New Small Business Deduction Rules Under Section 125

*Kenneth Keung**

Moodys Gartner Tax Law LLP, Calgary. BComm (2002) University of British Columbia; MTax (2004) University of Waterloo; LLB (2009) University of London; CPA, CA, CFP, TEP. Frequent writer and speaker on tax matters for numerous professional seminars and conferences.

Abstract

The new small business deduction (SBD) rules, which came into effect for taxation years beginning after March 21, 2016, have rendered most (if not all) traditional SBD multiplication planning obsolete. This paper contains an explanation of these new rules and demonstrates how they apply to various organizational structures. It also illustrates the broadness of these rules and why they can apply to common situations in which SBD multiplication was never a primary objective. Finally, it offers practical advice to practitioners about how to manage section 125.

Keywords CCPC; small business; private corporations; partnerships; anti-avoidance; associated companies.

This is one of two papers covering multiple tax changes that affect private companies today. The other paper, written by Grace Chow, contains a discussion about the new eligible capital property regime and the planning implications of increased tax rates in Canada.[1]

In this paper, I explore the implications of the new small business deduction (SBD) rules in the context of a Canadian-controlled private corporation (CCPC) whose taxation year begins after March 21, 2016. Examples are used throughout to illustrate these rules, many of which are drawn from discussions with other tax practitioners.

The End of Small Business Deduction Multiplication

SBD multiplication planning has been a tax-planning mainstay for decades. Many variations of SBD multiplication planning have been developed, all of which

* I am grateful to the many tax practitioners who generously discussed the implications of the new rules with me.

generally involve splitting profits into various corporations that are not associated with each other to multiply access to the $500,000 business limit. Often, these corporations are bona fide stand-alone businesses, but sometimes they are in substance one business but for the arrangement designed to divert profits (for example, the spouse of an owner of an Opco can set up a separate CCPC that charges fees to the Opco for tasks integrative to the Opco's business).

Before the 2015 election, the Liberals campaigned on reforming the small business tax regime to prevent it from being used by "high-income individuals . . . as an income splitting tool."[2] However, many practitioners did not anticipate such a dramatic and broad revision to these rules, which has not only eliminated the artificial splitting of income but which could also adversely affect stand-alone businesses transacting with each other.

Brief Overview of Old Section 125

The SBD rules are set out in subsection 125(1). The old provision sought to limit the amount of a CCPC's income that qualified for the SBD to the least of the amounts described in paragraphs 125(1)(a), (b), and (c):

1) the CCPC's income from
   a) an active business carried on in Canada, and
   b) "specified partnership income" (SPI) for the year, less any active Canadian business losses and specified partnership losses;
2) the CCPC's taxable income for the year (reduced by tax-exempt income and a proxy amount representing foreign income already sheltered by foreign tax credits under section 126); and
3) the CCPC's "business limit" for the year, which is $500,000 shared among an associated group of corporations pursuant to subsections 125(2) and (3).

The first component of old paragraph 125(1)(a) dealt with active business income (ABI) earned directly by the CCPC,[3] and the application was generally straightforward. The second component of old paragraph 125(1)(a) referred to SPI. Generally speaking, old subsection 125(7) defined SPI as the lesser of the CCPC's share of partnership income determined under subdivision j and its pro rata share of $500,000. In effect, the old SPI rules simply forced all partners (including non-corporate partners) to share pro rata a $500,000 notional SBD limit.

Much of the planning under the old SBD rules involved splitting ABI among corporations that were not associated with each other or diverting income from a partnership into the hands of various non-associated corporations (so that the income was not subject to the SPI rules); the main objective was to multiply access to the $500,000 business limit.

With the view to eliminating this planning, the government introduced significant amendments in respect of section 125, which apply to a CCPC's taxation year beginning after March 21, 2016.[4]

The new rules limit SBD entitlement by initially carving out the following types of ABI:

1) ABI earned from a partnership in which the corporation or its shareholder holds a direct or indirect interest, or in which the person who holds such an interest does not deal at arm's length with the corporation, which does not earn all or substantially all of its ABI from arm's-length customers;
2) ABI earned from another corporation in which the corporation, its shareholder, or a person who does not deal at arm's length with it either holds a direct or indirect interest, and the corporation does not earn all or substantially all of its ABI from arm's-length customers (however, most transactions between associated corporations are exempted); and
3) deemed ABI under subsection 129(6) that is earned from a non-CCPC or a CCPC that elects under subsection 256(2) not to be associated.

For a section of the Act that is relied on daily by small businesses, the new rules are astonishingly complex. This paper contains a detailed description of each component of these rules. To help readers navigate the most complicated parts of these provisions, the accompanying flow charts are provided.[5]

New Paragraph 125(1)(a)

The overall structure of subsection 125(1) is maintained and still limits entitlement to the SBD to the least of three amounts in paragraphs (a), (b), and (c). While paragraphs 125(1)(b) and (c) remain the same, the amount to be included in paragraph 125(1)(a) is now the total of

1) the total ABI carried on in Canada other than an amount that is
   a) described in paragraph (A)(a) of the definition of SPI (clause 125(1)(a)(i)(A) (carve-out A)),
   b) described in subparagraph (a)(i) of the definition of "specified corporate income" (SCI) (clause 125(1)(a)(i)(B) (carve-out B)), or
   c) paid or payable to the corporation by an associated corporation that is deemed to be ABI under subsection 129(6) when the associated corporation is not a CCPC or is a CCPC that has made an election under subsection 256(2) in respect of the taxation year (clause 125(1)(a)(i)(C) (carve-out C)),
2) SPI for the year (subparagraph 125(1)(a)(ii)), and
3) SCI for the year (subparagraph 125(1)(a)(ii.1)),

minus any active business losses and specified partnership losses.

At first glance, paragraph 125(1)(a) appears circular because subparagraph 125(1)(a)(i) appears to exclude SPI and SCI, whereas subparagraphs 125(1)(a)(ii) and (ii.1) bring SPI and SCI back in. However, on closer examination the carve-

Section 125 SCI Flow Chart: CCPC Providing Services or Property to Private Corporation

Does the CCPC (directly or indirectly, in any manner whatsoever) provide services or property to a private corporation that is not associated with it? The exception for associated corporations is revoked to the extent that the service or property is deductible by the recipient against income subject to any of the carve-outs in subparagraph 125(1)(a)(i).

No →

↓ Yes

Does the CCPC, a shareholder of the CCPC, or a person who does not deal at arm's length with either the CCPC or a CCPC shareholder hold a direct or indirect interest in the private corporation?

No →

↓ Yes

Does the CCPC earn all or substantially all of its ABI from providing services or property to

1) arm's-length persons (other than the private corporation); or
2) partnerships with which the CCPC deals at arm's length, other than a partnership in which a non-arm's-length person holds a direct or indirect interest?

Yes →

Clause 125(1)(a)(i)(B) carve-out does not apply.

CCPC may include income in paragraph 125(1)(a).

↓ No

All of the CCPC's income from providing services or property to the private corporation is carved out per clause 125(1)(a)(i)(B).

