

Corporate tax incentives for small businesses



**TAX
VIEWS**

**By
Vern
Krishna**

Canadian corporations that earn active business income are eligible for special tax treatment. The tax rules are intended to stimulate small businesses, which are an important component of our economy and a source of employment.

The technical rules, however, can be formidable and lead to costly disputes with the Canada Revenue Agency. The federal government's announcement in the April budget for corporate tax reductions for small Canadian businesses from 11 to nine per cent by 2019 is encouraging for this sector of the economy.

The basic federal corporate rate of tax is 38 per cent, which is reduced by 10 per cent for the provincial tax abatement. Therefore, all corporations are nominally taxable at a federal rate of 28 per cent. The abatement gives the provinces and territories some "room" to levy their own taxes. In the absence of such room, the federal government could effectively occupy the entire tax field, and elbow out the fiscal power of the provinces and territories.

There is, however, a further general rate reduction of 13 per cent on corporate income, which brings the federal rate down to 15 per cent. Provincial and territorial rates can add between 10 to 16 per cent.

Canadian-controlled private corporations (CCPCs) that earn active business income in Canada are eligible for further tax reductions. A CCPC can claim an annual tax credit of 17 per cent of its Canadian "active business income," up to a maximum of \$500,000, which is shared between associated corporations. Thus, the credit reduces a CCPC's



There are a myriad of technical rules to obtain the small business rate. "Business" includes "a profession, calling, trade, manufacture or undertaking of any kind whatever." The adjective "active" is interpreted generously.

Vern Krishna, TaxChambers LLP

federal corporate tax payable on its first \$500,000 of active business income from 28 per cent to 11 per cent.

The provinces add their own corporate taxes to the basic federal rate. Ontario, for example, adds 4.5 per cent to bring the combined federal-provincial rate to 15.5 per cent. British Columbia adds 2.5 per cent and Alberta adds three per cent.

There are a myriad of technical rules to obtain the small business rate. "Business" includes "a profession, calling, trade, manufacture or undertaking of any kind whatever." The adjective "active" is interpreted generously. For example, in *Cadboro Bay*:

"Any quantum of business activity that gives rise to income in a taxation year for a private corporation in Canada is sufficient to make mandatory the characterization of such income

as income from an 'active business carried on in Canada.'"

There is a rebuttable presumption that corporate income derives from business. As Justice Wilson said in *Can. Marconi*:

"There is in the case of a corporate taxpayer a rebuttable presumption that income received from or generated by an activity done in pursuit of an object set out in the corporation's constating documents is income from a business ... The question whether particular income is income from business or property remains a question of fact in every case. However, the fact that a particular taxpayer is a corporation is a very relevant matter to be considered because of the existence of the presumption and its implications in terms of the evidentiary burden resting on the appellant."

The presumption is, however, rebuttable, and must be interpreted in the context of the statu-

tory scheme for the taxation of corporate income, which taxes business income quite differently from passive investment income.

The distinction between business and investment income is a question of fact that depends upon several factors, including:

- Activity associated with the generation of the income;
- Number and value of transactions;
- Relationship between the income in question and total income; and
- Relationship between the value of the assets producing the income in question and total assets.

The greater the volume of activity, the value of transactions, and the closer the relationship between the income earned and the total income and assets of the taxpayer, the greater the likelihood that the income is "business income."

A corporation's business income is usually "active," unless it derives from a "specified investment business" or a "personal service business." A "specified investment business" is a business that derives its income principally from investments and property. Thus, it includes a business whose principal purpose is to earn income from interest, dividends, royalties, rents, etc.

A corporation's active business income also includes any incidental income that pertains to the business. For example, cash and short-term liquid investments are business assets if they are an integral part of the business. Hence, the income that they generate is business income. The critical element is whether the corporation depends and relies upon the investments for the operation of its business.

Thus, incidental business income — such as income from investment of surplus cash, rental of excess space, interest on accounts receivable, and certain investment income from associated corporations — qualify as active business income. However, active business income does not include income from property from a source in Canada.

The special regime for the taxation of Canadian active business income is founded in encouraging small businesses to grow and have access to capital. This is an important constituency, particularly during an election in the middle of a recession.

Although the underlying concept is straightforward, the details of the myriad rules pertaining to sources of income and association of corporations require careful attention. The Conservative budget's proposals to reduce the tax rate for Canadian controlled private corporations to nine per cent provides stimulus in the right direction.

Vern Krishna, CM, QC, is Of Counsel, TaxChambers LLP (Toronto) and professor of law, University of Ottawa. E-mail him at vern.krishna@taxchambers.ca; www.vernkrishna.com