THE CANADIAN BAR ASSOCIATION
L'ASSOCIATION DU BARREAU CANADIEN

CPA CHARTERED PROFESSIONAL ACCOUNTANTS CANADA COMPTABLES PROFESSIONNELS AGRÉÉS CANADA

The Joint Committee on Taxation of
The Canadian Bar Association
and
Chartered Professional Accountants of Canada

Chartered Professional Accountants of Canada, 277 Wellington St. W., Toronto Ontario, M5V3H2
The Canadian Bar Association, 500-865 Carling Avenue Ottawa, Ontario K1S 5S8

June 2, 2017

Brian Ernewein
General Director, Tax Policy Branch
Finance Canada
90 Elgin Street
Ottawa, ON K1A 0G5

Dear Mr. Ernewein:

Subject: Small Business Deduction Rules under Section 125 of the Income Tax Act – Follow-Up to Our Meeting with Canada Revenue Agency

Recently we met with senior members of the Canada Revenue Agency ("CRA") to review a submission the Joint Committee made seeking guidance regarding the manner in which the CRA would be administering section 125 as amended following the 2016 federal Budget proposals.

Although the meeting was extremely informative, the CRA agreed that the statutory language supports the interpretations in the submission. The CRA suggested that the concerns raised would have to be addressed by the Department of Finance because the statutory language does not appear open to other interpretations. Accordingly, we ask for your consideration of the issues raised in the submission, a copy of which we have enclosed.

We recognize that draft legislation to address farming and fishing co-operatives was released last month. However, we believe that those amendments are too narrow, as co-operatives operate in sectors beyond farming and fishing.

We trust you find the enclosed useful and would be pleased to discuss the issues raised at your convenience.

Yours very truly,

Kim G. C. Moody
Chair, Taxation Committee
Chartered Professional Accountants of Canada

K.A. Siobhan Monaghan
Chair, Taxation Section
Canadian Bar Association

Cc: Andrew Marsland, Senior Assistant Deputy Minister, Tax Policy Branch, Finance Canada
Randy Hewlett, Director General, Income Tax Rulings Directorate, CRA
Stéphane Prud'homme, Director, Income Tax Rulings Directorate, CRA
Gabe Hayos, Vice President, Taxation, CPA Canada

THE CANADIAN BAR ASSOCIATION
L'ASSOCIATION DU BARREAU CANADIEN

CPA CHARTERED PROFESSIONAL ACCOUNTANTS CANADA
COMPTABLES PROFESSIONNELS AGRÉÉS CANADA

The Joint Committee on Taxation of
The Canadian Bar Association
and
Chartered Professional Accountants of Canada

Chartered Professional Accountants of Canada, 277 Wellington St. W., Toronto Ontario, M5V3H2
The Canadian Bar Association, 500-865 Carling Avenue Ottawa, Ontario K1S 5S8

February 14, 2017

Randy Hewlett
Director General
Income Tax Rulings Directorate
Canada Revenue Agency
112 Kent Street, Ottawa, Ontario K1A 0L5

Dear Randy:

Subject: New Small Business Deduction Rules in Section 125

The new small business deduction rules were announced as part of the 2016 federal Budget. Having had the chance to review these rules and apply them to actual taxpayer situations, the Joint Committee has many concerns over the complexity and reach of these rules, particularly on their impact to structures and transactions where the multiplication of small business deduction was never a motivation.

Our objective in sending this letter to you is to begin a dialogue and bring to the Canada Revenue Agency's (Agency) attention unintended consequences to small businesses across the country that may arise from a broad or literal interpretation of these rules in advance of a proposed upcoming meeting this Spring. We hope that the Agency will respond by adopting narrower interpretations that we believe are more consistent with the policy objective behind the amendments to section 125. We also hope that the Agency will develop meaningful guides and aids to the public in navigating and complying with these rules.

The Joint Committee would like to acknowledge the significant contributions of the following individuals in the preparation of this material.

Hugh Neilson (Kingston Ross Pasnak LLP)
Bruce Ball (BDO Canada LLP)
Joe Truscott (Joseph Truscott Chartered Accountant)
Kenneth Keung (Moodys Gartner Tax Law LLP)
John Oakey (Collins Barrow)
Dino Infanti (KPMG LLP)
Kim G C Moody (Moodys Gartner Tax Law LLP)

If you would like to discuss any of comments in advance of the upcoming meeting, please contact us.

Yours very truly,

Kim G. C. Moody
Chair, Taxation Committee
Chartered Professional Accountants of Canada

K.A. Siobhan Monaghan
Chair, Taxation Section
Canadian Bar Association

Cc:

Marina Panourgias, Senior Rulings Officer, Income Tax Rulings Directorate, CRA
Gabe Hayos, Vice President, Taxation, CPA Canada
Ken Griffin, Vice Chair, Taxation Committee Chartered Professional Accountants of Canada

New Small Business Deduction Rules in Section 125
Joint Committee Comments
February 9, 2017

Purpose of the Amendments

Leading up to the 2016 Budget, rumours on changes to the Small Business Deduction (SBD) abounded. These ranged from denying the SBD to incorporated professionals, to imposing restrictions based on sector and/or employment similar to Quebec or even as extreme as a complete elimination of the SBD.