↓

Does the CCPC provide services or property directly to the private corporation?

No →

↓ Yes

Does the recipient private corporation have a business limit determined under subsection 125(2), (3), or (4)?

No →

CCPC cannot include any carved-out income in paragraph 125(1)(a).

↓ Yes

The CCPC may include carved-out income as SCI in paragraph 125(1)(a) equal to the least of

1) the CCPC's income from providing services or property directly to the private corporation, less any portion that is deductible by the private corporation against income subject to carve-outs in clause 125(1)(a)(i)(A) or (B);
2) the amount of the business limit assigned by the private corporation to the CCPC;
3) an amount that the minister determines to be reasonable in the circumstances (paragraph (b) of the definition of SCI).

Section 125 SPI Flow Chart: Earning Partnership Income or Providing Services or Property to a Partnership

Is the CCPC a member of the partnership?

No → Does the CCPC (directly or indirectly, in any manner whatever) provide services or property to the partnership?

Yes

No

Does one of the shareholders of the CCPC hold a direct or indirect interest in the partnership?

Yes

No

Does the CCPC not deal at arm's length with a person that holds a direct or indirect interest in the partnership?

No →

Yes

Does the CCPC earn all or substantially all of its ABI from providing services or property to

1) arm's-length persons, or
2) partnerships (other than the particular partnership) with which the CCPC deals at arm's length, other than a partnership in which a non-arm's-length person holds a direct or indirect interest?

Yes →

Clause 125(1)(a)(i)(A) carve-out does not apply.

CCPC may include income in paragraph 125(1)(a).

No

The CCPC is a designated member of the partnership.

All of the following income of the CCPC is carved out under clause 125(1)(a)(i)(A):

1) share of income of the partnership;
2) income from the provision (directly or indirectly, in any manner whatever) of services or property to the partnership;
3) any amount included under subsections 34.2(2), (3), and (12).

If the partnership provides services or property to another private corporation or partnership, does the anti-intermediary provision in paragraph (A)(c) of the SPI definition apply?

Yes

No

Is the CCPC a member or designated member of the partnership?

Member

Designated member

Cannot include any carved-out income in paragraph 125(1)(a).

The CCPC may include carved-out income as SPI in paragraph 125(1)(a) to the extent of its specified partnership business limit (SPBL), determined as follows: CCPC's percentage interest in the partnership's ABI × $500,000 (prorated for a short partnership year), minus any SPBL assigned to another.

The CCPC may include carved-out income as SPI in paragraph 125(1)(a) to the extent of any SPBL assigned to it by a person that holds a direct or indirect interest in the partnership and does not deal at arm's length with the CCPC.

outs in clauses 125(1)(a)(i)(A) and (B) actually refer to amounts described in specific components within the definitions of SPI and SCI in subsection 125(7). To the extent that a CCPC's income falls within carve-outs A and B, the income is prima facie tainted and excluded from the SBD, unless it is brought back into paragraph 125(1)(a) as SPI (subparagraph 125(1)(a)(ii)) or as SCI (subparagraph 125(1)(a)(ii.1)). As explained below, subparagraphs 125(1)(a)(ii) and (ii.1) both require an assignment of the business limit by another taxpayer to the CCPC. However, the carve-out in clause 125(1)(a)(i)(C) targets a specific mischief involving subsection 129(6), and once carve-out C applies, that amount cannot be brought back into paragraph 125(1)(a).

Clause 125(1)(a)(i)(A) Carve-Out (CCPC Earning Partnership Income or Providing Services or Property to a Partnership)

An amount is caught by carve-out A if it is described in paragraph (A)(a) of the SPI definition, which captures any ABI of a CCPC member or designated member of a partnership derived from

1) income allocation by the partnership for a fiscal period that ends in the year;
2) provision (directly or indirectly, in any manner whatever) of services or property to the partnership; or
3) stub period income from the partnership under subsections 34.2(2), (3), and (12).

The new concept of a designated member essentially treats certain CCPCs that are not otherwise members of a partnership as actual members for the purpose of applying carve-out A. According to the definition in subsection 125(7), a "designated member" of a partnership means a CCPC that is not a partner but provides (directly or indirectly, in any manner whatever) services or property to the partnership at any time in the CCPC's taxation year when, at any time in the year, either

1) one of the shareholders of the CCPC holds a direct or indirect interest in the partnership (subparagraph (b)(i) of the definition), or
2) if subparagraph (b)(i) does not apply,
   a) the CCPC does not deal at arm's length with a person that holds a direct or indirect interest in the partnership, and
   b) it is not the case that all or substantially all of the CCPC's ABI is from providing services or property to
      i) persons with which the CCPC deals at arm's length, or
      ii) partnerships (other than the particular partnership) with which the CCPC deals at arm's length, other than a partnership in which a person

that does not deal at arm's length with the CCPC holds a direct or indirect interest (subparagraph (b)(ii) of the definition).

As a result of these provisions, if a member or designated member of a partnership earns any ABI from the partnership (including a regular partnership income allocation under section 96), the income is prima facie excluded from paragraph 125(1)(a) under carve-out A.

The designated member definition does not refer to any de minimis threshold for the size of the shareholding or partnership interest. If a 1 percent shareholder of a CCPC holds a 1 percent direct or indirect interest in a partnership that receives any services from the CCPC, the CCPC is considered a designated member of the partnership under subparagraph (b)(i) of the designated member definition. In this situation, the quantum of the CCPC's income from the provision of service or property to the partnership or to other non-arm's-length customers is irrelevant.

When no shareholder of the CCPC has interests in the services or property recipient partnership, the CCPC can still be considered a designated member of the partnership under subparagraph (b)(ii) of that definition if a person holding the direct or indirect interest in the partnership does not deal at arm's length with the CCPC. However, subparagraph (b)(ii) is more lenient because it contains an "all or substantially all" arm's-length ABI exemption. As long as "all or substantially all" of the CCPC's ABI is derived from sales to persons or partnerships that are considered to be sufficiently distant under clause (b)(ii)(B) of the designated member definition, the CCPC is not considered to be a designated member of that partnership.[6] If the CCPC is neither a member nor a designated member, carve-out A does not apply, and the CCPC's income from sales to the partnership is automatically included in paragraph 125(1)(a).

Transactions with any non-arm's-length persons, not only the particular partnership in question, could cause the "all or substantially all" arm's-length ABI exemption to fail. As an illustration, assume that Ms. A's wholly owned corporation, A Co, earned $500,000 of ABI in the year, of which $150,000 was earned from sales to a wholly owned subsidiary of A Co, and $5,000 was earned from sales to B partnership, a partnership in which Ms. A's brother-in-law owns an interest. Since less than all or substantially all of A Co's ABI for the year is derived from sales to arm's-length persons, A Co fails the "all or substantially all" exemption and is therefore a designated member of B partnership (even though income from B partnership constitutes only 1 percent of A Co's income). A Co cannot include the $5,000 in subparagraph 125(1)(a)(i) as a result of carve-out A. Although the $150,000 earned by A Co from its subsidiary caused A Co to fail the "all or substantially all" test, that income itself is not subject to any carve-outs as a result of the associated corporation exception in subsection 125(10), which is discussed later.

