



# TAX NOTES

May 2016

## BUDGET 2016 TARGETS FEE-BASED STRUCTURES

The March 22, 2016 federal budget contained proposed legislation which, if enacted, will materially restrict the ability of corporations to claim the small business deduction to the extent that income is earned from the provision of management or consulting services to other corporations. These proposed restrictions will apply not only to so-called “head PC” structures, but also to other structures which utilized management fees or consulting fees in order to permit direct or indirect shareholders to claim separate small business deductions.

### Existing Structures

The structures targeted by the proposed legislation include the following typical structure:

- (a) The firm’s business is carried on through a Canadian-controlled private corporation (“**CCPC**”) (“**Opco**”), but Opco does not employ the individual members of the firm;
- (b) Each individual member of the firm holds his or her interest in Opco through a corporation (“**Holdco**”) of which he or she is an employee, with the individual and his or her family members as the shareholders of Holdco; and
- (c) Opco and Holdco enter into an agreement under which Holdco provides certain services to Opco as an independent contractor in exchange for a fee, usually in the range of \$500,000 per year.

Provided that Holdco and its shareholders do not control Opco, directly or indirectly in any manner whatever, Holdco and Opco should not be associated and should each be entitled to a separate, full small business deduction. Not only will each member of the firm be able to obtain a small business deduction via Holdco, but Opco will also remain entitled to its own small business deduction.

Historically, the risks of implementing such a structure centered on the reasonableness of the fees paid to the Holdcos and, more importantly, the potentially punitive personal services business rules.

### Proposed Amendments - Specified Corporate Income

The proposed amendments will force Opco and Holdco to share a single small business deduction, with Opco being entitled to the small business deduction as a default rule.



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Whether or not the regime applies to Opco and Holdco turns on whether or not Holdco earns income that is described in the proposed definition of “specified corporate income”. Holdco’s income described in the specified corporate income definition is its income from the provision of services or property to a corporation if Holdco, one of Holdco’s shareholders or a person not dealing at arm’s length with Holdco owns a direct or indirect interest in the corporation. An exception exists if substantially all (i.e. 90% or more) of Holdco’s income is generated by the provision of similar services or property to arm’s length persons or partnerships, in which case the income will be treated in the same manner as the arm’s length income.

However, having income described in the specified corporate income definition is not the same as having specified corporate income. Instead, Holdco’s actual specified corporate income will be limited to the lesser of two amounts: (a) the amount of Holdco’s income described in the specified corporate income definition; and (b) the amount, if any, of Opco’s business limit assigned to Holdco.

The proposed specified corporate income definition also contains a limit on specified corporate income that will apply in circumstances in which the Minister determines that the appropriate amount of specified corporate income is less than the amount otherwise determined. It is unclear when the Minister might make such a determination, but this power will presumably be exercised in circumstances when the Minister determines that specified corporate income has been inflated. It is hoped that the Explanatory Notes will provide further insight.

Opco will be able to assign a portion of its business limit to Holdco, even if Opco and Holdco are not associated. To the extent that such an assignment is made, Holdco’s specified corporate income will be increased and Opco’s business limit will be decreased. An assignment will require *both* Opco and Holdco to file a prescribed form with the returns for the year that the assignment is made.

Paragraph 125(1)(a) will be amended to exclude income described in the specified corporate income definition from Holdco’s income eligible for the small business deduction. Proposed subparagraph 125(1)(a)(ii.1) will include Holdco’s specified corporate income, as determined, in Holdco’s income eligible for the small business deduction. This means that Holdco’s income from providing services to Opco will, in most instances, only be eligible for the small business deduction to the extent that Opco has assigned Holdco a portion of its business limit such that Holdco’s specified corporate income amount will be greater than nil.

### **Numerical Example - Specified Corporate Income**

Suppose Holdco is one of four shareholders of Opco, an unassociated corporation which has total income in its current taxation year of \$3,000,000. Holdco owns 25% of the shares of Opco, and has entered into a consulting agreement with Opco under which Holdco is entitled to an annual fee of \$500,000 for consulting services provided. Holdco does not provide services to anyone other than Opco with any regularity.



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Since Holdco is a shareholder of Opco and does not earn substantially all of its income from providing services to arm's length persons or partnerships (other than Opco), all of the services provided by Holdco should be described in the specified corporate income definition. Consequently, none of the income from the provision of these services should be income eligible for the small business deduction.

If no portion of Opco's business limit is assigned to Holdco, Holdco will have nil specified corporate income. However, if Opco assigns \$125,000 of its business limit to Holdco, then Holdco's specified corporate income will increase from \$nil to \$125,000. Opco's business limit will be reduced from \$500,000 to \$375,000. If Opco makes similar assignments to all of its shareholders, Opco's business limit will be reduced to \$nil.

### **Anti-Avoidance Rule**

The budget proposals contain a specific-anti avoidance rule that will apply where a corporation provides services or property to a shareholder instead of a corporation, if any one of the reasons for doing so was to avoid the services or property being described in the specified corporate 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.

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 shareholder in order for this anti-avoidance rule to apply.

### **Taxable Capital Allocations**

The proposed legislation also includes provisions that target structures that made use of a subsection 256(2) election to avoid a grind to the group's small business deduction eligibility due to taxable capital considerations. These provisions will, if enacted, reduce or eliminate the efficacy of structures that relied on a subsection 256(2) election in order to avoid an associated group being subject a business limit reduction on account of having greater than \$10,000,000 of taxable capital employed in Canada. Any interest or other income received from the corporation making the subsection 256(2) election that is re-characterized as active business income by subsection 129(6) will no longer qualify for the small business deduction.

### **Coming Into Force**

The proposed amendments to section 125 apply to taxation years that begin on or after March 22, 2016. This means that the existing fee-based structures should remain effective until the conclusion of the taxation year of any service provider corporation that includes March 22, 2016.