

TSG SEMINAR CHANGES TO THE SMALL BUSINESS DEDUCTION

Tuesday, February 7, 2017



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CHANGES TO THE SMALL BUSINESS DEDUCTION (SBD)

- NEW RULES – Federal Budget, March 22, 2016
- Limitations on Access to SBD
- Structures Impacted
 - Professional partnerships and SPI
 - Inter-corporate management fees
 - “multiple-access” structures
 - Specified Corporate Income and SCI
- New SEC 256(2)

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New tax rules were introduced in the 2016 Federal budget to curtail the access and multiplication of the Small Business Deduction (SBD), through the use of corporate structures (including corporate structures of unrelated corporations) and also through the use of inter-company management fees.

A new concept was created by defining “Specified Corporate Income” (SCI). In addition restrictions and new rules were introduced to deal with corporations making a joint subsection 256(2) election.

CHANGES TO CORPORATE AND PARTNERSHIP STRUCTURES GOVERNMENTS CONCERN'S

- Aggressive corporate structures have been developed by individuals that side step the association rules under ss. 256 of the ITA;
- The above is true especially in a related party context whereby two corporations may be related but not associated each claiming their own SBD based on one receiving revenue from each other;

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Since the tax rules dealing with “association” dealt primarily with “ownership” and “control” issues, it was possible for 2 related corporations to have 2 separate and distinct Small Business Deduction (SBD) limits, as long as there was no common control or cross-ownership interest that would associate the two corporations. Now it may not be possible to achieve 2 separate SBD limits, if one of the corporations is receiving revenue from the other corporation.

CHANGES TO THE SBD

- Proposed new rules to restrict multiplication of the SBD
- Can apply where CCPC provides services of any kind to a private corp or partnership
- NEW SPI (Specified Partnership Income) definition
- Where CCPC, one of CCPC's shareholders or NAL person dealing with CCPC, holds an interest in private corp
- Effective for taxation years beginning on or after

March 22, 2016



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These new rules will apply to corporations for taxation years commencing on or after March 22, 2016.

In addition, the new rules can apply to corporate structures, where a CCPC provides services of any kind to another private corporation or a partnership. New Specific Partnership Income (SPI) rules have been introduced which will deem the income earned by the CCPC providing such services, to be Specified Partnership Income, and also be deemed to have a SBD allocation of NIL.

Similarly, where a CCPC provides services and receives fees from another private corporation (the “payor” corporation), in which any non-arm’s length person holds an interest, income received by the CCPC (“recipient corporation”) will be deemed to be SCI and there will be no SBD limit allocated to such income unless a joint election is filed to allocate a portion of the payors corporation’s SBD limit to the recipient corporation.

CHANGES TO PARTNERSHIP STRUCTURES

- Structures created to avoid the “specified partnership income rules” (“SPI”) in the ITA;
- Generally, a Canadian Controlled Private Corporate (“CCPC”), that is a member of a partnership can claim the lesser of:
 - The active business income that it receives as a member of the partnership; **and**
 - Its pro-rata share of the annual \$500,000 business limit determined at the partnership level.
- Structures implemented were as follows:

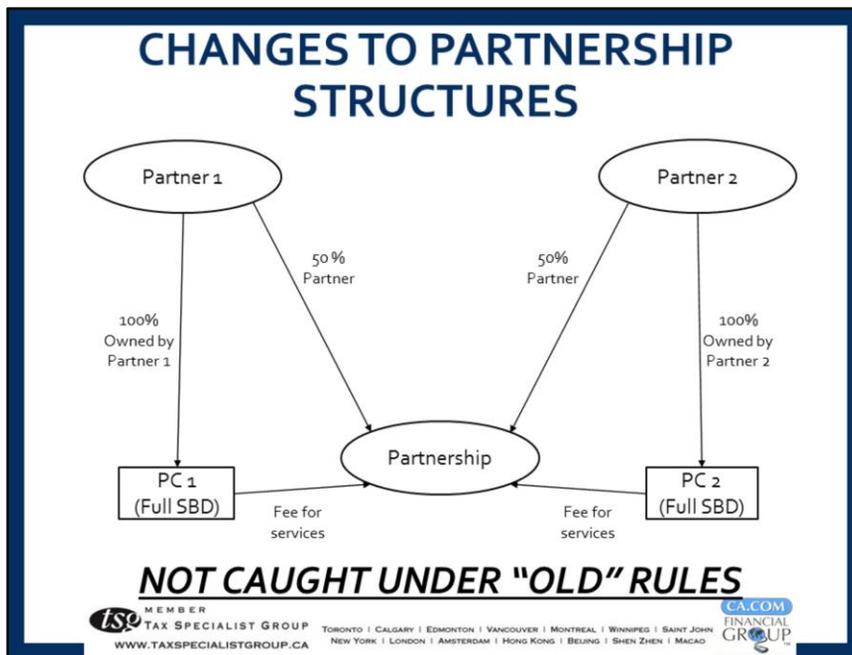


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Under the “old” rules, tax provisions were already in place to limit and effectively allocate only one (1) \$500,000 Small Business Deduction to corporate members of a partnership. The proportion that a particular corporate partner received of the \$500k SBD limit, was based on that corporate partner’s share of the overall taxable partnership profits.

However, structures were devised to somewhat circumvent these Specified Partnership Income (SPI) rules, by having a non-member CCPC earn active business income from the partnership. Under the “old” rules as long as the CCPC was not an owner or “member” in the partnership, the CCPC enjoyed its own SBD limit, and income paid to it by the partnership, would be deemed to be active business income for tax purposes.



Note that in this structure, only the individuals (being Partner 1 and Partner 2) are actually equity partners in the partnership. Any partnership income allocated to them would be subject to tax on their personal tax returns. However, fees charged by PC1 and PC2 to the partnership, would be treated as active businesses income in each such corporation. Insofar, as Partner 1 and Partner 2 are unrelated, each PC would be entitled to its own \$500k SBD limit. This structure worked not only for 2 Partners of the partnership, it also worked for large structures with many partners and PC's, thereby enabling a significant multiplication in the SBD.

CHANGES TO PARTNERSHIP STRUCTURES

Under "Old" Rules

- Professional Corporation 1 ("PC1") and Professional Corporation 2 ("PC2") provide services to the partnership that is owned by Partner 1 and Partner 2
- Partner 1 and Partner 2 deal at arm's length
- Services provided by PC1 and PC2 are considered income from an active business as defined in ss.125(7) of the ITA;
- PC1 and PC2 are not related to each other pursuant to ss.251 of the ITA;
- PC1 and PC2 are not associated to each other pursuant to ss.256 of the ITA;
- PC1 and PC2 are each entitled to their own SBD pursuant to ss.125 and their income would not be considered SPI;
- Partner 1 and Partner 2 who are individuals would not be subject to the SPI rules under the ITA.

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There are many instances where CRA provided "positive" tax rulings for such structures.

