Blaney McMurtry LLP

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Small Business Deduction Survives Budget: Ottawa Proposes Major New Limitations

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Now that the new federal Liberal government's first budget has been introduced, we can focus our attention on those measures that actually have been put forward rather than on those that everyone speculated *might be* put forward.

This is particularly the case with entrepreneurs, where it was feared that the small business deduction would be eliminated for many businesses engaged in providing services. The good news is that the small business deduction has *not* been eliminated for these businesses, but the bad news is that it has been significantly limited.

As most entrepreneurs are aware, a Canadian-controlled private corporation engaged in an "active business" (which includes the provision of services) is entitled to a small business deduction for its first $500,000 of annual active business income.

In Ontario, the combined federal and provincial corporate tax rate on qualifying income is 15 percent. This represents a significant deferral.

Where taxpayers, such as professionals, are engaged in providing services through a partnership, a corporation's entitlement to this low rate is restricted to its pro-rata share of the partnership's income; i.e.: if a corporate partner is entitled to 10 percent of the partnership's profits, then its small business rate would be limited to $50,000 of income per annum.

As a result, various structures have been developed to circumvent this restriction. For example, lawyers who practice in partnership through corporations may, in addition to sharing the partnership income, bill the partnership directly for services provided by the individual. In this way the income derived from services provided to the partnership does not form part of the partnership income and is therefore not subject to the restriction.

Similarly, a husband and wife may be engaged together in a business venture. Corporation A may be solely controlled by the wife and earn the income from the business venture directly. Corporation B may be solely owned by the husband and may bill Corporation A for services provided to the business. In this way the husband and wife's business could potentially generate $1 million per annum subject to the small business deduction.

The budget proposes to curtail these practices in a similar way. In the case of partnerships, the income earned by a corporation providing services to the partnership will be deemed to be partnership income (and thus subject to the apportionment restriction) where there is a non-arm's length relationship between shareholder of the service corporation and a member of the partnership. In the case of services being provided by one corporation to another, there will be no small business deduction available for service income where there is a similar non-arm's length relationship between the shareholders of the two corporations. Thus, access to the low corporate tax rate will be limited in the case of both professionals and business entrepreneurs.

Having said all of this, there is a long road between introduction of the proposed measures in a budget and implementation through legislation. Although we have a majority government, there could be either tweaks or significant amendments to this proposed legislation as a result of lobbying from various industry groups. We have already heard a suggestion that the Department of Finance is considering exempting medical professionals from this new measure. We will continue to monitor the legislation and advise our clients of the final results.

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