SMALL AND MEDIUM-SIZED ENTERPRISES (SMES)

THE ENGINE OF CANADA'S ECONOMY

THE LEGAL FRAMEWORK OF THREE SENSITIVE SPHERES FOR SMES' GROWTH: FINANCING, TAXATION AND INTERNATIONAL TRADE

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ABSTRACT

It is widely believed that small and medium-sized enterprises ("SMEs"), acting as a source of innovation and job creation, play a key role in the economy of Canada.

The legal framework which regulates SMEs' activities is vast. This thesis focuses on the legal framework and most important aspects of three critical areas: financing, taxation and international trade.

After describing and interpreting the legal framework of these areas and the information obtained from public and private institutions which are considered key in these issues, this thesis presents conclusions in relation to the question of how and in what way, if any, the current legislative and regulatory framework relating to SMEs contributes to the growth and prosperity of SMEs and to the importance of such a framework to SMEs' success and growth.

ABSTRACT

Il est reconnu que les Petites et moyennes entreprises (PME) canadiennes, sont sources d'innovation et d'emplois, et sont le moteur de l'économie canadienne.

Étant donné le fait que l'environnement légal qui réglemente l'activité des PME est vaste, cette thèse se concentre uniquement sur trois domaines d'une importance cruciale pour les PME : le financement, la fiscalité, et le commerce international.

Après avoir décrit et interprété d'une part la législation et la réglementation existante dans les domaines mentionnés, et d'autre part les informations fondamentales en cette matière qui ont été obtenues d'institutions publiques et privées, la présente thèse analyse comment, s'il en est, le cadre législatif et réglementaire soutient la croissance et la prospérité des PME au Canada.

INTRODUCTION

Each day we interact and contract with a diversity of enterprises and business entities. We engage and relate to them sometimes either as partners, employees or simply as customers. The common thread in our relationship with these companies is that most are either small or medium-sized businesses controlled or managed by "ordinary people" who nonetheless share an "entrepreneurial spirit." Normally, this entrepreneurial spirit helps these companies to innovate and create new and better goods and services, helping their economies remain competitive and innovative.

The characteristics and importance of small and medium-sized businesses are oftentimes compared with and, to a certain extent, challenged against the role large corporations or businesses play in economic activity.[1] On the one hand, small and medium-sized enterprises are different from big business at a number of levels: size, range of operations, resources and business culture (e.g. independence, simplicity and flexibility). On the other hand, small and medium-sized enterprises have capability to create new business ideas and concepts and constantly reinvent themselves in order to offset the concentration and dominance of big business.[2] The continuous creation and appearance of new business undertakings maintains or stimulates not only competition but also preserves innovation and productivity both for small and big businesses.

Historically, the roots of small business in Canada can be traced back to the undertakings and ventures started in the ninetieth and early twentieth century. The entrepreneurs of that time engaged principally in the extraction of natural resources and

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[1] See, for example, Rein Peterson, *Small Business: Building a Balanced Economy* (Ontario: Press Porcépic, 1977).
[2] *Ibid.*

the maritime industries, which in turn served as the basis for the economic development of Canada.[3]

For example, during the 1800s, external demand for New Brunswick's most abundant natural resource - timber - transformed the economy and environment of this province, and turned a relatively unimportant and sparsely populated backwater into a thriving commercial colony of almost 200,000 forest industry workers by 1851.[4] Farming, another industry associated with natural resources, also has historically had a high number of small businessmen participating in the sector.[5]

The maritime industry also witnessed the participation of small businesses in the 1800s and 1900s. The small business sector participated in the maritime industry mainly through "penny capitalists." The history of penny capitalists refers to "a working person who went into business in small scale, in the hope of profit (but with the possibility of loss) and made him or herself responsible for every facet of the enterprise."[6]

In Canada, a very large number of companies could be classified as either small or medium-sized. According to figures released in December 2001, 1,044,124 companies out of a total of 1,046,870 had between 1 and 499 employees.[7] In other words, when we take into account the 499 employees limit as the line which divides big business from

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[3] See, for example, Lewis R. Fischer, The Enterprising Canadians: entrepreneurs and economic development in eastern Canada, 1820-1914: proceedings of the second conference of the Atlantic Canada Shipping Project, March 30-April 1, 1978 (Newfoundland: Maritime History Group, Memorial University of Newfoundland; Memorial University of Newfoundland, 1979). [Enterprising].
[4] New Brunswick, *House of Assembly, Population and other Statistics of the Province of New Brunswick, year, 1852* in Journals of House of Assembly, Appendix (1851) cited in Enterprising, *ibid*, at 7.
[5] For example, at no time between 1871 and 1911 did the proportion of owner-operated farms fall below 87% of the total,[5] becoming the enterprise of small-scale capital. Urquhart and K.A. H. Buckley, eds., *Historical Statistics of Canada* (Cambridge and Toronto, 1965), at 351-2, cited in John Benson, *Entrepreneurism in Canada: A History of "Penny Capitalists"* (Lewiston, NY: E. Mellen Press, 1990), at 24. [Benson].
[6] Benson, *ibid*, at 8.

small and medium business, 99.73% of the businesses in Canada would be considered small and medium businesses,[8] employing six out of every ten Canadians.[9]

New market conditions and business environment are contributing factors to the growth of SMEs. It is no longer mostly about natural resources and automobile sectors, industries that require heavy capital investment, but information and technology industries in which SMEs can effectively compete with big business.

Small and medium-sized enterprises are the subject of numerous definitions which make it difficult at times to precisely define.[10] The problem of defining small and medium-sized enterprises is not trivial since an accurate definition of these undertakings is necessary to determine the number of enterprises participating in this sector in order to consider their importance for the development of the economy. For this reason I dedicate an entire section of this thesis to explore the most common methods used to define the expression and also proposes a single and detailed definition to be adopted in the future. Nevertheless, in order to understand the context surrounding small and medium-sized enterprises in Canada, one could define small and medium-sized enterprises as companies that enjoy decision making independence, have low annual sales figures, employ a relatively low number of people (less than 499) and do not dominate their economic sector of activities ("SMEs").[11]

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[7] Canada, Statistics Canada, Small Business Research and Policy, *How Many Business Are in Canada*, online: How Many Business Are in Canada <http://strategis.ic.gc.ca/epic/internet/insbrp-rppe.nsf/vwGeneratedInterE/rd00669e.html>.

[8] *Ibid.*

[9] Canadian Federation of Independent Business, "Building on Canada's Strength: Small Business Outlook and Budget Priorities For 2003", 9 January 2003, at 2.

[10] See, for example, Gérald d' Amboise, *The Canadian small and medium-sized enterprise: situation and challenges* (Halifax, N.S.: Institute for Research on Public Policy, 1991) [Amboise], or Jerry White, "Canadian Small Business Financing and Tax Planning Guide" (Don Mills, CCH Canadian, 1984) [White].

[11] For a more detailed definition of SMEs, see Chapter 1 below.

Because these undertakings are believed to create jobs, innovate and allow the entrepreneurial spirit to be fulfilled, most industrialized countries have recognized that SMEs are an important source of growth for their respective economies.[12] It is clear that that Canada has adopted this philosophy.[13]

This begs the following question, how does the legal framework regulating SMEs' support its activity and growth? How and in what way, if any, does the regulatory framework contribute to the growth and prosperity of SMEs? Are there any specific areas that support SME growth more than others? Additionally, can a given legislative framework contribute the success of SMEs'?

Those interested in the SME sector - legislators, small businessmen, lobbyists, NGOs - can count on the SMEs' legal framework as an instrument that can be used to support and enhance the growth of these undertakings. However, it does not appear that the different regulatory and legal aspects which comprise the SMEs' legal framework are able to generate a significant positive effect on the activities of SMEs. In this sense, the legal framework surrounding SME financing, taxation and international trade activities are the legal areas that prove to be the most sensitive to SME growth.[14]

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[12] See, for example, OECD, Directorate for Science, Technology and Industry, *Industry Issues – Taxation, SMEs and Entrepreneurship*, Working Paper No. JT00130282 (2002).

[13] See, for example, Canadian Federation of Independent Business, "The Path to Prosperity: Canada's Small and Medium-sized enterprises," online: <http://www.cme-mec.ca/national/documents/sme_final.pdf> [Path], or Gordon Nixon, "Canada's Path to Prosperity. Growing our Small and Medium-Sized Enterprise." RBC Financing Group. 2002, online: <http://www.rbc.com/newsroom/20021007Nixon_1.html> [Nixon]. As John Manley, Minister of Finance, stated on the occasion of presenting the Federal Budget 2003. Canada, Department of Finance, *Building the Canada We Want – The Budget Speech 2003* (Ottawa: Her Majesty the Queen in Right of Canada, 2003) [Building] at 11 – Feb 18, 2003:

> This budget goes even further in supporting entrepreneurs and small business in Canada. I am announcing today a long overdue change for small business owners. (...) [T]he budget plan had a clear goal]: To support a climate that rewards hard work and entrepreneurship. That encourages innovation and stimulates economic growth.

[14] See, for example, Amboise, supra note 10; White, supra note 10; or supra note 9.

Adequate rules governing SME financing are of vital importance for these entities since many of their operational problems stem from their lack of financing. Thus, the legal framework in this area should not be overly burdensome for small business and should also be facilitated to enable SMEs to obtain financing under competitive and reasonable terms and conditions.

Rules regulating taxation of SME activities can also be an important element that contributes to an SME's success. Taxes applicable to SME activities should not be levied in such a way that might impair an SME's ability to maintain its business, grow, prosper, and innovate.

Finally, taking into consideration the new global marketplace and in order to remain competitive, SMEs should benefit from a legislative framework that supports their endeavors in cross-border transactions or trade.

A legal analysis of these areas may suggest how and in what way, if any, these key legal areas promote and support small businesses. In addition, such an analysis may indicate the genuine relevance of law on SME growth. For this reason, it is the purpose of this thesis to describe and interpret, from a legal point of view, these three spheres of regulatory activity which contribute to SME success.

This thesis is divided into 5 chapters. Chapter 1 describes alternative approaches to defining SMEs and proposes a single definition. Chapter 2 examines different sources of financing for SMEs and explores their most relevant legal aspects. Chapter 3 describes and interprets some of the most sensitive taxes for SMEs' activities and how the legal framework is structured in relation to these taxes. Chapter 4 focuses on two measures undertaken by the Federal government to enhance the participation of SMEs in the global marketplace and how these measures are supported by regulations. Finally, Chapter 5 presents some of the conclusions that may be drawn from the previous chapters and addresses the question of how the legal framework of these areas contributes to the growth and prosperity of SMEs and the relative importance of law on the success of SMEs.

CHAPTER 1. ALTERNATIVE APPROACHES TO DEFINING SMEs

There is little doubt among public officials, legal and economic scholars and businessmen[15] alike about the importance that SMEs have for the economic and social development of Canada.[16] However, there is no consensus on how these companies should be identified since the concept of "small business" is not clearly defined. The concept, although commonly used, is somewhat vague, suggesting that an undertaking that is not large is a "small business", without being more specific.[17]

In general terms, there is no standard definition of SMEs in Canada; instead the concept has been used in different contexts using various meanings. The definitions used by federal and provincial governments, as well as by private parties are usually based upon qualitative or quantitative criteria, or on a mix of both which, it could be argued, are the ideal scenario for the purposes of defining and identifying SMEs.[18]

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[15] About the role that SMEs play for the economy of Canada, see, among others, the speech of the President and Chief Executive Officer of the Royal Bank of Canada Financial Group, Gordon Nixon, at the Queen's Centre For Enterprise Development on October 7, 2002. Nixon, supra note 13.

[16] The small business sector created the bulk of half of a million new jobs in 2002, supra note 9, and accounted for roughly half of the Canadian gross domestic product in the same year ,supra note 9, at 3.

[17] As an example of how SMEs can be defined in Canada, one could consider the definition used by the Small Business Administration ("SBA") in the United States. It is worth noting that the SBA has a department, with a full-time staff of analysts, lawyers and economists, whose duty is to constantly update, refine and interpret the conceptual definition of small business concerns that is part of the *Small Business Act. Small Business Act*, U.S.C. 15 § 631 (2001), online: Title 15, Chapter 14A, Sec. 631 <http://www4.law.cornell.edu/uscode/15/631.html>. On one hand, the *Small Business Act* defines small business concerns as companies which are:

> Independently owned and operated and which [are] not dominant in its field of operations.

Additionally, upper limits are specified in the number of employees and in the total dollar volume of sales for each industry group. On the other hand and according to this agency of the US' government and in an attempt to provide with a general definition, SMEs can be defined as "enterprises whose sales or employment fall within certain limits according to whether the firms are in manufacturing , retailing, wholesaling or construction industries." It must be kept in mind that the primary objective of the SBA's definition is to identify its clientele in a systematic, if somewhat specified, manner. Andrew T Nappi and Jay Vora, "Small Business Eligibility: A Definitional Issue" (1980) 18 Journal of Small Business Management, No 4 at 22, cited in White, supra note 10, at 507 [¶ 505].

[18] See, for example, Amboise, supra note 10.

The most common qualitative aspects used to define the term include an SME's geographical scale of operations, degree of independence and type of management.[19]

The geographical approach relates to an undertaking which operates locally or regionally. In this sense, the market share of this undertaking is often limited to the needs of nearby customers.[20]

The degree of independence, as another qualitative aspect, refers to both the type of ownership and, to a certain extent, an entity's decision-making latitude that results from it.[21] This degree of independence allows a SME to leverage this higher level of freedom in the decision-making process and its local business knowledge, making possible for the SME to quickly react to competitive pressures from other firms in markets where it sells its products and services. An undertaking's independence and flexibility to rapidly adapt itself to new circumstances, although not precise, are the key-terms for defining SMEs in this context of qualitative approaches.

The complexity and structure of the management of an undertaking also serve to discern SMEs from larger entities. Usually, large enterprises tend to be managed by skilled professional people who are charged with hierarchical authority. Administrative roles are also divided up according to a company's operational functions (traditionally: production, sales, financing, marketing, etc.). Conversely, SMEs are frequently administered by personal or direct management. The concept of personal or direct management in SMEs refers to persons who usually own and operate the undertaking and do not receive remuneration in the form of a salary for the services they render to the

[19] *Ibid.*
[20] With the participation of SMEs in the global marketplace, the geographical approach does not have the same relevance that it once had in defining SMEs.
[21] Amboise, supra note 10.

SME.[22] At the SME level, a single individual or a small group of individuals make all the decisions regarding to both general orientation of the undertaking and its day-to-day operations. By the same token, the same individuals usually finance and own the entity and control every aspect of an SME's production process.

Therefore, by using such a qualitative approach, it would be possible to conclude that SMEs are businesses which operate in a relatively restrictive atmosphere, look for great independence having a preference for a simpler administrative structure.[23] However, it seems that, as explained below, the quantitative approach is better used to distinguish SMEs from big undertakings.

Quantitative measures are in themselves practical; they are practical in situating a company in relation to others in the same set of circumstances, although it is left to users of such criteria to determine the upper and lower limits of each category.[24] In general terms, quantitative criteria are measurements of size. The choice of a measurement of size as a means to define SMEs is often justified by the ease of access to the required data.

Some measurements of size used for defining SMEs are (i) number of employees; (ii) quantities of goods produced; (iii) annual sales; (iv) added value generated in relation to the total of outputs of the sector; (v) level of salaries paid; (vi) the manner in which the capital stock of the SME is structured; and (vii) owner's equity and working capital levels.[25]

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[22] *Ibid.*
[23] *Ibid.*
[24] *Ibid.*
[25] *Ibid.*

From the quantitative measurements, the number of employees and the level of annual sales are the most common quantitative features used to identify and define SMEs.[26] In Canada, the Canadian Bankers Association, Industry Canada and the Canadian Federation of Independent Business ("CFIB")[27] have proposed their own definitions of the concept.

The Canadian Bankers Association, for example, defines small business as "those having authorized credit limits of $500,000 or less", and medium-sized businesses as those which "have authorization levels [of credit limits] of up to $1 million."[28]

Similarly, Industry Canada defines SMEs based upon the number of people employed and by distinguishing SMEs participating in the service sector from those in manufacturing. In this regard, it defines SMEs as follows:

> A goods producing firm is considered "small" if it has fewer than 100 employees, while for service producing firms the cut-off point is seen as 50 employees. Above that size, and up to 500 employees, a firm is considered medium-sized.[29]

The CFIB limits its definition to "a firm owned and managed by an independent owner."[30]

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[26] "It is not uncommon to find small- and medium-sized firms defined in terms of sales and/or number of employees", Jeffrey G. MacIntosh, *Legal and institutional barriers to financing innovative enterprise in Canada* (Kingston: Government and Competitiveness, School of Policy Studies, Queen's University, 1994) at 2.