The release of the Budget indicated these rumours were largely unfounded, with the statement that "*Small businesses—from health care professionals to small manufacturers— provide important goods and services, create opportunities and strengthen communities across Canada*" reaffirming the purpose of the SBD. At the same time, the Budget also introduced measures to prevent Canadian-controlled private corporations (CCPC) from multiplying access to the SBD, targeting structures perceived as abusive.

The Supplementary Information provided further details, addressing partnerships in great detail, and introducing the Specified Corporate Income regime because "*The tax planning described above could use a corporation (instead of a partnership) to multiply access to the small business deduction*". A third, much more targeted, measure was proposed for structures utilizing subsection 256(2) of the Income Tax Act ("Act").

It is our understanding that the underlying scope of these provisions was to ensure **a single business obtains access to a single SBD limit**. We do not question the reasonableness of this policy initiative. The new Specified Partnership Income (SPI) provisions and the new carve-out for structures utilizing subsection 256(2) generally target situations that fall outside this policy. However, the Specified Corporate Income (SCI) provisions seem capable of interpretation which goes far beyond the stated purpose of preventing, say, a large accounting or law firm circumventing the revised SPI restrictions in order to multiply access to the SBD.

The balance of this document illustrates the concerns that the Joint Committee has with these new provisions.

<u>Concerns with the Amendments</u>

In some examples practitioners have raised, the business structures appear to have the effect of accessing multiple SBD limits for a single business. Many of these structures may have been attacked under other provisions (personal services businesses, unreasonable expense deductions, deemed association and de facto control, for example). However, the application of the new SCI provisions are less subjective than these avenues, and therefore will likely be more effective, and much easier to administer. Such structures are not the focus of our concern.

We are concerned that the rules go beyond preventing access to multiple SBD limits for a single business to adversely affect parties carrying on independent businesses, and so outside the mischief these provisions seek to target. Furthermore, these rules operate to not only deny multiplication of the SBD but go so far as to decrease overall entitlement to the SBD to below $500,000 in some cases. We offer several

broad examples drawn from members of the Joint Committee to illustrate our concerns. We also offer below certain suggestions regarding ways the CRA might interpret the new rules in order to alleviate some of these concerns.

More generally, tax practitioners are also concerned about the complexity of the new section 125 rules, and we will discuss how the CRA can provide better assistance to taxpayers and practitioners to ensure they properly comply with these complex new rules.

Examples of the new rules restricting SBD access where parties carry on independent businesses

1. Agricultural and Fishing Cooperatives

It is fairly common for farmers and fishermen to form cooperative corporations to acquire, process and market the products they produce. For example, dairy farmers create a cooperative to process milk into various products and sell these to retail grocery stores.

Typically, a producer is required to own an interest in the cooperative to which the producer sells its products. Where the particular farming or fishing operation is carried out through a CCPC (often a family farm or fishing corporation of the type contemplated by section 110.6 for the capital gains deduction), the SCI provisions will clearly apply. The cooperative is a private corporation for purposes of section 125 (section 136 provides this result), and is the main, if not sole, purchaser of the farming or fishing business' products.

As a result, every farming or fishing CCPC selling substantially all of its products to a co-operative in which it holds an interest will be ineligible for the SBD. As noted above, ownership is typically a pre-requisite to sell to the cooperative, so there is no simple means for the producer to avoid this significant impact. Even if the producer is not a shareholder of the cooperative, the producer could potentially be caught under these rules if it receives patronage dividends as a member because the definition of a "shareholder" in subsection 248(1) includes a person entitled to receive payment of a dividend. We understand that the Canadian Federation of Agriculture is concerned that many of its members may be denied access to the SBD under these new rules.

Even where co-operatives are not relevant, fishermen and farmers often pool resources to form processing companies to process their products. Income from sales to these processing companies will now be ineligible for the SBD, while sales to a competitor processing entity will remain eligible. This denial of the SBD for transactions between legitimately separate businesses is a source of concern in many sectors outside of farming and fishing as well.

2. Credit Unions

Similar to the above, a small business (such as an IT or janitorial service company) which banks at a local credit union, and also provides its services to that credit union could easily lose access to the SBD on income earned from the credit union. This creates a distortion in the marketplace, as this would not be a concern for an organization banking at a chartered bank. As well, the smaller the business, the more likely "all or substantially all" of its income is not derived from customers other than the credit union.

