



TAX NOTES

May 2016

BUDGET 2016 TARGETS CERTAIN PARTNERSHIP STRUCTURES

Although many fears relating to the March 22, 2016 federal budget did not come to pass, the budget does contain an unwelcome surprise for professional firms and other partnerships using a service corporation or “sister PC” structure to maximize access to the small business deduction. Although these amendments potentially impact any corporation that provides services to a partnership, our comments in this Tax Note are focused primarily on professional firms in order to illustrate how the new rules will work.

Existing Structures

An example of a partnership structure for professional firms operates as follows:

- (a) The professional firm’s business is carried on through a limited liability partnership (“**LLP**”);
- (b) Each partner of the firm holds his or her interest in the partnership through a professional corporation (“**Partner PC**”) of which he or she is not an employee;
- (c) Each partner of the firm also controls a second professional corporation (“**Services PC**”) that is not a member of the partnership and of which he or she is an employee; and
- (d) Services PC and the partnership enter into an agreement wherein Services PC provides professional services to the partnership pursuant to a contract in exchange for a fee.

Services PC and Partner PC are associated and must share a small business deduction limit. However, provided Services PC was not a member of the partnership, its consulting fee income was not specified partnership income under the old rules. By agreeing to allocate the associated group’s small business deduction limit to Services PC, a full small business deduction in the Services PC is accessed.

Outside the professional corporation context, a common structure is to have the business conducted through a general partnership, the partners of which would be corporations controlled directly or indirectly by the owners of the business. Each owner would also control a second management corporation that would provide services to the partner corporations in exchange for a fee. Depending on the situation, the management corporations could either own the partner corporations as wholly-owned subsidiaries or both management and partner corporations could be owned by the individual owner.



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Proposed Amendments - Specified Partnership Income

The proposed amendments will effectively reduce Services PC's small business deduction limit to the amount that would be its specified partnership income if it were a member of the professional partnership. A number of provisions in section 125 will be amended to achieve this objective.

The proposed amendments turn on the new definition of "designated member". A designated member is defined to include a CCPC that is not a member of the partnership where the CCPC provides (directly or indirectly, in any manner whatever) services to the partnership, and one of its shareholders (or a person not dealing at arm's length with the CCPC) holds a direct or indirect interest in the partnership. In the typical structure, Services PC will be a designated member because it provides services to the partnership and its shareholder holds an indirect interest in the partnership via Partner PC.

The second new concept is the "specified partnership business limit". Simplifying slightly, the specified partnership business limit is equal to the person's percentage share of the income of the partnership multiplied by the \$500,000 small business deduction limit for a non-associated corporation. Since a person must be entitled to a share of the partnership income in order to have a specified partnership business limit greater than nil, a person who is a designated member of the partnership will not initially have any specified partnership business limit in a taxation year.

As a result, the default rule will result in a nil specified partnership business limit for the typical Services PC, such that it will not be entitled to access any small business deduction amount. However, the budget proposals permit a partner to assign to a non-arm's length designated member of the partnership some or all of its specified partnership business limit. A prescribed form for this assignment will be created, and will need to be filed on an annual basis by both the partner and the designated member in respect of the partner.

The definition of "specified partnership income" will also be amended to deal with designated members. The default will be that a designated member has nil specified partnership income, but, provided that some amount is assigned to the designated member, the designated member will have specified partnership income equal to the lesser of: (i) its income from the provision of services (directly or indirectly) to the partnership; and (ii) the amount assigned to it. The rules for computing the specified partnership income of a non-designated partner, like Partner PC, remain substantially unchanged, but specified partnership income will be reduced to the extent that the partner has assigned some or all of its specified partnership business limit to a designated member.



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All of these new concepts and amendments feed into an amended paragraph 125(1)(a). Among other things, a CCPC's income eligible for the small business deduction will no longer include its income from the provision of services (directly or indirectly) to the partnership. This means that designated members of a partnership, like Services PC, will only have income qualifying for the small business deduction to the extent of its specified partnership income.

Numerical Example - Specified Partnership Income

Suppose Partner PC is a member of Partnership ABC, which has total income in its current fiscal period of \$10,000,000. Partner PC has a 14% interest in the income of the partnership, meaning that it will initially have income of \$1,400,000, specified partnership income of \$70,000, and a specified partnership business limit of \$70,000.

Services PC, which has the same controlling shareholder as Partner PC, is entitled to be paid a \$500,000 fee by the partnership for consulting services provided throughout the year. As noted above, since the services are provided to the partnership and since Services PC's shareholder holds an indirect interest in the partnership, Services PC should be a designated member of Partnership ABC.

If no amount is assigned to Services PC by Partner PC, Services PC will have a nil specified partnership business limit and will therefore have nil specified partnership income.

If it is desirable for Services PC to have access to the small business deduction, Partner PC can assign its entire \$70,000 specified partnership business limit to Services PC. By so doing, Services PC's specified partnership business limit will be increased to \$70,000, and there will be a corresponding increase in Services PC's specified partnership income. Services PC will therefore have \$70,000 of income that qualifies for the small business deduction. As a result of Partner PC assigning its specified partnership business limit to Services PC, Partner PC's specified partnership business limit and specified partnership income will both decrease by \$70,000, such that no portion of Partner PC's income will qualify for the small business deduction.

In sum, the new rules provide that Partner PC and Services PC must share the specified partnership income amount that Partner PC would have had under the old rules.

Anti-Avoidance Rule

The budget proposals contain a specific-anti avoidance rule that will apply where a corporation provides services or property to a partner instead of a partnership, if any one of the reasons for doing so was to avoid the services or property being described in the specified partnership income definition. If these conditions are satisfied, then none of the income from the provision of the property or services will be eligible for the small business deduction.



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This anti-avoidance rule, although somewhat narrow in scope, could be relatively broad in its application because of the “one of the reasons” language. In particular, it will not be necessary for the avoidance of the small business deduction limitations to be a main or principal reason for providing services to a partner in order for this anti-avoidance rule to apply.

Coming Into Force

The proposed amendments to section 125 apply to taxation years that begin on or after March 22, 2016. For most professional partnerships and professional corporations, which have December 31 year-ends, this means that the existing structures should remain effective throughout 2016.

Although not all structures are impacted, it may be desirable to unwind certain structures at the end of the current taxation year (e.g., by December 31, 2016) if those structures will no longer provide any material tax or commercial benefits. It should be possible to pair the structure unwind with other tax planning (including planning relating to the proposed amendments regarding eligible capital property) in order to permit partners to benefit from the unwind. Alternatively, there may be merit in converting to different structures before or at the end of this year.