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New Developments in Small Business Taxation
Budget 2016 and recent developments

Before the release of new draft legislation on Monday afternoon, I had planned to discuss only Budget 2016 developments and new cases on solicitor-client privilege in the tax context. My talk will now be somewhat changed, because although the new principal residence rules are not central to “small business” concerns, they are new and interesting and will affect many of you and your clients.

TOPICS:

1. (Briefly) small business tax rates and the Budget
2. End of the Eligible Capital Property regime and New Class 14.1 (+ teaser on sales of goodwill)
3. New Restrictions on Small Business Deductions (associated corporations, non-arm's length supplies)
4. BRAND NEW rules on the principal residence exemption
5. New rules on insurance policies
6. *Chambre des Notaires du Quebec* and *Thompson*: the client's privilege with their solicitor

Rates

The Budget removed a previously announced reduction (to 9%) of the small business rate, meaning that the small business rate continues at 10.5%, and dividend gross-up and dividend tax credit rates (17%, and 21/29 of the gross-up) would be preserved for “non-eligible” dividends.

Eligible Capital Property: Disappearing Category

Eligible capital property, the best-known example of which is business goodwill, is disappearing as a tax category. The regime is being replaced with a new capital cost allowance (CCA) class, Class 14.1. It will henceforth be treated as any other type of depreciable capital property. (CCA worked differently—not all of the expense could be included, only 75%, and the rules on a disposition were different.)

New Class 14.1 will automatically receive transfers of the CEC (“cumulative eligible capital”) balance of all taxpayers as of January 1, 2017. There will be 10 years in which it can be depreciated at a 7% rate before the rate reverts to the new standard of 5%.

As a result of the new class and the new treatment, there is an expiring opportunity to crystallize dispositions of eligible capital property and receive favourable tax treatment, for Canadian-controlled private corporations. Essentially, a sale under the old 2016 rules means that your gain (less the cost) is

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treated half as active business income and half is added to the "capital dividend account". Under the new 2017 rules, with the sale becoming one of depreciable property, half is still added to the capital dividend account, but the other half will be taxed at the investment income rate which is much higher. The difference can be 10% of the total price in Ontario (since half the gain is taxed at 26.5% instead of at 46.2%).

If you have clients who are contemplating selling a business with a great deal of valuable goodwill (not necessarily balance sheet goodwill—it may be internally generated), it will be worth investigating making the sale within 2016. Talk to a tax advisor.

New Rules on Associated Corporations and Partnerships

The small business deduction for income in a Canadian-controlled private corporation ("CCPC") is limited to the "small business limit" of $500,000 of income. There is also a $15 million taxable capital limit (and the small business limit begins to be ground once a $10 million taxable capital limit is exceeded). To address obvious planning issues, that small business limit must be shared among associated corporations, preventing one owner from splitting the income among two corporations and doubling the limit.

Sometimes, two corporations (1co and 2co) are not associated by the associated corporations rules, but they are each associated with a third corporation (3co). The Act has a deeming rule that says 1co and 2co are now associated; they must therefore share a small business limit and taxable capital limit. However, this deeming rule can be worked around (if 3co is not a CCPC, or if it elects to have its small business limit be nil) to allow 1co and 2co and 3co to each remain unassociated.

The first change is to the deeming rule. Now, the deeming rule will still leave 1co and 2co unassociated. However, they will remain associated with 3co. Practically, this means that 3co's taxable capital will now count toward the taxable capital limit of each of 1co and 2co.

The second major change is to the income available for the small business deduction. Rules have been introduced to limit this both for partnership and corporate structures.

For partnerships, there will be a new "designated member" rule that deems a corporation providing services or property to a partnership and that is (a) a partner, (b) has a shareholder who is a partner, or (c) has a shareholder not at arm's length to a partner, to be a "designated member" which means it cannot claim the small business deduction on any income from services or property provided to the partnership. This addresses the very common "service corporation" structures that many partnerships use to multiply their small business limit.

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Similar rules will prevent the multiplication of small business limits by the use of service corporation structures to corporations, again if a shareholder in the primary corporation has a “direct or indirect interest” in the service corporation.

In either case, if the service corporation obtains 90% or more of its active business income from providing services or property to arm's length corporations other than the private corporation or partnership, it will be relieved of this. As so often, CRA here provides relief for corporations that don't need it, since less than 10% of the income would be disqualified from the small business deduction.