If Ms. A also had a direct or indirect interest in B partnership, the "all or substantially all" test would be irrelevant. A Co would have been considered a designated member irrespective of the quantum of arm's-length versus non-arm's-length sales because subparagraph (b)(i) of the "designated member" definition, rather than subparagraph (b)(ii), would have been operative.

As a result of carve-out A, it is no longer possible to circumvent the SPI rules simply by charging for services or property provided to a partnership. If carve-out A applies to an amount of income, the CCPC is not entitled to the SBD in respect of that income, unless the income is brought back into paragraph 125(1)(a) as SPI under subparagraph 125(1)(a)(ii), which requires an assignment of the specified partnership business limit (SPBL) by an actual member of the partnership to the CCPC. The mechanics of the assignment are discussed later in this paper.

Does the "All or Substantially All" Test Refer to Gross or Net Income?

The test of whether "all or substantially all" of an entity's "income" for the year from an active business is derived from customers who are deemed to be sufficiently distant by new section 125 is used in the "designated member" definition as well as throughout the section (as is discussed below). Unfortunately, the phrase and the surrounding provision are silent about whether "income" refers to gross or net income, creating confusion among practitioners.

Section 9 is the primary provision for business and property income, and section 9 defines income from business or property to be the taxpayer's profit therefrom. Therefore, unless the text or context of a provision suggests otherwise, income should generally mean profit or net income.

In some contexts, (for the purpose of the interest deductibility provision in paragraph 20(1)(c), for example), the courts have found that income refers to gross income. The Supreme Court of Canada in *Ludco* explained that its interpretation was a result of the immediately surrounding text in paragraph 20(1)(c):

> when one looks at the immediate context in which the term "income" appears in s. 20(1)(c)(i), it is significant that within the provision itself the concept of "income" is used in contradistinction from the concept of tax-exempt income. Viewed in this context, the term "income" in s. 20(1)(c)(i) does not refer to net income, but to income subject to tax. In this light, it is clear that "income" in s. 20(1)(c)(i) refers to income generally, that is, an amount that would come into income for taxation purposes, not just net income.[7]

In reaching its conclusion that "income" in paragraph 20(1)(c) refers to gross income, the court relied on the overall context of the provision. Taking a similar approach, the appropriate context for interpreting the "all or substantially all" income test in section 125 is the entire section 125. Section 125 is contained in division E, which provides rules for the computation of tax on taxable income, which is a net income or profit concept. Subsection 125(1) calculates a deduction from tax otherwise payable on the taxable income derived from an active business; again, this unquestionably refers to net income or profit. The purpose of the carve-outs to paragraph 125(1)(a) is to prevent multiple corporations from gaining access to a deduction with respect to profits derived from transactions that are considered to be offensive under these provisions. The "all or substantially all" test is used to sort out taxpayers whose income from these offensive transactions is merely incidental to their overall income, and there is nothing to suggest that a different measure of income should be applied specifically for this test than for the rest of the section. In this context, it is more likely that the proper textual, contextual, and purposive interpretation of income as it appears in the "all or substantially all" test in section 125 is net income or profit, rather than gross income.

Some practitioners point out that it is impractical to compute the net income from specific transactions because this would involve an internal allocation of expenses that otherwise would never be made. However, administrative burden to users is generally not a consideration in the principles of statutory interpretation.

Clause 125(1)(a)(i)(B) Carve-Out (CCPC Providing Services or Property to a Private Corporation)

Carve-out B works similarly to carve-out A, capturing an amount of income described in subparagraph (a)(i) of the definition of SCI in subsection 125(7). That subparagraph describes a CCPC's ABI from the provision of services or property to a private corporation directly or indirectly, in any manner whatever, if

1) at any time in the year, the CCPC (or one of its shareholders) or a person who does not deal at arm's length with the CCPC (or one of its shareholders) holds a direct or indirect interest in the private corporation (clause (a)(i)(A) of the definition); and
2) it is not the case that all or substantially all of the corporation's ABI for the year is from the provision of services or property to
   a) persons (other than the private corporation) with which the CCPC deals at arm's length, or
   b) partnerships with which the CCPC deals at arm's length, other than a partnership in which a person that does not deal at arm's length with the CCPC holds a direct or indirect interest (clause (a)(i)(B) of the definition).

Similar to carve-out A, carve-out B has no de minimis threshold for the size of the shareholding, which could cause this carve-out to apply in unexpected situations. For example, the ABI of a CCPC that provides services or property could be subject to carve-out B if its 1 percent shareholder has a sibling (or any non-arm's-length person or entity) who owns directly or indirectly 1 percent of the private corporation that receives the service or property. Theoretically, this puts a burden on CCPCs to investigate the ownership of each customer.

This broad application is partially compensated by the "all or substantially all" arm's-length ABI exemption which, unlike carve-out A, is available in all cases when applying carve-out B. As long as all or substantially all of the CCPC's ABI for the year is derived from sales to persons and partnerships that are considered to be sufficiently distant under clause (a)(i)(B) of the SCI definition, the income is not caught by carve-out B.

Despite the "all or substantially all" exception, these rules could be problematic for businesses that operate in small communities or that do business with widely held private corporations, since it may be hard to avoid selling to a private corporation in which a non-arm's-length person owns a direct or indirect interest. Moreover, businesses or their shareholders sometimes own a stake in their major customers to improve relationships and collaborations; these arrangements could now be jeopardized by the new rules.

Carve-out B applies only to income from the provision of services or property to a "private corporation," which is defined in subsection 89(1) to generally encompass any Canadian-resident corporation that is not a public corporation or controlled by a public corporation. A "public corporation" is defined in subsection 89(1) generally to mean a corporation that is resident in Canada and listed on a designated stock exchange in Canada.[8]

These definitions could produce surprising results in some situations. For example, a Canadian corporate subsidiary of a US publicly listed company is considered to be a private corporation. A Canadian credit union or an agricultural or fishing cooperative, being an unlisted entity, is also a private corporation pursuant to subsections 137(7) and 136(1).[9] Therefore, if a CCPC provides services or property to these entities, and its shareholder(s) or a non-arm's-length person holds any direct or indirect interest in such corporations (owning a share of the publicly listed US parent may count as owning an indirect interest in the underlying Canadian subsidiary, and membership in a cooperative or credit union is likely also considered an interest),[10] all income from these activities could be subject to carve-out A, unless the CCPC earns all or substantially all of its ABI from arm's-length customers other than that private corporation. This result was likely unintended by the legislators, and enforcement will certainly be challenging.

Subsection 125(10) Exception for Transactions Between Associated Corporations

Pursuant to subsection 125(10), carve-out B generally does not apply to the provision of services or property to an associated corporation. Associated corporations are already required by subsection 125(3) to share the business limit, and therefore no multiplication of SBD occurs when associated corporations transact with each other. As a result, a CCPC's ABI from sales to an associated corporation is included in paragraph 125(1)(a) and entitled to the benefit of the

SBD. However, to the extent that the associated corporations do not deal at arm's length, the ABI still counts against the "all or substantially all" arm's-length ABI test when assessing whether carve-out A or B applies to the CCPC's other sources of income.

