50 per cent this reduces the current out-of-pocket cost of the investment by half to \$2,750.

What Small Business Owners Should Do

Small business owners such as *George Neufeldt* and *Monique Nadeau* will benefit, provided they make the effort to sell their ideas to the right people. They should approach their circle of contacts and point out how RRSP funds can be used. There are also many organizations that manage RRSP funds that *George* and *Monique* can now approach. These include credit unions, banks, trust companies, and investment funds, which can all channel RRSP monies into small businesses using Small Business Investment Limited Partnerships.



Small business owners will benefit, provided they make the effort to sell their ideas to the right people

Companies like *Technologies Unlimited* should contact investment funds and venture capitalists who will manage some of the Small Business Investment Limited Partnerships. They can also call on Chambers of Commerce or local economic development corporations to put them in touch with individual investors.

3. Pension Funds Freed Up for Small Businesses

Pension funds now total about \$160 billion. Up to \$11 billion is available for investment in small businesses.

**Pension Funds
\$160 Billion**



**Available for
Investment in
Small Businesses
\$11 Billion**

If only \$1 billion is used, 20,000 small businesses could receive an investment of \$50,000

Two new vehicles have been created to channel pension funds into small businesses:

- Small Business Investment Corporations
- Small Business Investment Limited Partnerships

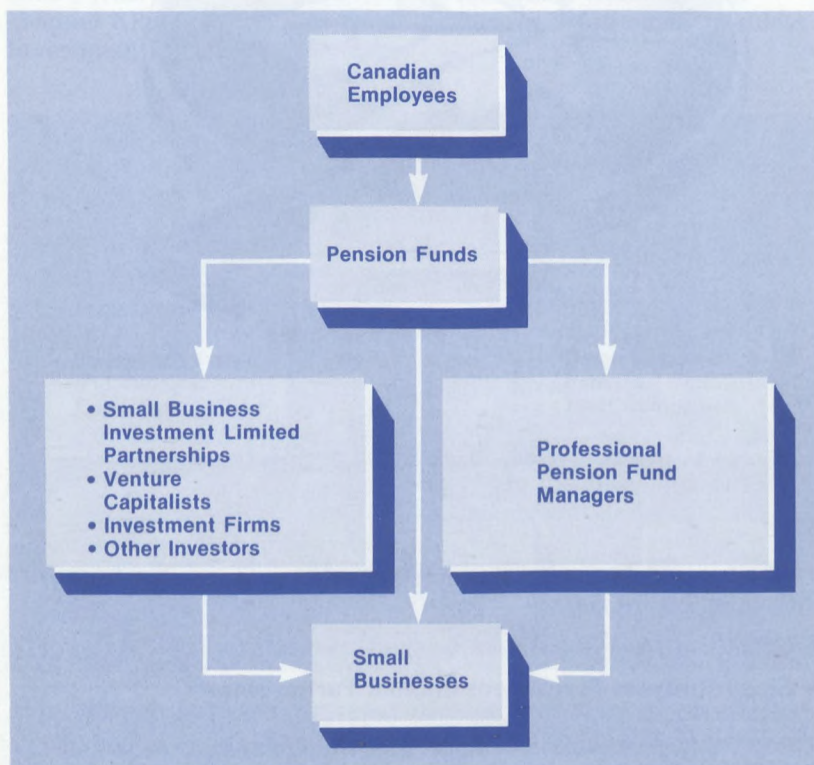
These vehicles will permit pension fund managers to invest in small businesses more easily. They will also encourage the flow of funds to small businesses through other groups, such as venture capitalists, who already make significant investments in small businesses.

Why These Investments Will Be Made

For each dollar invested in small businesses by pension fund managers three dollars can now be invested in foreign assets. Since pension fund managers have long been seeking an increase in the limit on foreign investment, they will be receptive to investment opportunities in small businesses. The incentive is there!

