ANTI-INTERMEDIARY RULES IN SECTION 125

The new section 125 small business deduction (SBD) rules, applicable to tax years beginning after March 21, 2016, ended most, if not all, traditional SBD multiplication planning. The new rules contain certain measures to prevent the new specified partnership income (SPI) or specified corporate income (SCI) rules from being circumvented by the insertion of an intermediary between the true transacting parties. This article highlights the operation of these anti-intermediary rules and their impact on some common business arrangements.

Income qualified for the SBD, which must be active business income (ABI) (paragraph 125(1)(a)) of a corporation, is now subject to three carve-outs under the new rules:

- ABI earned from a partnership in which the corporation or its shareholder holds a direct or indirect interest, or a person that holds such an interest is not dealing at arm's length with the corporation, which does not earn all or substantially all of its income from arm's-length customers (clause 125(1)(a)(i)(A); "the clause A carve-out");

- ABI earned from another corporation in which the corporation, its shareholder, or a person not at arm's length with either holds a direct or indirect interest, and the corporation does not earn all or substantially all of its income from arm's-length customers (clause 125(1)(a)(i)(B); "the clause B carve-out"); and

- deemed ABI under subsection 129(6) that is earned from a non-CCPC or a CCPC that elected under subsection 256(2) not to be associated (clause 125(1)(a)(i)(C)).

Generally, clause A or B carve-outs are prima facie not entitled to the SBD, unless another entity assigns business limit (subsection 125(3.2)) or "specified partnership business limit" (subsection 125(8)). Subsection 125(10) also excepts most transactions between associated corporations because those corporations must already share the $500,000 business limit.

Specified corporate income. To protect the integrity of the clause B carve-out and the SCI regime, anti-intermediary measures in new section 125 may invalidate the subsection 125(10) associated-corporation exception and limit the business limit assignment under subsection 125(3.2). Assume that Mrs. A wholly owns ACo, an opco that earns $800,000 per year selling widgets to arm's-length customers. Mr. A wholly owns SpouseCo. SpouseCo's sole source of income is the provision of administrative services to ACo. SpouseCo planned to charge $300,000

this year for those services. However, the new clause B carve-out would have prevented SpouseCo from claiming an SBD on the $300,000 unless ACo surrendered $300,000 of its business limit to SpouseCo (subsection 125(3.2)). The arrangement is restructured so that ACo does not receive services directly from SpouseCo, but instead contracts with IntermediaryCo (wholly owned by Mr. A) for $300,000 worth of administrative services. IntermediaryCo in turn subcontracts with SpouseCo to provide the subject services for $299,999.

Without the anti-intermediary measures, the SBD entitlement increases: ACo and SpouseCo are not associated, and each is entitled to $500,000 of business limit. ACo can claim the SBD on $500,000 of net income. The income earned by IntermediaryCo is subject to the clause B carve-out, but its income is only $1. SpouseCo can also claim the SBD on the $300,000 of subcontracting income (subsection 125(10)), because the income is earned from providing services to an associated corporation, IntermediaryCo. Thus, ACo and SpouseCo can claim an aggregate SBD of $800,000, contrary to the policy intent of new section 125.

To prevent this result, paragraph 125(10)(b) disallows the associated-corporation exception if the associated corporation that receives the service or property may deduct the amount in respect of income that is subject to a clause A, B, or C carve-out. On the facts, IntermediaryCo deducts SpouseCo's subcontracting services against its income from ACo; that income is subject to the clause B carve-out because ACo's shareholder does not deal at arm's length with IntermediaryCo, and IntermediaryCo does not earn all or substantially all of its income from arm's-length customers. Thus, the subsection 125(10) exception is disallowed between IntermediaryCo and SpouseCo.

However, barring further scope in the anti-intermediary rules, the family could still achieve the same result—contrary to the policy intent—by causing IntermediaryCo to assign $300,000 of its business limit, which it does not need, to SpouseCo under subsection 125(3.2). Therefore, paragraph 125(3.2)(c) prevents IntermediaryCo from assigning its business limit to SpouseCo to the extent that it has deducted amounts against income subject to the clause A or B carve-out. As a result, SpouseCo cannot claim any SBD on its $300,000 of income; the only SBD entitlement in the group is the $500,000 claimed by ACo.

Multiple PC structures. The anti-intermediary measures may also apply to relatively common business arrangements. For example, a professional partnership has professional corporate partners (PCPs), and each professional individual involved also owns a service professional corporation (ServicePC) that provides services to his or her PCP. Such a structure regularly preserved SBD entitlement under the old SPI rules, which forced partners to share pro rata a $500,000 notional business limit. By charging services against PCP's partnership income, that income was diverted to ServicePC: ServicePC was entitled to claim the full $500,000 SBD on income otherwise subject to the old SPI rules.

This structure fares poorly under the new rules. The subsection 125(10) exception does not apply to the service income earned by ServicePC, because it is deductible by PCP against the partnership income allocated from the partnership and that latter income is subject to a clause A carve-out, which applies to any partnership income earned by a partner. Thus, all of ServicePC

income may be carved out by clause B, and ServicePC may bring that income back into paragraph 125(1)(a) only if PCP assigns business limit to it under subsection 125(3.2). However, PCP is barred from assigning any business limit (paragraph 125(3.2)(c)), because the services that it receives from ServicePC are deductible against partnership income that is subject to the clause A carve-out. Therefore, if the service arrangement has diverted all of PCP's income to ServicePC, there is no SBD entitlement for either corporation—a harsh result.

To avoid this outcome, businesses and professionals in these structures should consider a restructuring that leaves income in PCP. As a result of this restructuring, PCP may at least be entitled to the SBD to the extent of its specified partnership business limit, which is a pro rata allocation of a notional $500,000 business limit among the partners.

Supply chain structures. 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 of its income from arm's-length customers, FishingCo's income earned from providing raw fish to 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.

Specified partnership income. An anti-intermediary measure for the SPI rules is set out in paragraph A(c) of the SPI definition. The underlying concept is similar to the SCI anti-intermediary rules, but the outcome is harsher: the CCPC may lose access to the SPI rules entirely without regard to the quantum of the offending income. This result was set out in a CPA-CBA joint committee submission of August 25, 2016.

Arguably, the policy objective may substantially be achieved without these complicated anti-intermediary rules by a broad interpretation of the phrase "directly or indirectly, in any manner whatever" in the clause A and B carve-outs. Ultimately, the cost of compliance with the new SBD rules falls on the intended beneficiaries of the SBD program: the small business owners.

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Canadian Tax Highlights
Volume 25, Number 2, February 2017
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