Nevertheless, the subsection 125(10) exception does not apply if the corporation receiving the services or property may deduct their cost against income that is subject to carve-out A, B, or C. This ensures that income otherwise subject to one of the carve-outs is not saved by the subsection 125(10) exception simply by an arrangement that diverts the income to an associated corporation. This point is illustrated in greater detail later in this paper.

Clause 125(1)(a)(i)(C) Carve-Out and Amendments to Subsection 256(2)

Carve-out C is applicable to income that is deemed to be ABI under subsection 129(6). If one corporation pays an amount to an associated corporation that would otherwise be property income to the recipient corporation (usually rent or interest), subsection 129(6) deems the income to be ABI to the extent that the amount is deductible against the payer's ABI. A common situation arises when one corporation carries on an active operation but rents the business facilities from an associated corporation; subsection 129(6) deems the rental income to be ABI so that the associated corporation may claim the SBD in relation to it. This usually creates a logical result since corporations within an associated group must share the $500,000 business limit under subsection 125(3) and the $10 million taxable capital limit under subsection 125(5.1).

However, under the old rules when the payer corporation would not have been entitled to claim SBD (either because it was not a CCPC or because it made an election under the "third corporation" association rule in subsection 256(2)), the application of subsection 129(6) effectively converted non-SBD-eligible profits into SBD-eligible profits. Additionally, when an election under subsection 256(2) was made, the taxable capital of the third corporation was disregarded when applying the business limit reduction rules under subsection 125(5.1) with respect to the other two corporations because the electing corporation was deemed not to be associated with them. To address this, carve-out C was added and the wording of subsection 256(2) was revised.

Under carve-out C, an amount deemed by subsection 129(6) to be ABI is excluded from subparagraph 125(1)(a)(i) if the payer corporation is not a CCPC or is a third corporation CCPC that has made an election under subsection 256(2). Unlike carve-out A or B, carve-out C does not allow excluded income to be brought back into paragraph 125(1)(a) as SCI or SPI. The reason is that this income, by definition, does not constitute SPI (since the income necessarily relates to an amount paid or payable by a corporation), nor can it constitute SCI because the payer corporation does not have any business limit to assign under subsection 125(3.2).

Effective for taxation years beginning after March 21, 2016, a corporation electing under subsection 256(2) is still associated with each of the other two corporations for the purpose of the business limit reduction in subsection 125(5.1). The election can therefore no longer be used as a planning tool to circumvent the business limit grind or to convert non-SBD-eligible income into SBD-eligible income.

Direct or Indirect Interest

A direct or indirect interest held by the CCPC that provides services or property (or its shareholders or a non-eligible person) in the entity receiving services or property is a key criterion in applying carve-out A or B. The phrase "direct or indirect interest" is not defined in the Act. While it likely permits looking through a chain of holding entities, it is not clear how broadly it can be interpreted. Could it, for example, be interpreted to include an employee who holds stock options in its private corporation employer or a holder of a right to purchase shares of a private corporation pursuant to a binding letter of intent? What is the status of a creditor's interest in its debtor (which ranks in priority to equity holders)?

When the Act uses the phrase "direct or indirect" in relation to an interest in an entity, it often makes specific reference to the type of interest involved. For example, when subsection 55(3.3) and subparagraph 88(1)(c.2)(iii) modify the definition of "specified shareholder," they use the phrase "direct or indirect interest in any issued shares of the capital stock of the corporation." Similarly, subsection 93(2.2) specifies that it is referring to a direct or indirect interest in the shares of an entity. It is unclear whether one can infer that Parliament, by leaving the phrase "direct or indirect interest" open-ended, intended the new carve-out rules in section 125 to encompass interests beyond an equity interest in corporations and partnerships.

On numerous occasions, the courts have interpreted the concept of "interest"; however, a review of these cases is beyond the scope of this paper. Manon Thivierge examined a number of these cases and concluded that the expression "interest in a corporation" is fairly restricted:

> [I]t should not include an interest or right with respect to the day-to-day activities or financial matters of a business, such as "contractual rights," since an interest in a corporation refers to an interest in the vehicle that is the corporation (such as its shares) and not what is within the vehicle (its business). Consequently, debts and liabilities of a business should not be included in the meaning of the phrase "interest in a corporation." It therefore seems reasonable to restrict the meaning of the phrase "interest in a corporation" to shares and other financial instruments providing to the holder a right to participate in the corporation's earnings.[11]

Therefore, an application of these SBD limitation provisions to a private corporation's creditors or other stakeholders beyond share ownership appears to be inconsistent with case law. Such a broad interpretation would also make compliance very burdensome since there is no de minimis rule regarding the size or significance of a direct or indirect interest necessary to trigger carve-out A or B.

Reinclusion of Carve-Out A Income as Specified Partnership Income (Subparagraph 125(1)(a)(ii))

When ABI is initially excluded from paragraph 125(1)(a) as a result of carve-out A, the income may be brought back into paragraph 125(1)(a) as SPI through subparagraph 125(1)(a)(ii).

The old definition of SPI in subsection 125(7) is a formulaic sum: $A + B$. Generally speaking, variable A was the lesser of the CCPC's share of partnership income and its pro rata share of $500,000. Variable B was the lesser of (1) the CCPC's active business losses and specified partnership losses, and (2) the amount of the CCPC's partnership income in excess of its pro rata share of $500,000. The purpose of variable B was to ensure that any active business losses of the corporation were offset first against business income that was not eligible for the SBD before reducing the income that would otherwise qualify for the SBD.

The amendments significantly modified variable A, while variable B remains substantially the same. The new variable A applies to a CCPC that is a member or designated member of a partnership, and is equal to the least of three amounts:

1) income excluded by carve-out A (paragraph (A)(a) of the SPI definition);
2) if the CCPC is a member, the CCPC's SPBL for the year; if the CCPC is a designated member, nil, unless any SBPL is assigned to it (paragraph (A)(b) of the definition); and
3) if the anti-intermediary rule is triggered, nil (paragraph (A)(c) of the definition).

Therefore, unless the anti-intermediary rule in paragraph (c) is triggered, income excluded by carve-out A may be brought back into paragraph 125(1)(a) to the extent of the CCPC's SPBL (if the CCPC is a member of the partnership) or the amount of SPBL that a member may assign to the CCPC (if the CCPC is a designated member).

Definition of Specified Partnership Business Limit and Assignment Under Subsection 125(8)

The definition of SPBL is contained in subsection 125(7), and it is analogous to the pro rata $500,000 limit in the old SPI definition. The SPBL of a person for a taxation year at any time is determined by the formula

$$(K/L) \times M - T$$

where

K is the person's share of a partnership's ABI from a business carried on in Canada,

L is the partnership's total ABI from a business carried on in Canada,

M is $500,000 (or a prorated amount when the partnership has less than 365 days in its fiscal period), and

T is the total of all amounts that the person assigns to another under subsection 125(8).

