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The Tax Informant

# The Department of Finance Canada and its civil servants in complete disarray (Part 1) – Section D

MAJOR MISTAKES AND OMISSIONS, BLUNDERS CAUSED BY "PRACTICAL" INCOMPETENCE, AND LETHARGY ARE CAUSING MAJOR HARM TO TAXPAYERS AND COSTING THE FEDERAL GOVERNMENT A FORTUNE!

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## D. A great example of "practical" incompetence: the partial or total loss of SBD for subcontractors who do not deal at arm's length with a shareholder of another SME

The example in section A of the six-year delay in modifying the taxation of dividends showed a $2.5 billion mistake simply because a "theoretical" concept that is well-known and important in taxation (the concept of integration) was ignored. In fact, some civil servants at the Department of Finance (when they do finally decide to act) show that they are completely unaware of what real life is for a taxpayer. We will provide other examples in our upcoming newsletters, and trust us, we've got plenty! The situation can be summed up as "How to penalize 99.5% of taxpayers who are acting legally in order to try to catch the 0.5% who are not."

**The potential loss of eligibility for the reduced rate of taxation of SMEs for subcontractors who do not deal at arm's length with a shareholder of an SME: in our opinion, a mess of a piece of legislation…**

In its federal budget of March 22, 2016, the Department of Finance announced a series of tax measures that sought to end the easy access to the small business deduction (SBD, the reduced tax rate of SMEs on the first $500,000 in annual profit). Let's quickly go over this. Even if some doctors, lawyers, and accountants who are part of professional groups that have taken advantage of this situation since the mid 2000s do not agree with this new limit, we are completely in favour of this new legislation. In our opinion, it was completely unwarranted for a group or pool of 10 doctors or lawyers working together to take advantage of the reduced tax rate on the first $500,000 in annual profit (potentially 10 times $500,000, so $5 million in this example) instead of one single limit of $500,000. In fact, this strategy, which had become possible in the mid 2000s after a few rulings by the CRA, should never have been possible in the first place. We have no problem with the Department of Finance restricting this possibility for pools of professionals. **This restriction should have been implemented much earlier.**

Many professionals have used this strategy to multiply their SBD by relying on a technique that involved, among other things, a partnership in order to avoid any problem with the concept of "personal services business". However, the Department of Finance Canada slammed the door on this possibility and implemented new rules so that this strategy of multiplying SBDs by professionals could not be done by a "central professional corporation" either.

Even though we don't have a specific problem with this objective, the way the civil servants at the Department of Finance prevented the use of a "central professional corporation" to multiply the SBD **is so bad that we almost think it's a scam**. Indeed, the method they decided to implement demonstrates that the technocrats and bureaucrats in charge are completely clueless as to how an SME actually operates in the real world. It is amateurish, sloppy, and an affront to anyone in the business world.

In this context, the problem of SBD multiplication problem could have easily been prevented by a specific anti-avoidance rule that could have deterred anyone tempted (see paragraphs 83(2.1) and 129(1.2) of the ITA

for examples of specific anti-avoidance rules that work very well). Furthermore, the civil servants at the Department of Finance implemented a specific anti-avoidance rule in paragraph 125.9 of the ITA and it would have been simple to add another one specifically targeting central professional corporations. **But no!** These civil servants chose another route… **one that is much more harmful to Canadian SMEs and has nothing to do with the problem** targeting professional groups (such as doctors, lawyers, and accountants). Crazy, right? You have no idea!

Here are a few examples (based on real life) of SMEs who will lose part or the entirety of their SBD right on their profits due to a nefarious legislation that was implemented by these civil servants:

**i)** A local construction SME has obtained a major contract for renovating a building that houses a Caisse Desjardins. Caisses Desjardins are structured as cooperatives and are presumed, for section 125, to be private corporations in accordance with subsection 136(1) of the ITA. The entrepreneur's spouse is a member of this Caisse Desjardins and has several accounts there. As a member of a cooperative, she is considered to have a direct or indirect interest in a private company, which is in reality a cooperative. The entrepreneur in the construction industry therefore does not deal at arm's length with an individual (his spouse) who has an interest in this Caisse Desjardins and because the income earned from this renovation contract will represent more than 10% of the company's yearly income, this income will not be subject to the SBD. What fool thought this would be a good idea?

**ii)** SME Inc. specializes in installing residential doors and windows. Peter is the sole owner. His installation contracts come, more or less equally, from three separate manufacturers of doors and windows in the region. As a subcontractor for separate manufacturers, the installation company who employs eight people is constantly busy and avoids being economically dependent on any single door and window manufacturer. Peter's brother-in-law, who is a shareholder of ABC Inc. that manufactures windows and doors, helped him when he launched his company by giving him his first contracts ten years ago. Following the new rules implemented in 2016, SME Inc. will lose its right to the SDB on about a third of its income because his brother-in-law is a shareholder of one of the three manufacturers that hire Peter's company to install their products. This is a perfect example of the exact situation in which countless companies in the residential or commercial construction industry find themselves (for instance, a company who installs gypsum for a general contractor) as well as many other fields (pool installation, the IT sector, the agri-food industry, etc.). What fool thought this would be a good idea?

**iii)** Several Canadian jurisdictions allow real estate brokers to incorporate their company. However, in accordance with some provincial laws regulating real estate brokerage (such as the *Real Estate Brokerage Act* in Quebec), the real estate broker must be affiliated with a "real estate agency". In accordance with these rules, the commission generated from the sale of a building must first be paid by the customer to the real estate agency who then gets billed by the incorporated estate broker. Now imagine the following situation that can happen. Nadia is a real estate broker part of the RE/MAX network and her business is incorporated. She is affiliated with the real estate agency of her region which also includes 75 other real estate brokers. Nadia's sister is a shareholder of this agency. Nadia's company will not have the right to claim the SDB in this example, because 100% of her company's commission from SMEs must first be paid, in line with the *Real Estate Brokerage Act*, to the real estate agency in which her sister is a shareholder. What fool thought this would be a good idea?

Many specialized tax organizations have already provided plenty of examples of this absurd rule that overreaches by creating too many innocent victims who operate SMEs. And yet, the civil servants at the Department of Finance look absolutely ridiculous as they turn a blind eye to this situation… They act as if there is no problem at all. Gross incompetence? You bet.