3. Incidental Non-Arm's Length Businesses

a) Rural Areas

Some tax practitioners have expressed concern that these rules will impact smaller, rural communities disproportionately, as these communities have fewer customers to draw on, making the potential for non-arm's length customers accounting for more than 10% of the CCPC's active business income much greater than for businesses in larger urban centers. As an example, if a shareholder of a major contractor in a rural center should happen to be related (sibling, child, parent) to a shareholder of the local building supply store, these provisions could potentially deny the building supply store's access to the SBD on sales to that contractor, despite the fact they are carrying on entirely separate businesses. In addition, it is not clear how one would determine if a problem does exist apart from asking a relative for personal information.

b) Related Businesspeople

Consider a taxpayer which owns and operates a sawmill. That sawmill obtains logs from independent loggers. The son of one of the shareholders of the sawmill carries on business as a logger, and sells to the logging corporation on exactly the same terms as over a dozen other loggers with no relatives involved in the sawmill. That one logging business will lose eligibility for the SBD, in whole or in part, under the new rules. Why should that business be treated differently than any other?

It is not unusual for families to have multiple entrepreneurs. They could be running separate businesses, but also transact with each other for completely non-tax related reasons. These new rules will disadvantage these entrepreneurial families. Please refer to the attached appendix, illustration for item 3(b), for a typical example.

c) Non-arm's length in fact

The non-arm's length aspect of the SPI and SCI rules also causes these rules to apply to unintended situations. Non-arm's length includes related persons, which is defined in the Act, but also includes relationships that are determined to be non-arm's length based on the manner in which they deal with each other. Business persons who are not related persons often collaborate very closely with each other both personally and in business, often acting together with coinciding objectives. Under the new rules, a factual determination will have to be made each year whether their relationship crosses the line of factual non-arm's length, potentially causing their businesses to loss access to the SBD. This is a significant compliance burden and punishes businesses for collaborating.

4. Large Private Corporations

There are many large private corporations in Canada that are employee-owned, and these enterprises often have hundreds, if not thousands, of employee-shareholders. A small contractor awarded a significant contract from such employee-owned private corporation could lose access to the SBD on income from that contract if the shareholder of that contractor happens to be related to a single employee-shareholder of the private corporation (even if that employee has nominal shares and has nothing to do with the process of awarding contracts). Similar to the comment above for rural areas, one would have to ask relatives for personal information to determine if an issue is present.

5. Subsidiaries of Foreign Corporations

The application of the SCI rules is limited to provision of services or property to a 'private corporation'. However, because of the definition of a private corporation under the Act, the SCI rules can apply to transactions with customers who are not 'private' in the conventional sense.

Consider Mr. Smith, who is one of the beneficiaries of a Trust. That Trust owns an interest in a corporation in the United States (USCo), which has a wholly-owned Canadian subsidiary (CanSub). Presumably, Mr. Smith is considered to hold an indirect interest in both USCo and CanSub through his beneficiary status in Trust. One can easily envision the mischief possible if he is not considered to hold an indirect interest merely because a Trust and/or a foreign corporation is interposed.

But what if that Trust is the iShares Dow Jones Fund? It owns an interest in many US resident corporations, including Ford Motors. Ford Motors, of course, owns Ford Canada. So, if Mr. Smith is a shareholder in an auto parts manufacturer (AutoCo) which sells its production solely to Ford Canada, does AutoCo lose eligibility for the SBD?

We are concerned that the answer may be YES, as follows:

(a) AutoCo is receiving its revenues from Ford Canada, in which Mr. Smith may be considered to hold an indirect interest.

(b) Ford Canada will be a private corporation unless its own shares are listed on a prescribed Canadian stock exchange (the shares of a subsidiary of a US corporation are not listed), or it is controlled by a Canadian public corporation.

(c) Ford Motors is listed on the Toronto Stock exchange, but it does not meet the definition of a "public corporation" in subsection 89(1) as it is not resident in Canada.

6. Complex partnership structures and paragraph (A)(c) of the definition of SPI

Complicated partnership structures can arise for reasons that have nothing to do with SBD multiplication. A broad reading of paragraph (A)(c) of the definition of "specified partnership income" could inappropriately restrict entitlement to the SBD and create uncertainty in a wide range of situations. Below is an example of such situations the Joint Committee came across.

A partnership (SLP) is created by a number of arm's length CCPCs and one partner (Propco) that is a non-CCPC. Previously, the individual CCPCs each provided services to Propco as part of their separate businesses. The partnership was created with the intention of gaining "critical mass" allowing it to obtain new business that none of the individual CCPCs could have obtained separately. Propco was brought in as a partner to secure its business and obtain additional business from it going forward. Service income from Propco and its subsidiaries exceeds 20% of the SLP's aggregate active business income. Each of the partners own less than 50% in SLP, and none individually controls SLP. Certain arm's length clients of SLP hold business properties through their own internal limited partnerships (CLPs) and, as part of the service delivery, SLP creates wholly-owned subsidiary corporations (GPCos) that act as the general partners of the CLPs. These GPCos hold nominal interest in the CLPs.

It appears that all of the income allocated by SLP to its CCPC partners is ineligible for the SBD by virtue of paragraph (c) of the definition of SPI. The controlling shareholder (if any) of each of the CCPC partners does not deal at arm's length with that CCPC partner, and that CCPC partner is a person that may be considered to hold an indirect interest in the CLPs (through SLP and GPCos). Therefore, by providing services to the CLPs, SLP is providing services to a partnership that fits the description of a "particular partnership" in subclause (c)(ii)(B)(I) of the definition of SPI.