What the Small Business Owner Should Do

Technologies Unlimited should take its business plan to major corporations, municipalities, hospitals, universities and colleges — in fact to any large employer. The pension funds of these organizations can be invested in small businesses using the Small Business Investment Corporation vehicle. *Technologies Unlimited* should approach trust companies and professional firms specializing in the management of pension funds on behalf of employers. They, too, will be looking for attractive investments in small businesses on behalf of their clients. *Technologies Unlimited* should also go to venture capitalists who will be



Pension fund investment in small businesses - the incentive is there

managing Small Business Investment Limited Partnerships on behalf of several pension funds.

It is now up to *Technologies Unlimited* and other companies to make it happen. They have to take the initiative, seek out investors and sell their ideas. Large investors do not have the resources to look for small business opportunities but they will be prepared to listen.

4. Labour – Another Source of Capital for Small Businesses

A strong incentive has been created for Canadians to invest in venture capital funds sponsored by labour organizations. Up to \$1 of every \$5 dollars invested by an individual in a labour-sponsored venture capital fund reduces the personal federal income tax payable by up to a maximum of \$700.

Two conditions must be met before this incentive can apply:

- Funds must be invested in small- or medium-sized businesses.
- Provincial legislation must be put in place to enable funds to be used.

Les Fonds de solidarité des travailleurs du Québec was established in Québec in 1983 by the Québec Federation of Labour. This budget measure is an incentive for the creation of similar funds in other provinces.

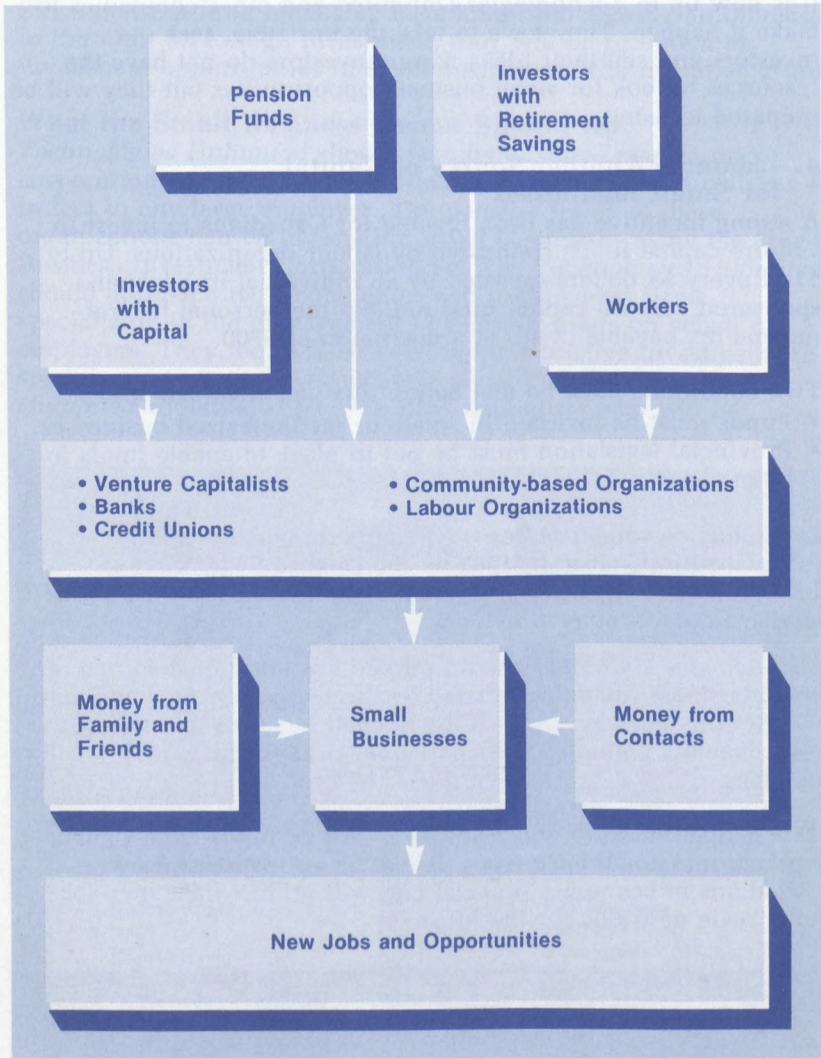
Technologies Unlimited should pursue this additional source of small business financing created by the budget. Some companies will get this money; it's up to each small business to develop its own business plan, to approach labour organizations and to sell its ideas.

