

Eligibility for Small Business Tax Rate

Issue

Access to the small business tax rate has been effectively removed for small businesses working solely for large private corporations. This greatly reduces the tax incentive for small businesses to operate in Canada and loss of small business in Canada is detrimental to the entire economy.

Background

Legislation was introduced in the March 21, 2016 federal budget and was intended to apply to year's beginning on or after the budget date, so it will apply to years ending March 20, 2017 or later. These rules affect corporate groups by removing access to the small business limit.

If you have two private companies and one company gets 10% or more of its taxable income from the other private company and there is a non-arm's length shareholder, then the income between the two companies is deemed to be "specified corporate income", (herein referred to as "SCI"). SCI is still considered active business income, but is no longer eligible for the small business deduction (i.e. gets the general corporate rate rather than the small business rate). There is no specified amount of the ownership the non-arm's length shareholder needs to own for these rules to apply as it's written. The company paying the other company is able to elect to share their small business limit with the other company to then have it taxed at the small business rate.

Example:

- Company A - Owned by Mr. A, say their taxable income is \$500,000.00
- Company B - Large private corporation in which Mr. A's cousin (not "related" for tax purposes, but "non-arm's length") owns 1 common share out of 100,000,000 common shares
- Company A gets 15% of its taxable income from Company B
- Since it's more than 10% and the other company has a non-arm's length shareholder, this income is considered SCI
- This means the \$75,000.00 ($\$500,000.00 \times 15\%$) of income Company A receives from Company B is no longer eligible to get the small business rate of 13%, but gets bumped up to 26%.
- Company B can elect to give Company A some of its small business limit up to \$75,000.00, but Company B is very unlikely to do so since Mr. A's cousin only owns a single share in a large corporation.

The intent of these rules was to catch corporate structures that circumvent the existing association rules to share the small business limit among many otherwise non-associated corporations. Unfortunately, the legislators used too broad of wording and currently there is no percentage of ownership the non-arm's length shareholder needs to own for these to kick in and as a result they cast a much bigger net than it appears they were intending.

A simple solution is to have the share ownership for the non-arm's length party defined as a percentage so it will not affect most of the small businesses working for large private corporations.

Recommendation

That the federal government define a share ownership percentage of 10% or higher for the non-arm's length party with respect to specified corporate income.