Also, it is probably not the case that all or substantially all of SLP's active business income is from the provision of services to persons dealing at arm's length with itself or each person that holds a direct or indirect interest in itself. SLP's income from services provided to Propco and its subsidiaries exceeds 20% of SLP's aggregate active business income. Propco is itself a holder of a direct or indirect interest in SLP.

If the CCPC partner has no controlling shareholder, CLP could potentially still be considered a "particular partnership" as described in subclause (c)(ii)(B)(I) of the definition of SPI to the extent the CCPC partner itself is considered to be a person with which the CCPC partner does not deal at arm's length.

Finally, it is not clear whether each of the CCPC partners should be considered to be providing services "indirectly, in any manner whatever" to the CLPs, by virtue of being a partner in SLP that is directly providing those services. If so, each CCPC partner would be a designated member, because one of its shareholders (in fact, all of them) holds an indirect interest in each CLP (through the CCPC, SLP and GPCo). If a CCPC partner is a designated member of a CLP, then the question becomes whether the CCPC partner would be considered to have income described in paragraph (a) of the description A of the definition of SPI. The CCPC partner may be considered to have indirectly, in any manner whatever, provided services to the CLP, by virtue of being a partner in SLP. If so, it could be subject to the carve-out in clause 125(1)(a)(i)(A). This appears to be an inappropriate result since the income in question is already subject to the same carve-out as income allocated from SLP. Presumably, the carve-out in clause 125(1)(a)(i)(A) cannot apply more than once to the same income.

7. Intermediary Entities

Between the Budget and enactment of the legislation, a concern was raised about the computation of the business limit when there is an assignment under subsection 125(3.2) between associated corporations, as detailed in CRA Document 2016-0651831E5. The legislation as passed now contains a welcomed exception in the form of subsection 125(10) for transactions between associated corporations. However, subsection 125(10), along with subsection 125(3.2), contains provisions preventing the use of intermediary entities that could in some circumstances inappropriately constrain the total SBD available. Below are excerpts illustrating these issues from an article that will be appearing in the February 2017 issue of Canadian Tax Highlights:[1]

The anti-intermediary measures may also apply to a structure in which SBD preservation or multiplication was never a primary motivation, such as a corporation carrying on business in a supply chain that has common or non-arm's length shareholders. Assume that FishingCo sells raw fish to FilletCo. FilletCo processes the fish and sells fish fillet to RestaurantCo, which in turn cooks fillet and serves it to arm's length customers. The three corporations are owned by separate shareholders not dealing at arm's length. If FishingCo does not earn all or substantially all its income from arm's length customers, FishingCo's income earned from providing raw fish to

[1] Kenneth Keung, "Anti-Intermediary Rules in Section 125", Canadian Tax Highlights, February 2017.

FilletCo is subject to the clause B carve-out and paragraph 125(3.2)(c) prevents assignment of business limit by FilletCo. In contrast, FilletCo and RestaurantCo can effectively share up to a $500,000 business limit through the subsection 125(3.2) assignment mechanism. The outcome is unfair to the owner of FishingCo and may reduce the aggregate SBD entitlement to less than $500,000. The policy rationale for denying FishingCo an SBD is unclear.

While it may be appropriate for the new rules to prevent a multiplication of SBD amongst the three corporations, we submit that it is not intended for these rules to reduce overall entitlement to the SBD to below $500,000, or punish specifically one corporation out of the three. We enclose in an appendix, illustration for item # 7, a pictorial and numerical illustration of the scenario described above.

A similar anti-intermediary measure is contained in the SPI rules as well, and the outcome could be even harsher since it completely eliminates a CCPC's entitlement to SPI rather than just limiting its access to SPI with respect to the offending income. The following example used by the Joint Committee in its August 25, 2016 submission illustrates this:

- *A Co is a partner in a Partnership X;*
- *A Co also owns 10% of B Co, another private corporation;*
- *Partnership X provides services to B Co and arm's length customers and, during the current year, its income from the services provided to B Co constituted 15% of Partnership X's total income.*

Since Partnership X provided services to B Co, which is a private corporation in which A Co holds an interest (albeit a small one) and it is arguably not the case that "all or substantially all" of Partnership X's income is from the provision of services or property to arm's length persons, paragraph (c) would cause A Co's SPI to be nil. Consequently, A Co is not entitled to claim the SBD on any of its income allocation from Partnership X for the year even though only a portion of the allocation derives from services to B Co.

This result appears to go beyond the stated policy objective of the new rules.

8. All or substantially all arm's length active business income exception

The SCI and SPI rules contain an exception for a corporation which earns all or substantially all of its active business income from the provision of services or property to arm's length customers. The problem with this exception is that the all or substantially all threshold factors in all parties not dealing at arm's length. This could include a number of situations where the income is earned from a large number of persons not dealing at arm's length. This requires taxpayers to segment their income between "arm's length" and "non-arm's length" just to determine whether the SCI or SPI rules may impact them. The income statement would also have to be segmented into SCI and SPI income in the event that the SCI or SPI rules do apply. This significantly increases the complexity and costs associated with normal annual tax compliance.

