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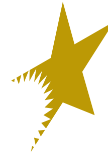

Planning For the Small Business Deduction May Lead to Traps Along the Way

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Originally published in *Blaneys on Business* (December 2012)

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Followers of the U.S. political scene have heard the term "small business owner" used endlessly in the last several months. The concept, however, is not unique to the United States, as many Canadians own small businesses too, and the "small business deduction" is one of the foremost tax planning tools available to Canadian companies.

While the small business deduction is understandably popular, prudence in its use is strongly advised, for what you hope for is not necessarily what you always get.

Briefly, a Canadian-controlled private corporation (i.e. one that is privately owned and not controlled by non-residents or public corporations) is afforded a significantly lower tax rate on its first $500,000 of active business income in any year. For example, in Ontario a corporation that can avail itself of this rate will pay tax at 15.5 per cent rather than at the general corporate rate of 26.5 per cent. This means an immediate tax saving of $55,000.

With this type of saving available, it is only natural that strategies have emerged to multiply the benefit. For example, two spouses engaged in separate but similar businesses may each form a corporation to carry on one of those respective businesses. Although the Canada Revenue Agency (CRA) has the discretion to deem these businesses "associated," and thus obliged to share this tax benefit, this structure has the potential to allow the 11 percentage point tax saving to apply to $1 million of active business income annually rather than $500,000.

Strategies have emerged as well that provide for a family corporation to be owned by a family trust, and thus enjoy the small business deduction benefit, too. When used in succession planning, family trusts create a further opportunity by allowing not only father and mother, but also children, access to the $750,000 capital gains exemption when shares of these family companies are sold. As one might expect, the CRA will take a very close look at these structures.

The first line of attack that the CRA might use when it examines the use of the small business deduction is through the "association" rules. The *Income Tax Act* contains a number of technical rules on share ownership that could cause such corporations to be deemed as associated and thus required to share the low rate of tax on the first $500,000 of active business income. As suggested previously, the CRA has the discretion to deem such companies to be associated if there is no valid non-tax reason for these businesses to be carried on in separate corporations. As well, under the association rules, shares of a company owned by a family trust can be deemed to be owned by the beneficiaries and shares owned by a trust in which minors are beneficiaries are deemed to be owned by the parents.

These rules can easily trip up an ownership structure, particularly where estate freezes are involved or where younger generations own shares in the same corporations as older generations. A common situation where shares of one company are owned by a parent while shares of a completely separate business are owned by an adult child could be caught if some of the usual planning techniques are utilized.

Another line of attack available to the CRA where family trusts are involved relates to the sale of such shares by family trusts which have minor beneficiaries. Under recently enacted legislation, the profits from such sales can be taxed as dividends at the highest marginal tax rate (32.5 per cent) rather than as capital gains, which could be taxed at up to 23 per cent if not eligible for the capital gains exemption.

To sum up, then, the small business deduction can be a compelling instrument. In fact, it might even be considered the holy grail of tax planning.

Keep in mind, however, that there can be many traps along the way to maximizing its benefit. ■