CHANGES TO PARTNERSHIP STRUCTURES NEW RULES – DESIGNATED MEMBER OF PARTNERSHIP (SS.125(7))

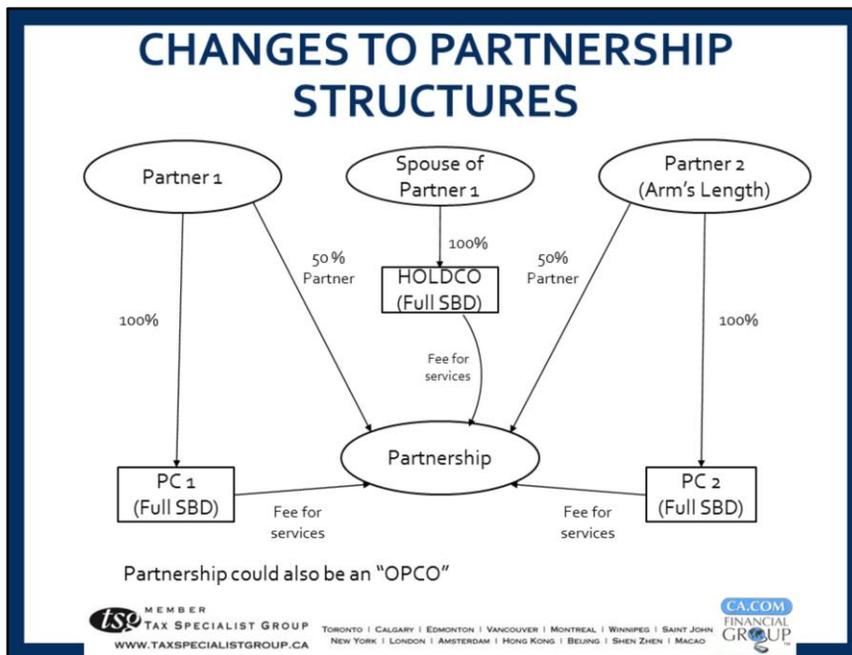
- CCPC provides services to a partnership, where:
 - CCPC is not a member of the partnership **and**;
 - Either a shareholder of the CCPC is a member of the partnership **or**;
 - The CCPC does not deal at arm's length with a member of the partnership **and**;
 - Greater than 10% of the CCPC's income from an active business is from providing services to persons or partnerships with which the CCPC does not deal at arm's length.

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The new rules significantly change this landscape and implement an abrupt end to the tax benefits achieved through multiplication of the SBD. One exception exists – where the CCPC generates less than 10% of its revenues or services to persons or partnerships with which either the CCPC does not deal at arm's length or from a corporation or partnership with which another non-arm's length person holds an interest, then such income would not be caught under the new rules. However, that would rarely be the case, as the CCPC would generally be receiving almost all, or substantially all of its revenues from that partnership or corporate entity.



In this scenario, the HOLDCO owned by the spouse will be deemed to be a “Specified Partner” of the partnership for purposes of the SBD, even though HOLDCO does not hold an equity interest in the partnership. Under the new rules this means that the income that it earns from the partnership in fees, will be Specified Partnership Income (SPI) for purposes of the SBD, and its SBD limit will be deemed to be NIL, unless a joint election is made with PC1 to allocate some of its proportionate share of the \$500k Specified Partnership Income – SBD limit to the HOLDCO. Similar rules will apply if the partnership was instead structured as a corporation.

CHANGES TO PARTNERSHIP STRUCTURES

Old Rules

- Partner 1 and Spouse of Partner 1 related to each other pursuant to ss.251(2)(a) of the ITA;
- PC 1 and HOLDCO each related under ss.251(c)(ii) BUT NOT ASSOCIATED;
- Income earned by HOLDCO considered ABI under ss.125(7) of the ITA;
- Since HOLDCO is not a partner in the partnership it is not subject to the SPI rules in ss.125(7) of the ITA and is entitled to a full small business deduction on its fees earned from the partnership.

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Under the “old” rules, the Specified Partnership Income (SPI) rules contained in subsection 125(7) of the Act did not apply, and HOLDCO would enjoy its own SBD limit.

CHANGES TO PARTNERSHIP STRUCTURES

New Rules

- Partner 1 and Spouse of Partner 1 related by ss.251(2)(a) of the ITA;
- PC1 and HOLDCO also related by sec 251 (c)(ii) of the ITA;
- But PC1 and HOLDCO not associated to each other pursuant to ss.256 of the ITA;
- Now ... HOLDCO deemed to be designated member of the partnership because:
 - PC1 is not a member of the partnership; and;
 - HOLDCO does not deal at arm's length with Partner 1; and;
 - Partner 1 holds a direct interest in the partnership.

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Note that there is no requirement for the spouse or the spouse's HOLDCO to actually own an equity interest in the partnership (or a payor corporation). The fact that it receives fee income from an entity in which a non-arm's length, related person holds an interest, is sufficient for the new rules to apply.

CHANGES TO PARTNERSHIP STRUCTURES

New Rules (Continued)

Now what?

- HOLDCO deemed to be a member of the partnership - Sec. 125(7)
- Its active business income from providing services to the partnership deemed to be specified partnership income (SPI)
- SPI deemed to be NIL
- Joint election available to assign SPI limit to deemed member

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In effect, HOLDCO's active business income, from providing services to the partnership, will now be deemed to be Specified Partnership Income (SPI). The SPI will be deemed to be NIL to the HOLDCO unless a joint election is filed to assign a SPI limit to the deemed partnership member.

SUMMARY TAX RULES FOR PROFESSIONAL CORPORATIONS

Small Business Deduction - SBD

New Rules

- Applies for taxation years beginning after March 22, 2016
- Specified Partnership Income (SPI) of each "deemed" PC Partner will be NIL
- Non-arm's length partner of Partnership can assign their SPI to their PC
- Impact: PC's and related corps must all share 1 annual \$500k SBD limit



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The overall impact of these new rules is that there will be one annual \$500k SBD limit, where there is one business. The overriding objective that Finance wanted to achieve, was to curtail and eliminate the multiplication of the SBD. This has been effectively achieved; albeit with some limited opportunities to multiply the SBD where it is possible to carve out and incorporate a truly separate business imbedded in the same entity.

CHANGES TO PARTNERSHIP STRUCTURES

Possible Solutions?

- Joint venture;
 - Each Participant claims its own SBD
- Franchising model;
 - Partners license the name of the partnership and own their own independent offices.
- Cost sharing model;
 - Cost sharing model in place, and partners are now independent entities.



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Other planning might include abandoning conventional models such as the partnership or a corporation in favour of a joint venture or “cost-share” structure. In order for this to work effectively for a practice of incorporated professionals, each of the “partners” would need to carry on an independent business, as a separate legal entity, with an agreement to share in certain common costs. The change to this type of structure might not be feasible in a practical manner of speaking.

CHANGES TO PARTNERSHIP STRUCTURES

Possible Solutions?

Key issues with the above mentioned solutions:

- How will the ex-partners bill for their services?
- There might be a need to manipulate the cost sharing arrangement to achieve a same or similar result as before;
- Will these structures become an accounting nightmare?
- What are the Income, HST, land transfer and payroll tax consequences to the partners of the dissolution of the partnership?
- Will the Canada Revenue Agency allege a joint venture is in fact really a partnership?
- Significant costs could be incurred to implement a new structure;
- In summary agreements will have to be carefully drafted.