[27] The CFIB is a very important private organisation in the SME sector. With 105,000 members, the CFIB enjoys tremendous bargaining power to lobby the Canadian government for better business conditions for SMEs.

[28] The Canadian Bankers Association, "The On-Line Glossary," online: CBA – Consumer Information – The On-line Glossary <www.cba.ca/en/ViewDocument.asp?fl=3&sl=68&tl=&docid=273>.

[29] Canada, Industry Canada, *Key Small Business Statistics* (Small Business Research and Policy), online: Small Business Research and Policy – Statistics – Key Small Business Statistics <http://strategis.ic.gc.ca/epic/internet/insbrp-rppe.nsf/vwGeneratedInterE/rd00668e.html>.

[30] Canadian Federation of Independent Business, "Guide de gestion de la petite enterprise", 2nd edition, Project Education PME, Chicoutimi, Université du Québec a Chicoutimi, at 5 cited in Amboise, supra note 10, at 18.

It seems that an appropriate definition for the term should include both qualitative and quantitative criteria. For this purpose, the following formula should be considered:

> Any firm that fulfils all the following conditions could be designated as a SME: 1. managers have decision-making independence (subsidiaries and franchises are excluded); 2. the firm has annual sales figures of less than $20 million and employs less than 500 people; and 3. it does not dominate its economic sector of activities (its turnover is less than that of the market leaders).[31]

This definition uses both qualitative and quantitative criteria and has the merit of being simple and easily applied; therefore each time that the concept of SME is used in this document, it will refer to companies which meet the criteria of this definition.

The following table summarizes the most important elements utilized for defining SMEs by using both qualitative and quantitative approaches.

Element / **Approach**	Qualitative Approach	Quantitative Approach
Geographical Scope of Operations	Yes. This approach uses this element to distinguish an undertaking operating either locally or regionally.	No
Number of Employees	No	Yes. Undertakings employing up to 49 employees are usually considered small. From 50 to 499 employees, undertakings are deemed medium.
Degree of Independence or Flexibility	Yes. The degree of independence refers to both the type of ownership and the undertaking's decision making latitude that results from it.	No
Quantity of goods produced	No	Yes. Varies from industry to industry.
Management Structure	Yes. The key points are the skills of the persons who manage the company and the existence of different administrative roles.	No
Annual Sales	No	Yes. Usually less than $20 M. It could also vary from industry to industry.
Added Value to the Sector	No	Yes. Varies from industry to industry.
Level of Wages	No	Yes. Varies from industry to industry.
Capital Structure	No	Yes. It requires the existence of different types of securities structuring the capital of the company.
Owner's Equity and Working Capital Levels	No	Yes. It relates to the level of the owner's capital committed to the venture.

[31] Amboise, *ibid.* at 19.

CHAPTER 2. SOURCES OF FINANCING FOR SMEs

2.1 INTRODUCTION

In 1996 the Federal government commissioned a task force on the future of the Canadian financial service sector to examine public policies affecting the financial service sector in general and to make recommendations relating to the conditions of SME financing in particular (the "MacKay Task Force"). Two years later, the MacKay Task Force concluded that there were not sufficient data available to make any judgment and/or recommendation relating to SME financing.[32] As a result of this finding, the Federal government mandated Industry Canada, the Department of Finance and Statistics Canada to work together to gather data and other statistical information relating to SME financing.[33] This mandate showed the Federal government's concern with clearly understanding the problems that SMEs were facing in financing their projects.

To consider the alternatives and the problems that SMEs have faced in securing financing for their ventures, this section describes and interprets some of the most important sources of financing available to SMEs and their relevant legal framework. The sources of financing for SMEs and their legal framework addressed in this section are: (1) personal and family financing; (2) banking loans; (3) the role of credit unions and *caisses populaires* in financing SME projects; (4) lease financing; (5) the importance of factoring for SME financing; (6) secured credits and the leading case of Bank of Montreal

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[32] Report of the Task Force on the Future of the Canadian Financial Services Sector, "Change Challenge Oportunity," online: <http://finservtaskforce.fin.gc.ca/rpt/pdf/Main_E.pdf>, at 218.

[33] Some examples of completed studies are: "Practices and Patterns of Informal Investors"; "Value Added by Informal Investors: Findings form a Preliminary Study"; "Issues Surrounding Venture Capital, Initial Public Offering (IPO) and Post-IPO Equity Financing for Canadian SMEs." Some examples of ongoing studies are: "Profiles of VC investors". Some examples of upcoming surveys and studies are: "Supplemental Demand Survey"; "Pension Funds and Their Investment in SMEs"; "Availability of Micro-Credit Financing: Venture Capital International Comparisons." For a complete list, see Canada, Industry Canada, *SME Financing in Canada 2002*, online:<http://strategis.ic.gc.ca/fdi>.

v. Hall; (7) the participation of angel investors and venture capitalists as providers of risk capital financing for SMEs; (8) public markets and the use of internet for SMEs' direct public offerings; (9) a brief explanation of why small business loans securitization may be a significant mechanism to enhance the provision of funds for SMEs; and (10) some examples of federal and provincial government financial assistance programs and institutions established to finance SME activities, such as the Business Development Bank of Canada ("BDC"), the small business financing program and the capital leasing pilot project and the work of the provincial venture capital corporations in financing SME projects.

2.2 Personal and Family Financing

As a result of the difficulties that SMEs face in obtaining or securing sufficient financing, SMEs often rely on financing from friends, relatives or from personal savings or resources.[34] The reason for this channel of funding is that strangers, whether institutional or individual, are usually ill prepared to spend the time required on small deals to verify an entrepreneur's integrity, work ethic, business plan and management team.[35]

The entrepreneurs and their families and friends usually facilitate financing for their ventures through equity investments[36] (this class of financing is commonly known as "love money").[37]

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[34] Allan L. Riding, Task Force on the Future of the Canadian Financial Services Sector, "Financing Entrepreneurial Firms: Legal and Regulatory Issues," online: <http://finservtaskforce.fin.gc.ca/research/pdf/rr9_e.pdf>, at 51.

[35] *Ibid.*

[36] Equity financing is money acquired from the small business owners themselves or from other investors. Susan Ward, Small Business: Canada, "Equity Financing," online: Equity Financing Definition <http://sbinfocanada.about.com/library/glossary/bldef-equityfinance.htm>.

One of the most common problems of this type of financing is that those who facilitate love money financing require participation in the management of the company in return for their contributions.[38] This circumstance may be seen as an obstacle from an entrepreneur's perspective if that individual does not wish to share the direction of the undertaking. Another common issue relating to love money financing is the fact that it can usually be tapped only once and cannot be called upon again when further investment or support is required.[39]

Once an SME's start-up enterprise is in place, the SME could grow through re-investing income or profits into the business, in the form of retained earnings,[40] up to a level where it has a sufficient equity base and a successful business record established. By using equity investments, SMEs are able to both increase their borrowing powers and improve their credit rating. This is where SMEs may be in a better position to obtain financing from other alternative secured sources, such as by debt financing from banks and other lending institutions.

2.3 Bank Loans

In general terms, the problems that SMEs face in order to obtain secured financing from banks stem from the fact that these entities have (i) little bankable collateral,[41] either

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[37] Oftentimes SMEs do not have a adequate credit record to borrow funds at convenient terms from a bank or lending institution. If an SME has not yet generated sales, then it would be probably inconvenient for it to raise debt capital from these types of institutions since it would need some time to generate enough revenue to make interests and capital payments.

[38] This hurdle also arises with other sources of financing (e.g.: venture capital financing).

[39] Graham Financial Corporation, "Bring your Own Umbrella: Alternative Financing Resources for Small to Medium Sized Companies," online: Financing Alternatives 09Jun01 <http://www.grahamfinancial.com/articles/alt_fin_sources_09Jun01.htm>.

[40] Retained earnings are earnings not paid out as dividends but instead reinvested in the core business or used to pay off debt. WebFinance Inc., "Retained Earnings," online: Retained Earnings Definition <http://www.investorwords.com/cgi-bin/getword.cgi?4235>.

[41] According to a study prepared by Larry Wynant and James Hatch, *Banks and Small Business Borrowers* (London: The Western Business School, The University of Western Ontario, 1991), at 160 "A great

in the quantity or character of the security that will be offered to the financial institution in an event of default[42] (there are situations where, due to the lack of collateral, the entrepreneur puts forward his own personal assets as collateral);[43] (ii) high systematic risks (financial and business risks); (iii) higher loan costs per dollar of investment generated by the higher costs of selecting, negotiating, monitoring and foreclosing on SMEs, compared to the costs per dollar per investments in larger firms; (iv) long lead times to positive cash flows; (v) reduced liquidity for their securities; and (vi) a higher likelihood of managerial ineffectiveness.[44]

As a consequence of these problems, banks are generally cautious to provide SMEs with debt financing.[45] However, according to a survey prepared by the CFIB, debt

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majority of the bankers that we interviewed saw strong collateral backing as a 'must' condition for small business loans," cited in MacIntosh, supra note 26, at 76. Therefore, this situation implies that SMEs with no bankable collateral might have problems accessing debt financing from banks.

[42] The types of collateral that a bank would normally accept include (i) accounts receivable; (ii) equipment; (iii) machinery; (iv) inventory; (v) vehicles; (vi) lands; and (vii) buildings.

[43] About the importance of collateral for securing SMEs' bank credits in Canada, see above Larry Wynant and James Hatch, supra note 41, or George Haines, Allan Riding and Roland Thomas, "Small Business Turndowns by Canadian Chartered Banks: Some Empirical Findings" (1989) WPS 89-06, Carleton University, School of Business. In relation to the request of personal guarantees in SMEs' loan applications, Wynant and Hatch found that they were required in connection with 87% of small business application loans.

[44] Particularly in the area of financial management.

[45] According to a an excerpt from a newsletter by chartered accounts Bessner Gallay Schapira Kreisman, which appeared in *The Globe and Mail*, on November 15 1993 at B4, there are 6 common mistakes that SMEs commit which in turn result in loan rejections. These mistakes are (i) not making a specific request for the amount, term or purpose of the loan; (ii) being unable to present financial information on the business prepared by reputable, independent accountant; (iii) asking for seed capital, ignoring the fact that banks are generally not seed capitalists -they lend money to facilitate activities of businesses with track records-; (iv) not making a personal guarantee, people should be prepared to stand behind their businesses; (v) refusing to assume the cost of an appraisal and environmental study when commercial real estate is used as collateral; and (vi) not developing a relationship with a bank. When a bank rejects a loan application requested by a SME, it is required, by the Code of Conduct for banks, to inform the reasons for its decision and to provide the SME with information on financing alternatives. A bank expects an applicant to maintain deposits with, and buy other services from it, such as credit cards or RRSPs. It seems that some lenders, though, such as mezzanine financiers, are more willing to facilitate, in these conditions, debt financing to SMEs. In addition to mezzanine financers and according to P. Cleroux in "Small business financing conditions: credit unions vs. banks" (1989) The Entrepreneur and the Challenge of the 90s', Proceedings of the 34th World Conference of the International Council for Small Business, Québec, at 85, states:

financing was the most common form of financing used by SMEs in 2000.[46] In addition, SMEs rely principally on chartered banks for debt financing as SMEs consider these financial institutions as the principal external lender for their ongoing operations.[47]

In relation to debt financing and its different alternatives (e.g.: term loans and lines of credit), banks often provide term loans[48] which are used by SMEs to acquire durable goods or real estate assets, like cars, buildings, land, machinery or equipment (fixed assets).

SMEs usually use bank financing to finance their operations and activities because they find that banks can offer a variety of services, including debt instruments, which might satisfy the different needs of SMEs. These services include transaction processing, account maintenance, payroll and other services, as well as loans. However, it is not possible to establish a unique pattern of demand for bank financing by SMEs because there is a number of different factors that needs to be taken into account in order to consider the circumstances in which a SME requests debt financing from a bank (i.e.: business sector, region, demographic characteristics of the SME owner).

In general terms, SMEs request bank financing in the form of either short and/or long-term credit (lines of credit vs. term loans), depending on their specific needs. When

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Small firms find better financing conditions in provinces where the credit unions have a significant share of the lending market. Increased competition leads to lower collateral requirements for small businesses which are the first concern of small business owners. (emphasis added in original).

[46] Canadian Federation of Independent Business, "Banking on Entrepreneurship – Result of CFIB Banking Survey" (2001) by Doug Bruce, online: <http://www.cfib.ca/research/reports/banks2001.pdf> at 3.

[47] In accordance with the Research Institute for SMEs, Université du Québec a Trois-Rivieres, Canada, Industry Canada, *Financing Small- and Medium-Sized Enterprises: Satisfaction, Access, Knowledge and Needs*, online: <http://strategis.ic.gc.ca/epic/internet/insbrp-rppe.nsf/vwapj/sme_attitude_e.pdf/$FILE/sme_attitude_e.pdf>, at 12, 75 % of the SMEs used a Canadian bank to finance their ongoing operations. [*Financing*]. Confirming this tendency and in accordance with Canada, Industry Canada, *Small and Medium-Sized Enterprise (SME) Financing in Canada (2002)*, online <http://dsp-psd.communication.gc.ca/Collection/Iu4-7-2002E.pdf> at 9, the majority of request for debts financing in 2000 were made to chartered banks (66%). [SME Financing].

a SME needs to purchase equipment or a building, for example, it would normally use long-term debt or leasing, which is repaid over the life of the asset. On the other hand, SMEs financing inventories would normally use short-term instruments, as inventories turn over in short periods of time. Generally, banks can provide both types of debt financing.

However, it seems that banks exhibit a preference for short term instruments in their dealings with SMEs. This argument is based on the idea that short term instruments allow banks the freedom to roll over the funding when the transaction is going well, but to extricate themselves quickly when the undertaking is performing poorly.

In addition, there is some evidence to sustain that SMEs rely on debt financing provided by banks because they perceive that easy access to the financial service provider via personal contact or over the telephone as an important factor. This is regular process where a SME contacts a bank to request short or long term credit. In this sense, the importance that SMEs allocate to a personal and long-term banking service relationship is supported by the findings of the CFIB which argues that the higher the account manager turnover rate, the higher the loan rejection rate in SMEs' loan applications. This is understandable given the importance of the client-account manager relationship.

In bank financing, the existence of bankable collateral plays an important role in determining whether a loan will be approved or not when a SME applies for this type of financing. For this reason, agriculture SMEs, for example, which normally have a important financing requirements and hold tangible assets that can be used as collateral,

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[48] SME Financing, *ibid*, from all debt financing instruments that SMEs applied for, term loans were the most sought after, followed by new lines of credit in 2002.

have greater possibilities of obtaining debt financing from a bank than knowledge-based SMEs which usually lack tangible assets.

Finally, it could also be argued that, in general terms and in consonance with the work of Feeney, Haines and Riding, entitled "SME Owners' Awareness and Acceptance of Equity Capital: Implication for Lenders," SMEs use bank financing because SME managers generally prefer to assume a debt rather than to invest in the equity of a company.

2.4 CREDIT UNION AND CAISSE POPULAIRE LOANS

Credit unions and caisses populaires[49] have been an important source of financing for SMEs since their inception in the early 1900s, especially in those regions of Canada where the presence of chartered banks is scarce.[50]

It was Alphonse Desjardins who opened on December 6, 1900 the first cooperative loan and savings society or people's bank in North America (also known by its French designation: caisse populaire).[51] Twenty years later, there were over 200 caisses throughout Québec and Ontario.[52]

It is believed that Desjardins was inspired to develop the concept of caisses populaires in Québec after hearing, that while serving as stenographer in the House of

[49] As of the first quarter of 2001, the number of credit unions and *caisses populaires*, the latter located predominately in the province of Québec, accounted for 1772 (703 credit unions and 1,069 *caisses populaires*). Canada, Department of Finance, *Canada's Credit Unions and Caisses Populaires*, online: <http://www.fin.gc.ca/toce/2002/ccu_e.html>.

[50] In the provinces of Saskatchewan and Manitoba, for example, SMEs have most of their business loans with credit unions (Saskatchewan 35.4% and Manitoba 35.3%). Canadian Federation of Independent Business, "Our Member's Opinions # 50," Jan-Jul 2002, online: <http://www.cfib.ca/research/surveys/results/omo50.pdf>, at q 2.

[51] Desjardins opened his first caisse populaire in Levis, Québec. Gayle Comeau, "Alphonse Desjardins – Founder of Caisse Populaires," online: 184-187 <http://collections.ic.gc.ca/heirloom_series/volume6/184-187.htm>.