New Rules on the Principal Residence Exemption

Those who know tax know that a surprise is just around the corner. This time, it was the release on Monday of new legislation to combat high prices in certain housing markets and brake one of Canada's few high-performing economic sectors.

The income tax measures relate to the “principal residence exemption” which protects homeowners from capital gains tax on the sale of a residence. One residence per family may be designated for any one calendar year.

The new rules will deny the exemption to persons who were not resident in Canada during the year they acquired the property, for the purposes of that year. It applies to all dispositions from October 3 on, so it is retroactive in the limited sense that persons who purchased relying on receiving that one year's exemption, but have not sold, will not receive it. There were also changes to eligibility for trusts; previously there were ways to structure the holding of a principal residence through a trust that were more generous than those where it was held directly. That appears to no longer be the case, and the types of trusts that can claim a principal residence exemption have also been limited.

Remember always that the exemption only applies to capital gains! Even if you live in it, gains from a property held on income account are fully taxable.

Furthermore, CRA will now require the submission of a T2091 form on the disposition of a principal residence. They have previously asked taxpayers not to submit the form if the exemption wiped out the full gain. Not only is the form required now, but if a taxpayer fails to submit it, the taxpayer can be reassessed past the normal reassessment period. This is an enforcement tool which has a stated purpose of catching “bad actors” frequently blamed for the desirability of Canadian real estate, such as non-residents, but which in fact forms part of CRA's concerted plan to hunt house-hoppers, flippers, and the many who innocently purchase a home but must leave it after a short time. Currently

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CRA relies heavily on information collected and forwarded by provincial governments through their land registry systems. I expect the inundation of T2091 forms to be heavily used by CRA in their ever-increasing enforcement campaign against ordinary homebuyers.

New Rules on Insurance Policies

Very briefly, Budget 2016 also introduced new rules regarding how receiving proceeds of disposition on an insurance policy affects the transfer of insurance policies between corporations and their shareholders, as well as on the calculation of the capital dividend account of a corporation receiving proceeds from a life insurance policy. This has been done to address certain planning arrangements allowing different corporations to hold the policy and receive benefits that would allow tax-free proceeds to be distributed in excess of the gain on the policy.

Certain planning structures related to insurance policies, including those involving partnerships, will therefore need to be reviewed.

Solicitor-Client Privilege

One final note. On June 3 the Supreme Court released *Chambre des Notaires du Quebec* and *Thompson*, cases discussing the scope of solicitor-client privilege in the face of CRA Requirements for Information. In particular, subsection 231.2(1) and 232(1) of the Income Tax Act, together, purport to allow the Minister to compel the divulgence of a lawyer's accounting records.

The Supreme Court held that this requirement was unconstitutional and that privilege needed to be determined on a case-by-case and document-by-document basis, saying “it is not appropriate to establish a list of documents that are prima facie protected by professional secrecy. Whether a document is protected by professional secrecy depends not on the type of document it is but, rather, on its content and on what it might reveal about the relationship of and communications between a client and his or her legal advisor.”

Finally, I will list some of the tax-related items from the 2016 Budget I am *not* talking about:

- No changes (as had been rumoured) to the “active business” vs. “investment business” rules.

- The government moved forward (as statements had indicated) with its measures relating to the conversion of capital gains into tax-deductible intercorporate dividends (“capital gains

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strips") These new rules, mostly changes to section 55 of the Act, came into force on July 1 and are retroactive to April 21, 2015.

- Matters concerning derivatives treatment, emissions allowances treatment, and foreign currency debts.

- Changes to Capital Cost Allowance classes (except for the new class 14.1 replacing ECP which I discussed above)

- New measures and proposals regarding transfer pricing and treaty shopping (some related to OECD BEPS initiative), cross-border surplus stripping, back-to-back cross-border loan structures and other cross-border structures.

- Finally, one very tricky new piece of legislation has recently been introduced that allows the Minister to advance "alternative basis or argument" in support of an assessment. How these changes will work out is not yet certain but it does appear to give the Minister a broad power in litigation to change the basis on which it has purported to assess.

As always, the information in this material is not legal advice. **Consult a tax advisor; do not refrain form consulting one on the basis of this material.**