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Other considerations to keep in mind, of “switching” to a different business model is:

- How would the billings, collections, cost allocations actually work?
- Will the accounting become too complex?
- Will CRA challenge the structure as “one business” in any event?

CHANGES TO CORPORATE STRUCTURES

NEW CONCEPT – SPECIFIED CORPORATE INCOME (SS.125(7)) (“SCI”)

- Specified corporation income, means the lesser of:
- Income from the provision of services or property to a private corporation if:
- The corporation or one of its shareholders or a person not dealing at arm’s length with one of them with one of them, holds a direct or indirect interest in the private corporation receiving the services;
- More than 10% of the corporation’s income from an active business is from providing services to persons or partnerships with which the corporation does not deal at arm’s length.

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The new concept of the Specified Corporation Income (SCI) will apply when a CCPC provides services to another corporation, and that corporation (or persons who do not deal at arm’s length with that corporation) holds a direct or indirect interest in the corporation to which services are provided. The one exception occurs, if the income from such services, comprises less than 10% of the total income earned by the CCPC providing the services.

If it does not meet this exception, then the income will be deemed to be SCI and that income will not be eligible for the SBD, unless a joint election is filed with the payor corporation to allocate a portion of its annual \$500k SBD to the CCPC.

CHANGES TO CORPORATE STRUCTURES NEW CONCEPT – SPECIFIED CORPORATE INCOME (SS.125(7)) (“SCI”)

- New concept of SCI will deny the SBD on intercompany fees between companies in related groups or with “common interests”;
- Companies that are related under ss.251 but not associated under ss.256 will be caught.

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Note that the new SCI rules apply even where the two corporations are not associated. In fact, the two corporations can be entirely unrelated, and the SCI provision could apply, if a person directly or indirectly has ownership in the “payor” corporation and that person is related to the recipient CCPC providing the services. The SCI provisions are far-reaching and will potentially apply to many structures.

SMALL BUSINESS DEDUCTION

Conception Overview

These next slides courtesy of and with acknowledgement to...

MOODYS GARTNER – Kim Moody, FCA, TEP
and
LEWIS & COMPANY – Hugh Wooley, CPA, CA

TSG Annual Conference – Toronto
January 16, 2017



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SMALL BUSINESS DEDUCTION

Conception Overview of Draft Legislation

- Proposed rules initially carve out three types of income of a CCPC from being eligible for SBD:
 - A. Clause A carve out active business income (“ABI”) earned by a CCPC from certain partnerships;
 - B. Clause B carves out ABI earned by a CCPC from a certain corporations (generally, exception exists for associated corporations); and
 - C. Clause C carves out ABI earned by a CCPC from a non-CCPC or a CCPC that makes an election under subsection 256(2) to not be associated with the recipient CCPC.

SMALL BUSINESS DEDUCTION

Conception Overview of Draft Legislation

- Income caught by Clause A or B excluded from SBD unless brought back into SBD eligibility as either:
 - Specified partnership income (“SPI”) –
 - if an actual member, based on its specified partnership business limit (“SPBL”), i.e. pro-ration of \$500,000;
 - if a “designated” member, will require an assignment of SPBL from a member; **OR**
 - Specified corporate income (“SCI”) –
 - Requires an assignment of business limit (“BL”) by the recipient of service or property.
- Income caught by Clause C cannot be brought back in.
- Anti-avoidance rules.

S.125(1)(A) – WHAT IS NOW ELIGIBLE FOR SBD?

125(1) Small business deduction – there may be deducted from the tax otherwise payable under this Part for a taxation year by a corporation that was, throughout the taxation year, a Canadian-controlled private corporation, an amount equal to the corporation's small business deduction rate for the taxation year multiplied by the least of

- a) the amount, if any, by which the total of
 - i. the total of all amounts each of which is the amount of income of the corporation for the year from an active business carried on in Canada, other than an amount that is
 - a. described in paragraph (a) of the description of A in the definition specified partnership income in subsection (7) for the year.
 - b. described in subparagraph (a)(i) of the definition specified corporate income in subsection (7) for the year, or
 - c. paid or payable to the corporation by another corporation with which it is associated, that is deemed by subsection 129(6) to be income for the year from an active business carried on by the corporation in circumstances where the associated corporation is not a Canadian-controlled private corporation or is a Canadian-controlled private corporation that has made an election under subsection 256(2) in respect of its taxation year in which the amount was paid or payable.
 - ii. the specified partnership income of the corporation for the year, and
 - ii.1 the specified corporate income of the corporation for the year

CARVE-OUT B – SUBPARAGRAPH (A)(I) OF SCI DEFINED IN 125(7)

- (a)(i) the total of all amounts each of which is the amount from an active business of the corporation for the year from the provision of services or property to a private corporation (directly or indirectly, in any manner whatever) if
- a. at any in the year, the corporation (or one of its shareholders) or a person who does not deal at arm's length with the corporation (or one of its shareholders) holds a direct or indirect interest in the private corporation, and
 - b. It is not the case that all or substantially all of the corporation's income for the year from an active business is from the provision of services or property to
 - i. Persons (other than the private corporation) with which the corporation deals at arm's length, or
 - ii. Partnerships with which the corporation deals at arm's length, other than a partnership in which a person that does not deal at arm's length with the corporation holds a direct or indirect interest, and...



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IF SUBJECT TO CARVE-OUT B, CAN IT BE BROUGHT BACK AS SCI?

If income is subject to carve-out B, it may still be brought back into s.125(1)(a) if it constitutes SCI

125(7) specified corporate income, of a corporation for a taxation year, means the lesser of

- a. the lesser of
 - i. [income subject to carve-out (B)], and
 - ii. the total of all amounts each of which is the portion, if any, of the business limit of a private corporation described in subparagraph (i) for a taxation year that the private corporation assigns to the corporation under subsection (3.2), and
- b. an amount that the Minister determines to be reasonable in the circumstances;



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ASSIGNMENT OF BUSINESS LIMIT – SUBSECTION 125(3.2)

125(3.2) For the purpose of this section, a Canadian-controlled private corporation (in this subsection referred to as the "first corporation") may assign all or any portion of its business limit under subsection (2), (3), or (4) for a taxation year of the first corporation to another Canadian-controlled private corporation (in this subsection referred to as the "second corporation") for a taxation year of the second corporation if

- a) the second corporation has an amount of income, for its taxation year, referred to in subparagraph (a)(i) of the definition specified corporate income in subsection (7) from the provision of services or property directly to the first corporation;
- b) The first corporation's taxation year ends in the second corporation's taxation year;
- c) The amount assigned does not exceed the amount determined by the formula

$$A - B$$

where

A is the amount of income referred to in paragraph (a), and

B is the portion of the amount described in A that is deductible by the first corporation in respect of the amount of income referred to in clauses (a)(a)(i)(A) or (B) for the year; and

- d) a prescribed form is filled with the Minister by
 - i. the first corporation in its return of income for its taxation year, and
 - ii. The second corporation in its return of income for its taxation year.



