

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

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June 19, 2015

Ms. Alexandra MacLean
Director, Tax Legislation Division, Tax Policy Branch
Department of Finance
L'Esplanade Laurier, East Tower
140 O'Connor Street, 17th Floor
Ottawa, ON K1A 0G55

Dear Ms. MacLean:

Subject: Consultation on the extension of the small business deduction

Please see the attached submission in response to the 2015 Federal Budget to consult on possible broadening of the types of income that would be eligible for the small business deduction.

We would like to thank you for your consideration of this matter. A number of members of the Joint Committee and others in the tax community have participated in the discussions concerning our submission and have contributed to its preparation, in particular:

Joel Nitikman (Dentons Canada)
Bruce Ball (BDO)
Craig Webster (Borden Ladner Gervais)

Don Carson (MNP)
Gabe Hayos (CPA Canada)

We trust that you will find our comments helpful and would be pleased to discuss them further at your convenience.

Yours very truly,



Janice Russell
Chair, Taxation Committee
Chartered Professional Accountants of Canada



Mitchell Sherman
Chair, Taxation Section
Canadian Bar Association

Cc: Gabe Hayos, Vice President, Taxation, CPA Canada

Consultation on the extension of the small business deduction
Submission by the Joint Committee on Taxation
June 19, 2015

Introduction

The 2015 Federal Budget called for consultations on a possible broadening of the kind of income that qualifies for the small business deduction (the “SBD”) in subsection 125(1) of the Act.¹ The Committee believes that a broadening of what qualifies for the SBD is warranted, to the extent and for the reasons set out below.

The Policy behind the SBD

The policy objectives of the SBD have been identified as follows:²

- (1) to enable small and new business to finance growth with retained earnings;
- (2) to lower entry barriers for small and new businesses in capital intensive industries;
and
- (3) to provide some means of compensating for the relative inefficiency of small firms, such inefficiency being one cause of large firm dominance.

Subsection 125(1) makes it clear that, until now, it was thought that these policy objectives could be achieved only by Canadian-controlled private corporations (“CCPCs”) carrying on an active business.

What is an active business for purposes of the SBD?

Through various nested definitions³ the SBD requires one to distinguish income from a business from property income. The difference has been explored in many papers and cases; depending on the facts of a particular case, the line between the two sources of income can be difficult to draw⁴. There is no one, all-encompassing test that distinguishes between the two: in essence the difference is how “busy” the taxpayer is in carrying out the activity. If the income basically “earns itself” (interest, royalties, dividends) without requiring substantial intervention from the

¹ *Income Tax Act*, RSC 1985, c. 1 (5th Supp.), as amended. All statutory references are to this Act unless stated otherwise.

² Kathleen A. Lahey, “Active Business’ as a Technique of Source Discrimination in the Formulation of Corporate Tax Policy” (1978), 16 *Osgoode Hall Law Journal* 35 at 50, online at <http://digitalcommons.osgoode.yorku.ca/ohlj/vol16/iss1/3/>.

³ See Appendix A to this submission.

⁴ That it can be difficult to distinguish between the two was recognized by the Supreme Court of Canada in *Canadian Marconi Canadian Marconi v. The Queen*, [1986] 2 S.C.R. 522 at paragraph 7.

taxpayer, then it is income from property; if the taxpayer must exert time and effort to earn the income, then it is business income.⁵

There is no bright line test that determines how “busy” a taxpayer must be before the character of the income will change from property to business: each case is decided on its own facts. Having said that, the threshold is a low one.⁶ Thus, for most activities, only a low or minimal amount of activity will create a business. Even for activities that generate one of the kinds of income listed in the definition of “specified investment business”, a low threshold applies because such income will not be income from a specified investment business if it is incidental to or pertains to an active business.

Policy implications

As (a) only a low level of activity is required to create a business and (b) the nature of business income and property income overlap, the Committee suggests that it is not always necessary to distinguish between the two. Given the policy objectives of the SBD as set out above, the Committee suggests that the SBD should be extended to some kinds of property income, because the generation of such income can contribute to the Canadian economy in the same way that small businesses do. In particular, taxpayers earning certain kinds of property income:

- (1) require lower rates of tax so as to create retained earnings that will finance growth;
- (2) require lower rates of tax so as to ease the prospect of entering capital-intensive industries; and
- (3) require lower rates of tax to provide a means of compensating for the relative inefficiency of small firms, such inefficiency being one cause of large firm dominance.

