NO.: **IT-73R6** DATE: March 25, 2002

SUBJECT: INCOME TAX ACT
The Small Business Deduction

REFERENCE: Section 125 (also subsections 14(1), 123.4, 129(4), and 129(6), the definitions "active business" and "specified shareholder" in subsection 248(1), paragraph 18(1)(*p*), subparagraph 12(1)(*e*)(ii) of the *Income Tax Act* and section 6701 of the *Income Tax Regulations*)

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Application

This bulletin cancels and replaces IT-73R5, dated February 5, 1997.

Summary

This bulletin deals with the rules concerning the small business deduction that may be claimed by a Canadian-controlled private corporation (CCPC) in respect of its income from carrying on an active business in Canada.

Active business carried on by a CCPC in Canada does not include a "specified investment business" or a "personal services business". These two types of businesses are discussed in this bulletin. In addition, details of the components of the calculation of the small business deduction are provided.

Section 125 of the *Income Tax Act* provides for a corporate tax reduction (commonly referred to as "the small business deduction") in respect of income of a CCPC from an active business carried on by it in Canada. The small business deduction is provided by way of an annual tax credit that is calculated as 16 % of the least of the corporation's:

(a) active business income for the year;

(b) taxable income for the year (subject to certain adjustments); and

(c) business limit for the year (which is generally $200,000).

The corporation must be a CCPC throughout the year to qualify for the small business deduction for that year.

The special low rate of tax provided by the small business deduction recognizes the special financing difficulties and higher cost of capital faced by small businesses and is intended to provide these corporations with more after-tax income for reinvestment and expansion. As the small business deduction is intended to benefit only small corporations, a large corporation's access to the deduction is restricted on the basis of its taxable capital employed in Canada.

This bulletin also discusses the impact of the small business deduction on the accelerated tax reduction for CCPCs and on any general tax reduction claimed by a CCPC.

Discussion and Interpretation

GENERAL COMMENTS

¶ 1. Subsection 125(1) provides a reduction (the "small business deduction") from Part I tax otherwise payable for a taxation year by a corporation that was, throughout the taxation year, a CCPC. "Canadian-controlled private corporation" is defined in subsection 125(7). See also the current version of IT-458, *Canadian-Controlled Private Corporation*.

¶ 2. The small business deduction, for a particular taxation year, is equal to 16 % of the least of (a), (b), and (c):

(a) the total of each amount of the corporation's income for the year from an active business carried on by it (other than as a member of a partnership) in Canada (see ¶s 3-10); and

- the corporation's "specified partnership income" for the year (see ¶ 20);

Minus

- the total of each amount of the corporation's loss for the year from an active business carried on by it (other than as a member of a partnership) in Canada; and
- the corporation's "specified partnership loss" for the year (see ¶ 21);

(b) the corporation's taxable income for the year minus any portion thereof exempt from tax under Part I because of an Act of Parliament and certain amounts pertaining to foreign tax credits for the year (see ¶ 22); and

(c) the corporation's business limit for the year (see ¶ 23).

INCOME FROM AN ACTIVE BUSINESS CARRIED ON IN CANADA – PARAGRAPH 125(1)(*a*)

Active Business

¶ 3. The term "active business carried on by a corporation" is defined in subsection 125(7) as any business carried on by a corporation other than a "specified investment business" (see ¶ 11) and a "personal services business" (see ¶ 18) and includes an adventure or concern in the nature of trade (see the current version of IT-459, *Adventure or Concern in the Nature of Trade*).

Income From an Active Business

¶ 4. "Income of the corporation for the year from an active business," as defined in subsection 125(7), means the corporation's income for the year from an active business carried on by it, including any income for the year pertaining to or incident to that business (see ¶s 5 and 6), as well as amounts received from a "NISA Fund No. 2," that are included under subsection 12(10.2) in computing the corporation's income for the year. "NISA Fund No. 2," as defined in subsection 248(1), means the part of a taxpayer's net income stabilization account described in paragraph 8(2)(*b*) of the *Farm Income Protection Act*.

"Income of the corporation for the year from an active business" does not include any income for the year from a source in Canada that is a property within the meaning assigned by subsection 129(4). That subsection provides that "income" or "loss" of a corporation for a taxation year from a source that is a property

(a) includes the income or loss from a specified investment business (see ¶ 11) carried on by the corporation in Canada other than income or loss from a source outside Canada,

(b) but does not include the income or loss from any property

- that is incident to or pertains to an active business carried on by the corporation (see ¶s 5 and 6), or

- that is used or held principally for the purpose of gaining or producing income from an active business carried on by the corporation (see ¶s 5 and 6).

