



## The Small Business Deduction—What You Need To Know

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The rate of tax that a Canadian corporation pays on its income can be a complex area. Many people probably don't know that the federal corporate tax rate is technically 38%. However, since taxable income earned in a province or territory is also subject to provincial/territorial income tax, the federal corporate tax rate is given a 10% reduction, bringing the effective rate to 28%.

There is another 13% reduction that brings the federal corporate tax rate to 15%. This reduction was introduced years ago in order to make Canada's corporate tax rates more competitive globally. This 15% rate

is the final corporate tax rate that is used to calculate tax on a corporation's income.

However, there is another incentive that reduces the federal rate even further. Forgoing the 13% reduction, a corporation can instead claim the federal small business deduction ("SBD"), which reduces the corporate tax rate by 19%—that is, from 28% to a mere 9%. There are important conditions, rules, and restrictions surrounding the SBD. The 2022 federal Budget also proposed a notable change to the SBD. This article discusses all the basic rules related to the SBD that you should be aware of.

### CCPC Status Required

First, to benefit from the SBD, the corporation must be a Canadian-controlled private corporation ("CCPC"). To qualify as a CCPC, a corporation must satisfy all of the following conditions:

- it must be a Canadian corporation, which is generally a corporation that is incorporated in Canada;
- it must be a private corporation, which is a corporation that is not a public corporation and is not controlled by a public corporation; and

- the corporation must not be controlled directly or indirectly, in any manner whatever, by one or more non-resident persons, one or more public corporations, or any combination thereof, and cannot be listed on a designated stock exchange.

Also, to qualify for the SBD in a taxation year, CCPC status must be maintained throughout the taxation year.

## Active Business Income

Only the corporation's income from an active business carried on in Canada is eligible for the small business deduction. Very generally, an active business would include any business other than a personal services business or specified investment business—these two concepts are discussed further below. Investment income and capital gains are also not active business income.

## Dollar Limit

A corporation can claim a small business deduction to the extent of its income from an active business carried on in Canada, but the amount cannot exceed the corporation's business limit for the year. Normally, the business limit is \$500,000. However, if the corporation is associated with any corporations, the associated group of corporations must share the \$500,000 limit. Associated corporations must file an annual agreement to allocate a percentage of the business limit. For example, if a corporation's allocated percentage was 50% and its business limit for the year was \$500,000, the corporation's allocated business limit would be \$250,000.

There are also rules, which are discussed below, that may reduce or eliminate the small business limit.

## Reduction for Investment Income

The business limit of a CCPC for a taxation year is reduced where its passive investment income for a year exceeds \$50,000. In particular, the small business limit of the CCPC for a particular taxation year ending in a calendar year is reduced on a straight-line basis, with a \$5 grind-down in the business limit for every \$1 that the total of the "adjusted aggregate investment income" of the CCPC and any corporation associated with the CCPC in the particular taxation year,

for its taxation year ending in the preceding calendar year, exceeds \$50,000. If the adjusted aggregate investment income in one year is \$150,000 or more, the business limit for the next year will be reduced to zero.

Note that the greater of the reduction for investment income and the reduction for capital (below) will apply, but not both simultaneously. Whichever reduction is the highest is the one that will actually reduce the small business limit.

## Reduction for Capital Exceeding \$10 Million

The small business limit is reduced where the corporation (plus any associated corporations) have taxable capital exceeding \$10 million. Where taxable capital exceeds \$10 million, the business limit is gradually reduced. The amount of the reduction is equal to 10 cents for every dollar by which taxable capital exceeds \$10 million. Thus, when the taxable capital reaches \$15 million (i.e., the excess amount is \$5 million), the \$500,000 small business limit is completely eliminated ( $\$5,000,000 \times 10\% = \$500,000$ ).

Note however, that Federal Budget 2022 proposes to increase the upper limit of taxable capital employed in Canada for purposes of calculating the reduction to the business limit. The amount at which the limit is fully eliminated would be increased substantially from \$15 million to \$50 million. The reduction of the business limit continues to apply on a straight-line basis, and the reduction rate would be a much lower rate of 1.25 cents per dollar of income in excess of \$10 million. For example, a CCPC with \$30 million in taxable capital would be subject to a 50% reduction in the business limit, with access to a business limit of \$250,000 (where previously it would be ineligible entirely). Also, a CCPC with \$40 million in taxable capital would be subject to a 75% reduction in the business limit, with access to a business limit of \$125,000. This change would apply to taxation years that begin on or after April 7, 2022.

## Short Taxation Years

The small business limit is reduced where a corporation has a short taxation year. The \$500,000 limit is prorated for a taxation year of less than 51 weeks, based on the number of days in the taxation year, divided by 365.

## Specified Investment Business

It would seem that the federal government does not want a passive investment business to enjoy the lower small business tax rate. An active business carried on by a corporation excludes income from a "specified investment business", thus income from such a business does not qualify for the small business deduction. Income from a specified investment business is also subject to a substantially higher tax rate in the hands of the CCPC, though a portion of it can be refunded when the CCPC pays a dividend.

A specified investment business is a business carried on by a corporation the principal purpose of which is to derive income from property, including interest, dividends, rents, or royalties, but does not include a business where:

- the corporation employs in the business throughout the year more than five full-time employees; or
- any other corporation associated with the corporation provides managerial, administrative, financial, maintenance, or other similar services to the corporation in the year and the corporation could reasonably be expected to require more than five full-time employees if those services had not been provided.

Thus, where either of the two conditions above are met, the corporation is not precluded from claiming the small business deduction by the specified investment business restriction.

## Personal Services Business

The concept of a personal services business ("PSB") was introduced to address situations where employees were incorporating and providing their services to their employer through their corporation. If not for the PSB rules, incorporating would be very beneficial to an employee as it would allow them to defer a substantial amount of personal tax by retaining the income earned within their corporation. This is because the corporate tax rate on small business income can be much lower than the rate that an employee would pay personally (depending on their tax bracket).

Thus, income from a PSB is ineligible for the SBD. Rather, it is subject to an additional tax such that in-

come from a PSB is taxed at a federal rate of 33%. This is the same rate as the highest personal federal tax bracket. The high rate eliminates any tax deferral advantage that would be enjoyed by retaining income earned within the corporation. Moreover, the types of deductions available are significantly restricted. All such deductions are disallowed except:

1. salary, wages, or other remuneration paid to an incorporated employee;
2. selling and similar expenses that would have been deductible in computing employment income if the individual had expended them; and
3. legal expenses incurred in collecting amounts owing for services rendered.

In a nutshell, PSB status is very disadvantageous from a tax perspective and is something that should be avoided if at all possible. Individuals who are thinking about incorporating or whose employer has asked them to incorporate should exercise caution to ensure that they are not subject to the PSB rules.

Technically speaking, a PSB arises where a corporation carries on a business of providing the personal services of an individual to another person who, absent the corporation, could reasonably be viewed as the individual's employer. A PSB will not arise unless the incorporated employee, or a related person, is a "specified shareholder", which means that they own at least 10% of the issued shares of any class of the corporation. But there are two exceptions. A business that meets the above criteria is not considered a PSB if:

1. the corporation employs more than five full-time employees in the business; or
2. the amount paid to the corporation for the services provided is received from an associated corporation.

## Questions or Concerns?

This article only briefly described some the key rules related to the small business deduction in a very general sense. There are other technical issues that may apply depending on the situation. If you have any questions relating to your corporate tax situation, don't hesitate to ask for professional advice.