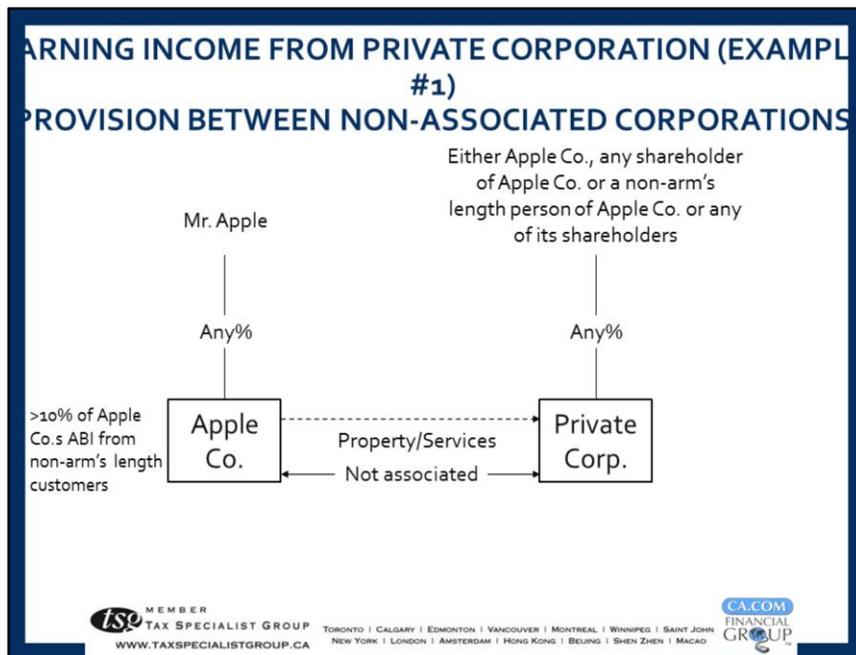
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- Apple Co's income from Private Corp carved-out under Clause B because:
 - Apple Co not associated with Private Corp;
 - Apple Co/one of its shareholders/a person not dealing with Apple Co or one of its shareholders hold interest in Private Corp; and
 - Not all or substantially all of Apple Co's ABI derived from providing services/property to arm's length persons.
- Apple Co may claim SBD on those income only if the income is SCI -> requires Private Corp to assign its business limit to Apple Co.

**EARNING INCOME FROM PRIVATE CORPORATION (EXAMPLE #2) –
CONT'D
ASSIGNMENT OF BUSINESS LIMIT**

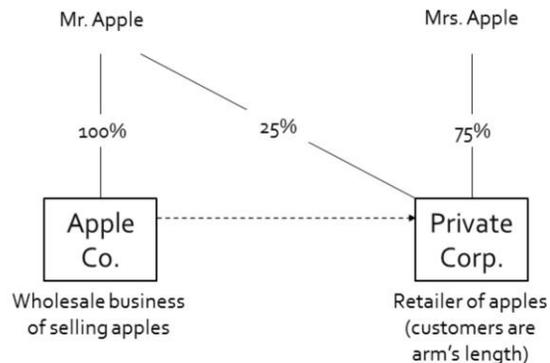
Numeric Illustration: (Cont'd from Example 1)

	<table border="0"> <tr> <td style="border: 1px solid black; padding: 5px; text-align: center;">Apple Co.</td> <td style="text-align: center; padding: 0 20px;"> ----- Services ----- </td> <td style="border: 1px solid black; padding: 5px; text-align: center;">Private Corp.</td> </tr> <tr> <td></td> <td style="padding-left: 20px;"> Revenue \$500,000 Related expenses <u>(\$300,000)</u> Net income \$200,000 </td> <td></td> </tr> <tr> <td></td> <td style="padding-left: 20px;"> Related to services </td> <td></td> </tr> </table>	Apple Co.	----- Services -----	Private Corp.		Revenue \$500,000 Related expenses <u>(\$300,000)</u> Net income \$200,000			Related to services		
Apple Co.	----- Services -----	Private Corp.									
	Revenue \$500,000 Related expenses <u>(\$300,000)</u> Net income \$200,000										
	Related to services										
Net income from other customers	\$300,000	Net income before paying Apple Co.	\$900,000								
Net income from Private Corp.	(\$200,000)	Payment to Apple Co	(\$500,000)								
Total Net income	\$500,000	Total Net income	\$400,000								

**EARNING INCOME FROM PRIVATE CORPORATION (EXAMPLE #2)–
CONT'D
ASSIGNMENT OF BUSINESS LIMIT**

- If Private Corp does not assign any of its \$500k business limit to Apple Co:
 - Private Corp may claim SBD on \$400,000 of ABI.
 - Apple Co may claim SBD on \$300,000 of ABI.
- Private Corp may choose to assign up to \$200,000 of its business limit to Apple Co. if it assigns \$100,000:
 - Private Corp may still claim SBD on \$400,000 of ABI.
 - Apple Co now has SCI of \$100,000 and regular ABI of \$300,000 -> may claim SBD on \$400,000 of ABI. However, Minister has power to deem SCI to be another amount it considers reasonable (could \$0).

EARNING INCOME FROM PRIVATE CORPORATION (EXAMPLE #3) PROVISION BETWEEN ASSOCIATED CORPORATIONS



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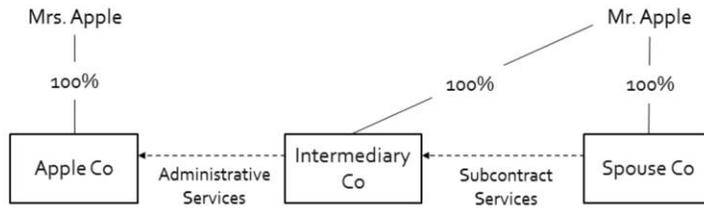
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- Income earned by Apple Co selling apples to Private Corp not carved out by Clause B because of the exception in 125(10):
 - Apple Co.'s income is active business income from provision of services/property to an associated corporation;
 - The amount is not deductible by the associated corporation (i.e. Private Corp) in respect of an amount included in its income that is referred to in any of the clauses (A), (B), or (C) carve-outs.
 - In other words, Private Corp's cost of buying apples from Apple Co is not deductible against income only subject to any of the carve-outs, because Private Corp retails apples to arm's length customers.
- Therefore, all active business income included in paragraph 125(1)(a), but Apple Co and Private Corp must share \$500,000 business limit as associated corporations under the usual rules.

EARNING INCOME FROM PRIVATE CORPORATION (EXAMPLE #4) BACK-TO-BACK SERVICE/PROPERTY PROVISION ARRANGEMENT

- Paragraph 125(10)(b) and Variable B of paragraph 125(3.2)(c) work in tandem to prevent taxpayers avoiding the 125(1)(a) carve-outs by using back-to-back service/property provision arrangements.
- If caught:
 - The association exception no longer applies, and
 - Business limit cannot be assigned.