Since the numerator *K* refers to a person's share of income from a partnership, only actual members of a partnership have SPBL. A designated member can access SPBL only if a member assigns SPBL to it under subsection 125(8).

To illustrate, consider the following example:

- Mr. A and B Co (wholly owned by Ms. B) are 50/50 partners of AB partnership, which operates an active business;
- Ms. B's husband's wholly owned corporation (Spouseco) provides administrative service to AB partnership.
- During the year, AB partnership earned $1.3 million before paying $500,000 in administrative fees to Spouseco. As a result, Spouseco earned $500,000 of net income, while AB partnership earned $800,000 of net income allocated equally to Mr. A and B Co.
- Spouseco did not earn all or substantially all of its ABI from arm's-length entities.

Under the old rules, B Co was entitled to $250,000 of SPI in respect of its share of AB partnership's income (50 percent of the $500,000 limit). At the same time, Spouseco was entitled to include $500,000 in paragraph 125(1)(a). Since Spouseco and B Co were not associated, Spouseco has access to the full $500,000 business limit. This structure allowed $750,000 of the total SBD to be claimed in respect of (arguably) a single business. If Mr. A had also invested through a CCPC, this structure would have allowed the SBD on up to $1 million of income.

Under the new rules, all of B Co's 50 percent share of AB partnership's income ($400,000) is initially excluded from paragraph 125(1)(a) by carve-out A. However, as a member of AB partnership, B Co has SPBL of $250,000: $400,000 ÷ $800,000 × $500,000. This allows B Co to claim $250,000 of SPI pursuant to subparagraph 125(1)(a)(ii), effectively bringing back $250,000 of carved-out income into paragraph 125(1)(a). Assuming that B Co has full access to the business limit (no other associated corporations with which to share the business limit), B Co can claim the SBD on $250,000 of income, being the least of the amounts under paragraphs 125(1)(a), (b), and (c).

Spouseco starts out with no SPBL because it is not a member of AB partnership. Spouseco is, however, a designated member because a non-arm's-length person (Ms. B) has an interest in AB partnership, and it fails the "all or substantially all" arm's-length ABI exemption test. As a designated member, its \$500,000 of income earned from AB partnership is excluded from paragraph 125(1)(a) by virtue of carve-out A. Without an assignment of SPBL to Spouseco, Spouseco has no SPI and cannot bring back any of the carved-out income into paragraph 125(1)(a).

The mechanics of an SPBL assignment are provided by subsection 125(8), which allows a member of a partnership to assign all or any portion of its SPBL for the taxation year to a designated member if

1) the designated member and the member do not deal at arm's length,[12]
2) the SPBL of the member is in respect of a fiscal period of the partnership that ends in the designated member's taxation year, and
3) a prescribed form is filed by both the member and the designated member in their tax returns for the year.

Since B Co does not deal at arm's length with Spouseco, B Co is permitted to assign all or a portion of its \$250,000 SPBL to Spouseco using subsection 125(8). It may be advantageous for B Co to make the assignment if it does not need the SPBL—for example, if it is in a loss position or its business limit is subject to the taxable capital grind under subsection 125(5.1). If an assignment of \$250,000 is undertaken, Spouseco would have \$250,000 of SPI and could bring \$250,000 back into paragraph 125(1)(a) for the purpose of claiming the SBD. In that case, B Co cannot claim the SBD; variable *T* of the definition of SPBL reduces B Co's SPBL by any assignment.

Since the definition of SPBL does not require a partnership member to be a corporation to have SPBL and there is nothing in subsection 125(8) requiring an assignor to be a corporation, Mr. A could also assign his \$250,000 SPBL to Spouseco if he does not deal at arm's length with Spouseco (for example, if he acts in concert with Spouseco without separate interests). This is in fact the intended result of this legislation, as evidenced by the Department of Finance's illustrations in the 2016 budget documents.[13]

The SPBL assignment may be unavailable in certain common partnership business structures. To assign SPBL, a partnership member must have SPBL to begin with. Variable *K* in the SPBL definition restricts SPBL to a partner's share of the income of the partnership from an active business carried on in Canada. The Joint Committee on Taxation's submission on August 25, 2016 gave several examples of how this requirement could prevent SPBL assignments:

> 1. If a partnership carries on a specified investment business that requires services from a corporation that is a "designated member" of the partnership, the active business income derived by the designated member

> by providing such services would not be eligible for the SBD because the partner's SPBL would be nil and thus no SPBL may be assigned to the designated member.[14]

Consider the example of a real-estate-holding partnership that earns rental income with less than six full-time employees, and that uses a property management corporation, one of whose shareholders holds an interest in the partnership. Even though the property management service income constitutes ABI, it is subject to carve-out A and may never be SPI. The joint committee gave two other examples:

> 2. If a partnership carries on an active business that requires services from a corporation that is a designated member and the net income of the partnership is nil, the same result as described above applies with respect to the designated member's income from providing such services. . . .
>
> 3. In certain cases, members of partnerships receive their otherwise proportionate share of partnership income by a combination of providing services to the partnership and receiving a reduced allocation of partnership income. Sometimes, the services are provided through a related non-partner corporation which would constitute a designated member of the partnership. Given the inflexibility of element "K," the computation of a partner's SPBL is limited to the reduced partnership income allocation to that partner which in turn limits the amount of SPBL that may be assigned to that designated member.[15]

Consider an active business partnership with two partners; each partner's respective wholly owned corporation provides services to the partnership. The partnership earned ABI of $1 million in the year before management fees, and both partners' corporations charge the partnership management fees of $500,000, reducing the partnership income to nil. Since each partner's share of the income of the partnership is nil for the year, the partners have no SPBL to assign to their respective corporations. Therefore, neither the partners nor their respective corporations are entitled to the SBD on the income. This appears to be an inappropriate result since the policy behind the new rules is that income from a single active business should yield at least one SBD.

Anti-Intermediary Rules for Specified Partnership Income (Paragraph (A)(c) of the Definition)

Variable *A* of the SPI definition contains another limiting factor: paragraph (c). Paragraph (c) automatically produces a nil amount if the conditions contained in it are met. Since variable *A* is equal to the least of the amounts in paragraphs (a), (b), and (c), paragraph (c) could reduce SPI to zero, even if the partner or designated member has or is assigned SPBL.

Paragraph (c) is triggered if a CCPC is a member or designated member of a partnership that

1) itself provides services or property directly or indirectly in any manner whatever to another
   a) private corporation in which the CCPC (or one of its shareholders) or a person who does not deal at arm's length with the CCPC (or one of its shareholders) holds a direct or indirect interest, or
   b) partnership, where the CCPC (or one of its shareholders) does not deal at arm's length with it or a person that holds a direct or indirect interest in it; and
2) does not earn all or substantially all of its ABI from the provision of services or property to
   a) persons dealing at arm's length with the partnership and each person holding a direct or indirect interest therein, or
   b) other partnerships with which the partnership deals at arm's length, other than a partnership in which a person not dealing at arm's length with the CCPC holds a direct or indirect interest.