[52] *Ibid.*

Commons, the case of a settler of the region who had to pay $5,000 to cover the cost of a $150 loan.[53] The case reflected the outrageous and usury interest rates that were charged on desperate people who borrowed small amounts of money.[54]

He realized that this situation was prevalent and that many thousands of Canadians found themselves in similar situations. For this reason, he decided to find a cure to the financial woes besetting specially the agricultural and working classes of Québec who had no access to ordinary banks and who, with no other alternative, were pushed, in their need for a loan to turn to money lenders who often practiced usury.[55]

As envisioned by Desjardins, the concept of credit unions or caisses populaires implied the creation of organized institutions integrated by people with common bonds of interest, who would be considered members and who would contribute with very small savings which then would be lent to their members for specific purposes.[56] These institutions were created, not for profit, but to serve members as credit cooperatives.[57]

Desjardins was of the view that small farmer producers, which existed in a large number in the region of Québec, had special credit needs that ordinary profit-oriented financial institutions were unable to recognize and meet.[58] It is argued that, for example, the caisse populaire of Levis (Québec) had 75% of its loan applications for amounts between $1.00 and $100.00.[59] Banks of that time would normally have rejected such loan

[53] *Ibid.*
[54] *Ibid.*
[55] *Ibid.*
[56] When Desjardins called a meeting of townspeople in Levis, Québec, to discuss a plan for the first caisse populaire, built on the concept of co-operative self-help, of the 128 people present, 80 signed up as members contributing their savings in nickels and dimes, totaling $26.40. History of Credit Unions, "Central," online: <http://www.cuco.on.ca/aboutcu_history.asp>.
[57] *Ibid.*
[58] Supra note 51.
[59] *Ibid.*

applications which implied that, by providing with accessible financing, the caisses populaires made a real difference in the average person's life.[60]

He further deemed that only a cooperation of members, small businessmen, with similar needs would be useful to respond in a fair way to requests for credits not simply based on the profit principle.[61] In this sense, the principle behind the creation of caisses populaires was to lend money to their members, mainly small farm producers, in a cooperative and responsible manner and only for productive purposes.[62]

According to Statistics Canada, of the total number of debt applications that credit unions received in 2000 from SMEs, 88% of them received approval from these lending institutions, which confirms the importance of these institutions for SMEs debt financing to this day.[63]

These co-operative financial institutions are owned and controlled by their members with one main purpose: to provide for deposit and loan services for their members. Credit unions and caisses populaires are cooperatives of people who unite to meet their own needs at the lowest possible price.[64] For historical reasons, there is a large number of credit unions and caisses populaires located in agricultural regions. For this reason, this type of financial institution still plays a key role in satisfying the financial needs of SMEs, especially in the agriculture sector. As stated above, agricultural SMEs have a great need for debt financing because they have to finance the assets that they use

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[60] *Ibid.*
[61] Supra note 56.
[62] It is surprising to note the fact that almost the half of the SMEs registered with the CFIB as members and operating in Québec (44.9%) have most of their business loans with Caisse Populaire Desjardins which implies that, after more than 100 years after its creation, it is deeply rooted in Québec culture. Supra note 50.
[63] SME Financing, supra note 47, at 9.
[64] Desjardins Group, "A Cooperative," online Desjardins Group <http://www.desjardins.com/en/>.

in their activities. Consequently, more of the business of these financial services providers is done with agricultural SMEs.

The very cooperative nature of credit unions and caisses populaires makes them very different from banks.[65] For example, users of credit union or caisses populaires' services are required to become members of these institutions, something that is not required from banks when services are requested from this type of financial institution. In this sense, members of a credit unions or caisses populaires requesting services or products from these lending institutions, such as business loans, in fact are dealing with enterprises that belong to them.[66]

Additionally, credit unions and caisse populaire loans are different from bank loans. According to the Filene Research Institute Monograph, credit union loan losses are less than two-thirds as sensitive to business cycles as bank loan losses.[67] Similarly, this study found that a mild recession (2% increase in the unemployment rate for one year) may have different implications for bank and credit union loan losses: $11.8 billion increase in bank write offs and $441 million increase in credit unions write offs.[68] These findings suggest that credit unions and caisses populaires need less capital than banks to protect themselves from loan losses[69] and, further, that bank loans are more sensitive to business cycles than credit union and caisse populaire loans which implies that banks may

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[65] *Ibid.*
[66] *Ibid.*
[67] David M. Smith and Stephen A. Woodbury , Filene Research Institute Monograph, "Banks and credit unions have different capital needs," cited in Cuna Chief Financial Officer Council, "Banks and credit unions have different capital needs," online: <http://www.cunacfocouncil.org/download/cfonews802.pdf>. It is believed that the differences in credit union and bank's governance and policy have a considerable impact on the risks undertaken by banks and credit unions and explain the different macroeconomic shocks on banks and credit unions. *Ibid.*
[68] *Ibid.*
[69] *Ibid.*

have a propensity to charge higher interest rates in their loans than credit unions and caisses populaires to cover liabilities.[70]

Additionally, members of credit unions and caisses populaires have, among others, the right to (i) express their opinions by taking part in annual general meetings;[71] (ii) file their candidacy for election to the position of volunteer officers; and (iii) receive patronage allocations.[72]

Credit unions and caisses populaires are regulated at the provincial level since their activities usually do not extend beyond provincial borders. There is, however, one national central credit union which is chartered and regulated by the Federal government under the *Cooperative and Credit Associations Act*[73] and which has the nine provincial credit unions as its shareholders: the Credit Union Central of Canada.[74]

2.5 LEASE FINANCING

Lease financing is other financial activity which is regulated only at the provincial level through, for example, provincial personal property security acts[75] which commonly provide with a definition of lease financing.

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70 *Ibid.* See also Robert M. Feinberg, "Are Credit Unions Just Small Banks? Determinants of Loan Rates in Local Consumer Lending Markets," online: <http://www.econ.mq.edu.au/seminars/feinberg_paper.doc>, at 1.

71 Generally, credit unions and caisses populaires operate on the "one member, one vote" principle. This means that all members' votes have the same weight. This also means that it is impossible to take control of a caisse populaire or credit union, which could happen in a company where a major shareholder decides to do so. Supra note 64.

72 *Ibid.*

73 S.C. 1998, c. 1, s. 3 (Lexis).

74 The Credit Union Central of Canada was established, mainly, to provide liquidity for the credit union system in Canada. Credit Union Central of Canada, "Our Role," online: Our Role <http://www.cucentral.ca/Public/insidecdn/ourrole/content/ourrole.htm>.

75 Under the *Personal Property Security Act* ("PPSA") of Ontario, for example, the structure of the lease transaction determines whether the law governing security interests and secured transactions will govern the transaction as a secured financing or whether such law will recognize a transaction as a "true" lease which is outside of the scope of the PPSA. If a lease is a true lease, the lessor is granted the traditional rights of an owner of the leased equipment and its rights as owner need not be protected by registrations under the

Under lease financing, the owner of an asset (the "lessor") conveys to the user (the "lessee") the right to use the asset in return for a number of payments or instalments over an agreed period of time, with the possibility for the lessee to purchase the asset at the end of the lease by paying an agreed amount of money.[76] Since leasing is simply a way of acquiring an asset without paying cash, taking a loan, or employing other forms of financing, almost any asset can be leased.[77]

Lease financing is an attractive option because it allows SMEs to obtain an asset while keeping debt off their balance sheets.[78] Additionally, lease financing provides SMEs with economy and flexibility[79] to use their cash flow to finance inventory, production, distribution or marketing instead of using it to acquire assets that they may acquire by means of lease financing.

Since the *Bank Act*[80] does not allow chartered banks to make leases for passenger vehicles and light trucks, which is the single largest segment of the market, the bulk of lease financing - almost 85% - to SMEs in 2000 came from manufacturers' dealers and suppliers, combined with leasing companies.[81]

PPSA. Borden Ladner Gervais, "World Leasing Yearbook 2003 - Canada - Legal Issues," online: <http://www.cfla-acfl.ca/wly-legalissues-2003.pdf>, at 12.

[76] SME Financing, supra note 47, 34.

[77] *Ibid.* In 2000, only a 9% of SMEs surveyed made a request for lease financing, with an overall approval rating of 98%. *Ibid*, at 10. In addition to this fact, the Canadian Financing Leasing Association estimates that 60% of the leasing industry's customers are SMEs. Canada, Industry Canada, Small Business Research and Policy, *Part I: Lease Financing: An attractive Option for Some SMEs*, online: Part I: Lease Financing: An attractive Option for Some SMEs <http://strategis.ic.gc.ca/epic/internet/insbrp-rppe.nsf/vwGeneratedInterE/rd00636e.html>.

[78] SME Financing, supra note 47, at 34.

[79] Michael Andrews and Mahmood Iqbal, "Operational Issues Related to the Provision of a Small Business Loan Act-Type Guarantee for Leasing," online: <http://strategis.ic.gc.ca/epic/internet/insbrp-rppe.nsf/vwapj/Operational_Issues_SBLA_Type_Guarantee_Eng.pdf/$FILE/Operational_Issues_SBLA_Type_Guarantee_Eng.pdf>, at 7.

[80] S.C. 1991, c. 46 (Lexis).

[81] SME Financing, supra note 47, at 35. However, it could be argued that banks may contribute indirectly with this source of financing for SMEs by financing their dealers and suppliers.

2.6 <u>FACTORING (ACCOUNTS RECEIVABLE)</u>

There is one source of financing that may grow with SME sales or turnover: factoring.[82] As sales or turnover increases, factoring can be used to obtain additional funds for SMEs in order to meet the increasing demand for financing.[83]

The concept of factoring refers to the sale of accounts receivable, at a discount rate, to a third party, a factoring company.[84] In other words, when a SME provides another with goods or services on a promise to pay for a period of time, it is essentially extending supplier credit and creating an "account receivable" at a later date. When the SME wants to immediately realize the value of its receivables to obtain fresh funds for its business rather than waiting for these receivables to be paid by customers, it may sell the accounts receivable to the factor which will advance funds in the range of 80% and 90% of the value of the invoices.[85]

One of the benefits that factoring has for SMEs is that these companies do not need to be credit worthy to factor their invoices.[86] In fact, it is not necessary for SMEs to be in business for a long period of time or be profitable in order to use factoring.[87] The requirement for SMEs to use this alternative of financing is to have a creditworthy customer.[88] In other words, when factoring is used by a SME to obtain financing, the

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[82] Sales Linked Financing Ltd., "Factoring – Information," online: <http://www.ezcapital.com/html/information-f.cfm>.
[83] *Ibid.*
[84] SME Financing, supra note 47, at 54.
[85] Michael Yasny, "Factoring: A Solution to your Cash Flow Needs," online: Information-f- <http://www.smallbusinesscanada.ca/pdf/SBCM0199.pdf>, at 8. [Factoring]. The amounts retained by the factor provides for a reserve for contingencies such as the rejection of the goods by the buyer. Canada, Industry Canada, *Factoring and the Financing of Receivables*, online: Factoring and the financing of receivables <http://strategis.ic.gc.ca/epic/internet/insof-sdf.nsf/vwGeneratedInterE/so01883e.html>.
[86] Factoring, *ibid.*
[87] *Ibid.*
[88] *Ibid.*

provider of this type of financing -the factor- relies on the quality of the SME's accounts receivable, and not on its equity base, liquidity and cash flows as is the case for bank financing.[89]

Although factoring is another alternative that SMEs have to obtain financing for their ventures, it seems that it is a less known and less common source of financing for SMEs.[90] It is sustained that SMEs do not use factoring mainly because they believe that do not need this type of financing or simply because they are not aware of it.[91]

There are two types of factoring products available for SMEs: recourse and non-recourse factoring. It is believed that most Canadian invoice discounters are recourse factors; which means that the client -the SME that presents the invoice to discount- is liable for advances made in the event that its customer does not pay in full.[92]

For discounting invoices, SMEs can work with a factor on a "spot" or as needed basis. In this sense, lower rates of discounts over the invoices may be applicable for long-term contract commitments.[93] Therefore, it seems that there may be a preference for SMEs to use this source of financing on an on-going basis.[94]

With factoring, SMEs can improve their cash flows, pay their suppliers and vendors more rapidly, and increase their credit rating by carrying higher cash balances.[95]

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[89] *Ibid.*
[90] This is confirmed by the low number of SMEs that sought this type of financing in 2000. According to SME Financing, supra note 47, at 55, only 0.4% of SMEs used factoring as an alternative source of financing in 2000. In addition and supporting this finding, Financing, supra note 47, at 59, revealed that from 1998 to 2001, only 42 out of a total of 2116 SMEs (1.98%) used factoring to finance their projects.
[91] Financing, supra note 47, at 59.
[92] Michael Bogin and Mark Borkowski, "Factoring for Future Success - How invoice discounting can protect your financial viability," online: <http://sympatico.workopolis.com/content/partners/cma/pdf/oct2002-Article7.pdf>.
[93] *Ibid.*
[94] *Ibid.*
[95] Factoring, supra note 85.

2.7 SECURED CREDITS. BANK ACT

It is common practice for banks to require some type of security from SMEs for the amounts borrowed by them, such as (i) the execution of personal guarantees;[96] (ii) the creation of a security on personal assets of the managers; and/or (iii) the execution of a general security agreement by means of which a "security interest" is created in certain or all the assets of the SME.[97]

After a security interest is validly created in any or all of the SME's assets, the bank attains the status of secured creditor. As a secured creditor, the bank possesses the right, upon the default of an SME, to proceed against the collateral and applying it to the payment of the debt,[98] and the priority and enforcement advantage over ordinary (non-secured creditors) who are dependent solely on the debtor's personal promise to pay.[99]

It is, therefore, of extreme importance for secured creditors to have the security interests perfected in order to recover the loan and to avoid any delays in realizing it, in cases where SMEs default on the payment of amortizations or interests.

The case of Bank of Montreal v. Hall[100] presents an example of how important the creation of an enforceable security for banks is.[101] The principal issue in that case was

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[96] The request for a personal guarantee from, for example, the principals of the SME, is particularly common where the SME is thinly capitalized, is a new customer or when is undertaking a new venture.
[97] This agreement must be registered pursuant to the terms of the personal property security acts of each province in Canada. See, for example, the *Personal Property Security Act* of Ontario, R.S.O. 1990, Chapter P.10, section 47 (1), amended by: 1991, c. 44, s. 7; 1993, c. 13, s. 2; 1996, c. 5; 1998, c. 18, Sched. E, ss. 193-202; 2000, c. 26, Sched. B, s. 16; 2001, c. 9, Sched. D, s. 13; 2002, c. 30, Sched. E, s. 14. These agreements provide banks with a great deal of flexibility in securing specific assets of the SME, including tangibles such as consumer goods, inventory and equipment, as well as intangibles such as accounts receivable.
[98] Bryan A. Garner, *Black's Law Dictionary – Seventh Edition* (St. Paul, Minn.: West Group, 1999).
[99] Norman Siebrasse and Catherine Walsh, "Leveraging Knowledge Assets," online: Leveraging Knowledge Assets – 1. <http://www.lcc.gc.ca/en/themes/er/fsi/siebrasse/siebrasse_walsh.pdf>.
[100] Bank of Montreal v. Hall [1990] 1S.C.R. 121.
[101] In this case, a farmer of Saskatchewan, Arthur Hall, contracted loans from Bank of Montreal and granted, as collateral, two mortgages on his real property and a security interest in a piece of farm machinery of his property, both in favour of the Bank of Montreal. Hall defaulted on his loans and, in

whether a security interest created pursuant to sections 178 and 179 of the *Bank Act*,[102] could constitutionally be subjected to the enforcement procedures for security interests prescribed by a provincial act, the *Limitation of Civil Rights Act* of Saskatchewan,[103] especially in regard to its sections 19 and 36.[104]

The case was finally decided by the Supreme Court of Canada which recognized that the rights, duties and obligations of creditors and debtors were to be determined solely by reference to the *Bank Act*[105] without interference of any other provincial law.[106] Furthermore, the Supreme Court recognized that "the security interest created by ss. 178 and 179 [of the *Bank Act*], while at a variance with provincial law, was *intra vires* Parliament because of the policy reasons behind the creation of this security interest."[107] In this sense, it was acknowledged by the Supreme Court that the reasons behind the creation of this security interest by the *Bank Act*[108] was to meet the pressing need to provide, on a nationwide basis, for a uniform security mechanism which might facilitate access to capital to producers of primary resources and manufactures.[109] Furthermore, the Supreme Court of Canada found that to require a bank to defer to the provincial

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1984, the Bank of Montreal seized the farm machinery and commenced an action to enforce its real property mortgage loan agreement.

[102] Supra note 80.

[103] R.S.S. 1978, c. L-16, online: Limitation of Civil Rights Act R.S.S. 1978, c. L-16 <http://www.canlii.org/sk/sta/cssk/20030227/r.s.s.1978c.l-16/whole.html>.