What should the threshold be?

Having said that, the Committee recognizes that not all forms of property income should be entitled to the SBD incentive. For example, neither a taxpayer earning interest from a T-Bill nor a taxpayer who buys a single property and rents it for a lengthy period should be so entitled. So the question is, what test should be applied to distinguish property income earners to which, in policy terms, the SBD should be directed, from the rest?

Various tests could be used: one would be the number of employees or contractors used to generate the income, but the Committee believes that almost any activity that employs more than five full-time employees would be an active business in any event and would not be a specified investment business. Another possibility would be to use a certain level of gross or net revenue

⁵ *Stewart v. The Queen*, 2002 SCC 46 at paragraphs 50-51.

⁶ *Ollenberger v. The Queen*, 2013 FCA 74 at paragraphs 25-29; *Weaver v. Canada*, 2008 DTC 6517 (FCA) at paragraphs 25-28.

as a test, but then a taxpayer could earn interest on T-Bills or rent and still meet the threshold, which would be inappropriate.

Conclusion

The Committee suggests that a test that could be used is the number of hours expended in respect of the property income activity (active businesses would not have to meet this test). While there is no magic number, the Committee suggests that if a taxpayer expends at least 500 hours in any year on an activity, then in policy terms that taxpayer is contributing sufficiently to the Canadian economy that his income should benefit from the SBD incentive. This would require taxpayers to keep accurate records of the time expended, would allow the CRA to audit the claim for the SBD and would be a simple, clear limit that is not subject to significant litigation.

In particular, we recommend the following:

- the definition of “income of the corporation for the year from an active business” should be modified so that it includes income that is derived in whole or in part from property where at least 500 hours of time is spent (by employees of the corporation or by contractors retained by the corporation) on the income-earning process. The definitions in subsection 129(4) should also be modified for consistency.
- income that is considered incidental to an active business should continue to be active business income where the current conditions are met. We also believe that the rules could be simplified to refer to this income directly (as discussed in Appendix A, this result is currently reached in a somewhat circuitous manner) .

The Committee would be pleased to discuss the above with you at your convenience.

Appendix A

Subsection 125(1) applies only to “income of the corporation for the year from an active business”. That phrase is defined in subsection 125(7) to include the corporation's income for the year from an “active business carried on by it” including any income for the year pertaining to or incident to that business, other than “income for the year from a source in Canada that is a property (within the meaning assigned by subsection 129(4)). Subsection 125(7) defines “active business carried on by a corporation” to mean **any** business carried on by the corporation other than a specified investment business or a personal services business and includes an adventure or concern in the nature of trade. The same subsection defines a “specified investment business” to mean a business (other than a business of leasing personal property) the principal purpose of which is to derive income (including interest, dividends, rents and royalties) from property but does not include a business where the corporation employs in the business throughout the year more than 5 full-time employees, or any other corporation associated with the corporation provides, in the course of carrying on an active business, managerial, administrative, financial, maintenance or other similar services to the corporation in the year and the corporation could reasonably be expected to require more than 5 full-time employees if those services had not been provided. (Curiously, subsection 125(7) defines “income of the corporation for the year from an active business” to mean “the corporation's income for the year from an active business carried on by it”. While it is obvious that “it” refers to the corporation, the expression “active business carried on by a corporation” does not appear in the definition of “income of the corporation for the year from an active business” in subsection 125(7) and yet that is the phrase that is defined in that subsection.) Subsection 129(4) defines “income” or “loss” of a corporation for a taxation year from a source that is a property to include the income or loss from a specified investment business carried on by it in Canada other than income or loss from a source outside Canada, but to exclude the income or loss from any property that is incident to or pertains to an active business carried on by it, or that is used or held principally for the purpose of gaining or producing income from an active business.

It is not clear exactly why the definition of “income of the corporation for the year from an active business” includes incidental business income and excludes income from property as defined in subsection 129(4), which itself includes specified investment business income but excludes incidental income, when the definition of “active business carried on by a corporation” in subsection 125(7) already excludes income from a specified investment business. However, the end result is that income that may prima facie appear to be income from property is included in income for the year from an active business if there is a sufficient nexus between the property income and the active business.