If paragraph (c) had not been included in the definition of SPI, a taxpayer group could continue to multiply SBD by using an intermediary partnership. For example, a partnership could sell property to a non-arm's-length corporation that is not associated with the corporate partners of the partnership. This would have resulted in the members and designated members of the partnership being entitled to gain access to $500,000 of the SBD in aggregate ($500,000 in aggregate SPBL, which provides for SPI and the corresponding ability to claim the SBD), while the corporation buying from the partnership would also be entitled to its own $500,000 business limit.

However, paragraph (c) is harsh because it eliminates a CCPC's entitlement to SPI with no regard to the quantum or relative proportion of the offending transaction. Consider the following example, which was used by the joint committee in its August 25, 2016 submission as an illustration:

> - A Co is a partner in a Partnership X;
> - A Co also owns 10% of B Co, another private corporation;
> - Partnership X provides services to B Co and arm's-length customers and, during the current year, its income from the services provided to B Co constituted 15% of Partnership X's total income.
>
> Since Partnership X provided services to B Co, which is a private corporation in which A Co holds an interest (albeit a small one) and it is arguably not the case that "all or substantially all" of Partnership X's income is from the provision of services or property to arm's length persons, paragraph (c) would cause A Co's SPI to be nil. Consequently, A Co is not entitled to claim the SBD on any of its income allocation from Partnership X for the year even though only a portion of the allocation derives from services to B Co.[16]

Reinclusion of Carve-Out B Income as Specified Corporate Income (Subparagraph 125(1)(a)(ii.1))

The concepts behind SCI and SPI are similar. When a CCPC's income from providing services or property to another private corporation is initially excluded from paragraph 125(1)(a) as a result of carve-out B, it may be possible to bring the income back into paragraph 125(1)(a) as SCI under subparagraph 125(1)(a)(ii.1).

Definition of Specified Corporate Income

Defined under subsection 125(7), the SCI of a CCPC for a taxation year means the lesser of (1) and (2):

1) the lesser of
   a) the amount of the CCPC's income subject to carve-out B, and
   b) the amount of business limits assigned to the CCPC under subsection 125(3.2) by the private corporation receiving services or property with respect to the carve-out B transactions (paragraph (a) of the definition), and
2) an amount that the minister determines to be reasonable in the circumstances (paragraph (b) of the definition).

In other words, if a CCPC's income from providing services or property to a private corporation is subject to carve-out B, the income may be SCI only if the private corporation receiving the services or property assigns a portion or all of its business limit to the CCPC. SCI allows the CCPC to claim the SBD on income otherwise excluded by carve-out B. However, irrespective of the actual assignment, the minister may override the CCPC's SCI to a lesser amount that it "determines to be reasonable in the circumstances."

Assignment Under Subsection 125(3.2)

Pursuant to subsection 125(3.2), when a CCPC (described as the "second corporation" in the legislation) provides services or property "directly" to another CCPC (described as the "first corporation" in the legislation), the first corporation may assign its business limit for the taxation year to the second corporation if the first corporation's taxation year ends in the second corporation's taxation year. The business limit assigned to the second corporation under subsection 125(3.2) allows the second corporation to treat carved-out income as SCI.

An election under subsection 125(3.2) requires the filing of a prescribed form with both corporations' tax returns. The amount that may be assigned is limited to a formula in paragraph 125(3.2)(c): $A - B$. Variable A is the amount of the second corporation's income from providing services or property directly to the first corporation. Variable B is the portion of the amount described in variable A that is deductible by the first corporation in respect of income subject to carve-out A or B.

To illustrate, consider the following example:

- Ms. C's wholly owned corporation (C Co) operates an active business.
- Mr. C's wholly owned corporation (Spouseco) provides consulting services to C Co.
- During the year, C Co earned $800,000 before paying $300,000 in consulting fees to Spouseco. As a result, C Co earned $500,000 net income, and Spouseco earned $300,000.
- Spouseco does not earn all or substantially all of its ABI from sales to arm's-length entities.

Under the old rules, since C Co and Spouseco are not associated with each other, C Co and Spouseco were entitled to claim the SBD on $500,000 and $300,000 of income, respectively from (arguably) a single business.

Under the new rules, Spouseco's net income of $300,000 is initially excluded from paragraph 125(1)(a) by carve-out B. C Co (the "first corporation" in subsection 125(3.2), because it is the corporation receiving services or property) may assign up to $300,000 of its own business limit to Spouseco (the "second corporation," because it is the corporation providing services or property). The amount of $300,000 is the upper limit assignable by C Co to Spouseco, because it is the amount of Spouseco's income from providing services directly to C Co. Assuming that C Co is willing to assign $300,000 of its business limit under subsection 125(3.2) to Spouseco, Spouseco's SCI becomes $300,000, unless the minister invokes its discretion under paragraph (b) of the SCI definition to determine a lower amount. Variable *B* of the formula in paragraph 125(3.2)(c) does not apply to restrict the amount of assignable business limit since C Co does not itself deduct the consulting services against income subject to carve-out A or B.

As a result, Spouseco brings $300,000 of carved-out income back into paragraph 125(1)(a) by virtue of subparagraph 125(1)(a)(ii.1), allowing it to claim the SBD on $300,000 of income. C Co's business limit decreases by the $300,000 assignment pursuant to new subsection 125(3.1). Accordingly, C Co's entitlement to the SBD is reduced to $200,000.

Is the Assignment Limit Under Subsection 125(3.2) Based on Gross or Net Income?

As discussed earlier, variable *A* in paragraph 125(3.2)(c) limits the assignment to the "income" of the second corporation from providing services or property to the first corporation. The provision is silent on whether "income" refers to the gross or net income.

The concept of income in relation to the "all or substantially all" test was discussed earlier. Similarly, the context of paragraph 125(3.2)(c) within section 125 needs to be considered to properly interpret paragraph 125(3.2)(c).

Subsection 125(1) provides for a deduction against tax otherwise payable on the net income or profits from an active business. The portion of the income that is entitled to the SBD is constrained by the amount of the business limit. It is therefore logical that the business limit is a concept tied to net income and not gross income. Because subsection 125(3.2) also uses the concept of income to determine how much of the business limit may be assigned from one CCPC to another, it is likely that the proper textual, contextual, and purposive interpretation of variable *A* in the formula in subsection 125(3.2) is that it is referring to the second corporation's net income from the provision of services or property.

Therefore, if the second corporation earns $500,000 of service revenues from the first corporation but because of expenses nets only $100,000 of profit, the first corporation may assign only $100,000 of the business limit to the second corporation under subsection 125(3.2). To the extent that the second corporation sells to multiple customers and carries on different activities, it may be challenging to properly determine the second corporation's profit specifically on the sales made to the first corporation in order to determine the amount of the business limit that is assignable by the first corporation.