This budget measure will result in a flow of funds from Canada's workers into small businesses. It will be an investment by Canadians in economic renewal and will protect their own jobs and create new jobs for the future.



Canada's workers and small businesses – a partnership for the future

Let's review how more capital has been made available for your business



Now you know how the budget will help you attract capital, improve the equity base of your company and reduce your reliance on debt financing

How to Improve Your Cash Flow

From time to time small businesses have cash flow problems. The process of growth creates a demand for working capital that sometimes cannot be met easily.

Measures to help improve your cash flow

1. Cash Refund for Research and Development Increased

For every dollar spent on research and development, small businesses can obtain a 35 cent tax credit. If your company is not in a tax-paying situation and is unable to use the credit immediately, it will receive a full cash refund of credits resulting from expenditures of up to \$2,000,000. You now get a full refund instead of 40 per cent. This means you can obtain credits of up to \$700,000.

This is an ideal incentive for companies like *Technologies Unlimited*. Let's look at how *Technologies Unlimited* can take advantage of this tax credit when it spends its \$250,000 on research and development.

	Before 1985 Budget	After 1985 Budget
Current R&D Expenditures	\$250,000	\$250,000
Tax Credit 35%	87,500	87,500
Refundable Portion	(40%) 35,000	(100%) 87,500
Net Cash Required for R&D	\$215,000	\$162,500

A net improvement of \$52,500

This change will improve the cash flow which is critical at the early research and development stage. It could permit small businesses like *Technologies Unlimited* to obtain additional financing from their bankers or other financial sources in anticipation of the tax credit. For example, *Technologies Unlimited* will have to raise less in equity than would have been required previously, since the remainder will be funded by the government through the tax refund. Until it actually receives the

refund, *Technologies Unlimited* might be able to obtain "bridge financing" from a financial institution. The fact that a lower amount of equity is now required will reduce the amount the firm must give up to fund its research and development.

In addition, the definition of research and development has been broadened. This will enable small businesses like *Technologies Unlimited* to count more of their expenditures as research and development for taxation purposes. Consult with your accountant.

2. Frozen Unemployment Insurance Contributions

Unemployment insurance contributions by both employers and employees are frozen at 1985 levels for 1986.

For *Paul and Jennifer Gardner's* manufacturing business, with 50 employees and an annual payroll of \$1,000,000, this will mean a cash saving of about \$3,500. The 11 per cent increase previously announced will not go into effect.

Contribution without rates being frozen	\$36,400
Contribution with rates frozen	\$32,900
Saving	\$ 3,500

3. Small Business Bond Program Extended

The small business bond program, which was to have ended on December 31, 1985, has been extended to the end of 1987. It is designed to reduce interest costs for small businesses in serious financial difficulty. Financial institutions that lend money to these small businesses do not pay taxes on the interest they receive. Consequently they can offer a much lower rate of interest on loans. On the other hand, when the bond is used, the small business does not get a tax deduction for its interest expense.

How it Works

The use of a small business bond would have the following effect on the cash flow of a company with a bank loan of \$500,000:

	Regular Bank Loan	Small Business Bond Bank Loan
Amount of Loan	\$500,000	\$500,000
Interest Rate	12%	7%
Interest Paid	\$ 60,000	\$ 35,000

A cash saving of \$25,000 per year or over \$2,000 per month

Helping You Plan for Your Retirement

Concern has been expressed over the inability of small business owners to properly plan for their retirement. Unlike most employees, entrepreneurs often have no pension plan other than the Canada Pension Plan. In addition, most small business owners can only make contributions to RRSPs in the good years. In leaner times, every available dollar must stay in the business. Many small business owners have only their businesses to rely on for security in their retirement.

