

Think the new small business deduction rules don't affect you? Think again!

Moodys Private Client
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Proposed amendments to the *Income Tax Act* introduced in the 2016 Federal Budget will significantly alter the Small Business Deduction (SBD) scheme for taxation years that begin following March 21, 2016. An admittedly over-simplification of the complexities of these amendments is that they aim to restrict the multiplication of the SBD in which unassociated corporations provide services to a partnership or corporation a partner or shareholder of which is not at arm's length with the service-providing corporation. A simple example of this is HusbandCo providing services to WifeCo. There has been much discussion, and there is sure to be more, on the application of these amendments to the structures they are intended to effect; however, that is not the subject of this blog.

The breadth of these amendments reaches the most basic of planning and circumstances, and all practitioners should be aware – as we'll describe in a couple of situations below.

Situation #1 – Consider the very 'run-of-the-mill' sister structure of OpCo and LandCo. OpCo and LandCo are family-owned. OpCo operates the business of the family and LandCo owns a building that is leased to OpCo as the office or retail space for the business. This is a very common structure implemented for creditor-proofing and other purposes.

As in previous years, OpCo and LandCo make an agreement allocating the SBD they share as associated corporations. By virtue of existing subsection 129(6), LandCo's lease revenue from OpCo is deemed active business income to which LandCo's allocated portion of the OpCo-LandCo shared SBD may be applied... Right? Wrong! Not anymore, at least not without more from the tax preparers for OpCo and LandCo.

LandCo's lease revenue from OpCo is income meeting the description in subparagraph (a)(i) of the proposed definition for "specified corporate income" in subsection 125(7). The shareholders of LandCo directly or indirectly hold an interest in OpCo and substantially all of LandCo's active business income is from OpCo. This income is 'carved-out' from the SBD, unless OpCo assigns a portion of its business limit to LandCo. Proposed subsection 125(3.2) provides that the assignment be made by prescribed form filed by (i) the payor corporation (OpCo) in its return of income for its taxation year and (ii) the recipient corporation (LandCo) in its return of income for its taxation year. In short, the existing benefits and effects of this common structure can still be achieved, but only if the tax preparers for OpCo and LandCo recognize that the proposed amendments require additional filings.

Situation #2 – The proposed amendments will have a greater effect when a corporation earns active business income from a private corporation that has a shareholder dealing not at arm's length with the first corporation, no matter how small that shareholder's interest. Consider the following example: Mr. X operates his business through a corporation (ElectricalCo). ElectricalCo is awarded a contract by a private corporation (ConstructionCo). The contract is significant and represents 40 per cent of ElectricalCo's active business income for the year. Mr. X's brother happens to be an employee of ConstructionCo and ConstructionCo has an employee stock option program in which Mr. X's brother

participates (e.g. Mr. X's brother has a 3 per cent interest in ConstructionCo).

Similar to situation #1 above, ElectricalCo's active business income from the ConstructionCo contract is income meeting the description in subparagraph (a)(i) of the proposed definition for "specified corporate income" in subsection 125(7). A person who does not deal at arm's length with Mr. X and ElectricalCo (i.e. Mr. X's brother) holds an interest in ConstructionCo (the insignificance of that interest is not consequential); and it cannot be said that substantially all of ElectricalCo's active business income for the year is from sources other than ConstructionCo, given that that income represents 40 per cent of ElectricalCo's active business income for the year. Accordingly, the income from the ConstructionCo contract is 'carved-out' of ElectricalCo's SBD, unless the subsection 125(3.2) assignment is made. However, unlike in situation #1, ConstructionCo and ElectricalCo deal at arm's length, so it is difficult to imagine ConstructionCo assigning a portion of its business limit to ElectricalCo.

Suppose ElectricalCo had \$500,000 of active business income for the year, including \$200,000 of income from the ConstructionCo contract. The loss of the SBD on the ConstructionCo contract income eliminates the 13.5 per cent deferral on that \$200,000 (\$27,000) and bears a \$3,680 increased overall tax cost of paying out the income as dividends.^[1]

The workings of the proposed amendments to the SBD regime are complex. The above examples serve only to demonstrate the potential far-reaching application of the amendments. Variations of these examples may have similar consequences and other considerations may be at play as well, such as the extent of the assignee-corporation's active business income, which will not be caught by the proposed amendments. Nevertheless, the examples highlight that all business owners and their advisors need to review the application of the SBD to their active business income, including the source of that income. Active business income from a source in which a party not at arm's length has a direct or indirect interest, no matter the size of that interest, is cause for a second look.

^[1] 2016 Alberta highest rates assumed.