Anti-Intermediary Rules for Specified Corporate Income: Variable B in Paragraphs 125(3.2)(c) and (10)(b)

Similar to paragraph (A)(c) of the SPI definition, the SCI provisions contain anti-intermediary measures, consisting of two provisions that work in tandem: paragraph (b) of subsection 125(10) and variable *B* of paragraph 125(3.2)(c).

Paragraph 125(10)(b) disables the associated corporation exception if the services or property provided is deductible against the recipient's own income that is subject to carve-out A, B, or C. Variable *B* in paragraph 125(3.2)(c) prevents the first corporation from assigning its business limit when the second corporation's services or property is deductible by the first corporation in respect of income subject to carve-out A or B.

Consider the earlier example involving C Co and Spouseco. Rather than having Mr. C's corporation (Spouseco) provide consulting services to Ms. C's corporation (C Co), the following arrangement is entered into:

- Mr. C sets up another wholly owned corporation (Intermediaryco).
- Intermediaryco agrees to provide consulting service to C Co, but Intermediaryco subcontracts with Spouseco to provide this service.
- During the year, C Co earned $800,000 before paying $300,000 in consulting fees to Intermediaryco, which in turn paid the $300,000 to Spouseco. As a result, C Co earned $500,000 of net income, Intermediaryco earned $0, and Spouseco earned $300,000.

Even though Intermediaryco and Spouseco are associated, the associated corporation exception in subsection 125(10) does not apply because the cost of the services provided by Spouseco to Intermediaryco is deductible by Intermediaryco against carve-out B income (the income that Intermediaryco earned from C Co).

Therefore, Spouseco's income of $300,000 is subject to carve-out B. At the same time, even though Intermediaryco's net income is nil and it has no use for its business limit, it cannot assign the business limit to Spouseco under subsection 125(3.2) because variable *B* in paragraph 125(3.2)(c) reduces the assignment to the extent that Spouseco's income is deductible by Intermediaryco against carve-out B income. As a result, Spouseco cannot claim any of the SBD, and only C Co is entitled to claim the SBD on its $500,000 of income.

These anti-intermediary measures may apply to common business transactions in which three or more entities owned by a non-arm's-length group of persons transact with each other, and in certain circumstances could even reduce the aggregate access to the business limit to below $500,000. Examples of this possibility are discussed in another article.[17]

In a blatantly artificial structure, such as the Intermediaryco arrangement described above, it is also possible that Spouseco could be construed as providing services (directly or indirectly, in any manner whatever) to C Co, which would have caused it to lose access to the SBD, irrespective of the intermediary transactions. In this case, C Co cannot assign any business limit to Spouseco since paragraph 125(3.2)(a) permits assignment only when services or property are provided "directly."

Other Limits Pertaining to Subsection 125(3.2) Assignments

Even though the provision of services or property, directly or indirectly in any manner whatever, can attract the application of carve-out B, subsection 125(3.2) permits an assignment only when the action is done directly. This requirement is perhaps designed to deny business limit assignments to subcontractors of services (as described above), but it is currently unclear if it is designed to prevent any other mischief. Such a distinction does not exist in respect of the SPBL assignment under subsection 125(8).

Even though carve-out B applies to services or property provided to a "private corporation," subsection 125(3.2) permits only a CCPC to assign a business limit. If a CCPC that does not meet the "all or substantially all" arm's-length ABI test provides services or property to a non-arm's-length private corporation that is not a CCPC, the SBD is never available to the CCPC on the income from the services or property because the business limit can never be assigned in respect of those transactions.

Minister's Discretion Under Paragraph (b) of the Definition of Specified Corporate Income

Paragraph (b) of the definition of SCI is a specific anti-avoidance rule. The power granted to the minister under this paragraph is unique since it is rare that a provision in the Act gives the minister undefined discretionary power to determine a specific amount. Consider section 68, in which the minister has the discretion to deem an amount but the section limits the minister's discretion to arm's-length reasonableness principles. In contrast, paragraph (b) of the SCI definition and the accompanying technical notes do not provide the minister much in the way of guidance or limits. According to the technical notes, the definition of SCI is "intended to address structures that avoid the [SPI] rules and to prevent the inappropriate multiplication of the [SBD]"; as an example, the minister can determine a lower amount if the SCI may otherwise include "income that is reasonable to consider to be attributable to or derive from income that would not be eligible for the [SBD]."[18] This provision is therefore akin to a miniature general anti-avoidance rule for the SBD.

While the discretionary power granted to the minister under this paragraph could be used to eliminate most planning that circumvents the SBD rules, commentators have suggested that the Canada Revenue Agency (CRA) would likely use the power to prevent the trading of business limits among CCPCs that provide services or property to a central service corporation.[19]

A broader (and more worrisome) implication is that these provisions could set the precedent for introducing similar anti-avoidance provisions in other parts of the Act. As pointed out by the joint committee, disputes regarding the minister's exercise of discretionary power will require taxpayers to engage in parallel litigation, since the exercise of the CRA's discretion is subject to judicial review by the Federal Court, rather than the Tax Court.[20]

Subsection 125(9) Anti-Avoidance Rule

Subsection 125(9) is an anti-avoidance rule that targets a particular arrangement designed to circumvent the new SBD rules:

- a person or partnership receiving services or property holds a direct or indirect interest in a particular partnership or corporation, and
- one of the reasons for providing the service or property to the person or partnership (instead of to the particular partnership or corporation) is to avoid the SPI or SCI rules.

If these two conditions are met, the CCPC providing the services or property may not include any income derived from its provision under paragraph 125(1)(a).

Consider the following example in which subsection 125(9) could apply:

- Mr. E and Ms. D deal at arm's length with each other, and each has a wholly owned corporation, E Co and D Co, respectively.
- Mr. E and Ms. D are also 50/50 partners in ED partnership, and both E Co and D Co provide services relating to the business of ED partnership.
- Rather than having E Co and D Co charge ED partnership, which would cause carve-out A to apply, the parties structure their affairs so that E Co provides its services to Ms. D and D Co provides its services to Mr. E.

Without subsection 125(9), E Co and D Co may have been successful in gaining access to up to $500,000 of the SBD each. However, since Ms. D and Mr. E each hold an interest in ED partnership and one of the reasons that the services are provided to Ms. D and Mr. E rather than to ED partnership is to avoid the application of carve-out A, subsection 125(9) applies to prevent D Co and E Co from including any income earned from providing services to Mr. E and Ms. D in paragraph 125(1)(a), and no SBD is allowed.

Practical Aspect of Managing the New Small Business Deduction Rules

Because the new SBD rules are complicated and laden with potential traps, practitioners must thoroughly understand the rules to properly advise their CCPC clients. I hope that tax return schedules will be designed so that they are easy for practitioners and taxpayers to navigate, but it is hard to imagine how these schedules can take into consideration all the nuanced aspects of these rules. At the same time, a good reasonableness check is often to ensure that the aggregate SBD entitlement of a corporate group does not exceed $500,000.