[104] The conflict arose between sections 178 and 179 of the *Bank Act*, supra note 80, and sections 19 and 36 of the *Limitation of Civil Rights Act*, *ibid.* While the *Bank Act* provided, and still provides in its s. 427(3), that a lender may, on a default of the borrower, seize the security, the *Limitation of Civil Rights Act* prohibited a creditor from immediately repossessing the secured item on pain of determination of the security interest and required that the secured creditor give notice to the debtor of its intentions to take possession of the secured property.

[105] Supra note 80.

[106] The Supreme Court of Canada found that ss. 19 and 36 of the *Limitation of Civil Rights Act*, supra note 103, conflicted with ss. 178 and 179 of the *Bank Act*, supra note 80, so as to render ss. 19 and 36 inapplicable to the security taken pursuant to ss. 178 and 179 of *the Bank Act*. Supra note 100.

[107] Supra note 100.

[108] Supra note 80.

[109] Supra note 100.

legislations would displace the legislative intent of Parliament when it evaluated the arguments for the enactment of the *Bank Act*[110] security interest.[111]

Finally, the Supreme Court also agreed that the fact that banks do not have to defer to provincial lending legal frameworks facilitates the ability of banks to realize on their collaterals, which in turns it is also translated into important benefits for the borrower, such as reduction in interest rates, since lending becomes less complicated.[112] In other words, it was recognized by the Supreme Court that sections 178 and 179 of the *Bank Act*[113] benefited both lenders and borrowers.

In addition to the existence of secured credits in the *Bank Act*[114] at the Federal level, all Canadian provinces and territories enacted statutory secured transactions regimes which comprehensively govern the validity, publicity, priority and enforcement of security rights in personal property and moveable.[115] It is believed that this provincial legislation modernized the law and facilitated the granting of secured credit.[116]

Since the enactment of provincial secured transaction legislations, many banks began to rely on provincial security agreements due to the fact that a provincial security right could be taken on all present and after-acquired personal property or moveables of the debtor, a SME, whereas the security interest created through the *Bank Act*[117] could only be given in specific types of tangible assets.[118]

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[110] Supra note 80.
[111] Supra note 100.
[112] *Ibid.*
[113] Supra note 80.
[114] *Ibid.*
[115] Uniform Law Conference of Canada, "Harmonization of the Federal Bank Act Security and the Provincial Secured Transaction Regimes," online: Background Paper 1- Harmonization of the Federal Bank Act Security and the Provincial Secured Transaction Regimes <http://www.ulcc.ca/en/cls/ppsa-bp1.html>.
[116] *Ibid.*
[117] Supra note 80.
[118] Supra note 115.

Under the current legal framework, banks are allowed to take not only *Bank Act*[119] security under section 427 but also provincial security rights to secure their loans while other sources of financing, such as credit unions, are only able to take provincial security rights.[120] It is argued that this two-tiered system of security mechanisms provides an unfair advantage to banks over other non-bank financial institutions.[121]

In addition, it is believed that this two-tiered system of federal and provincial secured transaction legislations imposes (i) priority problems; and (ii) additional search and registration costs since a third party who wishes to acquire an interest in personal property or moveables of another must undertake a search of both the provincial and the Federal registries.[122]

2.8 Providers of Risk Capital: Angel Investors and Venture Capitalists

Commonly, SMEs reach a point up to which their previous sources of financing cannot provide them with further infusions of capital mainly because the magnitude of the funds needed or the level of risk involved are too high. At this point, financing from angel investors and venture capitalists becomes the next most accessible source of financing for SMEs. [123]

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[119] Supra note 80.
[120] Supra note 115.
[121] *Ibid.*
[122] *Ibid.*
[123] Angel investors are individuals who provide capital to one or more startup companies and who usually are affluent or have a personal stake in the success of the venture. Their investments are characterized by high levels of risk and a potentially large return on investment. Web Finance, Inc., "Angel Investor," online: Angel Investor Definition <http://www.investorwords.com/cgi-bin/getword.cgi?212>. Venture capital can be defined as funds that are generally invested in the form of equity or quasi-equity which rarely affords any guarantee. Quebec Venture Capital Association, "Venture Capital – Definition," online: <http://www.reseaucapital.com/Venture_Capital.html>.

According to Gordon Nixon, President and Chief Executive Officer of the Royal Bank of Canada Financial Group, SMEs have access to a wide variety of financial providers which offer loans at competitive terms in Canada.[124] However, he also believes, based on the results obtained through a study conducted by the Royal Bank of Canada, that there is a shortage of higher-risk debt and smaller scale equity financing in Canada.[125] It is here, he believes, where venture capital should be more accessible and angel investing in emerging enterprises more coordinated.[126]

Financing from angel investors and venture capitalist is commonly referred as risk capital since it is not only unsecured but also illiquid.[127] The risk is generally rewarded by the opportunity to participate, in equity or in semi-equity financing transactions, in the upside of the SME. Generally, any gain to provide a return commensurate with the risk undertaken by angel investors or venture capitalists comes through appreciation on the equity invested by way of capital gains and not from dividends or interests payments.[128]

Notwithstanding the fact that SMEs have these sources of financing at hand, only 2.4% of SMEs reported that they made a request for equity capital from either angel investors or venture capitalists in Canada in 2000.[129] In addition, in 2001 the total amount of venture capital invested in Canada reached $4.9 billion in a total of 818

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[124] Supra note 13.
[125] *Ibid*, at 5.
[126] *Ibid.*
[127] An angel investor or venture capitalist can make investments in SMEs by means of acquiring common shares, preferred shares, subordinated debt accompanied by conversion privileges, rights or warrants to purchase common shares or any combination of these instruments.
[128] In this sense, see, for example, BDC's exit strategies. Canada, Business Development Bank of Canada, "Our Selection Criteria," online: Our Selection Criteria – BDC <http://www.bdc.ca/en/business_solutions/venture_capital/about_us/selection_criteria.htm >.
[129] SME Financing, supra note 47, at 11.

ventures. These numbers represent a decrease of 27% from the $ 6.6 billion invested in 2000.[130]

One of the reasons why SMEs are unwilling to request equity financing from angel investors or venture capitalists relates to the fact that entrepreneurs are generally reluctant to share control of their companies.[131]

Since knowledge-based SMEs do not have tangible assets to be used as collateral in "traditional" loan transactions, and since the lack of tangible assets can be seen as a challenge for a financial system that has traditionally dealt with asset-backed financial products, it seems that knowledge-based SMEs are the ones that mostly benefit or require risk equity or semi-equity capital from angel investors or venture capitalists to grow.[132]

Once a SME grows through angel and venture capital investments, it may raise more capital in the form of public stock issues. This is the most desirable exit scenario that angel investors and venture capitalist strive for in order to cash out their investments in SMEs. [133]

2.9 PUBLIC MARKETS AND THE USE OF INTERNET FOR DIRECT PUBLIC OFFERINGS

If financing through debt is a challenge for SMEs, it should come as no surprise that equity markets, in regard to public offerings, are harder for SMEs to attain. The

[130] *Ibid.*
[131] According to Financing, supra note 47 at 68, 41% of the entrepreneurs expressed unwillingness to share capital of their companies.
[132] See, for example, BDC's Venture Capital Group sector of investments. Canada, Business Development Bank of Canada, *About US*, online: About Us – BDC Venture Capital <http://www.bdc.ca/en/business_solutions/venture_capital/about_us/default.htm>.
[133] For example, BDC's venture capital group exit strategies in SMEs may come from initial public offerings (normally on the Toronto Stock Exchange and/or on the NASDAQ). See some examples on EDC's venture capital group exit strategists in Canada, Business Development Bank of Canada, *Our winners*, online: Our winners <http//www.bdc.ca/en/business_solutions/venture_capital/our_winners.htm>.

maturity and extent of public disclosure required by securities laws and stock exchange regulations from a company which wants to make a public offering discourages SMEs from raising capital on the markets.[134] These disclosure requirements generate an increase in the costs of capital for SMEs and thereby present a significant barrier for SMEs to raise funds through capital markets.[135] However, there are other costs which also impair the ability of SMEs to raise capital from these markets. According to an analysis prepared by Paul Benson, the anticipated costs for a multi-province offering in Canada undertaken by a SME of approximately $20,000,000 may reach as much as $425,000 in direct costs (e.g.: company's legal counsel, financial advisors, road show, listing fees, printing, French translation and underwriter's legal counsel fees).[136]

In addition to the high costs associated with the idea of going public, when a firm is relatively unknown, access to the financial markets is generally delayed at the expenses related to the first stock issue.[137] SMEs commonly suffer from the time that securities regulators take to issue "comment" letters and, by the same token, SMEs' responses to these comments might also take long due to the fact that they are not prepared to timely furnish the information required by the regulators.[138]

In any case, it seems that the existence of the so-called "information asymmetry" that exist between insiders (SMEs' managers and owners) and outsiders (potential providers of financing) is one of the main reasons that explain the difficulties that SMEs

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[134] Supra note 26.
[135] *Ibid.*
[136] Paul E.C. Benson, "The Going Public Decision" (1993) *Insight* (June) at 3-6.
[137] Stéphane Rousseau, "The Future of Capital Formation for Small and Medium-sized Enterprises: Rethinking Initial Public Offering Regulation after the Restructuring of Canadian Stock Exchanges" (2000) 34 R.J.T., at 674.
[138] *Ibid.*

have to raise money through equity markets.[139] Since SMEs do not have the information and accounting systems that larger companies use, it is more difficult and expensive for outsiders to gather information required to facilitate financing.

Even though it seems that it is expensive and complicated for SMEs to raise money through capital markets, there is a moment in time where SMEs reach sufficient critical mass making them attractive to a broader group of investors. At this stage, a mature SME can entertain the idea of doing an initial public offering ("IPO") as an alternative source of financing.

On the one hand, an efficient IPO market provides venture capitalists with the necessary incentives to engage in small firm financing.[140] Through an efficient IPO market, venture capitalists with interests in small firm financing can be certain that there are good chances for cashing their investments out through SME IPOs. On the other hand, the presence of venture capitalists helps to construct an efficient IPO market since it reduces the information asymmetry between SME insiders and other market participants through the certification effect that the participation of venture capitalists generates.[141]

The presence of reputable underwriters in SME IPOs might also provide a certification effect on the price and quality of the securities being issued. To the extent that reputable underwriters reduce the *ex ante* uncertainty that induces under-pricing, firms with great level of *ex ante* uncertainty, such as SMEs, should employ more reputable underwriters. However, empirical studies indicate that reputable underwriters tend to issue large-size offerings while less reputable underwriters are associated with

[139] Ontario, *Ontario Securities Commission Task Force on Small Business Financing - Final Report*, online: <http://www.osc.gov.on.ca/en/About/Publications/small_business.pdf>, at 101.
[140] Supra note 26.

smaller sized IPOs.[142] These circumstances are particularly severe for SMEs since it implies that underwriter certification is not available with respect to SME IPOs. One of the reasons which explains why more reputable underwriters are reluctant to provide services to SMEs is related to the commissions that they charge for their services. The customary commissions that reputable underwriters expect simply cannot be met by the relatively small amounts of money generated in SME IPOs. Another reason relates to their reputation. Since SME IPOs present a higher level of risk and uncertainty than IPOs of larger businesses, reputable underwriters could potentially expose themselves to business failures that do not provide any attractive benefit to such reputable underwriters.[143]

It is worth noting that the IPO market for SMEs does not interest some of the most active participants in equity markets: institutional investors. While institutional investors are active purchasers of new issues, these investors usually reluctant to participate in SME IPOs due to, for example, more conservative investment policies, which are imposed by legal restrictions that limit the percentage of the equity of a single company

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141 According to W.L. Megginson and K.A. Weiss, "Venture Capitalist Certification in Initial Public Offerings" (1991) 46 J Fin. 879 at 881, cited in Rousseau, supra note 137, at 696, "there are strong reasons to believe that venture capitalists are effective certifying agents."

142 See S.P. Ferris, J.S. Hiller, G.A. Wolfe and E.S. Cooperman, "An Analysts and Recommendation for Prestigious Underwriter Participation in IPOs" (1992) 17 J. Corp. L. 581, 597 and 598; R. Michaely and W.H. Shaw, "The Pricing of Initial Public Offerings: Tests of Adverse-Selection and Signalling Theories" (1994) 7 Rev. Fin. St. 279, 297 and 298; S.M. Tinic, "Anatomy of Initial Public Offerings of Common Stock" (1988) 43 J. Fin. 789, 813; see also J.R. Booth and R.L. Smith, "Capital Raising, Underwriting and the Certification Hypothesis" (1986) 15 J. Fin. Econ. 261.

143 As Jeffrey J. Hass, "Small Issue Public Offerings Conducted Over the Internet: Are They 'Suitable' For the Retail Investor?" (1998) 72 S. Cal. L. Rev. at 95, cited in Gavin Sinclair, "Internet Direct Public Offerings: New Opportunities For Small Business Capital Finance," (2000) Manitoba Law Journal Vol. 27 No. 3, at 306 [Sinclair] explains:

> Investment banks seek to underwrite those offerings that will prove profitable to both themselves and their investor clientele. By achieving that goal, investment banks will increase their reputational capital and consistently be able to go back to their clientele with future offerings. All this leaves the vast majority [of small issuers] without underwriters for their offerings.

that they can hold or the type of security that may be purchased.[144] However, even if the legal restrictions were in some way relaxed, there is no evidence that such a policy would have a significant impact on the interest of these institutions in SMEs since institutional investors find it uneconomical to deal in the relatively illiquid stocks of companies with small capitalization, as is the case for SMEs.[145]

In order to address the problems that SMEs have to access public equity financing, the Ontario Securities Commission[146] task force on Small Financing (the "Task Force") reported in 1996 that the adoption of the Small Business Prospectus Form ("SBPF") was necessary, according to the Task Force's report, in order to reduce the direct and indirect costs of preparing and qualifying a prospectus, thus making public equity financing more accessible to SMEs.[147] For the purpose of considering which companies could use the SBPF, the Task Force recommended the use of revenue ceilings as the sole criterion to identify SMEs. Therefore, the use of the SBPF would be limited to issuers with no more than $10 million in gross revenues in their most recently completed financial year.[148]

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[144] See, for example: *Bank Act*, supra 80, s. 466 (1). Banks may not own more than 25 per cent of the equity or control more than 10 per cent of the voting rights of an issuer; "National Instrument – Mutual Funds 81-102", 22 O.S.C.B. 1999, (2nd Supp), c. 105, s. 2.2; *Insurance Act*, R.S.O. 1990, c. I.8, s. 435(1)(d), online: Insurance Act, R.S.O. 1990, c. I .8 <http://www.e-aws.gov.on.ca/DBLaws/Statutes/English/90i08_e.htm>. Insurers may not own more than 30 per cent of the common shares or 30 per cent of the total issued shares of a company.

[145] See Graham Bannock, "European Second-tier Markets for NTBFs" (1994) London, Commission of the European Communities, 20 and 21; C.A. Hessel and M. Norman, "Financial Characteristics of Neglected and Institutionally Held Stocks" (1992) 7 J. Acct. Aud. & Fin 313; J. Lakonishok and others "The Impact of Institutional Trading on Stock Prices" (1992) 32 J. Fin. 23 (97 per cent of institutional purchases confined to the largest quintiles of the NYSE, AMEX and OTC firms); and F. Reilly, "A Three-Tier Stock Market and Corporate Finance" (1975) 4 Fin. Mgmt. 7.

[146] It is generally agreed among practitioners that the Ontario Securities Commission is the leading securities commission in Canada.

[147] Supra note 139, at 71.

[148] *Ibid.* at 20.

In general terms, the SBPF would reduce the amount of historical information that a prospectus usually contains.[149] Given the fact that the cost of compelling historical information can be significant, the production of this information is not cost-effective for SMEs.[150] Therefore, the Task Force was in favour of a sharp reduction in the extension of historical information, including financial statements, in the SBPF.[151]

However, the liability rules under which issuers, their board of directors and their officers as well as their underwriters are constrained can constitute a serious barrier to the simplification of disclosure information contemplated in the SBPF. Since less information would be available to investors because of the inherent characteristics of the SBPF, more possibilities of material omissions and the application of sanctions could arise, unless the current legal framework on liability were also changed.[152] For this reason, some form of "safe harbor" provision might be needed to protect these persons in cases of liability for omissions incurred with the SBPF.[153]

Other alternatives that have been proposed to help SMEs to raise equity capital from the general public is the conduct of direct public offerings over the internet ("DPOs").[154] It seems that DPOs might help SMEs to raise equity capital from the

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[149] *Ibid.* at 74.
[150] *Ibid.*
[151] *Ibid.* The SBPF would include audited statements of operations, deficits or surplus and changes in financial positions only for the most recently completed financial year, instead of the last three financial years as it is currently required.
[152] According to Rousseau, supra note 137, at 741

> [T]the risk of liability for omissions in connexion with the SBPF would create strong incentives to continue to provide a level of disclosure similar to that provided under the standard prospectus, undermining thereby the entire purpose of implementing the new prospectus form.