Uncertainty regarding scope and interpretation

Going beyond specific examples, the amendments utilize very broad language which raise uncertainty as to their scope and proper interpretation.

I. The Meaning of 'Income'

'Income' is used in multiple instances in new section 125. For instance, the "all or substantially all" test is based on the "income for the year from an active business"; similarly, the amount of business limit assignment under subsection 125(3.2) is limited to "income" from provision of services or property to the recipient corporation. There is confusion as to whether income for these purposes refer to "gross income" or "net income", and how the determination should be done if the corporation carries on multiple activities or businesses. Some have even wondered whether this now necessitates a "domestic transfer-pricing" approach. Having to apply such an approach simply to determine whether the rules apply creates significant complexity

II. 'Direct or Indirect Interest'

Neither the phrase "direct or indirect" nor the word "interest" is defined in the Act. It is likely that the phrase "direct or indirect" allows one to look through a chain of holding entities or as illustrated in item #5 above, a person's beneficial interest in the property of a trust, but it is unclear how much broader the phrase could be interpreted. Consider a private corporation that issues stock options to its employees, or a situation where a binding letter of intent has been entered for a purchase of shares of a private corporation. Is a relative of such right holder now caught by these amendments? Such situations appear to be outside the realm of the mischief these amendments were targeting.

Also, it has been suggested that one could potentially interpret the phrase indirect interest to include someone's interest as a creditor, which may be plausible given that a creditor's claim to the assets of the debtor ranks ahead of shareholders. When the Act uses the phrase "direct or indirect" in relation to interest in an entity, it often make specific reference as to what type of interest it is referring to. For example, when "direct or indirect" is used in subsection 55(3.3), subparagraph 88(1)(c.2)(iii), and subsection 93(2.2), they all specify that the provision is referring to direct or indirect interest in the shares of an entity. In the amendments to SBD, the phrase "direct or indirect interest" is left open-ended, potentially making these new SBD limitations applicable even where there is no holding of shares or membership interest in a corporation or partnership, respectively.

It is also useful to review the manner in which Canadian courts have interpreted the concept of "interest" when used in other provisions of the Act. In an article by Manon Thivierge in 2011,[2] she reviewed a number of such cases and suggested that the expression "interest in a corporation" is fairly restricted:

… it should not include an interest or right with respect to the day-to-day activities or financial matters of a business, such as "contractual rights," since an interest in a corporation refers to an interest in the vehicle that is the corporation (such as its shares) and not what is within the vehicle (its business). Consequently, debts and liabilities of a business should not be included in the meaning of the phrase "interest in a corporation." It therefore seems reasonable to restrict the meaning of the phrase "interest in a corporation" to shares and other financial instruments providing to the holder a right to participate in the corporation's earnings.

An application of these SBD limitation provisions to a private corporation's creditors or other stakeholders outside of share ownership would appear to be an obvious over-reach, and inconsistent with case law.

[2] Manon Thivierge, "Restrictive Covenants and Section 56.4," Report of Proceedings of the Sixty-Third Tax Conference, 2011 Conference Report (Toronto: Canadian Tax Foundation, 2012), 9:1-32.

Even if this were not the case, having an undefined term as a key criterion for whether the rules apply creates confusion and uncertainty for taxpayers.

Possible Interpretations

We do not believe the situations set out above were envisioned, or targeted, by the drafters of these proposals. The targets noted in the Budget, and many situations we have seen identified as impacted by these proposals, were arrangements that had the effect of permitting multiple business limits in respect of a single business, contrary to the expressed policy. We concur that this legislation will be very effective in preventing such results in future, and should be interpreted as such.

However, as the above examples demonstrate, the breadth of the rules will also deny the SBD in many other situations, where access to this benefit is, in our view, appropriate and in accordance with tax policy. We would urge CRA to consider interpretations of the law which may mitigate these concerns or, where the clear words of the legislation preclude such interpretation, that CRA clearly and explicitly state its view in this regard and confirm the adverse result to the noted taxpayer(s). This would hopefully encourage the Department of Finance to consider legislative changes to address areas where CRA's interpretation cannot resolve the inequity.

We would suggest the following areas where guidance from CRA is required:

(a) Where payments are made between associated corporations, access to the business limit is not multiplied. Clearly, however, the associated group should not be able to enhance its eligibility to the SBD inappropriately. We would suggest the following reasonable interpretations in respect of associated corporations:

    (i) Where payments are made between associated corporations, and deductible against income which is subject to the SCI or SPI rules, the associated corporations be permitted to determine the portion of such deduction which reduces SCI or SPI, and the portion which reduces income which is not eligible for the SBD due to these provisions.

    (ii) The associated group may allocate the SCI and/or SPI received between the members of the associated group at their discretion, in the same manner as they are permitted to allocate the business limit.

    For example, assume ServiceCo earns $600,000 of active business income, derived from a private corporation with which ServiceCo, or a shareholder of ServiceCo, has an interest. ServiceCo has been assigned $200,000 of business limit from this customer. It has no other income during the year. ServiceCo deducts rent of $450,000 paid to RentCo, with which it is associated.

