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Expanding Small Business Deduction (SBD) Access for Co-operatives

ISSUE STATEMENT

The current federal tax framework inadvertently penalizes entrepreneurs who operate within the co-operative business model by restricting their access to the Small Business Deduction (SBD). In 2016, with the passage of Bill C-29, the federal government introduced measures aimed at preventing the multiplication of benefits derived from the SBD. An unintended consequence was that these provisions penalized co-operatives and Canadian-controlled private corporations (CCPCs) that are members of co-operatives (or whose shareholders are members), because they are now deemed to be a related party.

Although co-operatives and their members were not specifically targeted by these measures, they were affected and continue to operate with these financial consequences. Specifically, the Specified Corporate Income (SCI) regime, that was introduced to prevent corporations from being used to circumvent partnership restrictions, has been interpreted in a manner that goes far beyond its stated purpose. This has created structural inequity that forces many independent small businesses to pay the general corporate tax rate of approximately 27% instead of the 9-13% small business rate.¹ This structural inequity creates an additional tax burden on co-operatives, draining capital from local economies and placing co-operative entrepreneurs at a disadvantage.

While the federal government acknowledged this distinction by implementing amendments to the Income Tax Act in 2017 and 2019, those fixes were based on initial examples limited to agricultural and fishing co-operatives. Because those illustrations were never intended to be exhaustive, the result is an incomplete fix that leaves co-operatives in all other industries behind. Our objective is to simply complete this established correction for all eligible co-operatives.

BACKGROUND

The 2016 Budget introduced the SCI and the Specified Partnership Income (SP) regimes to ensure that a single business obtains access to only a single SBD limit. While the policy intent to prevent the multiplication of benefits is reasonable, the implementation has adversely affected parties carrying on entirely independent businesses.

¹ Xero, "Small business tax rate in Canada: Federal and provincial guide," <https://www.xero.com/ca/guides/small-business-tax-rates/>

- **The Intent vs. Reality:** The measures were intended to target tax planning where a corporation was used instead of a partnership to multiply SBD access, such as in large accounting or law firms. In reality, these rules now capture legitimate, separate businesses where multiplication was never a motivation, often reducing their overall entitlement to the SBD to below the \$500,000 limit.²
- **The Technical Distortion:** The broad interpretation of SCI rules captures any Canadian-Controlled Private Corporation (CCPC) selling to a co-operative in which it holds an interest, even when the ownership is a pre-requisite for business and not a tax strategy.
- **The Incomplete Fix:** Initial illustration of these restrictions focused primarily on agricultural and fishing co-operatives to highlight the issue, though this was never intended to be an exhaustive list. Consequently, while the government implemented amendments to the *Income Tax Act* in 2017 and 2019 to provide specific exemptions for these sectors, the scope of the fixes was too narrow and left co-operatives in other industries behind.^{3 4}
- **Existing Penalties:** Co-operatives in all other industries—such as forestry, retail, manufacturing, services and more—remain ineligible for the SBD on income derived through the co-operative because they are technically deemed related parties. This creates an unlevel playing field where a small contractor is penalized for serving an employee-owned co-operative or credit union but would remain fully eligible for the SBD if they provided the exact same service to a large, non-co-operative private corporation. Furthermore, because the taxable capital of “associated” members can be aggregated under these rules, small co-operative businesses often lose their SBD eligibility entirely if they collective capital exceeds the \$15 million threshold, even if the individual businesses are small.
- **Professional Validation:** In 2017 through numerous submissions, the Joint Committee on Taxation of the Canadian Bar Association and the Chartered Professional Accountants of Canada has described these rules as incredibly complex and noted that they effectively punish businesses for collaborating with one another.⁵ The Joint Committee specifically

² See submission titled June 2017 - CRA-Small Business Deduction Rules in Section 125.

https://www.ctf.ca/EN/EN/Library/Joint_Committee_Submissions.aspx#:~:text=June%202017%20%2D%20CRA%2DSmall%20B%20business%20Deduction%20Rules%20in%20Section%20125

³ Government of Canada, Explanatory Notes Relating to the Income Tax Act. <https://fin.canada.ca/drleg-apl/2017/ita-lir-0517-n-eng.pdf>

⁴ Government of Canada, Legislative Archive. <https://laws-lois.justice.gc.ca/eng/acts/i-3.3/section-125.html>

⁵ See submission titled June 2017 - CRA-Small Business Deduction Rules in Section 125.

https://www.ctf.ca/EN/EN/Library/Joint_Committee_Submissions.aspx#:~:text=June%202017%20%2D%20CRA%2DSmall%20B%20business%20Deduction%20Rules%20in%20Section%20125



raised concerns that these rules disproportionately impact smaller, rural communities where businesses have fewer customers and are naturally more likely to interact with related parties or co-operative entities. By applying a broad and literal interpretation of these rules, the tax system creates significant uncertainty and an unfair compliance burden for collective entrepreneurs and legitimate commercial partnerships.

RECOMMENDATION

The Government of Canada should implement a targeted legislative amendment to Section 125 of the Income Tax Act to restore tax neutrality and ensure the legislation functions as intended for all small business owners. This would entail:

- **Expanding Sector Access:** Extend the legislative relief currently enjoyed by farming and fishing co-operatives to all eligible co-operatives and qualifying member-owned CCPCs regardless of the sector in which they operate.
- **Clarifying Statutory Language:** Address the root cause of eligibility issues by narrowing the definition of the Specified Corporate Income to exclude legitimate transactions between independent co-operative members and their co-operatives.
- **Harmonizing Tax Treatment (a necessary technical correction):** Align the control and association tests to recognize the “one member, one vote” structure of co-operatives. This technical fix acknowledges that no single member of a co-operative holds de facto control in a democratic model, ensuring independent entrepreneurs are not unfairly grouped for tax limit purposes. By finishing the legislative work started for the farming and fishing sectors, the government can achieve sector neutrality and fulfill its policy intent of supporting small business growth across all industries.
- **Unlocking Reinvestment Capital:** Correcting this 14-18% tax penalty, by restoring access to the combined federal/provincial small business tax rate, will directly free up capital for co-operative members to reinvest in equipment, technology, and local job creation.

CONCLUSION

Expanding SBD access is a necessary and long-overdue technical correction to the Income Tax Act. By implementing a targeted “cleanup” of Section 125, the government can harmonize tax treatment across all co-operative sectors and ensure the legislation functions as originally intended for all small business owners. Removing these structural barriers will eliminate the current tax disincentive for CCPCs to join co-operatives, finally levelling the playing field for Canadian entrepreneurs regardless of their chosen business structure. This proposal is not merely a sector-specific request, but a professionally validated solution supported by the Joint Committee on Taxation to resolve the technical distortions currently penalizing collectively owned business models across Canada.