# The Federal Government Attacks Structures Used to Multiply the Small Business Deduction

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## What is the Small Business Deduction?

The small business deduction ("SBD") is an incentive deduction that provides small Canadian controlled private corporations a reduced corporate income tax rate of 15% on their first $500,000 of active business income earned each year. This is opposed to the normal tax rate on active business income of 26.5%. As you can see, the SBD represents a potential tax savings of $57,500 per year.

## Why the Government is Concerned

Given the potential tax savings, there is an incentive to try to get more than one small deduction through the use of many tax planning techniques. As a result, the Income Tax Act contains various anti-avoidance rules that attempt to block attempts to multiply the small business deduction within groups of corporations subject to common control.

Two of these tax planning techniques came under fire by the Federal government in the 2016 budget. With the advent of professional incorporation in Canada, many professionals are looking for more tax efficient structures for their practices.

## Tax Measure #1 – Specified Partnership Income

The first avoidance structure is commonly used by professional partnerships, such as lawyers and accountants. If the partners of the partnerships were professional corporations ("PC"), each of the corporate partners would have to share one $500,000 small business deduction. If partner A, being PC A, was entitled to one third of the partnership's income, Then PC A would only be able to claim a SBD on up to one-third of the $500,000 SBD limit. This is called the Specified Partnership Income rules. To get around this, professionals remained as individual partners in their partnerships, but incorporated their own stand-a-lone PCs, which remained outside of the partnership. These PCs would have the professional as an employee and would provide professional services to the partnership. This structure would give each PC their own $500,000 SBD.

In order to attack this structure, the 2016 Federal budget expanded the Specified Partnership Income definition to include the income earned by the PC from providing, either directly or indirectly, services or property to a partnership as a "designated member" of the partnership. A designated member of a partnership will generally be considered a corporation that is not a member of the partnership, but the corporation is owned by a person who is a direct member of the partnership or by a personal who does not deal at arm's length with the person who is a direct partner of the partnership and more than 10% of the corporation's income is derived from the partnership.

### Tax Measure #2 – Specified Corporate Income

The second avoidance structure is very prevalent in many industries. Given that most small business corporations are family owned, it was not uncommon for the business to be divided in business segments with each business segment controlled by one family member. Under the existing rules, this would be permissible and multiple SBDs could be created. A common example of this is in a professional practice where the professional's spouse would incorporate a separate corporation to provide management services and rent office equipment to the professional practice. This structure created a separate SBD and provided an opportunity for family income splitting between the professional and their lower income spouse and children.

In order to combat this second avoidance structure, the 2016 Federal budget creates the concept of "Specified Corporate Income" ("SCI"). Income that is SCI would not be eligible for the SBD even though it may be active business income. SCI would simplistically be considered income earned from the provision of services or property, either directly or indirectly, to a corporation with which the corporation (or one of its shareholders) does not deal at arm's length. There would be an exception where less than 10% the corporation's income is derived from arm's length parties. These rules will cast a very broad net, even to corporations that are neither associated or related for purposes of the ITA.