New measures help turn this situation around

1. Capital Gains Tax Exemption

Each individual is now exempt from paying taxes on up to \$500,000 of capital gains during his or her lifetime. This has a major impact on small business owners' ability to have adequate funds for their retirement.

Paul and Jennifer Gardner are planning to retire within a few years. Let's look at what happens if they sell their business in 1990 for \$300,000 and make a capital gain of \$240,000.

	Before 1985 Budget	After 1985 Budget
Proceeds from sale	\$300,000	\$300,000
Capital Gain	240,000	240,000
Tax on Capital Gain ¹	60,000	—
Cash Retained	\$240,000	\$300,000

¹Assumes 50% tax rate.

Paul and Jennifer will now gain an extra \$60,000 for their retirement

2. Improvements In RRSP Rules Which Will Help Entrepreneurs

Small business owners often need all their available cash for their businesses and are only able to contribute to RRSPs when they are doing well. This prevents them from using RRSPs fully to plan properly for their retirement.

To improve this situation, the government has:

- allowed a “carry-forward” of unused contributions for up to seven years. If a person does not make a contribution in 1986, he can still make the 1986 contribution in any year until 1993.
- increased the maximum annual contribution from \$5,500 today, to \$15,500 by 1990.

Let’s look at the benefit of these new measures for *Paul* and for *Jennifer Gardner* if they are unable to make RRSP contributions in the next three years because of the cash requirements of their business.

	Before 1985 Budget	After 1985 Budget	
	Actual Contribution	Actual Contribution	Cumulative Carry Forward Available ¹
1986	—	—	\$ 7,500
1987	—	—	17,000
1988	—	—	28,500
1989	\$5,500	\$42,000	—

¹this assumes sufficient pensionable earnings in 1986, 1987, 1988 and 1989.

Under the new rules maximum contributions are being increased gradually. Unused contributions for 1986, 1987 and 1988 of \$7,500, \$9,500 and \$11,500 respectively, can be carried forward and used in 1989 together with the 1989 maximum contribution of \$13,500.

Paul and Jennifer will be able to build up a substantial retirement fund more quickly

Retirement planning for the small business owner has been simplified. People starting a small business now have more assurance of security when they retire. One of the biggest concerns of small business owners has now been eased, allowing them to focus on the task of building their businesses.

A Summary of What the Budget Does for You

Starting up Your Small Business

- The *capital gains tax exemption* and the *freeing up of RRSP monies* for investment in small business makes more money available from the following sources:
 - your family, friends and personal contacts;
 - local investors through:
 - the local Chamber of Commerce
 - the local economic development corporation
 - your lawyer, accountant or business advisor; and
 - credit unions, banks and trust companies.
- The encouragement of *labour-sponsored venture capital* pools makes more money available from labour organizations.
- The *increase in RRSP contribution limits* from \$5,500 to \$15,500 by 1990 will allow you to set aside adequate retirement funds out of pre-tax personal income. If you can't make a contribution to your RRSP in any year, you can still make that year's contribution in any of the next seven years provided you have sufficient pensionable earnings. This recognizes that in some years your priority will be to put your money back into the business. These measures will help alleviate your concerns about the retirement aspects of owning a business.

Benefits For Research and Development

- The *increased refundable tax credit* for R&D will make it easier to handle the cash flow demands of the development stage. You should investigate the possibility of obtaining operating capital on the basis of the refundable credit from banks, credit unions, and trust companies.
- Because of the *capital gains tax exemption* and the *freeing up of RRSP money* for investment in small businesses you will find money available for research and development. You should contact:
 - venture capitalists, in particular those who draw funds from the local community;
 - small business mutual funds that pool many small business investors to spread risk; and
 - local investors with capital through:
 - your Chamber of Commerce
 - the local economic development corporation
 - your lawyer, accountant or business advisor.
- To benefit from the *freeing up of pension funds* for investment in small businesses you should approach:
 - venture capitalists;
 - major corporations;
 - local governments;
 - educational institutions;
 - hospitals;
 - Crown corporations; and
 - small business investment limited partnerships or funds that will be established by investment firms and venture capitalists.

