2016 federal budget: impact on professionals

March 2016

Professionals that are regulated by a governing professional body—such as physicians, dentists, veterinarians, lawyers, accountants, engineers and architects—often choose to operate through professional corporations (PCs). In the weeks prior to the 2016 federal budget, there was some concern that the new Liberal government would amend the definition of the types of companies that qualify for the small business tax rate,[1] with the concern being that a PC would no longer qualify for the small business deduction (SBD).[2]

The measures in the 2016 federal budget did not go this far. However, the budget did propose significant changes to address concerns about partnership and corporate structures that have been implemented to increase or multiply access to the SBD.

What are the proposals?

A Canadian-controlled incorporated business is entitled to claim the SBD on the first $500,000 of its active business income. Where Canadian-controlled private corporations (CCPCs) are members of a partnership, each CCPC is only entitled to claim its *pro-rata* share of the $500,000 business limit. These rules are referred to as the "specified partnership income" (SPI) rules. Without these rules, each CCPC that is a member of a partnership could claim a separate SBD of up to $500,000 in respect of the portion of the partnership's active business income allocated to it. However, certain structures have been implemented to circumvent these rules. In general, as a result of the measures announced in the budget, these structures will no longer work to achieve this result.

Example #1

One typical structure that has been used is where a partner incorporates a CCPC and the partnership pays the CCPC as an independent contractor under a contract of services. Since the CCPC is not a member of the partnership, the CCPC is able to claim the full SBD in respect of its active business income earned from the partnership.

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[1] Similar to recent Quebec amendments, which provide that a company will only qualify for the small business deduction (for tax years beginning in 2017) if it either (i) has employees who satisfy criteria regarding a minimum number of hours worked in a year (generally, 5,500 hours); or (ii) it is a corporation where at least 25 percent of its activities consist of activities in the primary or the manufacturing and processing sector.
[2] Although the federal small business tax rate was scheduled to decline to 9 percent by 2019, the 2016 federal budget announced that the government intends to maintain the rate at 10.5 percent.

Under the proposed rules, where a CCPC provides services or property to a partnership and the shareholder of the CCPC (or a person not dealing at arm's length with that shareholder) is also a member of the partnership, the CCPC will be deemed to be a member of the partnership, thereby restricting its access to the SBD.

Initially, the SPI limit of the CCPC will be nil. However, an actual member of the partnership who does not deal at arm's length with the CCPC will be able to notionally assign all or a portion of the partner's SPI limit to the CCPC.

There is an exception to these rules where the CCPC earns all or substantially all of its active business income (90 percent or more) from providing services or property to arm's length persons other than the partnership.

Example #2

Another common structure that has been set up uses two corporations, a PC and another associated corporation to provide services (for example, ServiceCo). As part of the partnership agreement, the PC provides professional services to the partnership. A service agreement is set up between ServiceCo and the PC, whereby the PC will pay ServiceCo for services provided by the professional (who is an employee of ServiceCo). Under the current rules, ServiceCo and the PC are able to share the full $500,000 SBD.

Under the proposed rules, however, access to the SBD will be restricted where a CCPC (in the above example, ServiceCo) earns active business income from providing services or property (directly or indirectly) to a private corporation and either the CCPC, one of its shareholders or a person who does not deal at arm's length with such shareholder, has a direct or indirect interest in the private corporation. In this situation, none of ServiceCo's income will qualify for the reduced small business rate.

Again, there is an exception to these rules where the CCPC earns all or substantially all of its active business income (90 percent or more) from providing services or property to arm's length persons other than the private corporation.

There is also the ability for the PC to notionally assign its small business limit to ServiceCo. However, the amount that can be allocated will be effectively limited to that which would be available to the PC had it been subject to the SPI rules.

These measures apply to taxation years that begin after March 21, 2016.

What should you do?

These proposals will affect many professionals who are members of a professional partnership. However, they don't necessarily mean that current structures need to be unwound. PCs still offer a number of tax advantages, including:

- **Tax deferral benefits where surplus funds can be retained in the corporation.** Corporations that do not qualify for the SBD will be subject to a 15 percent federal corporate rate on all active business income (as opposed to the 10.5 percent small business rate). Although this reduces the tax-deferral advantage, it does not eliminate it.

- **The opportunity to income split with family members** (where permitted by the particular profession and jurisdiction). If the corporation can pay dividends to a lower income spouse or adult child, the tax savings can be considerable.
- **The ability to claim the lifetime capital gains exemption[3] on the sale of the practice**, assuming this is permitted in the professional's province.

The major benefit that has been lost is the ability to increase access to the small business deduction.

Conclusion

If you are a member of a partnership and you have implemented a structure using one or more corporations to access the SBD, you have been able to realize significant benefits over the years. However, tax rules are constantly changing and strategies that may have worked in the past may no longer be tax effective.

Based on the government's recent proposals, we are investigating the available options—including maintaining the existing structure, dissolving the structure or looking at alternative structures. The option that's right for you will likely depend on your particular situation, so we suggest consulting with your tax advisor to determine your best course of action going forward.

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[3] currently up to $824,176