If the original gain on the sale of real property was categorized in a previous year as income from an active business, amounts included in income in subsequent years in respect of the realization of the mortgage reserve pursuant to subparagraph 12(1)(*e*)(ii), are considered to be income from an active business. This also applies to any mortgage interest received pertaining to such mortgage.

As discussed in ¶ 7, subsection 129(6) provides an exception to these general rules for certain amounts received or receivable from associated corporations.

¶ 5. Income of a corporation that "pertains to" or is "incident to" the income of the corporation from an active business is referred to in the definition of "income of the corporation for the year from an active business" in subsection 125(7) but those terms are not defined in the Act.

In examining the ordinary dictionary meaning of these words, "incident to" generally includes anything that is connected with or related to another thing, though not inseparably, or something that is dependent on or subordinate to another more important thing. "Pertains to" generally includes anything that forms part of, belongs to or relates to another thing.

The courts have found that, in interpreting the meaning of "pertains to" or "incident to" in context, there has to be a financial relationship of dependence of some substance between the property in question and the active business before the property is considered to be incident to or to pertain to the active business carried on by the corporation. In addition, the operations of the business have to have some reliance on the property such that the property is a back-up asset that could support the business operations either on a regular basis or from time to time.

If, for example, a corporation carrying on an active business holds term deposits that are not used or connected to its business operations, the term deposits are not property that is incident to or pertains to an active business carried on by the corporation, nor are the term deposits used or held principally for the purpose of gaining or producing income from an active business by the corporation. Accordingly, a determination is required of whether the source of income (e.g., term deposits) is a separable activity, apart from the corporation's main business activities.

The courts have held that when a corporation derived income from an activity that was inseparable from its normal active business, such income was properly classified as active business income. If the income is part of the normal business activity of the corporation, and it is inextricably linked with an active business, it is considered active business income. For example, in the 1981 case of *Supreme Theatres Ltd. v. The Queen*, [1981] CTC 190, 81 DTC 5136, it was held by the Federal Court – Trial Division that rental income from hiring out the part of a building that was a motion picture theatre auditorium constituted active business income derived from the company's normal business activity of operating motion picture theatres, while the rental income from hiring out a portion of a parking lot was not.

¶ 6. As indicated in ¶ 4, for the purpose of the small business deduction, income from property does not include income "from any property that is incident to or pertains to an active business carried on by the corporation" or "from any property that is used or held principally for the purpose of gaining or producing income from an active business carried on by the corporation." Income from property that is employed or risked in a corporation's business operations is considered to be active business income. This must be distinguished from income from property, which is not connected to or is not necessary to sustain a corporation's business operations. It is a question of fact whether a property is used principally in an active business. Factors to be considered in determining whether a property is used in an active business include the actual use to which the asset is put in the course of the business, the nature of the business involved and the practice in the particular industry. The issue of whether property was used or held by a corporation in the course of carrying on a business was considered by the Supreme Court of Canada in *Ensite Limited v. Her Majesty the Queen*, [1986] 2 CTC 459, 86 DTC 6521. The court held that the holding or using of property must be linked to some definite obligation or liability of the business and that a business purpose test for the use of the property was not sufficient. The property had to be employed and risked in the business to fulfil a requirement which had to be met in order to do business. In this context, risk means more than a remote risk. If the withdrawal of the property would have a decidedly destabilizing effect on the corporate operations, the property would generally be considered to be used in the course of carrying on a business. In other words, the property has to be an integral part of the financing of the business or necessary to the overall business operations in order for income from the property to be part of the "income of the corporation … from an active business."

For example, although a mortgage receivable is an asset whose existence may be relevant to the equity of a corporation, it is not generally an asset used in an active business because the funds tied up in the mortgage are not available for the active business use of a corporation. However, if the corporation could establish that the mortgages are employed and risked in the business such that the mortgages are inextricably tied to or vitally connected with the business, they could be considered to be used in an active business carried on by the corporation.

¶ 7. A corporation may derive income from holding property in Canada (e.g., income in the form of real estate rentals, interest, or royalties). If such income is received or receivable from an associated company and the amount is or may be deductible in determining the associated company's income from an active business carried on by it in Canada, then paragraph 129(6)(*b*) deems the income in the recipient's hands to be income from an active business carried on by it in Canada.

If subsection 129(6) deems rental income to be active business income and capital cost allowance on the rented building was deducted in calculating active business income, any recapture of capital cost allowance on the disposition of the building would also be considered to be active business income.