Structures with multiple entities should be reviewed. Legacy structures designed to multiply the SBD will likely have no further application and should be simplified or wound up. The existence of multiple entities also increases the risk of triggering the anti-intermediary measures that could complicate compliance and potentially reduce aggregate SBD access below $500,000. Entities that are jointly owned by otherwise arm's-length businesses to achieve economies of scale and foster collaboration may also require reconsideration if they are now preventing SBD access for these businesses—for example, consider the case of arm's-length farmers selling grains to a processing corporation or partnership that they jointly own.

Owners of CCPCs should also carefully review their direct and indirect investments in other private corporations or partnerships, as well as review whether any of their customers that are corporations or partnerships have a direct or indirect owner with whom they may not deal at arm's length. To the extent that ABI is derived from non-arm's-length entities or from entities with non-arm's-length owners, the CCPC may need to prepare a segmented income statement to determine the profit specifically relating to those transactions (by allocating expenses and overhead against revenues from those transactions) in order to make a determination in respect of the "all or substantially all" ABI exemption. If there is an assignment of the business limit under subsection 125(3.2), there may even be a need to separately determine the profit earned from different non-arm's-length customers in order to compute the amount of assignable business limit. There is currently little guidance on how to allocate costs between customers, and this may become an area of contention between taxpayers and the tax administrators.

Are There Still Ways To Multiply Access to the Small Business Deduction?

The new SBD rules effectively eliminate most (if not all) forms of SBD multiplication planning for businesses operating as a single unit. Businesses that do not operate as a single unit may still find it possible to structure arrangements that allow for access to multiple SBDs.

For example, joint ventures and cost-sharing arrangements do not attract the application of these new rules. As long as an arrangement does not constitute a partnership, carve-out A does not apply and each participant's income may be eligible for the full SBD. The distinction between a partnership and a joint venture or cost-sharing arrangement is a question of fact and beyond the scope of this paper, but practitioners and taxpayers employing these arrangements must exercise continuous vigilance to ensure that these arrangements remain outside the definition of a partnership.

Another potential restructuring alternative is to divide the business into logical separate businesses. For example, a business with different geographical divisions could consider spinning out each division as a separate corporation or partnership, each with different arm's-length owners. Alternatively, cross-charges arrangements between arm's-length entities may be structured, depending on the circumstances. However, these strategies must involve careful consideration of the broad concepts deployed in section 125 (such as direct or indirect interest, provision of services or property directly or indirectly in any manner whatever, and factual non-arm's-length relationships) and the various anti-avoidance rules discussed above.

More importantly, before undertaking any SBD planning that involves a significant disruption in a taxpayer's business, the taxpayer should consider the integrated tax system in Canada and appreciate that losing access to the SBD is merely a loss of a deferral. The tax tail should not wag the business dog.

Notes

1 Our conference presentation also highlighted certain features of subsection 55(2) of the Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this paper are to the Act. This discussion is excluded here because of the number of recent papers that cover this subject. The following are a few of the Canadian Tax Foundation papers discussing subsection 55(2): Rick McLean, "Subsection 55(2): What Is the New Reality?" in *Report of Proceedings of the Sixty-Seventh Tax Conference*, 2015 Conference Report (Toronto: Canadian Tax Foundation, 2016), 22:1-71; Ron Dueck, Janette Pantry, and Rosanna Lau, "Subsection 55(2): Practical Applications," in *2016 British Columbia Tax Conference* (Toronto: Canadian Tax Foundation, 2016), 10:1-38; Kenneth Keung and Kim G.C. Moody, "Subsection 55(2)—The Road Ahead," in *2016 Prairie Provinces Tax Conference* (Toronto: Canadian Tax Foundation, 2016), 10:1-43; Rick McLean, "Subsection 55(2) Amendments: What's the Purpose?" in *2016 St. John's Tax Seminar* (Toronto: Canadian Tax Foundation, 2016), 2:1-48; and Marissa Halil, Alex Ghani, and Manu Kakkar, "Is Safe Income Really Safe?" in *2016 Ontario Tax Conference* (Toronto: Canadian Tax Foundation, 2016), 10:1-27.

2 Liberal Party of Canada, *Real Change: A New Plan for a Strong Middle Class* (Ottawa: Liberal Party of Canada, 2015), at 80.

3 "Active business carried on by a corporation" is defined in subsection 125(7).

4 Canada, Department of Finance, 2016 Budget, Tax Measures: Supplementary Information, Notice of Ways and Means Motion To Amend the Income Tax Act and Other Tax Legislation, March 22, 2016.

5 Several components and the structure of this flow chart are taken from the SCI flow chart contained in David G. Thompson, "Small Business Deductions/Multiplication/Dealing with PCs," in *2016 British Columbia Tax Conference*, supra note 1, 8:1-28.

6 Generally, "substantially all" is considered by the CRA to mean 90 percent or more, but this matter should be reviewed on a case-by-case basis. In certain cases, the Tax Court of Canada has accepted percentages as low as 80 to meet the test. See *Ruhl v. R*, [1998] GSTC 4 (TCC); *McDonald v. R*, [1998] 4 CTC 2569 (TCC); *Keefe v. The Queen*, 2003 TCC 791; and *McKay v. The Queen*, 2000 CanLII 234 (TCC).

7 *Ludco Enterprises Ltd. v. Canada*, 2001 SCC 62, at paragraph 61.

8 Section 262 allows the minister of finance to designate a stock exchange as a "designated stock exchange."

9 Subsections 137(7) and 136(1) deem credit unions and cooperatives not to be private corporations, but neither provision applies for the purposes of section 125.

10 The definition of a "share" in subsection 248(1) explicitly includes a share in a cooperative corporation or a credit union.

11 Manon Thivierge, "Restrictive Covenants and Section 56.4: Traps for the Wary," in *Report of Proceedings of the Sixty-Third Tax Conference*, 2011 Conference Report (Toronto: Canadian Tax Foundation, 2012), 9:1-32, at 9:23.

12 Paragraph 125(8)(a) refers to a person who is described in paragraph (b) of the "designated member" definition in respect of the designated member. Paragraph (b) of the designated member definition describes a number of different persons. However, taking into account the preamble of subsection 125(8), which states that the assignor must be a member of the partnership, paragraph 125(8)(a) should be referring to those members of the partnership that do not deal at arm's length with the designated member.

13 See Tax Measures: Supplementary Information, supra note 4.

14 Joint Committee on Taxation of the Canadian Bar Association and Chartered Professional Accountants of Canada, “Federal Budget 2016: Proposed Amendments to Small Business Deduction Entitlement and Transfer of Life Insurance Policies,” submission to the Department of Finance, August 25, 2016.

15 Ibid.

16 Ibid.

17 Kenneth Keung, “Anti-Intermediary Rules in Section 125” (2017) 25:2 *Canadian Tax Highlights* 9-10.

18 Canada, Department of Finance, *Explanatory Notes Relating to the Income Tax Act, Excise Tax Act, Excise Act, 2001 and Related Texts* (Ottawa: Department of Finance, October 2016), at clause 44.

19 Thompson, supra note 5.

20 Supra note 14.