EARNING INCOME FROM PRIVATE CORPORATION (EXAMPLE #4) BACK-TO-BACK SERVICE/PROPERTY PROVISION ARRANGEMENT



Net income before paying Intermediary Co	\$800,000	Admin Service Revenue	\$300,000	Subcontract Income	\$300,000
Admin fee to Intermediary Co	<u>(\$300,000)</u>	Subcontract fee to Spouse Co	<u>(\$300,000)</u>		
Total Net income	\$500,000	Total Net income	\$0		

**EARNING INCOME FROM PRIVATE CORPORATION (EXAMPLE #4) –
CONT'D**

BACK-TO-BACK SERVICE/PROPERTY PROVISION ARRANGEMENT

- Apple Co and Spouse Co, because they are not associated, each entitled to \$500,000 business limit.
- Without paragraph 125(10)(b), could multiple SBD entitlement simply by Spouse Co not assigning business limit to anyone:
 - Intermediary Co is indifferent because it earns net income of \$0;
 - Apple Co claims SBD on \$500,000 of net income because it did not assign business limit to anyone; and
 - Spouse Co earned its \$300,000 from Intermediary Co, an associated corporation, so subsection 125(10) would have deemed carve-out B to not apply. It also retained all its business limit, allowing it to claim SBD on the entire \$300,000 of net income.
- Result: SBD claimed on \$800,000



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**EARNING INCOME FROM PRIVATE CORPORATION (EXAMPLE #4) –
CONT'D**

BACK-TO-BACK SERVICE/PROPERTY PROVISION ARRANGEMENT

- 125(10)(b) therefore disallows the subsection 125(10) where such back-to-back arrangement is involved:
 - The exception is ineffective because the subcontract fee is deductible by Intermediary Co in respect of Intermediary Co's income referred to in carve-out B (Intermediary Co's revenue is from Apple Co, which is a corporation in which a non-arm's length person holds an interest and Intermediary Co does not earn all or substantially all of its active income from arm's length customers).
- However, paragraph 125(10)(b) alone is insufficient to prevent such arrangement.



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**EARNING INCOME FROM PRIVATE CORPORATION (EXAMPLE #4) –
CONT'D**

BACK-TO-BACK SERVICE/PROPERTY PROVISION ARRANGEMENT

- Even with paragraph 125(10)(b) – but without variable B of paragraph 125(3.2)(c), the group could do the following to avoid the 125(1)(a) carve-outs:
 - Apple Co would not assign its business limit, but Intermediary Co would assign its business limit to Spouse Co under subsection 125(3.2). Intermediary Co indifferent because its net income \$0.
 - As a result, even though the subsection 125(10) exception does not apply and carve-out B applies to the \$300,000 earned by Spouse Co, Spouse Co could still bring the \$300,000 back into SBD entitlement as SCI.
- Therefore, variable B of 125(3.2)(c) prevents assignment of business limit to the extent the amount is deductible against the assignor's income referred to in carve-out A or B.

**EARNING INCOME FROM PRIVATE CORPORATION (EXAMPLE #4) –
CONT'D
BACK-TO-BACK SERVICE/PROPERTY PROVISION ARRANGEMENT**

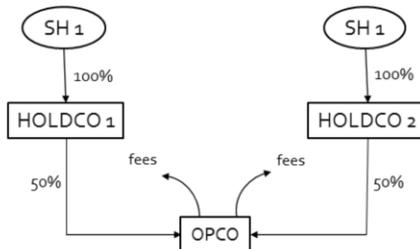
- Here is how the rules work together:
 - Since the \$300,000 subcontracting fee is deductible by Intermediary Co in respect of its own income referred to in carve-out B, the subsection 125(10) exception does not apply and Spouse Co's \$300,000 net income is carved-out from paragraph 125(1)(a) per carve-out B.
 - Intermediary Co's assignment of business limit under subsection 125(3.2)(c) is limited to A – B:
 - A - amount of income Spouse Co earned by providing services directly to it: \$300,000.
 - B - amount that income deductible by Intermediary Co in respect of its own income referred to carve-out A or B: \$300,000.
 - Therefore, assignment not allowed.
 - Result: the only SBD entitlement in the group is Apple Co's \$500,000 of net income.

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CHANGES TO CORPORATE STRUCTURES NEW CONCEPT – EXAMPLE



Assume that

HOLDCO 1 and HOLDCO 2 are unrelated

Therefore

- OPCO and HOLDCO 1 and HOLDCO 2 all deal at arm's length
- Each corp has access to \$500k SBD

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For instance – consider this scenario. All three corporations are unrelated and deal at arm's length with each other. Because they are all unrelated and they all deal at arm's length with each other, each corporation does have full access to the \$500k SBD. However, that SBD limit can be compromised should OPCO pay fees to HOLDCO 1 and HOLDCO 2.

CHANGES TO CORPORATE STRUCTURES NEW CONCEPT – EXAMPLE (CONT'D)

Old Rules

- Fees paid by OPCO to each of HOLDCO 1 and HOLDCO 2 considered ABI
- PSBI may not be a factor
- Each corp had \$500k SBD

New Rules

- CAUGHT!
- Definition of SCI under 125(7)(a)(i)(A)



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Under the “old” rules fees paid by OPCO to each of HOLDCO 1 and HOLDCO 2 would be considered Active Business Income (ABI) in each HOLDCO. Personal Services Business Income (PSBI) would not likely be a factor as each HOLDCO was a 50% shareholder in OPCO, and the fees could arguably represent a distribution of profit, that was something other than employment income that would have been payable to each shareholder. Under the “old” rules each HOLDCO would likely have been able to use their \$500k SBD limit against management fee income it earned from OPCO. Under the new rules, this income will be considered to be Specified Corporate Income (SCI) as defined in sub paragraph 125(7)(a)(i)(A).

CHANGES TO CORPORATE STRUCTURES NEW CONCEPT – SPECIFIED CORPORATE INCOME (SS.125(7)) (“SCI”)

Where does this leave us?

- Companies that are unrelated under ss.251 and not associated under ss.256 could be caught due to the definition of SCI – 125(7)(a)(i)(A):
 - “at any time in the year, the (payee) corporation (**or one of its shareholders**) or a person who does not deal at arm’s length with the (payee) corporation (**or one of its shareholders**) holds a direct or indirect interest in the (payor) private corporation”



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CHANGES TO CORPORATE STRUCTURES NEW CONCEPT – SPECIFIED CORPORATE INCOME (SS.125(7)) ("SCI")

Where does this leave us?

- How does paragraph 251(1)(c) of the ITA interplay with the definition of SCI and its non-arm's length requirement?
- The practitioner will have to watch out for:
 - Common mind which directs the bargaining for both parties to a transaction;
 - Were the parties to a transaction "acting in concert" without separate interests?
 - Was there de-facto control?



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CHANGES TO CORPORATE STRUCTURES NEW CONCEPT – SPECIFIED CORPORATE INCOME (SS.125(7)) (“SCI”)

Where does this leave us?

- There is now a new set of tasks for the practitioner;
- First the practitioner has to determine if the revenue is in fact SCI and;
- Then concern themselves with the related and associated rules under ss.251 and ss.256 respectively.

PARADIGM SHIFT!