[153] *Ibid.*
[154] Donald C. Langevoort, "Angels on the Internet: The Elusive Promise of 'Technological Disintermediation' For Unregistered Offerings of Securities" (1998) 2 J. Small and Emerging Bus. L. 1, at 3.

general public by means of both reducing printing and mailing costs and by permitting SMEs to update material online.[155]

The DPOs, however, present concerns for potential investors in securities issued by using this new method. The main concern is that, because DPOs would enable SMEs to sell securities directly to anyone with internet access, this situation could eliminate key sources of market-based investor protection, such as investment banks which review the merits of an offer, perform due diligence and provide aftermarket investors support.[156]

Additionally, there are two legal obstacles for the use of DPOs. Since provincial securities legislations contain provisions which state that no person may trade in securities unless the person is registered as a dealer, and the requirement which provides that no person may act as underwriter unless registered as such, it would be correct to assume that DPOs face serious obstacles.[157] In this sense, the benefits of DPOs are restrained because SMEs are required to be registered in order to market and trade their securities.[158] This situation means that any trading of securities has to be done through a registered dealer, thus posing a significant impediment to DPOs.[159]

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[155] Sinclair, supra note 143, at 309.
[156] *Ibid*, at 315.
[157] *Ibid*, at 319.
[158] *Ibid.*
[159] *Ibid.* The basic threshold to keep in mind is that, under the current provincial legal framework, direct trading of SMEs' securities to investors is prohibited, unless the person trading on those securities is registered as a dealer and/or underwriter. Additionally, none of the existents exemptions from the registration requirements are available to SMEs' DPOs. As it was informed by the British Columbia Securities Commission, *Notice and Interpretation Note # 97/9* at 2, cited in Sinclair, *ibid.* at 320:

> Issuers and other securities market participants are reminded that it is presently not possible to conduct a public offering in British Columbia, including an initial public offering, on the Internet (i.e., by posting a prospectus on the Internet for the purpose of selling the securities offered under the prospectus), without the involvement of a registrant. The Securities Act requires that, where the issuer of the securities is not itself registered, the securities offered under a prospectus be sold through a person registered in British Columbia under the Securities Act to trade securities. (footnotes omitted).

As a measure to permit the use of DPOs without involving a registered dealer or underwriter, it has been suggested that a new SME internet DPO exemption be available from the prospectus requirements (the "Small Business DPO Exemption"), with a parallel registration exemption (the "Small Business Registration Exemption").[160] It has also been put forward that the aggregate amount that could be raised pursuant to the Small Business DPO Exemption would be capped at $10 million, recognizing the fact that the exemption would be used to relax the disclosure requirements only to the extent required to balance the disproportionate burdens that SMEs face in the current equity public market.

Finally, since the prospectus would likely be in a digital form, it has been suggested that it could be hosted at an electronic site such as in the System for Electronic Document Analysis and Retrieval ("SEDAR"), or alternately, at the websites of the provincial securities regulators.[161]

2.10 SECURITIZATION OF SMALL BUSINESS LOANS

Securitization is another way to finance one's business. Under a securitization transaction, financial assets, such as small business loans, are transferred from their owner, the "Seller" – or "Lessor" in the case of leasing securitization- to an institution commonly known as "special purpose entity" ("SPE")[162] which funds the acquisition of these assets by issuing publicly rated securities to different parties (investors).[163]

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[160] Sinclair, *ibid.*
[161] Sinclair, *ibid.*
[162] The principal reason for establishing a SPE is to separate the risks of the securitized assets from the Seller's own credit risks. Historically, most SPEs have been established by the investment banking arms of the large Canadian chartered banks which dominate the asset backed securities ("ABS") market. It is calculated that 97% of the ABS outstanding involving multi-sellers SPE and 93% of the ABS outstanding involving single-seller SPE are administered by the major Canadian banks' investment baking subsidiaries.

In small business loans securitization, the Seller, a financial institution with a large portfolio of small business loans, can use these financial assets to obtain additional capital for its operations. In other words, if the Seller holds financial assets which can generate an income stream over a period of time, as is the case with small business loans; he could then package and sell them under a securitization program to investors in return for the immediate payment of a sum of capital. For this purpose, the Seller has to transfer the small business loans to the SPE which in turn has to repackage the assets as ABS to offer them for sale on the capital markets.[164] This process is called securitization of small business loans.[165]

Since SMEs usually do not have significant financial assets to structure a securitization program, it does not seem that securitization is a possible source of financing for SMEs. In addition, SMEs cannot afford the high costs associated with the establishment of a securitization program (e.g.: investment bank fees, legal and accounting charges and due diligence work as well as rating agency fees).[166] Further, SMEs are rarely prepared, due to the lack of information and adequate financial reporting systems, to comply with the ongoing reporting requirements which normally are involved once a securitization program has been established.[167] In other words, insufficient

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Aon Structured Finance Services, "Capital Leasing Pilot Project – Impact of Securitization on the Canadian Small Business Financing Act," online: Impact of Securitization <http://strategis.ic.gc.ca/epic/internet/insbrp-rppe.nsf/vwapj/Impact_Securitization_Eng.pdf/$FILE/Impact_Securitization_Eng.pdf>.

[163] Normally, the issuance of debt instruments in a securitization program is created to obtain the highest possible debt rating (AAA). In this sense, investors who acquire these debt securities tend to be large institutional investors such as pension funds who require AAA investments as part of their portfolios. *Ibid.*

[164] Canada, Industry Canada, *Canada Small Business Financing Act – Assessing New Opportunities*, online: <http://strategis.ic.gc.ca/pics/la/csbfa_e.pdf>, at 5.

[165] Robana Abderrahman, "The Challenge of Securitizing Small Business Loans", online: <http://www.sbaer.uca.edu/Research/1993/SBIDA/93sbi148.txt>, argues that the securitization of small business loans is an emerging market.

[166] Supra note 162.

[167] *Ibid.*

underlying assets to establish securitization programs and the costs and operative problems make securitization unattractive for smaller sellers, such as SMEs.

However, small business loans securitization could indirectly help SMEs to obtain financing. With securitization programs of small business loans, Sellers have better access to capital markets which might increase their availability to offer additional financing to SMEs. However, there are several reasons which constrain the development of small business loans securitization which in turn may impact on the availability of additional financing for SMEs. The most important constraints include lack of product standardization, difficulties in risk assessments and high transaction costs.[168] These factors make small business loans securitization more costly and less attractive in comparison to the securitization of other financial assets such as mortgages, auto loans and credit card debts.[169]

2.11 <u>EXAMPLES OF THE GOVERNMENT'S FINANCIAL ASSISTANCE PROGRAMS</u>

Governments, general speaking, recognize the difficulties that SMEs have to fund their ventures by tapping into debt and equity financial markets. The government of Canada is no exception. In order to enhance the existence of different sources of financing for SMEs and to support this important sector of the Canadian economy, the government of Canada at both federal and provincial levels provide a wide range of financial assistance programs to SMEs in the form of both debt and equity capital.

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[168] Federal Reserve Bank of Boston, Communities Affairs Department. "Communities and Banking – The Growing Securitization of Small Business Loans," online: <http://www.bos.frb.org/commdev/pdf/summer98.pdf>, at 4.
[169] *Ibid.*

The purpose of this section is to explain the role of the BDC as a provider of financing to SMEs, the importance of the Canada Small Business Financing Program and the Capital Leasing Pilot Project and to provide a brief overview of the provincial venture capital corporations and their role in SME financing.

2.11.1 The Business Development Bank of Canada

The BDC, created under the *Business Development Bank of Canada Act*,[170] is crown corporation wholly owned by the government of Canada. One of the main purposes for establishing the BDC was to create a bank that would not compete with private sector lending institutions but one that would focus on market gaps in SME financing.[171] It is sometimes referred as "Canada's SME bank."[172]

In order to support SMEs with appropriate financial solutions, BDC's mandate changed in 1995 after 20 years. With this change, according to Sylvie Ratté, BDC's Market Manager, BDC is now a complementary bank and not a last resort bank for SMEs, as it used to be before the changes were introduced.[173]

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[170] S.C. 1995, c. 28 (Lexis) [*BDC Act*]. It is possible to trace the creation of the BDC back to 1939 and to the onset of the World War II. At the beginning, the BDC, called the Industrial Development Bank ("IDB"), focused its financial aid on "industrial enterprises" engaged, especially, in manufacturing; but from the early 1950s, the IDB was authorized to provide financial aid to a broader sphere of companies. When the IDB was replaced by the Federal Business Development Bank ("FBDB") -the predecessor of the BDC-, the government of Canada was of view that it was necessary to authorize the bank to provide not only financing to SMEs but also consulting advices about how to manage businesses effectively. As it is now stated in s. 4 (1) of the *BDC Act*:

> The purpose of the Bank is to support Canadian entrepreneurship by providing financial and management services and by issuing securities or otherwise raising funds or capital in support of those services.

The provision of consulting services by the BDC was necessary due to, among other reasons, a shift from a resource-based economy to a knowledge-based economy.

[171] *Ibid*, s. 14 (4). BDC plays its gap-filling role when it offers, for example, term loans with repayments instalments of over a 5 or 7 years period, which are unusual for small business financing.

[172] *Ibid.* In this regard, s. 4 (2) provides:

> In carrying out its activities, the Bank must give particular consideration to the needs of small and medium-sized enterprises.

[173] Interview of Sylvie Ratté (4 June 2003).

The changes introduced to the *BDC Act*[174] in 1995 were inspired not only by the objective of transforming the BDC from a bank of last resort to a complementary bank for SMEs but also by the goal of making legal financing documentation easier to read and comprehend by entrepreneurs who seek financial aid from the BDC. In this regard and according to Andrée Leblanc Daviault, BDC's VP Legal Services, several changes were introduced to the *BDC Act* in order to shorten BDC's legal documentation in small financing transactions.[175] As a measure of simplifying smaller financing transactions, for example, the BDC does not require the execution of loan agreements for this type of financing.[176] Everything is in the letter of financing which is accepted by the SME.[177]

In order to raise funds to provide financing for SMEs,[178] the BDC issues, sells and pledges debt securities, secured by the Government of Canada, to public and private investors in both domestic and international financial markets.[179] Since 1995 it has clarified its nature as a commercially driven institution required to earn a rate of return at least equal to the federal government's cost of funds.[180]

The BDC fulfills its mandate by offering three products to SMEs: term debt[181], subordinated debt and venture capital financing.[182]

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174 Supra note 170.
175 Interview of Andrée Leblanc Daviault (10 June 2003).
176 *Ibid.*
177 *Ibid.*
178 For the BDC, a SME is a company that employs less than 500 employees. Supra note 173.
179 Supra note 170, s. 18 (1).
180 In fiscal year 2001, BDC's consolidated net income reached $88.32 million and a dividend of $13.8 million was paid to the Government of Canada. See Canada, Business Development Bank, *Summary of Corporate Plan Fiscal 2003-07*, online: www.bdc.ca/NR/rdonlyres/eemzkg7k7fw2docpsvglmvdavvvlvrkowipqvlu3yehaz2u4lbinoendrajpl6omokhskiamqn6gr2a76ok4v4osque/Corp_Plan2003_E.pdf> at 6.
181 Up to the present, the BDC has authorized 6.456 term loans. Canada, Business Development Bank of Canada, *BDC in Numbers*, online: BDC in Numbers <http://www.bdc.ca/en/about/overview/bdc_numbers.htm>.

In general terms, the BDC's term debt financing presents the following characteristics: (i) amounts are limited up to $100,000; (ii) repayment periods are established up to 6 years; (iii) there are possibilities for deferred capital payments up to 12 months; and (iv) interest rates can be either floating or fixed.[183] The BDC is authorized to provide term debt financing by means of section 14 (1) of the *BDC Act.*[184] The provision of term debt financing by the BDC to SMEs has to be related to, for example, the enhancement of working capital, the acquisition of fixed assets, or the acquisition of a franchise.[185] Further, the BDC is authorized to acquire and hold security of any kind and in any form.[186] In this sense, the BDC may take security on goods, wares and merchandise in the same form and manner as security on such property might be taken by a bank under section 427 of the *Bank Act.*[187]

The BDC also offers financing for SMEs through subordinate financing.[188] The BDC's subordinate financing involves (i) amounts ranging from $250,000 to

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[182] *Ibid.* The BDC has authorized 63 venture capital investments during the fiscal year of 2002, with an amount of venture capital financing committed of $374 million to 155 companies.

[183] Canada, Business Development Bank of Canada, *Financing for Starting a Business*, online: Financing for Starting a Business <http://www.bdc.ca/en/my_project/Projects/financing/fs_start_business_general.htm?context={F1E6CD9B-FEEE-42B0-80DE-F88F65FF15CE}>.

[184] The section 14 (1) of the *BDC Act*, supra note 170, states:

> The Bank may make loans to, or investments in, any person, or give guarantees in relation to any person.

[185] Supra note 183.

[186] Supra note 170, s. 15 (1).

[187] Supra note 80. See also *BDC Act*, supra note 170, s. 15 (2) (b).

[188] Subordinated financing is often referred as a "hybrid" which brings together features of both debt and equity financing. In a subordinate financing transaction, on the side of the borrower, it has the obligation to pay interests and capital. On the side of the lender, it is subordinated to secured lenders but in priority to other unsecured creditors and normally it is entitled to a stock option or royalties on sales or future cash flow. Canada, Business Development Bank of Canada, *What is Subordinate Financing?*, online: Overview: Subordinated loan BDC, quasi-equity financing <http://www.bdc.ca/en/business_solutions/subordinate_financing/default.htm>.

$5,000,000; (ii) terms of payments which range between 3 and 7 years; and (iii) flexible repayment conditions, tied to cash-flow projections.[189]

Finally, the BDC offers venture capital investments. By March 2002, the BDC doubled its venture capital portfolio of investments reaching $270 million.[190] The BDC's venture capital group makes investments especially in advanced technologies[191], information technology[192], life sciences[193], and telecommunications.[194]

From the portfolio of financing products that the BDC offers to SMEs, Ratté states, and Daviault agrees that the most popular is BDC's term loan.[195] However, according to a survey prepared by the CFIB, only 0.9% of the CFIB's members (945 out of a total of 105,000) have most of their business loans with the BDC.[196] This information suggests that the BDC's most popular product is not popular with SMEs.