    All of the income of ServiceCo and RentCo is described in subparagraph (a)(i) of the definition of Specified Corporate Income contained in subsection 125(7). The corporate group would, under the above interpretation, be permitted to allocate the $500,000 business limit within the associated group, and to allocate the $200,000 of SCI among the associated group, as it sees fit. As there is only $200,000 of SCI to assign, only $200,000 of income will be eligible for the SBD in aggregate.

(b) CRA has historically interpreted "all or substantially all" to mean 90% or more. However, as highlighted at the APFF Conference some years ago (2013-0495631C6), the Courts have accepted less than 80% in some cases (eg. *Watts*; 2004 TCC 535). While *Reluxicorp* (2011 CCI 336) rejected 74.83%, the Court's comment suggested that all or substantially all is "closer to the totality than the majority", suggesting a 75% test rather than a 90% test. In the SBD context, this seems especially relevant given the cross-ownership test was set at 25% back in the 1980's, increasing it from 10%. While setting a lower standard for "all or substantially all" would not resolve all issues, it would resolve some, especially in smaller centres, and for related businesspeople.

(c) By adopting a narrower interpretation of "direct or indirect interest", the CRA could alleviate a number of concerns described in this document. Below are examples of possible interpretations for your consideration:

- A holding of a minority interest in a publicly-traded entity does not generally result in an "indirect interest" in any investees of that entity.
- "Direct or indirect interest" excludes, a debt holder, or a holder of stock options or any type of rights in shares, as well as a beneficiary interest in a trust other than a personal trust.
- An interest does not generally result in "direct or indirect interest" where the holder has no significant influence in an entity.
- "Direct or indirect interest" does not generally apply to interests in co-operatives or credit unions.

We understand that a narrow interpretation of the phrase "direct or indirect interest" may not be possible given the broad words chosen by Parliament. Nevertheless, the CRA should provide clear guidance on what is and is not an interest for common structures and transactions.

(d) An alternative or additional approach to reduce the breadth of the new rules is to adopt a narrower view of "non-arm's length" for the purpose of applying section 125. However, given that the term is specifically defined in the Act, we understand that the CRA may not be able to adopt a more restrictive interpretation and if the CRA makes a clear statement in that regards, the Joint Committee can pursue a legislative fix with representatives of the Department of Finance. Nevertheless, the CRA should provide guidance to assist taxpayers to determine factual arm's length versus non-arm's length relationship in common situations. Moreover, it will be helpful to taxpayers if the CRA can provide guidance on the level of documentation taxpayers should retain to document related party transactions and support an arm's length relationship determination.

(e) Many practitioners have cited the paragraph (b) limit of the definition of Specified Corporate Income contained in subsection 125(7), restricting any business limit assignment to "an amount that the Minister determines to be reasonable in the circumstance", as problematic in its uncertainty. We believe this is intended to be a "provision of last resort" should some creative and unanticipated structure frustrate the intent of the provisions. Concerns might be alleviated if CRA were to issue a statement in that regard and/or provide examples where they would consider invoking this provision. Identifying factors which CRA would consider in their determination would also be valuable.

(f) Compliance with new section 125 will require taxpayers to calculate net income from provision of services or property to non-arm's length entities, and to segment revenues and expenses between arm's length and non-arm's length transactions. Can the CRA provide guidance on the proper methodology to carry out these determinations, particularly in respect of allocation of expenses to different transactions?

(g) One of the triggers for the SCI and SPI rules is the provision of services or property (directly or indirectly, in any manner whatever) to a private corporation or partnership. On the other hand, an assignment of business limit under subsection 125(3.2) is permitted only where the provision of services or property is done "directly". Can the CRA provide guidance on when services or property are provided indirectly versus directly?

(h) In respect of the partnership structure described in item #6 above, can the CRA comment on how the rules should be applied:

- Would the all of the income allocated by SLP to its CCPC partners be ineligible for the SBD by virtue of paragraph (c) of the definition of SPI?

- Would the answer above be different for a particular CCPC partner that has no controlling shareholder?

- Would each CCPC partner of SLP be considered a "designated member" of each CLP? And if so, please provide guidance on how to apply the carve-out in clause 125(1)(a)(i)(A).

- If SLP has a wholly-owned subsidiary corporation that is required, for regulatory purposes, to carry on a portion of the overall SLP business activity and receives back-office support services from SLP (provided on a cost-recovery basis), would this arrangement, by itself, deny SBD eligibility for all CCPC partners (assuming SLP continues to fail the all or substantially all arm's length income test because it continues to provide services to Propco)?