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CONTINUING EXAMPLES

Examples where the new rules apply

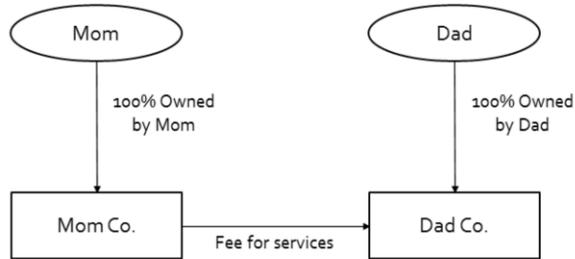
Example 1

Facts:

- Mom and dad each own their own company;
- Mom Co and Dad Co generate active business income pursuant to ss.125 of the ITA;
- Fee for service paid by Mom Co to Dad Co

EXAMPLES

Examples where the new rules apply



EXAMPLES

Examples where the new rules apply

Example 1

Analysis:

- Under the old rules:
 - Mom Co and Dad Co are related pursuant to ss.251(2) of the ITA because Mom and Dad who are the shareholders are related to each other. However, the companies are not associated.
 - Fee paid by Mom Co to Dad Co would be eligible for the SBD;
- Under the new rules:
 - The fee received by Dad Co would fall within the definition of SCI if less than 90% of income from an active business in Dad Co is from other arm's length services.

EXAMPLES

Examples where the new rules apply

Example 2

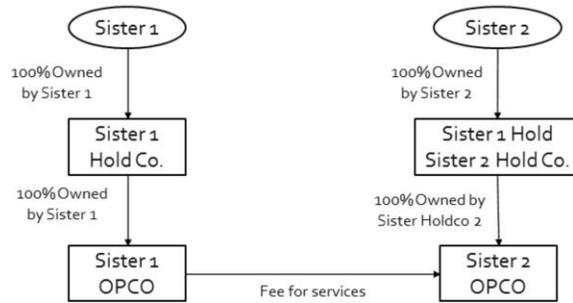
Facts:

- Sister 1 and Sister 2 each own their OPCO via a holding company;
- Sister OPCO 1 and Sister OPCO 2 generate active business income pursuant to ss.125 of the ITA;
- Fee for service paid by Sister 1 OPCO to Sister OPCO;

EXAMPLES

Examples where the new rules apply

Example 2



EXAMPLES

Examples where the new rules apply

Example 2 (Ignoring PSB Rules)

Analysis:

- Under the old rules:
 - Sister 1 HOLDCO, Sister 1 OPCO, Sister 2 HOLDCO and Sister 2 OPCO would be related pursuant to ss.251(2) of the ITA because the shareholders are related, but Sister 1 OPCO and Sister 2 OPCO are not associated.
 - Fee paid by Sister 1 OPCO to Sister 2 OPCO would be eligible for the SBD;
- Under the new rules:
 - Since the shareholders are related and both indirectly control their OPCOs; the fee paid by Sister 1 OPCO to Sister 2 OPCO would meet the definition of SCI if the fees represent over 10% of the income from an active business in Sister 2 OPCO.
 - Service income in Sister 2 OPCO not eligible for SBD

EXAMPLES

Examples where the new rules apply

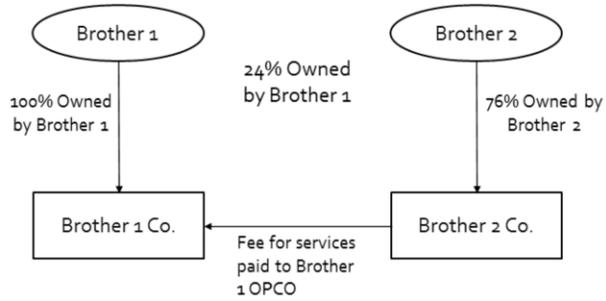
Example 3

Facts:

- Brother 1 owns Brother 1 OPCO and Brother 1 owns 24% of Brother 2 OPCO;
- Brother 2 owns 76% of Brother 2 OPCO;
- Brother 1 OPCO and Brother 2 OPCO generate active business income pursuant to ss.125 of the ITA;
- Fee for service/property paid by Brother 2 OPCO to Brother 1 OPCO;

EXAMPLES

Examples where the new rules apply



EXAMPLES

Examples where the new rules apply

Example 3

Analysis:

- Under the old rules:
 - Brother 1 OPCO and Brother 2 OPCO would be related pursuant to ss.251(2) of the ITA because the shareholders are related, but not associated.
 - Fee paid by Brother 2 OPCO to Brother 1 OPCO would be eligible for the SBD;
- Under the new rules:
 - Since the shareholders are related, the fee paid by Brother 2 OPCO to Brother 1 OPCO would be considered SCI if Brother 1 OPCO does not have more than 90% earned from arm's length parties

EXAMPLES

Examples where the new rules apply

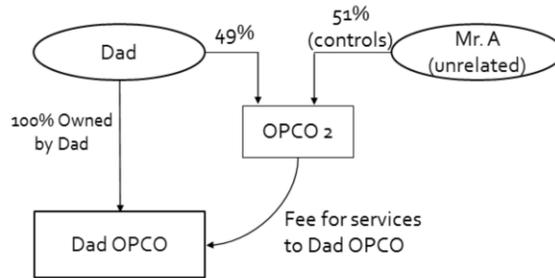
Example 4

Facts:

- Dad owns 49% of OPCO #2 and Dad owns 100% of Dad OPCO;
- Mr. A an unrelated person to Dad owns 51% of OPCO #2;
- Dad OPCO and OPCO 2 generate active business income pursuant to ss.125 of the ITA;
- Fee for service paid by OPCO #2 to Dad OPCO;

EXAMPLES

Examples where the new rules apply



EXAMPLES

Examples where the new rules apply

Example 4

Analysis:

- Under the old rules:
 - Dad OPCO and OPCO #2 would not be related pursuant to ss. 251(2) of the ITA, and not associated, however Dad OPCO is affiliated to Dad.
 - Fee paid by OPCO #2 to Dad OPCO would be eligible for the SBD;
- Under the new rules:
 - Dad controls (and deals not at arm's length) with Dad OPCO, and also holds a direct interest in OPCO #2; therefore, income from OPCO #2 would represent SCI if greater than 10% of the income from an active business is from OPCO #2;
 - If so, service income from OPCO #2 not eligible for SBD

EXAMPLES

Examples where the new rules apply

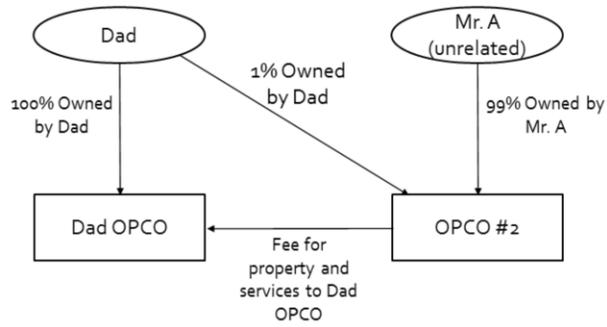
Example 5

Facts:

- Dad owns 1% of OPCO #2 and Dad owns 100% of Dad OPCO;
- Mr. A an unrelated person to Dad owns 99% of OPCO #2;
- Dad OPCO and OPCO 2 generate active business income pursuant to ss.125 of the ITA; Fee for service/property paid by OPCO #2 to Dad OPCO;

EXAMPLES

Examples where the new rules apply



EXAMPLES

Examples where the new rules apply

Example 5

Analysis:

- Under the old rules:
 - Dad OPCO and OPCO #2 would not be related pursuant to ss. 251(2) of the ITA, and not associated; however Dad OPCO is affiliated to Dad.
 - Fee paid by OPCO #2 to Dad OPCO would be eligible for the SBD;
- Under the new rules:
 - Dad controls (and deals not at arm's length) with Dad OPCO, and also holds a direct interest in OPCO #2; therefore, income from OPCO #2 would represent SCI if greater than 10% of the income from an active business is from OPCO #2;
 - If so, service income from OPCO #2 not eligible for SBD.