Maintaining an Adequate Cash Flow

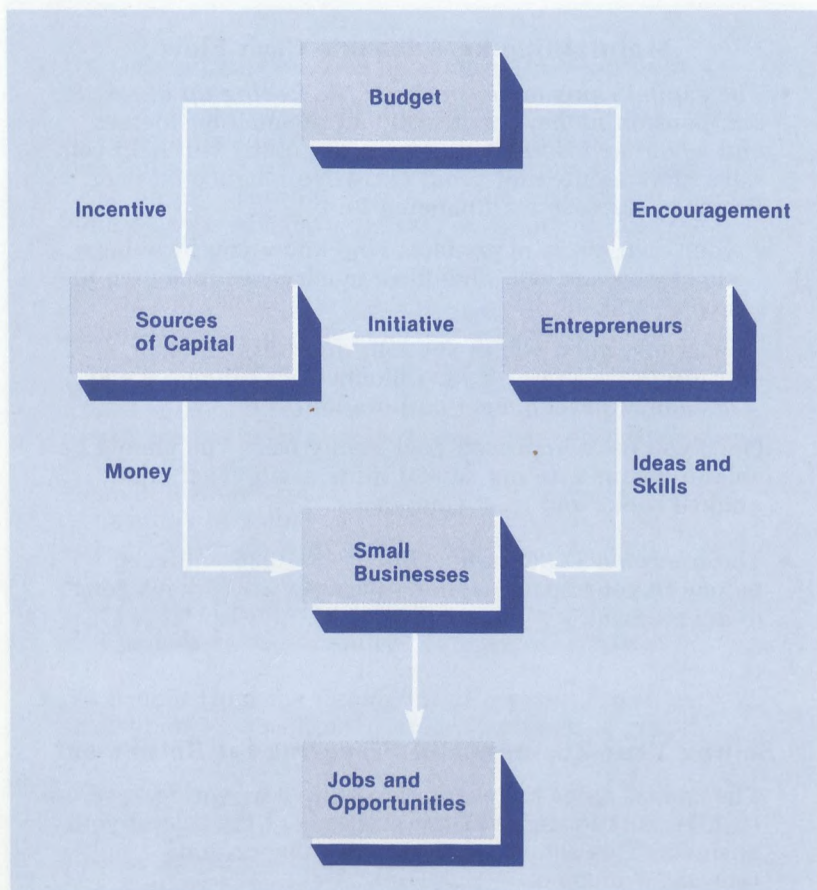
- The *capital gains tax exemption*, the *freeing up of RRSP and pension money* for investment in small businesses and *labour-sponsored venture capital* funds will help you raise more equity and avoid excessive reliance on debt. Present your case for financing to:
 - your own circle of contacts who know you have been successful and will now have much more incentive to invest; and
 - local investors, whom you can find through local institutions such as your Chamber of Commerce and economic development corporation.

Once you have improved your equity base, you should be able to obtain working capital more easily from credit unions, banks and trust companies.

- The *freeze on U.I.C. contributions* for 1986 will keep money in your business that otherwise would have gone to government.

Selling Your Business and Preparing for Retirement

- The *capital gains tax exemption* will allow you to keep up to 33⅓ per cent more of the proceeds of the sale of your business. This should significantly enhance your retirement income.
- The *increased contributions to RRSPs* that you can now make will allow you to build up this source of retirement income much more quickly than in the past. In addition, for the year when you can't make an RRSP contribution, even though you have sufficient pensionable earnings, you can make that year's contribution in any of the next seven years. You no longer have to worry about missing a year or two.



Meeting the Challenge of the 1985 Budget

Throughout the small business consultations your government listened and now has acted. Consultation is an ongoing process and we want to continue hearing from you. Call the Small Business Secretariat, collect, through the hotline at (613) 995-9197.

The budget measures are designed to create a strong economic climate within which your small business can operate successfully and profitably. It removes the obstacles to start-up and growth.

Only you have the vision of what your business can be. Only you can make it happen. The government has done its share in freeing up the resources you need to make your vision real. *The challenge is now up to you.*