Complexity of The New Rules & Aids to Taxpayers

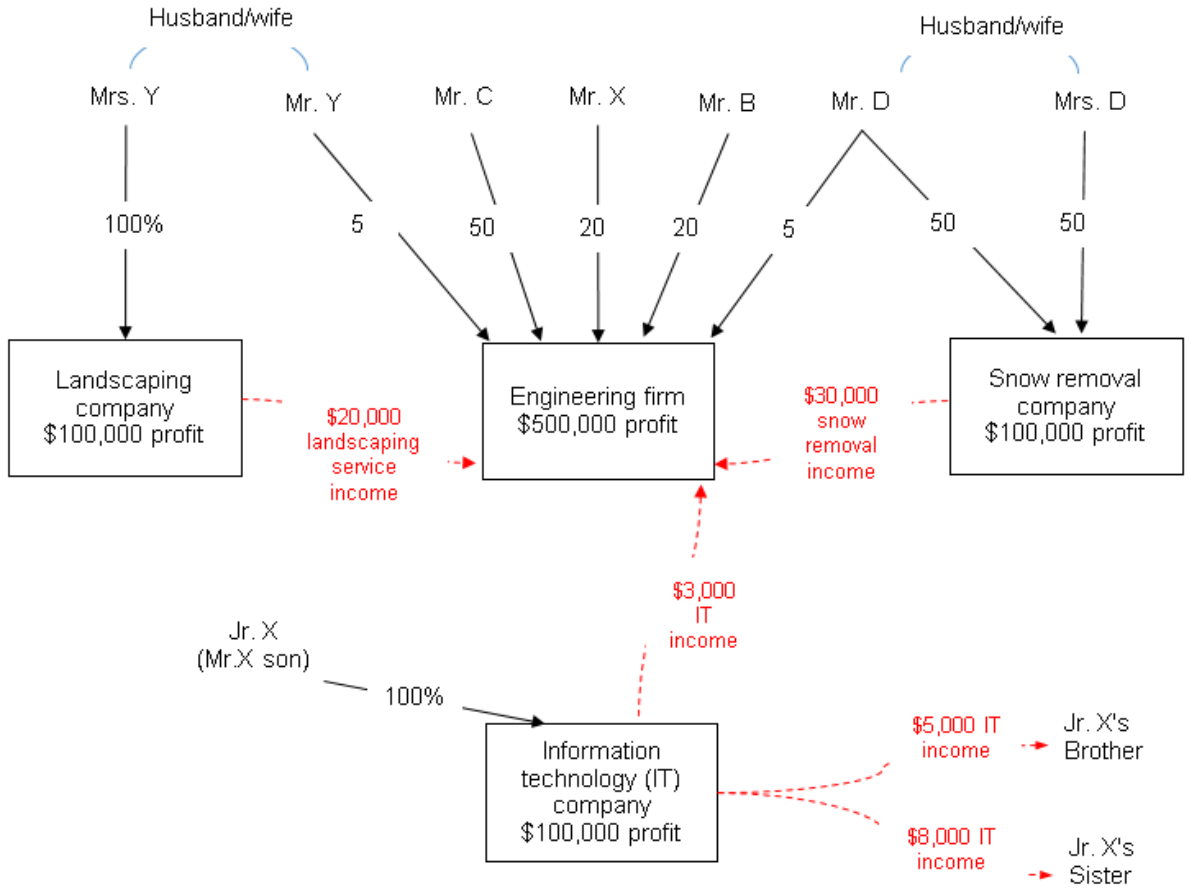
New section 125 is astounding in its complexity. The Act has various provisions which are similarly complex for the average taxpayer, e.g. sections 55 and 56.4 are both extremely complex provisions that can apply in unintended situations. There is however one important difference between section 125 and these other provisions, and that is that the SBD is utilized by small privately held companies dealing with every day business transactions; whereas, sections 55 and 56.4 are usually contemplated for significant transactions. The impact of the overreaching nature and complexity of the new SBD rules will affect a significant number of companies who are simply trying to comply with their annual tax filings.

It is very possible that small business owners and the general practitioner accountants who advise and assist them may misinterpret or misapply the new section 125 rules. We feel it is in the CRA's and taxpayers' interest for the CRA to provide guidance and assistance, and this is consistent with item 10 of the Taxpayer Bill of Rights *"You have the right to have the costs of compliance taken into account when administering tax legislation".*

To date, we are not aware of updated tax return schedules from the CRA that fully take into account new section 125. However, even with a well-designed schedule, it is doubtful it can capture all the nuances of these rules without it being overly complicated for the taxpayers. We note that the CRA has recently published an updated T4012 'T2 Corporation – Income Tax Guide' which does make reference to new section 125. However, the guidance provided does not appear to be sufficient to guide taxpayers through the determination of when someone falls into the new rules. Would the CRA consider providing aids to the public that will help in navigating the new rules? For instance, CRA could provide examples of different structures that are caught under the new rules and could explain the assignment mechanism in detail. We enclose for your consideration in an attached appendix, Simplified SCI Flowchart and Simplified SPI Flowchart, which have been circulating in the tax professional community. Something similar to the attached would likely assist general practitioners in complying with the new rules.