EXAMPLES

Examples where the new rules apply

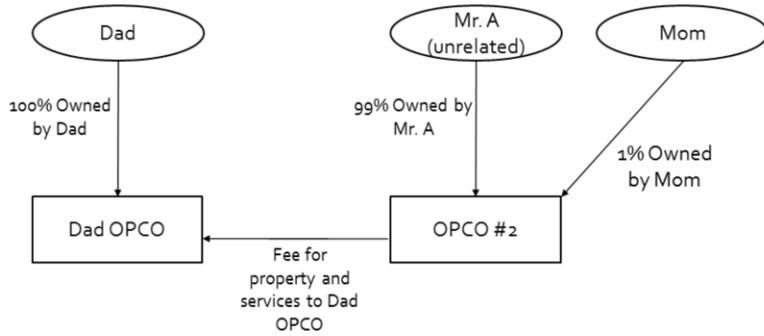
Example 6

Facts:

- Dad owns 100% of Dad OPCO;
- Mr. A an unrelated person to Dad and Mom owns 99% of OPCO #2;
- Mom owns 1% of OPCO #2;
- Dad OPCO and OPCO 2 generate active business income pursuant to ss.125 of the ITA;
- Fee for service/property paid by OPCO #2 to Dad OPCO;

EXAMPLES

Examples where the new rules apply



EXAMPLES

Examples where the new rules apply

Example 6

Analysis:

- Under the old rules:
 - Dad OPCO and OPCO #2 would **not** be related pursuant to ss.251(2) of the ITA, and **not** associated, however Dad OPCO and Dad would be affiliated to each other and related to Mom.
 - Fee paid by OPCO #2 to Dad OPCO would be eligible for the SBD;
- Under the new rules:
 - Mom is related to Dad, and therefore, considered to be related and not dealing at arm's length with Dad OPCO. Mom also owns a direct interest in OPCO #2 and therefore, if the fee paid by OPCO #2 to Dad OPCO represents greater than 10% of the income from an active business of Dad OPCO, the income would be considered SCI.

EXAMPLES

Examples where the new rules apply

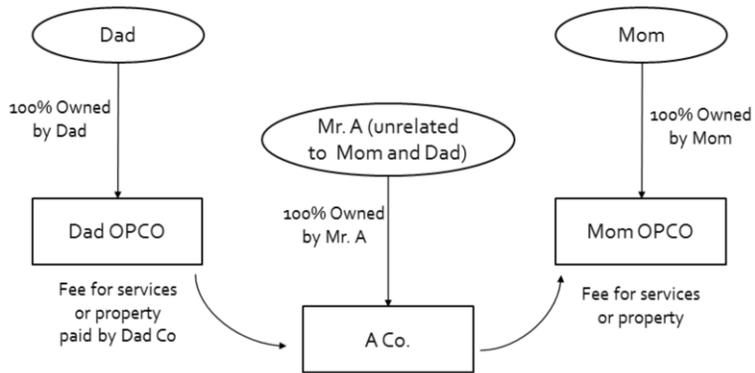
Example 7

Facts:

- Dad owns 100% of Dad OPCO;
- Mr. A unrelated to Dad and Mom owns 100% of Mom OPCO;
- Dad OPCO and A Co generate active business income pursuant to ss.125 of the ITA;
- Mom OPCO is providing services to Dad OPCO through A Co
- Fee for service/property paid by Dad OPCO to A Co and the **same fee** paid to Mom OPCO for the services provided by Mom OPCO to Dad OPCO.

EXAMPLES

Examples where the new rules apply



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EXAMPLES

Examples where the new rules apply

Example 7

Analysis:

- Under the old rules:
 - The shareholders of Dad OPCO and A Co., are not related pursuant to ss.251(2) of the ITA, and would not be associated.
 - Fee paid by Dad OPCO to A Co would be eligible for the SBD;
 - Subsequent fee paid from A Co to Mom OPCO would be eligible for the SBD, since the shareholders of A Co and Mom Co are not related to each other and A Co. and Mom Co. are not associated to each other.

EXAMPLES

Examples where the new rules apply

Example 7

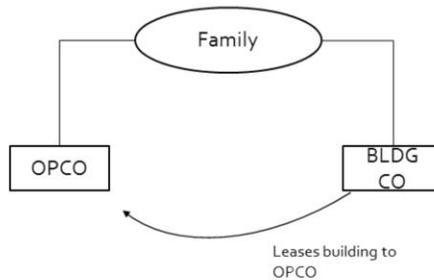
Analysis:

- Under the new rules:
 - The fee paid by a A Co to Mom OPCO would be considered SCI if it represents greater than 10% of the income from an active business of Mom OPCO, because the shareholders of Mom OPCO and Dad OPCO are related to each other, and Mom OPCO has provided services to Dad OPCO indirectly via A Co.
 - In this example in order to determine if SCI exists a detailed analysis of the contract will need to be done to ensure that SCI does in fact exist.

SBD Changes

Example 8

- Proposed amendments affect basic planning and ordinary structures



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The proposed amendments can affect very commonly-used business structures, such as the one shown above.

In this example, BLDG Co. charges rent to OPCO, in respect of property owned by BLDG Co. and leased to OPCO. The two corporations are associated as they are controlled by the same group of related shareholders. However, the new proposals will require additional tax filings.

SBD Changes

Example 8

- Under existing tax law...
Subsection 129(6) deems the lease income to be ABI in BLDG Co.
- Simply allocate portion of Annual SBD limit on Schedule 23
- Anything else to consider?



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Under the old rules, the only thing that was required was to allocate the Annual SBD between the 2 corporations. Since rental income earned by BLDG Co. is deemed to be ABI under 129(6), the income in BLDG Co. would be eligible for the SBD, as long as part of the Annual \$500,000k limit was allocated to it. This was done simply by making the allocation on Schedule 23 of both corporations.