As a provider of financing, the BDC is specially focused on helping knowledge-based SMEs grow and prosper.[197] Companies that base their businesses on knowledge and services and which usually do not have tangible assets to offer as collateral have a harder time in getting traditional financing.[198] For this purpose, the BDC

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[189] Canada, Business Development Bank of Canada, *Our Product Focus*, online: Our product focus-BDC <http//:www.bdc.ca/en/business_solutions/subordinate_financing/our_prod_foc.htm>.
[190] Canada, Department of Finance, *The Budget Plan 2003*, online: <www.fin.gc.ca/budget03/PDF/bp2003e.pdf> at 129.
[191] Canada, Business Development Bank of Canada, "Our Sector Focus," online: Our Sector Focus – BDC <http://www.bdc.ca/en/business_solutions/venture_capital/about_us/sector_focus.htm>. E.g.: Discoveries of alternative energy sources.
[192] *Ibid.* E.g.: Networking/communications.
[193] *Ibid.* E.g.: Bioinformatics and proteomics industries.
[194] *Ibid.* E.g.: Wireless networking.
[195] Supra notes 173 and 175.
[196] Supra note 50.
[197] Supra note 132.
[198] Paul J. N. Halperin, *Financing Growth in Canada* (Calgary: University of Calgary Press, 1997).

has created a product, called "co-vision", which is a term loan with minimal collateral requirements, for start-ups (up to $100,000).[199]

About the legal framework which regulates BDC' businesses, Ratté was of view that "[it] actually allows us to operate the way we want. [In relation to the BDC's legal framework], there is nothing really that needs to be fixed at this point."[200] On this issue, Daviault concurred with Ratté's opinion. Daviault is of the view that the BDC's functions are clearly set in the *BDC Act*[201] and that there are no legal loopholes or difficulties with its current wording.[202] As an example, Daviault pointed out to Section 14 of the *BDC Act*[203] which, in her opinion, establishes appropriate loan conditions for BDC clients.[204]

2.11.2 <u>*Canada Small Business Financing Program and the Capital Leasing Pilot Project*</u>

Beginning in 1961, the government of Canada started a special program of financing directly tailored to the needs of SMEs: the Small Business Loans Program ("SBLP").[205]

After some modifications, the SBLP was replaced by the Canada Small Business Financing Program ("CSBF").[206] This program now not only helps SMEs to

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199 Supra note 173.
200 Supra note 173. See also supra note 170 above for a reference to the BDC's legal framework.
201 Supra note 170.
202 Supra note 175.
203 Supra note 170.
204 Supra note 170. The relevant provision of Section 14 of the *BDC Act*, supra note 104, provides:
(3) The loans, investments and guarantees may be made or given only where, in the opinion of the Board or any committee or officer designated by the Board,(*a*) the person is engaged, or is about to engage, in an enterprise in Canada;(*b*) the amount invested, or to be invested, in the enterprise by persons other than the Bank and the character of the investment are such that the Bank may reasonably expect that those persons will have a continuing commitment to the enterprise; and (*c*) the enterprise may reasonably be expected to prove successful.
205 The SBLP was created by the *Small Business Loan Act*, R.S., 1985, c. S-11, s. 1; 1993, c. 6, s. 1(E), online: SBLA – Act <http://strategis.ic.gc.ca/SSG/la01025e.html>.

procure business improvement loans but also, as of April 1, 2002, access to lease financing for new or used equipment under the five-year Capital Leasing Pilot Project ("CLP").[207]

To be eligible for CSBF loans and CLP leases, SMEs cannot have estimated gross revenues in excess of $5 million during the fiscal year in which they apply.[208] The main goal of the CSBF and CLP is to increase the availability of loans and capital leases for establishing, expanding, modernizing and improving SME businesses by means of encouraging financial institutions and leasing companies to offer and make available their services to SMEs.[209] The fact that the Canadian Federal government, under the CSBF and CLP, will guarantee 85% of the lender's losses upon an event of default by the SME, is what attracts financial institutions and leasing companies to offer their services to SMEs.[210]

Basically, financing under the CSBF and the CLP can be facilitated by either commercial term loans or capital leases.[211] Commercial term loans can be used to finance up to 90% of the acquisition price or improvement costs of real property, immovable and new or used equipment. Capital leases are available to finance new and

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[206] The CSBF was created by the *Canada Small Business Financing Act*, R.S., 1998, c. S-36, online: Canada Small Business Financing Act <http://strategis.ic.gc.ca/SSG/la01103e.html> [*CSBF Act*].
[207] The CLP was included in the *CSBF Act*.
[208] *CSBF Act*, supra note 206, s 2 (a) and (b).
[209] Canada, Industry Canada, Canada Small Business Financing Program, *Buy or lease – now the choice is yours*, online: <http://strategis.ic.gc.ca/pics/la/02-085_e_final.pdf>.
[210] Supra note 206, s 8 (a).
[211] The maximum amount that SMEs can obtain under the CSBF Program, by using both term loans and capital leases, is limited to an aggregate of $250,000. In addition, all loans and leases must be paid in full within 10 years.

used equipment required to operate a business and generally include an option to purchase such equipment.[212]

Additionally, financial institutions and leasing companies are allowed to take security on the assets financed, in accordance with provincial laws.[213] Further, they can also require corporate and/or personal guarantees from SMEs managers and owners, up to 25% of the total financed amount.[214]

2.11.3 Provincial Venture Capital Corporations

Various provinces of Canada have established different types of venture capital companies aimed at encouraging the financing of SMEs.[215] These provincial venture capital corporations use the monies raised from residents to make investments in qualifying SMEs. Some of the most representative venture capital corporations established by provincial authorities are located in the provinces of Nova Scotia, British Columbia, Ontario and Québec.[216]

The rational behind the creation of these provincial venture capital companies varies form province to province. However, it is possible to find a common pattern among them: make capital available to SMEs operating in their respective

[212] Capital leases can be used to finance the acquisition of, for example, vehicles, hotel and restaurant equipment, medical and health services equipment, computer and software, telecommunications equipment and manufacturing equipment.
[213] Supra note 209.
[214] *Ibid.*
[215] As the Québec Business Investment Company ("QBIC") program states: "The [QBIC] program ("...") is designed to SMEs Québec corporations to have access to external sources of financing to provide permanent capitalization and secure their long-term development." The QBIC was created by the *Québec Business Investment Companies Regulation*, R.R.Q. 1981, c. S-29.1, r. 1. See Québec, Ministère des Finances, *Easing of eligibility conditions for the refundable tax credit for home support of older persons and other tax measures*, online: <www.finances.gouv.qc.ca/en/documents/bulletin/pdf/99-5-a-b.PDF>.
[216] Provincial governments normally do not guarantee the success of any investment in a provincial venture capital corporation.

provincial territories by inducing eligible investors [217] to obtain a tax credit[218] for the amounts invested in provincial venture capital companies which in turn are reinvested in SMEs.[219]

Provincial venture capital corporations have a set of rules and regulations that determine in which SMEs (eligible businesses) they may be allowed to invest through the acquisition of a defined number of shares.[220]

In addition, it can be noted that in certain circumstances, provincial venture capital corporations have been established as venture capital investment funds for specific reasons. For example, they have been established (i) as labour sponsored organizations with the goal of creating employment opportunities;[221] or (ii) to provide funds to SMEs with financing needs for the development of new environmental technologies or services.[222]

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[217] The Labour Sponsored Investment Funds of Ontario ("LSIFs"), established by means of the Ontario Investment and Employee Ownership Program Tax Credit, for example, defines "eligible investors" as an individual and includes an RRSP trust of which the individual or spouse or common-law partner of the individual, is the annuitant.

[218] The tax credits granted by provincial governments for investments in their venture capital corporations range between 15% and 30% of the amounts invested. For example, the LSIFs allow an eligible investor to claim for a tax credit to an annual maximum of 15% of the total permissible amount invested ($5,000 maximum investment x 15%). Similarly, in the province of Québec, individuals who invest in a QBIC might benefit from a deduction applicable to their income up to 150% of their share of the QBIC's eligible investment.

[219] Normally there are holding periods that investors in LSVCF have to observe.

[220] For example, an eligible business might be defined as one which does not own more than $5 million in assets and which employs no more than 50 employees as it is the case with the LSIFs in Ontario.

[221] According to Francois Vaillancourt of the Department de Sciences Economiques and Centre de Reserche et Developpment en Economique of Universite de Montreal, "Labour-Sponsored Venture Capital Funds in Canada: Institutional Aspects, Tax Expenditures and Employment Creation", cited in Halperin, supra note 198, at 572, the first labour-sponsored venture capital fund was Le Fond de Solidarite des Travailleurs du Québec, created by a Québec law on June 23, 1983. The Labour-Sponsored Venture Capital Corporation ("LSVCCs") of the Province of Manitoba is other example of this type of venture capital company.

[222] See the Green Venture Capital Program established in the province of British Columbia as an example of this government sponsored investment venture capital program as it is set out in the *Small Business Venture Capital Act*, R.S.B.C. 1996, c. 429, online: Small Business Venture Capital Act <http://www.qp.gov.bc.ca/statreg/stat/S/96429_01.htm>.

2.12 SUMMARY

From the sources of financing analyzed, it seems that SMEs find bank and credit union and caisse populaire loans most accessible to sustain and expand their businesses.[223]

In addition, it appears that some aspects of the legal framework of SME financing are positive elements that facilitate the transfer of funds to fulfill SMEs' financing needs. In particular (i) the *Bank Act*[224] provides with a uniform security mechanism,[225] on a nationwide basis, which ease the provision of financing to SMEs by banks;[226] (ii) the provincial secured transaction legislations permits non-bank lending institutions, such as credit unions and caisses populaires, to offer secured credits to SMEs;[227] and (iii) the *CSBF Act*[228] offers to lenders the guarantee of the Federal government to cover up to 85% of the lender's losses in loan and lease transactions under the CSBF and CLP.[229]

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[223] See section 2.3 and 2.4 above for more information on this topic.
[224] Supra note 80.
[225] *Ibid*, section 427.
[226] See section 2.7 above, for more information on this topic.
[227] *Ibid.*
[228] Supra note 206.
[229] See section 2.11.2 above, for more information on this topic.

CHAPTER 3. UNDERSTANDING SOME OF THE MOST SENSITIVE TAXES FOR SMES' ACTIVITIES

3.1 INTRODUCTION

The health and vitality of entrepreneurial spirit is viewed as a vital ingredient in generating economic growth.[230] As such, the governments of most industrial countries provide fiscal incentives and tax breaks especially designed for SMEs.[231]

Even though there is no separate tax system for SMEs in Canada, the tradition of helping SMEs through tax relief appears to be well entrenched in the Canadian tax system.[232] However, it seems that SMEs believe that the current tax system impairs the growth of their activities. According to Pierre Emmanuel Paradis, Senior Economist for the CFIB, CFIB's members consider that the total tax burden applicable to them as the main barrier for growth.[233] In addition, among the CFIB's members top tax priorities are the reduction of (i) personal income taxes for all Canadian (74% of support); (ii) GST and HST (55% of support); (iii) employment insurance premiums (50% of support) and (iv) corporate income taxes (46% of support).[234]

This chapter focuses on some of the significant taxes levied on SME activities and their applicable legal framework. The chapter describes and analyses the main legal

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[230] See, for example, supra note 1; supra note 26; Marcus Dejardin, "Entrepreneurship and Economic Growth: An Obvious Conjunction?, online: <http://www.spea.indiana.edu/ids/pdfholder/idsissn00-8.pdf> [Dejardin]; or OECD, *The Sources of Economic Growth in the OECD Countries* (OECD: Paris, 2003).
[231] See, for example, supra note 12.
[232] As the Minister of Finance stated in his budget speech when the first dual rate of corporate tax was introduced in 1949: "My own belief is that small businesses should be encouraged and it seems to me that a useful way to do this is to lower the tax and take less out of the funds they need for growth and expansion." Canada, Department of Finance, *Budget Speech 1949*, cited in Vern Krishna, *The fundamentals of Canadian income tax: an introduction* (Toronto: Carswell, 1988), at XIX.1. [Krishna].
[233] Interview of Pierre Emmanuel Paradis (22 May 2003). 77.2% of the responders to the CFIB's survey entitled "Our Members' Opinions Survey #51, July to December 2002", based on 24,120 responses, at Q5, cited the tax burden as the principal barrier to growth.
[234] Canadian Federation of Independent Business, "Survey on Federal Tax Policy and Collection", November 2001, based on 7,155 responses, online, <http://www.cfib.ca/legis/national/5156.pdf> at 7.

aspects of (i) federal and provincial sales taxes; (ii) federal and provincial corporate income taxes; (iii) the small business deduction; and (iv) capital gain taxes.

3.2 <u>FEDERAL AND PROVINCIAL SALES TAXES</u>

In Canada, sales taxes are structured at two different levels: federal and provincial. At the federal level, the Good and Services Tax ("GST")[235] applies to the supply of most goods and services in Canada at a rate of 7%. At the provincial level, each provincial jurisdiction has the authority to establish its own rate of sales taxes which are, on average, around 7%.[236]

Different business groups, including SMEs, have been urging the federal and provincial governments to move to a single integrated sales tax system.[237] An integrated system would procure relatively greater simplicity since SMEs would be required to deal with only one sales tax, one set of books and one sales tax authority.[238]

Three Atlantic Provinces (Nova Scotia, New Brunswick and Newfoundland) have harmonized their sales taxes with the GST to create the harmonized sale tax ("HST") which applies to the same goods and services as the GST but at a combined rate of 15% (7% federal and the remaining provinces).[239]

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[235] *Excise Tax Act*, R.S.C. 1985, c. E-15, s 122 (Lexis).

[236] Canadian Federation of Independent Business, Tax Bites, March 2002, "Federal and Provincial Sales Taxes (2002)," online: <http://www.cfib.ca/research/comments/tax_bites_pst.pdf>.

[237] Canada, Canada Customs and Revenue Agency, *Guide For Canadian Small Businesses – Chapter 2 The Goods and Services Tax (GST) and Harmonized Sales Tax (HST)*, online: RC4070 – Guide For Canadian Small Businesses <http://www.ccra-adrc.gc.ca/E/pub/tg/rc4070/rc4070eq-04.html#P377_31965>. See also Canada, Industry Canada, *Small Business Tax Requirements and Services*, online: Your Guide to Government Services and Support for Small Business < http://strategis.ic.gc.ca/SSG/me00074e.html>.

[238] *Ibid.*

[239] Canada, Department of Finance, *Harmonized Sales Tax*, online: Harmonized Sales Tax <http://www.fin.gc.ca/hst/hst1-e.html>.

In general terms, SMEs that commercialize goods and services subject to taxes[240] in Canada are required to register for and charge GST (HST as the case may be).[241] However, SMEs that qualify as "small suppliers" are not required to be registered for this tax. In order to be exempted from registration of the GST, a SME must qualify under the "small supplier" exemption which requires that a SME be a sole proprietorship, a partnership or a corporation, with total (worldwide) revenues of $30,000 or less in the last four consecutive calendar quarters.[242] Even though a SME that qualifies under the small supplier definition is exempted from registration of the GST, it may still become a tax registrant.[243]

As a GST registrant, SMEs must charge 7% on the taxable goods and services that are sold or provided. In addition, in those provinces where the HST is not applicable, SMEs are required to charge not only the GST but also the provincial sales taxes ("PST").[244] When SMEs are required to charge both taxes, GST and PST, they have to calculate the GST on the price of the goods and services to be offered or provided before they calculate the PST.[245]

3.3 Federal and Provincial Corporate Income Taxes

For the tax framework applied to SMEs to be effective, especially in regard to income taxes, one must attempt to strike a balance between simplicity, fairness and protection of the state against undue revenue losses from any exploitation of the SME tax

[240] E.g.: commercial real property and newly constructed residential property; clothing and footwear, car repairs; and hotel accommodation.
[241] Supra note 237.
[242] *Ibid.*
[243] *Ibid.*
[244] *Ibid.*
[245] *Ibid.*

system. Income tax refers to a levy on income which has to be paid by SMEs to both federal and provincial authorities, generally, on an annual basis. [246]

According to a KPMG report on top corporate income tax rates in 2002, Canada ranks fifth behind Japan, Italy, Belgium and the US. [247] Even if Canada were to implement announced tax cuts by 2005,[248] it would still have one of the highest income tax rates in the world.[249] It is believed that a reduction in the rate of corporate income tax would not only attract more investments to SMEs but also, if corporate income taxes were reduced to a level below the rate that is levied on personal income, it would also increase the incentives for entrepreneurs to incorporate their businesses.[250]

Generally, provincial governments in Canada have an agreement with the federal government under which all corporate income taxes are collected by the Federal government on their behalf. This saves SMEs from having to complete and file two income tax returns.[251]

Generally, SMEs report business income using the accrual report method.[252] Farmers, an activity commonly associated with SMEs, can use the cash report method

[246] A federal [or provincial] tax imposed on an individual or entity's net income. Supra note 98, at 1470.
[247] Path, supra note 13, at 16.
[248] Tax cuts announced in the October 2000 Economic Statement and subsequently in Budget 2001. Canada, Department of Finance, *Economic Statement and Budget Update – Overview*, online: <http://www.fin.gc.ca/ec2000/pdf/overe.pdf>.
[249] *Ibid.* According to C.D. Howe Institute: Backgrounder, March 2000, Canada might have general corporate combined income tax rates of a range between 30 and 40% in 2004.
[250] Kenneth Hendricks, Raphael Amit and, Diana Whistler, "Business Taxation of Small and Medium-Sized Enterprises in Canada," Working Paper 97-11, at 12.
[251] This is so except in the provinces of Québec, Ontario and Alberta where separate corporate tax administrations are maintained. Plamondon & Associates Inc. (Ottawa), "Compliance Issues: Small Business and the Corporate Income Tax System," online: <http://www.fin.gc.ca/taxstudy/wp96-9e.pdf> at 16.
[252] By using this method, SMEs' business income is reported in the fiscal period it is earned, regardless of when it is received, and expenses are deducted in the fiscal period they are incurred, whether they are paid or not. In other words, an accrual report method records entries of debits and credits when the liability arises, rather when the income or expense is received or disbursed. Supra note 98, at 20.

instead of the accrual report method.[253] Under the cash report method, farm SMEs can report income as it is received and deduct allowable expenses as they are paid. This method helps SMEs because they do not have to bear the risk of paying taxes for income that they might not actually receive.[254]

Income taxes can be paid by SMEs, in the year in which the income is earned, by way of quarterly installments or by lump sum payments.[255] Under the installment payment approach, SMEs have to estimate their annual incomes for the following year in order to calculate quarterly figures. Any discrepancy is paid or refunded on or about April 30 of the year following the one for which the SME has filed its tax returns.[256]

Despite criticism against the current corporate income tax system applicable to SMEs, Canada, through its *Income Tax Act*,[257] is one of the few countries which applies a low federal corporate income tax rate on SMEs.[258]

