BUDGET 2016: SMALL BUSINESS GETS SMALLER

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A long-standing policy underlying the *Income Tax Act* (the "**Tax Act**") has been to subject the first $500,000 of active business income earned by a "Canadian-controlled private corporation" (a "**CCPC**") to a reduced rate of taxation (the "**small business deduction**").

The low rate of federal tax on the first $500,000 of active business income earned by a CCPC was scheduled to be reduced to 9% by 2019. However, in Budget 2016, the Government announced that the low rate would be frozen at 10.5% for the foreseeable future.When initially introduced, the low tax rate was not limited to small businesses; in fact, it was available to any CCPC, regardless of its income earned or the size of its business. Over time, the availability of the small business deduction has been reduced. For instance, it is no longer available to CCPCs with taxable capital in excess of $15 million.

Budget 2016 continues the trend of increasingly restricting access to the small business deduction.

Under the existing rules in the Tax Act, corporate partners in a partnership are required to share the small business limit of $500,000, so that if there are four equal partners in a partnership, each corporate partner is only eligible to claim the low rate of tax on up to $125,000 of the partnership income allocated to it. This can be contrasted with the tax impact if the four corporations carried on business as a joint venture instead of a partnership, which would permit each corporate participant to claim the reduced tax rate on up to a full $500,000 of income from the joint venture.

As a result of these restrictions on partnerships, many partners (including a large number of lawyers and accountants), have used a variety of structures to conduct business with a partnership in an effort to maintain access to the low rate of tax on a full $500,000 of income.

One structure, described in the Budget papers, involved an accountant that was a member of a partnership forming a corporation (the "**service corporation**") to provide accounting services to the partnership of which he was a partner. If the service corporation were a partner of the partnership, the service corporation would have to share the $500,000 business limit with all the other partners of the partnership. However, as the service corporation only provides services to the partnership and is not a partner, the service corporation is not subject to the "specified partnership income" rules, which force the small business limit to be shared amongst corporate partners.

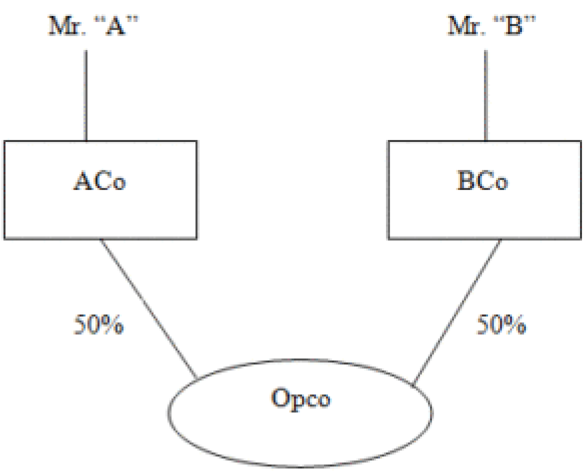
Budget 2016 seeks to nullify this type of planning by amending the definition of "specified partnership income" and adding the concept of a "designated member" of a partnership. A CCPC will be a "designated member" of a partnership if it provides services "directly or indirectly in any manner whatever" to the partnership, and a shareholder of the CCPC holds a direct or indirect interest in the partnership or a person that the CCPC does not deal with at arm's length holds a direct or indirect interest on the partnership. If a CCPC is a designated member of a partnership, it will be able to claim the small business deduction only in respect of income connected with the partnership to the extent of its proportionate share of the $500,000 business limit to be divided amongst all the partners and designated partners of the partnership.

Outside of the partnership context, Budget 2016 also imposes further restrictions on the ability of corporations to access the small business deduction. Aside from the special rules for partnerships, under the existing rules in the Tax Act, a corporation is required to share the $500,000 business limit with corporations that are "associated" with it within the meaning of section 256 of the Tax Act. Generally, corporations that control one another, or are subject to common control, are considered to be associated with one another.

Under the new rules, in addition to sharing the small business limit with associated corporations, a corporation (the "**supplier corporation**") will generally be limited in claiming the small business deduction on any income it earns from providing property or services directly or indirectly to another private corporation if the supplier corporation, a shareholder of the supplier corporation, or a person that does not deal at arm's length with the supplier corporation, or one of its shareholder holds a direct or indirect interest in the private corporation receiving the property or services (in this bulletin, referred to as the "**loosely connected private corporation**"). The supplier corporation will generally be able to claim the small business deduction only against income earned from the supply of services or property in this circumstance to the extent that the loosely connected private corporation allocates a portion of its small business limit to the supplier corporation.

Prior to the introduction of these proposed amendments, a common structure adopted by two individuals operating a business was as follows: Mr. "A" owns all the shares of ACo. Mr. "B" owns all the shares of BCo. Each of ACo and BCo owns 50% of the shares of Opco, which operates a small business (see Figure 1). Each of ACo and BCo provide services to Opco. As there is no common control, none of the corporations are associated and each of ACo, BCo and Opco could claim the small business deduction on the first $500,000 of income connected with the subject enterprise, for a total of $1,500,000 of income eligible for the small business deduction.

Figure 1



Under the new rules, only Opco will be eligible for the small business deduction on $500,000 of income connected with the subject enterprise unless it elects to share its business limit with ACo and/or BCo, thus limiting the total amount of income eligible for the low rate of tax amongst all three corporations to $500,000.

(An exception to the new restriction will apply if all or substantially all of the active business income of a supplier corporation for a taxation year is earned from providing services or property to arm's length persons other than the loosely connected private corporation.)

A disturbing wrinkle in the new rules is that any claim to the small business deduction with respect to income from services or property provided to a loosely connected private corporation will not be allowed, notwithstanding compliance with all the provisions of the Tax Act, that is in excess of "an amount that the Minister determines to be reasonable in the circumstances". No guidance is given in the Budget proposals as to how the Minister will determine if an amount is reasonable.

Granting such a broad discretion to the Minister is not in accordance with the rule of law and is out of place in a statute which is based on the application of detailed rules to facts to determine taxes payable. Even the General Anti-Avoidance Rule in the Tax Act is based on the interpretation by the court of a misuse of the provisions of the Tax Act and not on the Minister's view as to what is reasonable.

Associated Corporation Anti-Avoidance Rule

The Government has become concerned that taxpayers have been making use of the elective provisions in subsection 256(2) of the Tax Act in a manner not intended by the legislature in order to effectively permit two corporations to not be considered to be associated with one another for the purpose of maximizing access to the small business deduction, while retaining the ability to characterize investment income that one corporation receives from the other as active business income (by virtue of the corporations continuing to be considered to be associated for this particular purpose). The Government proposes to amend subsection 256(2) of the Tax Act to counteract such planning.

Personal Services Business Tax Increase

To prevent employees from gaining access to the deductions available to the self employed and the lower tax rate available to small business corporations, the Tax Act has created a set of rules that deny these benefits to persons that form corporations that engage in the business (a "**personal services business**") of providing the services of a shareholder of the corporation or a related person in circumstances where, in the absence of the corporation, the person providing those services would be considered an employee. Under these rules, a corporation that operates a personal services business is not eligible for the small business deduction or the general tax rate reduction. However, with the increase in the top personal marginal tax rate, in the absence of other changes, the Government felt that too large a deferral benefit would be available to a corporation that carried on a personal services business over the taxation rate that would be imposed on an employee. Consequently, Budget 2016 proposes an additional tax on income from a personal services business of 5% to increase the federal tax rate on this income from 28% to 33%.

by Michael Templeton

A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.