SBD Changes

Example 8

- Under new rules...
 - Proposed definition of “specified corporate income” see subparagraph (a)(i) in ss.125(7)
 - Income considered specified corporate income (“SCI”) unless...
 - an assignment is made in prescribed form filed by the payor corporation (OPCO)
- AND
- a prescribed form filed by the recipient corporation



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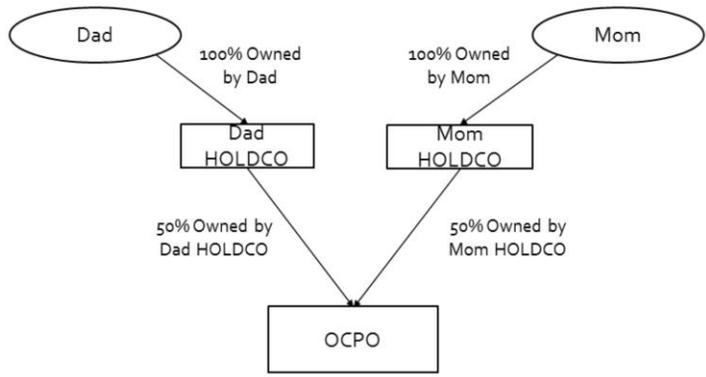


Note that the newly proposed provision in the 2016 Federal Budget creates a new definition for “specified corporate income”, in subparagraph 125(7)(a)(i) of the Act. Effectively, where a corporation receives substantially all of its income from property, it will be treated as specified investment business income (SIBI), even where the payor corporation is an associated active business corporation.

However, the two corporations can jointly file an election, where the payor corporation agrees to make an assignment of its Annual 500k SBD Limit to the other related corporation. Presumably, filing Schedule 23 and making the allocation on that for is not sufficient for these purposes.

Example 9

• Interaction of ss.256(2) and ss.129(6) of the ITA:



Example 9

Facts:

- OPCO, Dad HOLDCO and Mom HOLDCO are associated for tax purposes under 256(1)(d) and 256(2) of the ITA;
- OPCO pays a safe income dividend to each HOLDCO for \$1.0M (\$2.0 M total);
- Each HOLDCO loans back the funds on a secured basis to OPCO at an interest rate of 5%, thereby generating \$50,000 of interest income in each HOLDCO;
- Ss.129(6) applies to deem the interest to be active business income.

Example 9

• Old ss.125(1)(a)(i) rule:

- ASSUME 256(2) election made
- Would enable each HOLDCO to claim their own SBD on the \$50k of interest income earned from OPCO.

• New ss.125(1)(a)(i) rule:

- Will deem the income earned under 129(6) (the interest income earned by the HOLDCOs) not to be eligible for the SBD because OPCO filed a 256(2) election.

CHANGES TO THE SEC. 256(2) ELECTION: FEDERAL SMALL BUSINESS DEDUCTION

- The Federal budget for 2016 was tabled on March 22nd, 2016;
- The measures as they relate to the federal small business deduction are proposed to apply to taxation years beginning on or after March 22nd, 2016;
- Changes also made to Sec 256(2) Election

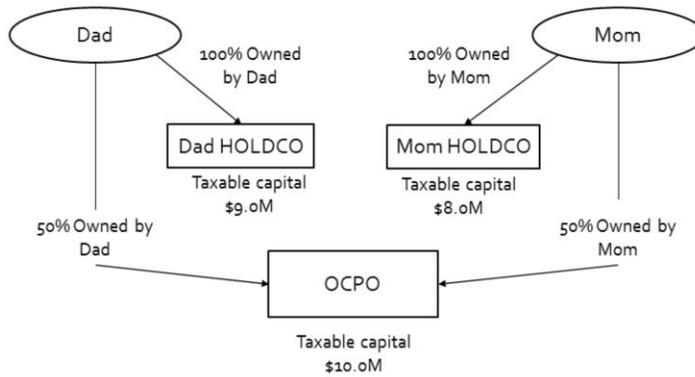


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CHANGES TO THE SEC 256(2) ELECTION

- Classic structure when a ss.256(2) election is used:



CHANGES TO THE SS.256(2) ELECTION

• Under the old ss. 256(2) rule:

- If ss.256(2) election **is not** filed by the family HOLDCO and the associated group's taxable capital was over \$10 Million; the business limit reduction under ss.125(5.1) would apply and "grind down" the small business deduction to nil;
- SBD gone at \$15M Taxable Capital
- If ss.256(2) election **is** filed by the family HOLDCO then Dad OPCO and MOM OPCO can claim their own SBD based on their own taxable capital.
- The above is as a result of the wording in ss.256(2) of the ITA which exempts the elected corporation out of the rules in ss.125

CHANGES TO THE SS.256(2) ELECTION OLD RULES

	Without 256(2)	With 256(2)
Taxable Capital -		
Assoc group	\$	
Dad OPCO	9.0	
Mom OPCO	8.0	
Family	10.0	
HOLDCO		
	\$ <u>27.0</u>	<u>Each < 10M</u>
SBD available to		
Dad OPCO	- \$	500k
Mom OPCO	-	500k
Family	-	o
HOLDCO		
	\$ <u>-</u>	<u>\$ 1,000</u>

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CHANGES TO THE SS.256(2) ELECTION

• Under the new ss. 256(2) rule if a 256(2) election is filed:

- Family HOLDCO will continue to be associated with Dad OPCO and Mom OPCO for all purposes of the act;
- However, Dad OPCO and Mom OPCO will be deemed not be associated with each other for SBD purposes but will still be associated with Family HOLDCO, however, Family HOLDCO's business limit will be zero;
- Therefore, family HOLDCO's taxable capital will continue to be taken into account in determining the taxable capital of Mom OPCO and Dad OPCO for the purposes of a s.125.

CHANGES TO THE SS.256(2) ELECTION NEW RULES

	With 256(2)	
Taxable Capital -		
Dad OPCO & Family HOLDCO	9.0	
	<u>10.0</u>	
	<u>19.0</u>	>10.0M
Mom OPCO and Family HOLDCO	8.0	
	<u>10.0</u>	>10.0M
	<u>18.0</u>	
SBD available to		
Dad OPCO	-	
Mom OPCO	-	
Family HOLDCO	-	
	<u>NIL</u>	

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SOME THOUGHTS AND POSSIBLE SOLUTIONS

Observations related to the new legislation

- Accountants will need to identify SCI – will this needlessly increase time and cost to the client? Will it be recoverable?
- The assignment provisions under ss.125(3.2) are an option to the taxpayer if the entire group is under the \$500,000 business limit, however there is now the possibility sharing the SBD among non-associated corporate groups;
- This is an option when the income from an active business is under \$500,000 in the entire corporate group;
- Can we file a late assignment under ss.125(3.2) under ss.220(3.2)?

FINAL THOUGHTS AND POSSIBLE SOLUTIONS

Observations related to the new legislation

- The application date for the SCI is for taxation years that begin on or after March 22nd, 2016, perhaps the practitioner should wait until implementing solutions?
- Especially for entities incorporated before March 22nd, 2016 that have not had a taxation year end as of yet; the practitioner could consider forcing a short year end on March 20th, 2016 and get the small business deduction rate for another 12 months prior to any implementation;
- Could the Department of Finance modify the legislation to have de-minimis shareholder holding that will automatically “carve out” certain taxpayers?

TSG Seminar Changes To The Small Business Deduction

THANK YOU!

Next session is...

Thursday, March 2, 2017
U.S Tax Filing Issues, FATCA

See you then!



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