Those SMEs which qualify as Canadian-controlled private corporations ("CCPC")[259] are levied, by way of the small business deduction which is explained below, with the lowest federal corporate income tax rate in respect of the first $200,000

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[253] Cheryl Carley, "Reducing Business Income for Tax Purposes," online: Bus Tax <http://www3.sk.sympatico.ca/carley/reducing%20business.html>. See also, Peter W. Hogg, *Principles of Canadian Income Tax Law* (Ontario: Carswell, 1997), at 206, [Hogg]; and Vern Krishna, *The fundamentals of Canadian income tax: an introduction*, Seventh Edition (Toronto: Carswell, 2002), at 164.
[254] *Ibid.*
[255] Hogg, supra note 253, at 84.
[256] *Ibid.*
[257] *Income Tax Act*, R.S.C. 1985, (5th Supp.), c. 1, online: Income Tax Act <http://laws.justice.gc.ca/en/I-3.3/>.
[258] Supra note 12, at 12. It is reported that the revenue cost of the relief provided by the Federal government to SMEs is substantial. For example, according to Canada, Statistics Canada, *Corporation Taxation Statistics* cited in Krishna, supra note 232, at XIX.2, the cost was $1.2 billion in 1980.
[259] Supra note 257, s. 125 (1) and (7). The definition excludes foreign-controlled private corporations, and public corporations, as well as individuals operating unincorporated businesses as sole proprietorships or partnerships.

tranche of its Canadian active business income (approximately 12%).[260] A CCPC is a SME which is resident in Canada and that is not controlled, directly or indirectly, in any manner whatsoever, by one or more non-resident individuals, by one or more corporations or by any combination of non-residents and public corporations.[261]

3.4 THE SMALL BUSINESS DEDUCTION

The *Income Tax Act*[262] contains a provision called the "small business deduction" (Section 125) which is designed to encourage the establishment and growth of SMEs in Canada.[263] Although it is called the small business deduction, it is really a credit and not a deduction since it is deducted directly from tax rather than income. The small business deduction is, by far, the most important benefit available to SMEs because it helps them retain more of their earnings for reinvestment and expansion.[264]

By using the small business deduction, SMEs may deduct 16% of federal taxable corporate income in the taxation year[265] up to a limit of $200,000.[266] As a result of the application of the small business deduction, SMEs benefit from a reduction in the federal corporate income tax rate on the qualifying income with a rate of approximately 12% on

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[260] This rate, when combined with the different provincial income tax rates, which are also low for this kind of income (in the average of 8%), brings the combined rate to approximately 20%. Canadian Federation of Independent Business, "Tax Bites, February 2003, Federal and Provincial Corporate Income Taxes, 2000 to 2006," online: <http://www.cfib.ca/research/comments/tax_bites_cit.pdf>.
[261] Supra note 257, s. 125 (7) (a).
[262] Supra note 257.
[263] See, supra note 10, at 334.
[264] *Ibid*, at 141.
[265] Supra note 257, s 125 (1).
[266] The *Income Tax Act* has special provisions concerning cases of associated CPCCs. The act provides that when several CPCC are "associated" with each other, they must share a single limit of $200,000. *Ibid.* s. 256.

the first $200,000 of active business income. This threshold of $200,000 is called the "business limit."[267]

The federal government accepted the arguments presented by various participants of the SME sector, such as the CFIB, who claimed that the business limit should be increased because, since its inception, it has never been indexed or increased to compensate for the impact of inflation on SME activities.[268] The increase was introduced by the federal government in the last Federal Budget 2003 to support SME growth and innovation.[269] By means of this amendment, the government will gradually raise the current maximum business limit from $200,000 to $300,000 over the next four years.[270] It is further believed that SMEs will save up to $9,000 per year once the measure is fully implemented.[271] With this move, entrepreneurs should have more funds at their disposal to reinvest in their ventures in order to produce new products and services or to improve the existent ones since a larger part of their incomes will be levied at the lowest federal corporate income tax rate.[272]

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267 Hogg, supra note 253, at 452.

268 Supra note 9, at 9. This measure was supported by 86% of the CFIB's SME members. Originally, the CFIB recommended an increase in the federal small business tax threshold to $400,000. Supra note 9, at 2. Even though the increase did not match the CFIB's proposal, it is believed that the CFIB's surveys and research projects were vital to influence the government in order to modify the business limit. In this sense, the Minister of Finance, John Manley, recognized the role that the CFIB plays when he declared, during his Budget Speech on February 18, 2003 that: "We have heard many good ideas from the Canadian Federation of Independent Business ("...") on how we can further support entrepreneurship and small business in Canada." Building, supra note 13, at 12.

269 It seems that the Federal Budget 2003 had a clear goal on entrepreneurship: "To support a climate that rewards hard work and entrepreneurship. That encourages innovation and stimulates growth." Building, supra note 13, at 12.

270 Canadian Federation of Independent Business, "The 2003 Federal Budget" (2003), online: <http://www.cfib.ca/legis/national/5146.pdf> at 1.

271 *Ibid.*

272 Supra note 9.

To use the small business deduction, SMEs must (i) qualify as CCPC and (i) have income obtained from qualifying "active businesses".[273] For several years, the definition of "active business" was left to the judiciary to define. However, a successive number of court cases expanded the concept so that the recourse to this exception was available to a wide range of business activities. This situation called the attention of Parliament which modified the *Income Tax Act*[274] in order to specifically provide a definition of "active business", although in an exclusionary manner.[275] Since this reform, if an SME's income is obtained through an active business and the entity qualifies as a CCPC, then the SME's first $200,000 in income (and its correspondent increases over the 4 year period) is eligible for the lowest federal corporate income tax rate of approximately 12%, provided it does not come within the scope of any exception.[276]

In order to use and benefit from the small business deduction to the maximum extent possible, SMEs usually pay substantial salaries (or bonuses) to senior employees (who are usually also shareholders) so as to lower the taxable income to the lowest level possible.[277]

3.5 TAXES ON CAPITAL GAINS

Capital gain taxes seriously affect SMEs' activities and potential financing possibilities. The supply of capital to SMEs is determined by the relative tax treatment of capital gains that investors in SME ventures, especially angel investors and venture

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[273] Supra note 257, s. 125 (1) (a) (i).
[274] *Ibid.*
[275] Accordingly, the definition of "active business" in s. 125 (7) of the *Income Tax Act*, supra note 257, does not include an income from specific investments, or a personal services business.
[276] Canada, Industry Canada, *Summary of Current Tax Measures for Small Business*, online: Summary of Current Tax Measures for Small Business <http://strategis.ic.gc.ca/epic/internet/insof-sdf.nsf/vwGeneratedInterE/so01959e.html#THREE>.
[277] Supra note 251, at 8.

capitalists, are able and willing to incur on their investments, compared to the after tax returns that they can expect from alternative investments, such as receiving dividends by investing in larger firms.[278]

The capital gains tax system can support the growth of SMEs by allowing them to retain more of their business. It is in this sense that capital gains taxes may favor SMEs by means of capital gains exemptions from income taxes up to a certain level and for determined individuals and through tax free rollovers of capital gains on qualified SMEs investments when they are reinvested in other SMEs.

In regard to the first issue, capital gains exemptions, Canada implemented in 1987 a "lifetime capital gains exemption"[279] by which the first $500,000 of capital gains from the disposition of qualified farm property or shares of a CCPC by an individual (not trusts or corporations) are exempt from income taxes.[280]

On the other hand the Federal government has also introduced a tax free capital gains rollover[281] for small individual investors (not trusts or corporations);[282] which allows investors to defer the taxation of capital gains on investments in eligible SME shares if the proceeds of disposition of their shares are reinvested in shares of another SME.[283] The Federal Budget 2003 eliminated the cap of $2,000,000 which applied to the

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[278] Supra note 12, at 21.
[279] *Income Tax Act*, supra note 257, section 80.03 (8).
[280] Supra note 276. The CFIB lobbied the Federal government to raise this exemption to $1 million in the Federal Budget 2003. However, the Federal government did not change it. Supra note 9, at 9.
[281] The small business capital gains rollover was introduced by the Federal Government in its 2000 five-year $100 billion tax reduction plan. Canada, Department of Finance, *Finance Minister Releases Draft Income Tax Amendments Implementing Key Elements Of Government's Five-Year Tax Reduction Plan*, online: Finance Minister Releases Draft Income Tax Amendments Implementing Key Elements Of Government's Five-Year Tax Reduction Plan < http://www.fin.gc.ca/news00/00-101e.html>.
[282] PWC, "2003 Federal Budget – Generally Favourable From A Tax Perspective", online: Tax News Network Canada: Budget 2003: PwC Commentary <http://www.ca.taxnews.com/tnnpublic.nsf/notespages/Headline%2015?OpenDocument&ExpandSection=1>.
[283] Supra note 190, at 141.

original investment and reinvested amounts on which the rollover was available.[284] The rollover has to be implemented anytime in the year of disposition of the previous investment or within 120 days after the end of that year.[285]

3.6 SUMMARY

The legal framework of SME taxation presents some important measures designed to encourage SMEs' activities which need to be highlighted. Namely, it presents (i) the small business deduction in section 125 of the *Income Tax Act*[286] through which SMEs are taxed with the lowest federal corporate income tax rate, permitting SMEs to retain more income to be reinvested in their ventures;[287] (ii) the lifetime capital gains exemption in section 80.03 (8) of the *Income Tax Act*[288] by which the first $500,000 of capital gains from the disposition of qualified farm property or shares of a SME are exempt from income taxes;[289] and (iii) the tax free capital gains rollover in section 44.1(1) of the *Income Tax Act* by which investors are allowed to defer the taxation of capital gains on investments in eligible SME shares if the proceeds of disposition of their shares are reinvested in shares of other SME.

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284 *Ibid*, at 330.
285 Certified Management Accountants, "2003 Federal Budget: addressing SME competitiveness, accrual accounting," online: http://www.cma-canada.org/cmacan/NewsUpdates/pdf/03BudgetAnalysis.pdf
286 Supra note 257.
287 See section 3.4 above, for more information on this topic.
288 Supra note 257.
289 See section 3.5 above, for more information on this topic.

CHAPTER 4. INTERNATIONAL TRADE AND SMEs: A TREND TOWARD A GLOBAL SME

4.1 INTRODUCTION

The forces of globalization and increased world trade have created enormous opportunities for SMEs. But, globalization has also produced more and fiercer international competition. To what degree have SMEs participated in global investment and trade? According to the Organization for Economic Cooperation and Development ("OECD"), smaller firms in the 1990s increased their shares of exports and in outward foreign direct investments in the OECD countries and in many Asian countries.[290]

Two factors best explain the participation of SMEs in the globalized economy. First, better information processing and communication technology have contributed to the creation of this new global economy.[291] This also helps sustain better awareness of international economic opportunities for all market players, including SMEs. The dismantling of trade barriers erected following the Great Depression of the 1930s is a second contributing factor. Canada's support for the establishment of the World Trade Organization ("WTO") coincides with this international trend toward a global economy and shows, at the same time, an understanding of the importance of global market access for innovative SMEs.

What is the participation of SMEs in export transaction and international markets? There is some evidence that supports the conclusion that relatively few SMEs are really successful exporters in Canada. For instance, a study shows that, in 1998 and 1999 -the

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[290] Zoltán J. Ács, *Small firms, globalization, and Canadian public policy* (Edmonton: University of Alberta, Centre for International Business Studies, 2000).
[291] *Ibid.* See also University of Toronto, "Canadian Use of Communication Technologies in the Global Context," <online: http://home.utm.utoronto.ca/~awazette/junk.html>.

latest data available on this issue-, of nearly 30,000 Canadian exporters, a small number of the largest exporters (about 1,500 or 5%) accounted for over 80% of the value of all exports.[292] Although the number of SMEs participating in export transactions during the same period comprised almost two thirds of the total number of exporting establishments (18,266 out of 19,300), SMEs contributed less than 2% of the total value of exports.[293] These findings suggest that export transactions undertaken by Canadian companies are highly concentrated within the sphere of few companies.

The objective of this Chapter is to describe two measures undertaken by the government of Canada to support SMEs in their international ventures: (i) the work of Export Development Canada and (ii) the Canadian Commercial Corporation's Progress Payment Program.

4.2 EXPORT DEVELOPMENT CORPORATION OF CANADA

While focusing on supporting SMEs in marketing and exporting their products abroad and helping them in establishing operations internationally, the government of Canada created the Canadian credit export agency: the Export Development Corporation of Canada ("EDC").[294] This crown corporation is Canada's source of official export credit.[295]

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[292] Canada, Industry Canada, *Profile of Canadian Exporters 1993-1999*, online: September 2001, vol. 3, no. 2 – Feature Story <http://strategis.ic.gc.ca/epic/internet/insbrp-rppe.nsf/vwGeneratedInterE/rd00372e.html>.
[293] *Ibid.*
[294] EDC is a federal crown corporation created by the *Export Development Act* on October 1, 1969. *Export Development Act*, R.S., 1985, c. E-20, s. 1, as am. by S.C. 2001, c. 33, s. 2(F) (Lexis). [*EDC Act*]. Canada has different programs aimed at supporting SME activities abroad at the federal, provincial and municipal levels. However, it is argued, as it is explained in the report of the Special Joint Committee Reviewing Canadian Foreign Policy, that those programs created and organized at the provincial and municipal levels are better designed to service SMEs. Canada, Parliament, House of Commons, Standing Committee on Foreign Affairs and International Trade, *Canadian SMEs in the world economy: developing effective business-government partnership for international success: report of the House of Commons Standing*

Although EDC was created to promote Canadian exports in general, its work is now focuses mainly on supporting SMEs.[296] It is expressly recognized that EDC has not only a commercial but also a social policy mandate.[297] On the one hand, EDC collects interest on its loans and premiums for its insurances. This means that EDC is expected to operate in a "financially sound manner", interpreting this to mean that the EDC must be "self-sustaining."[298] On the other hand, EDC has a social role when it acts as a bridge between the support provided by commercial banks and what export SMEs need to succeed in export markets. In other words, it is believed that EDC fills the gap that exists between what banks have and are willing to offer in terms of support for SME export transactions and what SMEs actually need to succeed in international business transactions.[299]

Although the EDC has the expertise that SMEs need, SMEs still have trouble accessing international markets due namely to a lack of international experience, staff with experience in export markets, and current information on commercial and political market risks.

Committee on Foreign Affairs and International Trade, online: 1ST Report of the Standing Committee on Foreign Affairs and International Trade <http://collection.nlc-bnc.ca/100/201/301/hoc_comm-e/fore/35-2/reports/01_1996-06_p/fore-01-cov-e.html>. [Standing Committee]. It is further sustained in the same report that, in order to avoid overlapping activities, the federal government should withdraw from services and programs which were required fifty years ago, but which are now provided by provinces and municipalities on a more effective basis.

295 Standing Committee, *ibid.*

296 Nearly 90% of EDC's customers are SMEs. Canada, Export Development Canada, Who We Are, online: EDC – Who We Are <http://www.edc.ca/corpinfo/whoweare/index_e.htm>. [Who We Are]. Accordingly, EDC's SME customers account for 6,575 out a total of 7,223. Canada, Export Development Corporation, *Canada's Bridge to Global Trade and Investment*, online: <http://www.edc.ca/Corpinfo/Pubs/report/2002/2002_annualreport_e.pdf> at i. [Canada's Bridge].

297 Canada, Export Development Canada, *Why We Exist*, online: EDC Who We Are – Why We Exist <http://www.edc.ca/corpinfo/whoweare/why_exist_e.htm>.

298 Canada, Export Development Corporation, *How We Work*, online: EDC – How We Work <http://www.edc.ca/corpinfo/whoweare/how_we_work_e.htm>.

299 Supra note 297.

Generally speaking, EDC helps SMEs by providing (i) them with convenient insurance products and relatively adequate guarantees;[300] and (ii) their foreign buyers with financing.[301]

In relation to insurance products, EDC offers insurance policies which protect SME exporters against losses due to commercial and political risks.[302] EDC's insurance policies cover risks such as buyer insolvency, default on payments, repudiation of goods, contract termination, transfer payment difficulties, war, revolution, cancellation of government import or export permits or inability to repatriate capital or equipment due to political problems.[303] In addition, EDC's insurance services and products can help SMEs to get capital. This can be done by way of obtaining insurance on the export SMEs' foreign receivables. If the export SME's foreign receivables are insured by EDC, commercial banks may be more willing to use those foreign receivables as collateral, enabling the SME to increase its working capital lines of credit.[304] Further, SMEs might also be able to sell their insured foreign receivables by EDC to their banks, financial institutions or factoring companies.[305]

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300 Who We Are, supra note 296.