Appendices

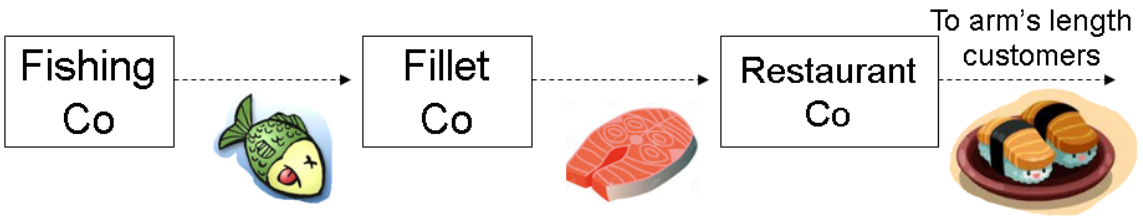
Illustration for Item 3(b)



	Engineering firm	Landscaping company	Snow Removal Company	IT company
Paragraph 125(1)(a)				
(i) ABI carried on in Canada, less	500,000	100,000	100,000	100,000
(B) amount described in sp. (a)(i) of SCI definition	-	(20,000)	(30,000)	(3,000)
(ii.1) Specified Corporate Income:				
Business Limit assigned under 125(3.2)	-	-	-	-
ABI entitled to the small business deduction:	500,000	80,000	70,000	97,000
Tax - before new rules		15,000	15,000	15,000
Tax - after new rules		17,300	18,450	15,345
Increased tax burden		2,300	3,450	345

Notes:
IT Company does not meet the all or substantially all arm's length ABI exemption because of income from siblings.
Assumed effective tax rate on income entitled to the SBD: 15%; income subject to general corporate tax rate: 26.5%

Illustration for Item #7



Fishing Co		Fillet Co		Restaurant Co	
Revenue from Fillet Co	$200,000	Revenue from Restaurant Co	$300,000	Net Income Before Paying Fillet Co	$600,000
Fishing Expense	($50,000)	Inventory Cost to Fishing Co	($200,000)	Inventory Cost to Fillet Co	($300,000)
Total Net Income	$150,000	Total Net Income	$100,000	Total Net Income	$300,000

Assume all three corporations are controlled by separate shareholders not dealing at arm's length, and that Fishing Co and Fillet Co do not meet the all-or-substantially-all arm's length customers test.

Fishing Co	Fillet Co	Restaurant Co
$150,000 subject to carve-out B. Fillet Co cannot assign business limit under 125(3.2) to Fishing Co because the fish cost is deductible in respect of Fillet Co's income from Restaurant Co, which is itself subject to carve-out B. Therefore, no SBD on the $150,000.	$100,000 subject to carve-out B. Restaurant Co can assign business limit under 125(3.2) to Fillet Co, because the fillet cost is not deductible against income subject to any carve-out. Therefore, if Restaurant Co is willing to assign $100,000 business limit to Fillet Co, Fillet Co can bring $100,000 of income back into s.125(1)(a) as SCI [as long as Minister do not deem SCI to be nil]. SBD entitlement on $100,000.	Restaurant Co's income not subject to carve-outs because it sells to arm's length customers. SBD entitlement on $300,000.

SIMPLIFIED SCI FLOWCHART

(CCPC providing services/property to a private corporation):

Does the CCPC (directly or indirectly, in any manner whatsoever) provide services/property to a private corporation that is not associated? Note that the exception for associated corporations is revoked to the extent the service/property is deductible by the recipient against income subject to any of the carve-outs in sub-paragraph 125 (1)(a)(i).

NO → Clause 125(1)(a)(i)(B) carve-out does not apply.

↓ **YES**

Does the CCPC, a shareholder of the CCPC or a person who does not deal at arm's length with either the CCPC or a CCPC shareholder hold a direct or indirect interest in the private corporation?

NO → Clause 125(1)(a)(i)(B) carve-out does not apply.

↓ **YES**

Does the CCPC earn all or substantially all of its active business income from providing sevices/property to:

(I) Arm's length persons (other than the private corporation), or

(II) Partnerships with which the CCPC deals at arm's length, other than a partnership in which a non-arm's length person holds a direct or indirect interest.

YES → CCPC may include income in paragraph 125(1)(a).

↓ **NO**

All of the CCPC's income from providing services/property to the private corporation is carved-out per clause 125(1)(a)(i)(B):

↓

Does the CCPC provide services/property directly to the private corporation?

NO → CCPC cannot include any carved-out income in paragraph 125(1)(a).

↓ **YES**

Does the recipient private corporation have business limit determined under subsections 125(2), (3) or (4)?

NO → CCPC cannot include any carved-out income in paragraph 125(1)(a).

↓ **YES**

The CCPC may include carved-out income as SCI in paragraph 125(1)(a) equal to least of:

a) CCPC's income from providing services/property directly to the private corporation, less any portion of that income that is deductible by the private corporation against income subject to carve-outs in sub-paragraph 125 (1)(a)(i)(A) or (B);

b) The amount of business limit assigned by the private corporation to the CCPC;

c) An amount the Minister determines to be reasonable in the circumstances [paragraph (b) of definition of SCI].

SIMPLIFIED SPI FLOWCHART

(CCPC earning partnership income or providing services/property to a partnership):