

TAX ALERT



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November 2016

The small business deduction

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The small business deduction has been the focus of much attention recently, with perceived abuse of the available deferral provided to corporations. Of particular concern are corporate and partnership structures that work around the existing partnership and association rules to multiply their small business deductions. In response, the 2016 Federal Budget has taken steps to close these gaps in the legislation and limit the use of the small business deduction to its original intention.

What's new?

Effective for taxation years beginning after March 22, 2016, legislative changes limit access to the small business deduction for certain partnership and corporation structures. In particular, those structures in which a corporation provides property or services to a partnership or another corporation with *common* ownership will be affected.

Background

The small business deduction (SBD) is a tax deferral available for Canadian Controlled Private Corporations (CCPCs) amounting to a maximum tax credit of 17.5 per cent on a CCPC's first \$500,000 of active business income. Each associated group of CCPCs is entitled to one \$500,000 business limit, which may be allocated among the group. Similarly, a CCPC that is a member of a partnership may claim an SBD equal to the lesser of its active business income earned from the partnership and its proportionate share of the partnership's notional \$500,000 business limit.

The Changes

Overview

The 2016 Federal Budget introduced the concepts of "designated member," "specified corporate income" and the exclusion of certain types of property income earned from associated corporations for the purposes of claiming the SBD. These changes have closed

previous gaps in the legislation that allowed for the unintended multiplication of SBDs.

Designated member and specified corporate income

If you are a member of a partnership and property or services are provided (directly or indirectly) to that partnership through a non-member CCPC of which you are a shareholder (or are related to a shareholder), that CCPC may be considered a designated member of the partnership. A designated member will no longer be entitled to its own SBD. The CCPC will only have access to the SBD to the extent that its related partner assigns that partner's portion of the partnership's \$500,000 business limit to it.

Similarly, if you are a shareholder of a CCPC that provides property or services (directly or indirectly) to another (recipient) CCPC in which you own an interest, the first CCPC may be deemed to earn specified corporate income. A CCPC earning specified corporate income is no longer entitled to its own SBD. The CCPC may only claim an SBD to the extent that the recipient CCPC allocates a portion of its \$500,000 business limit to it.

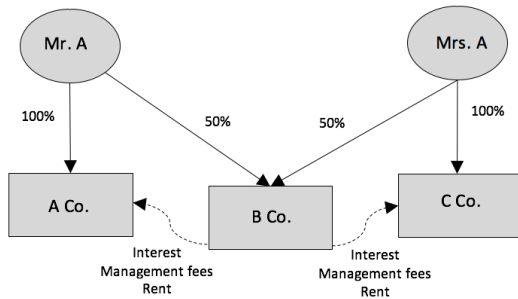
Income from property earned from associated corporations

The SBD is intended for active business income (ABI) and not income from property (i.e. rent, royalties, interest). The Income Tax Act (Canada) (the Act), however, does provide an exception for income from property earned from an associated corporation

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if that corporation earns ABI. Consider, for example, the corporate structure in the image below. Interest, management fees or rental income earned from A Co. and C Co. are income from property but are deemed to be ABI, assuming B Co. is earning ABI. This re-characterization allows A Co. and C Co. to claim the SBD. The issue arises when the group also makes an election under s. 256(2) of the Act – the so-called “third corporation election” – to disassociate two corporations that are only associated through a third corporation. This election will now break the re-characterization of income from property, and CCPCs like A Co. and C Co. will no longer be entitled to the SBD.



B Co. elects under s.256(2) to not be associated to A Co. and C Co. As a result, the interest/management fees/rent earned by A Co. and C Co. are no longer considered to be ABI.

So, what do we do now?

If any of the above structures sound familiar and you think your days of paying low corporate rates are over, we may be able to provide some comfort.

Don't worry about it!

Your corporate structure will continue to provide the benefit of low corporate tax rates of between 25 per cent and 30 per cent, depending on your province. With top marginal rates paid personally of 50 per cent or more, there is still a significant deferral available by earning income through a corporation.

In addition, the SBD is, in fact, a deferral of tax and not a true tax savings due to the concept of integration, which provides a correlation between corporate, dividend and personal tax rates. Integration ensures the government eventually receives its approximately 50 cents on every dollar earned, whether it is earned through a corporation first and then paid out to the shareholders, or earned by the shareholders directly. For income earned through a corporation, the tax rate paid by the shareholder on dividend income is adjusted to account for the tax rate paid by the corporation. Thus, income that is taxed at the higher, non-small business rate in a corporation can be paid to its shareholders as eligible dividends, which are taxed favorably at the personal level. On the other hand, income taxed at the small business rate in a corporation must be paid to the shareholders as ordinary dividends, which are taxed at a higher rate than eligible dividends.

If your corporation is not taking advantage of the deferral by reinvesting its after-tax earnings into its operations and instead paying the majority of it out to its shareholders each year, these changes will not significantly affect your overall tax bill, as illustrated hereⁱ:

ⁱ This calculation is based on the combined federal and Ontario provincial tax rates and assumes the highest personal marginal tax rate.

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	Proprietorship	Active business income < \$500,000	Active business income > \$500,000
Taxable income	\$100,000	\$100,000	\$100,000
Corporate tax @ 15% (small business rate)		\$15,000	
Corporate tax @ 26.5% (general rate)			\$26,500
Net income	\$100,000	\$85,000	\$73,500
Personal tax on ineligible dividend @ 45.33%		\$38,530	
Personal tax on eligible dividend @ 39.34%			\$28,915
Personal tax on income	\$53,530		
Net after-tax income	\$46,470	\$46,470	\$44,585

Consider other arrangements

If the deferral provided by the SBD is vital to your business, consider the following strategies.

Separate your businesses

If you can reasonably separate your business into smaller business units that can then be spun off to separate corporations,

you may be able to increase your access to the SBD. For example, if you operate two franchise locations within one corporation, you may want to separate each location into its own corporation. This spin-off can generally be done on a tax-deferred basis and, if the ownership is structured properly, may allow for multiple SBDs. There are, of course, non-tax issues to consider, such as franchise, employment, banking and supplier agreements. A recent decision by the Federal Court of Appealⁱⁱ suggests that actual control of each corporation is a relevant consideration, looking at factors other than mere share ownership.

Joint ventures and cost-sharing arrangements

A group of individuals in the same line of business may enter an agreement to share costs without the formality of a partnership or central billing corporation. The individuals run their businesses through their existing corporations, maintaining their own customers and the ability to claim the small business deduction. However, the benefits of sharing costs (such as overhead, administrative costs and staffing costs) that a partnership affords remain available through the joint venture or cost-sharing agreement. Again, there are non-tax considerations that may make these arrangements impractical for certain businesses. For example, joint ventures do not limit the legal liability of their venturers.

Contact your Collins Barrow advisor to discuss further how these changes may affect your business.

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