301 *Ibid.* Some of the most common EDC's streamlined financing alternatives for export SMEs include: direct loans for foreign buyers, EDC's lines of credit, simplified note purchase, Northstar Trade Finance or marketing letters. Canada, Export Development Canada, *Financing*, online: EDC – Export Financing <http://www.edc.ca/prodserv/financing/index_e.htm>.

302 According to EDC's insurance policy, SMEs might be covered against losses, in cases where foreign purchasers do not pay the agreed prices, up to 90% of the value of the contract. Canada, Export Development Canada, *Insurance*, online: EDC – Accounts Receivable Insurance <http://www.edc.ca/prodserv/insurance/index_e.htm?Ad_ID=HPinse>.

303 *Ibid.*

304 For example, under the Master Accounts Receivable Guarantee ("MARG") program, SMEs are able to increase their operating lines of credit from banks against the value of their foreign accounts receivable insured by EDC. Canada, Export Development Canada, *Master Accounts Receivable Guarantee*, online: EDC _Small Business – Master Accounts Receivable Guarantee <http://www.edc.ca/Prodserv/SmallBus/marg_e.htm>.

305 Canada, Export Development Canada, *Factoring*, online: Export Development Corporation (EDC) <http://www.edc.ca/Prodserv/SmallBus/factoring_e.htm>. One of the companies that buy foreign accounts receivable insured by EDC is Atlantic Trade Finance Inc. Atlantic Trade Finance Inc, "Invoice Discounting," online: Products <http://www.atlantictradefinance.com/Services.html>.

SMEs can also use EDC's financing products to provide their customers with relatively flexible medium or long term financing in the form of direct loans, loan guarantees and lines of credit to encourage foreign buyers to 'buy Canadian' capital, quasi-capital goods and certain related services.[306] Commonly, in direct loan transactions, EDC pays the export SME the value of the export contract, transforming the credit sale into a cash sale in favor of the SME, and then it collects from the foreign borrower over the life of the contract which, generally, has repayment terms between 1 to 10 years.[307]

According to Frank Trentadue, EDC's Manager of SME Financial Services for the Québec region,[308] EDC's mandate is to facilitate international trade for Canadian exporters in general and for SME exporters in particular, specifically in the more risky markets and where there are no other sources of help available for SME businesses.[309] Notwithstanding the fact that EDC's mandate is to facilitate international trade for SME exporters to deal in international markets which present more risks, most of EDC's help is still concentrated on relatively low risk countries: 67% of EDC's volume of support for international trade is within North America and the Caribbean, including Mexico.[310] In

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[306] Canada, Export Development Canada, *Buyer Financing*, online: EDC - Small Business – Buyer <Financing http://www.edc.ca/ProdServ/SmallBus/loans_e.htm>. Generally, EDC financing is available for up to 85% of the value of the export contract. In addition, in order to qualify for the EDC's financing products, the transaction has to be an export and involve products containing approximately over 50% of Canadian content.
[307] *Ibid.*
[308] Interview of Frank Trentadue (10 June 2003).
[309] On this issue, the pertinent part of the *EDC Act*, supra note 294, provides:

> 10. (1) The Corporation is established for the purposes of supporting and developing, directly or indirectly, Canada's export trade and Canadian capacity to engage in that trade and to respond to international business opportunities.

[310] Canada's Bridge, supra note 296, at 40. It is possible to compare this tendency of EDC to provide support to SME transacting within North America and the Caribbean with the fact that 85% of Canada's trade is with the United States which implies that international trade of Canada is highly concentrated. Canada, Export Development Corporation, online: EDC – Who We Are – Why Trade Is Crucial To Canada <http://www.edc.ca/corpinfo/whoweare/why_trade_e.htm>.

addition and contrary popular belief, due to the fact that the government of Canada is focused on the creation of value for its economy through the development of the knowledge-based economy,[311] EDC's assistance in the form of short-term financial services, as for the 12 month period ended on December 31, 2002, was mainly concentrated in the forestry industry and not on the knowledge-based industry.[312]

Apparently, the EDC does not have to deal with relatively important legal issues when transacting with SME clients. In this regards, Trentadue opined that:

> Typically we are dealing specifically with commercial risk issues. Not necessarily [with] legal issues. By extension maybe there are legal issues. For example, we [might not be] comfortable with the [export/import/financing] contract because its terms and conditions are not standard in the industry. ("...") When you are dealing in international markets, there are maybe legal issues but I think that probably legal issues are less [problematic than others in SME export transactions]. (emphasis added). [313]

4.3 THE CANADIAN COMMERCIAL CORPORATION - THE PROGRESS PAYMENT PROGRAM

The Canadian Commercial Corporation was established as a federal agency in 1946 with the general objective of assisting SMEs in selling their products and services to foreign governments and international organizations ("CCC").[314]

In 1995, the CCC launched the Progress Payment Program designed to provide SMEs with better access to pre-shipment financing ("PPP").[315] In general terms, the PPP

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[311] In most industrial countries, the knowledge-based economy, including industries such as biotechnology and communications, is replacing what once was the principal economic sector for many of them: the resource-based economy, including industries such as forestry and agricultural activities. The added-value that the knowledge-based generate permits industrial countries to stay at the forefront of economic prosperity. About the importance that the knowledge-based economy for Canada's economy has, see, for example, Canada, Export Development of Canada, *Summary of the 2002-2006 Corporate Plan*, online: <http://www.edc.ca/corpinfo/pubs/corp_plan_summary_e.pdf>.

[312] Canada's Bridge, supra note 296, at ii. EDC's 2002 corporate accounts show that forestry was the sector that received the highest level of assistance from EDC in the form of short term financial services.

[313] Supra note 308.

can be used by SMEs with insufficient working capital to undertake a specific export contract.[316]

According to the PPP, the CCC examines the risks associated with the export transaction of the SME, its foreign customer (principally foreign governments, agencies and international organizations) and the terms of the proposed transaction.[317] If the CCC is satisfied with the terms of the transaction, then it can offer a guarantee for the completion of the export contract.[318] When the CCC approves the transaction and offers a guarantee for the completion of it, and if the SME's bank is also satisfied with the overall financial condition of the transaction, then the SME's bank might be willing to lend beyond the SME's normal line of credit.[319]

It is the government stamp given through the CCC that gives the SME's bank the indication that it can advance funds beyond the SME's normal line of credit knowing that the CCC will guarantee any loss in case of default of the SME. In other words, it is the government stamp given through the CCC that gives this institution its *raison d'être*.[320]

4.4 SUMMARY

SMEs have in the EDC and the CCC two important allies to look for support for their international ventures.[321] EDC supports SMEs' international activities especially

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314 The CCC was created by the *Canadian Commercial Corporation Act*, R.S.C. 1985, c. C-14 (Lexis).
315 Canada, Canadian Commercial Corporation, *Canadian Exporters*, online: Canadian Exporters <http://www.ccc.ca/eng/ser_cdn_exp.cfm#progress>.
316 *Ibid.*
317 Canada, Canadian Commercial Corporation, *The Progress Payment Program*, online: <http://www.ccc.ca/eng/images/content/publications/ppp.pdf>, at 5.
318 As a result of CCC's involvement in SME export transactions, the CCC charges SMEs a fee under the PPP. Normally, the costs charged by the CCC are no more than 2% of the contract value.
319 Normally, if all the conditions are met, the SME's bank might provide a project line of credit up to $2 million to cover the production costs of a particular sale. It is worth noting the fact that this project line of credit is granted beyond the SMEs' regular line of credit. Supra note 315.
320 Standing Committee, supra note 294.
321 See section 4.2 and 4.3. above, for more information on these topics, especially footnotes 302 and 306.

through its insurance and financing products.[322] In this sense, the EDC's insurance products help SMEs to reduce the risks which exist in doing business in foreign markets.[323] More importantly for countries with higher risks, EDC's financing products also permit SMEs to offer financing to their foreign buyers.

CCC's assistance to SMEs comes via its guarantee for the completion of an export contract involving a SME.[324] With this guarantee in place, banks are in a better position to offer financing to SMEs with insufficient working capital to undertake a specific export contract knowing that, if the SME defaults, they can collect the credit from the CCC.[325]

Additionally, the assistance that EDC and CCC put forward for SMEs' international endeavors seems to be adequately supported by the terms of the *EDC Act*,[326] especially its section 10 (1.1), and on the *Canadian Commercial Corporation Act*[327], especially its section 9, respectively.

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[322] *Ibid.*
[323] See section 4.2 above, for more information on this topic, especially the importance of EDC's insurance products which covers up to 90% of a loss if the foreign buyer does not pay to the SME the value of the export contract and how foreign accounts receivables of a SME insured by EDC may ease the provision of additional funds for the company.
[324] See section 4.3. above, for more information on this topic.
[325] *Ibid.*
[326] Supra note 294.
[327] Supra note 314.

CHAPTER 5 CONCLUSIONS

By analyzing the areas of SME financing, taxation and international trade, it is possible to identify several components of the legal framework of these areas which are helping SMEs to grow and innovate. However, there is still some work to be done on some aspects of the legal framework of these areas to provide further assistance to SMEs.

In the area of SME financing, the uniform security mechanism established by the terms of the *Bank Act*,[328] utilized by banks on a nationwide basis, seems to be an adequate instrument to ease the supply of funds to SMEs by these providers of financing.[329] In addition, it appears that the provincial secured transaction legislations is permitting non-bank lending institutions, such as credit unions and caisses populaires, to increase their ability to facilitate funds to SMEs through secured credit transactions.[330] These two elements of the legal framework of SME financing seem to be contributing in making bank and credit union and caisses populaires loans the most common source of financing sought by SMEs.[331]

However, it seems that it is possible to improve the role of one of the players in SME financing: the BDC.[332] In this sense, it appears that the *BDC Act*[333] could be modified in order to help BDC to make its loans more attractive to SMEs[334] and to

[328] Supra note 80, section 427.
[329] See the arguments of the Supreme Court of Canada in Bank of Montreal v. Hall, supra note 100, and section 2.7 of Chapter 2 for an explanation of why the uniform *Bank Act* security interest is an important element to facilitate the supply of funds to SMEs.
[330] See Harmonization of the Federal Bank Act Security and the Provincial Secured Transaction Regimes, supra note 115.
[331] See section 2.3 and 2.4 of Chapter 7 above, for more information on this topic, especially footnotes 47 and 62. See also section 2.7 of Chapter 7 above for more information on the advantages that banks have over other non-bank lending institution in obtaining security interest at both federal and provincial levels.
[332] See Chapter 2, section 2.11.1, for an indication of the use of BDC's term loans by SMEs.
[333] Supra note 170.
[334] See section 2.11.1 of Chapter 2 for more information on this topic.

enhance BDC's ability to provide more financial assistance to SMEs which operate in the knowledge-based economy, especially in the form of equity capital.[335]

With respect SME taxation issues, it appears that the legal framework of SMEs is supporting the future of these companies especially through the *Income Tax Act.*[336] Through the use of the small business deduction[337] of section 125 of the *Income Tax Act*,[338] SMEs are levied with the lowest federal corporate income tax rate on the first $200,000 of SME active income.[339] In the same direction and in order to provide further assistant in this issue, the Federal government will modify the *Income Tax Act*[340] to raise the business limit of the small business deduction from $200,000 to $300,000 over a 4 year period.[341] It is believed that this move will permit SMEs to retain more income to reinvest in their ventures since a larger part of their incomes will be taxed at the lowest federal corporate income tax rate of 12%.[342]

Similarly, the *Income Tax Act*[343] sustains SME activities through additional taxation measures designed to promote investments in these companies. Namely, the tax free small capital gains rollover, which allows investors to defer the taxation of capital gains on investments in eligible SME shares if the proceeds of disposition of their shares

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335 *Ibid.* See also, the Budget Plan 2003, supra note 190, at 129.
336 Supra note 257.
337 See section 3.4 of Chapter 3 above for an explanation of the small business deduction.
338 Supra note 257.
339 See section 3.3 and 3.4 of Chapter 3 above for more information on this topic.
340 Supra note 257.
341 Supra note 9. It seems that, to support SMEs' growth by means of taxation measures, the Federal government is following the example of the provinces of British Columbia, Saskatchewan and New Brunswick which have already raised their provincial small business limits, through amendments introduced to their respective income tax acts, to $300,000. The provinces of Alberta, Manitoba and Ontario are planning to raise their threshold even more to $400,000. See also, the Budget Plan 2003, supra note 190, at 334.
342 Supra note 9.
343 Supra note 257.

are reinvested in shares of another SME, [344] and the lifetime capital gains exemption, by which the first $500,000 of capital gains from the disposition of qualified farm property or shares of a SME are exempt from income taxes.[345]

It is the later issue, the lifetime capital gain exemption, which can be reformulated to respond to the new SMEs' business environment since it is not functioning adequately. In this sense, it can be argued that the ceiling of $500,000 should be increased in order to reflect the accurate value of the assets subject to this exemption because, since it was introduced in 1987, it has remained unchanged.[346] Therefore, it seems that the *Income Tax Act* should be modified in this issue to reflect the effect that the inflation has caused on the value of the qualified assets under this exemption.

The legal framework of SMEs as it relates to international trade issues presents the *EDC Act*[347] which adequately supports the assistance that EDC offers to SMEs. In this sense, it appears that EDC is an important partner for SMEs' international ventures, sustaining these companies to operate internationally by reducing their risks in foreign markets through EDC's insurance products and by facilitating the acquisition of their products through EDC financing offered to SMEs' foreign buyers.[348]

Nevertheless it seems that the *EDC Act*[349] presents some loopholes which can be addressed. Since EDC's assistance for SMEs, through either insurance or financing

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[344] *Ibid*, s. 44.1(1). The tax free small capital gains rollover was modified this year to increase its effectiveness in supporting investments in SMEs. See supra note 190, at 142. See also section 3.5 of Chapter 3 above for an explanation of the small capital gains rollover.
[345] *Ibid*, s. 80.03 (8). See also supra note 190, at 141.
[346] Supra note 9, at 9. See section 3.5 of Chapter 3 above for an explanation of the lifetime capital gains exemption.
[347] Supra note 294.
[348] See section 4.2 of Chapter 4 above for more information on this topic.
[349] Supra note 294.

products, is now focused in markets that present low risks[350] when in fact it should be focused on markets with high political and economical risks,[351] it could be argued that the *EDC Act*'s mandate is not being observed and should be redrafted to reinforce the idea that EDC's main goal is to support SMEs in those markets that really present risks for their businesses.[352] In addition, since most of EDC's assistance to SME is in the form of short-term financial services (as for the 12 month period ended on December 31, 2002) mainly concentrated in the forestry industry and not in the knowledge-based industry,[353] the *EDC Act*[354] should also be amended to reinforce the idea that EDC's assistance to SMEs should be focused not only on Canada's resource-based economy but also on its thriving knowledge-based economy.[355]

Special attention should be paid on the benefits associated with the harmonization of the federal *Bank Act*[356] security interest regime with the provincial secured transaction regimes for SMEs' activities and lending institutions' operations.[357] In addition, further study may be useful as regards the relevance of harmonizing the GST with the provincial sales taxes for SMEs' operations.[358]

Overall, the Canadian government is attempting via various programs and initiatives to support and sustain the SME sector. The measures included in the Federal Budget 2003[359] to support the growth and development of SMEs, especially through taxation incentives, are signals of this policy concern. In particular, for the extension of

[350] Canada's Bridge, supra note 296, at 40.
[351] Supra note 308.
[352] *Ibid.*
[353] Canada's Bridge, supra note 296, at ii.
[354] Supra note 294.
[355] Canada's Bridge, supra note 296, at ii.
[356] Supra note 80.
[357] Supra note 115.
[358] Supra note 237 and 238.

the assistance available, there is some evidence to argue that Canada is seriously considering the issues under analysis and that the government is using the legal framework of these areas to support SMEs' growth. However, one may argue that government expenditures through tax dollars in SME needs may be better allocated once the basic tax structure is in place and once adequate financing and export development counselling is in place.

Finally, the answer to the question of: is the legal framework relevant to SMEs growth? seems to be a very difficult one to answer. Even though SMEs need a legal framework which can be used in support of their activities, it seems that the growth of these companies is more related to the entrepreneurial spirit rather than to the existence of a supportive legal framework.[360] In fact, it is the innovative activity of the entrepreneur which usually leads the SME to create new opportunities for growth[361] and not the legal framework that regulates its activities.

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[359] Supra note 190. See also Building, supra note 13.
[360] See, for example, supra note 1; James R. Markusen Thomas F. Rutherford, "Developing Domestic Entrepreneurship and Growth through Imported Expertise," online: <http://sccie.ucsc.edu/events/pastevents/markusen.pdf>; Bruce A. McDaniel, *Entrepreneurship and innovation : an economic approach* (London: M.E. Sharpe, 2002).
[361] Dejardin, supra note 230.

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