¶ 8. If a corporation is incorporated to earn income by doing business, there is a general presumption that profits arising from its activities are derived from a business (or from separate businesses as discussed in the current version of IT-206, *Separate Businesses*). Thus, from the time that the activities contemplated commence (see the current version of IT-364, *Commencement of Business Operations*) until they permanently cease, most corporations carry on or will have carried on one or more businesses. However, in some circumstances, a corporation's entire profits can be characterized as income from property, as might be the case where the corporation is formed for the sole purpose of holding shares of a second corporation or holding a property to be rented with limited landlord responsibilities. It is, of course, quite possible that a corporation will earn income from property as well as income from a business carried on, if such property income is not income from another separate business.

Cessation of a Business

¶ 9. Income related to a business that arises after cessation of that business cannot qualify as income from a business except when it arises from:

(a) bad debt recoveries;

(b) the recapture of various reserves;

(c) the sale of the inventory of the business;

(d) the disposition of eligible capital property of the business and the income is the amount of the excess described in subsection 14(1);

(e) the recapture of capital cost allowance; or

(f) a similar item to those described in any of (a) to (e) above.

Income that does qualify as income from a business because it arises from a source described in (a) to (f) above will be considered to be income from the same category of business as that to which the source originally related. For (e) above, however, this does not apply to situations in which the depreciable property is subsequently treated as a rental property and capital cost allowance is claimed against the rental income since the rental property would give rise to income from property that is not income from an active business. If the property was only rented or leased for a short time during which it was listed for sale and no capital cost allowance was claimed against the rental or lease income, the income would still be considered to be income from the same category of business before the rental or lease. It is a question of fact whether or not a corporation has ceased to carry on a business.

A temporary period of inactivity does not necessarily mean that a corporation has ceased (and subsequently recommenced) to carry on a business. For example, the nature of a real estate development business is such that no real estate may be held at certain times or real estate that is held may not be actively developed for a significant period of time. Unless it is evident that the corporation does not intend to recommence its development activities, it is considered to be carrying on business throughout the dormant period. In any event, a corporation ceases to carry on a business before (but not necessarily immediately before) the time when it:

- commences to distribute its assets to its shareholders in the course of winding up the corporation; or
- sells or otherwise disposes of the business.

Meaning of "Carried On in Canada"

¶ 10. Whether or not a particular business is carried on in whole or in part in Canada is a question of fact. However, as a general rule, a business that involves the sale or leasing of goods is usually carried on in the country where the corporation is resident, unless the business (or a part of it) is conducted by a virtually autonomous branch operation outside Canada. When a corporation's business involves the rendering of services, that business is carried on in Canada only to the extent that services are rendered in Canada, necessitating an apportionment of net business income on a reasonable basis. Income derived from property, ancillary to the activities involved in carrying on a business, that is categorized as income from an active business may also have to be apportioned on a reasonable basis having regard to the place where the related business is carried on.

Specified Investment Business

¶ 11. A "specified investment business" carried on by a corporation in a taxation year is defined in subsection 125(7) to be a business the principal purpose (see ¶s 12 to 14) of which is to derive income from property. Such income includes interest, dividends, rentals from real estate (including subrentals) and royalties. Specifically excluded from the definition is any business carried on by a credit union or a business of leasing property other than real property. However, the business of the corporation will generally be considered to be an active business rather than a specified investment business when either:

(a) the corporation employs in the business throughout the taxation year more than five full-time employees (see ¶s 15 to 17); or

(b) an associated corporation, in the course of carrying on an active business, provides managerial, administrative, financial, maintenance or other similar services to the corporation in the year and it is reasonable to assume that the corporation would have required more than five full-time employees in its business if those services had not been provided.

The exceptions in (a) and (b) above do not apply to a business carried on by a prescribed labour-sponsored venture capital corporation where the principal purpose of the business is to derive income from property. Section 6701 of the Regulations contains the meaning of "prescribed labour-sponsored venture capital corporation" for the purposes of this rule in the definition of "specified investment business" in subsection 125(7).

Investment activities of a corporation cannot constitute a "specified investment business" if such activities are not

- the main business of the corporation, or
- a separate business of the corporation (see the current version of IT-206, *Separate Businesses*).

¶ 12. "Principal purpose" is not a defined term in the Act for the purposes of the definition of "specified investment business" in subsection 125(7), but it is considered to be the main or chief objective for which the business is carried on.

¶ 13. A corporation that operates a business may buy real property for the purpose of using the site in the future as a business premise. In the interim, if rental income is derived, such income would probably be considered to be active business income rather than income from a specified investment business. In such cases, it is presumed that the principal purpose test referred to in the definition of "specified investment business" in subsection 125(7) would not be met for as long as the corporation's principal purpose in owning the site is not to derive rental income from it. A corporation that operates a hotel is generally considered to be in the business of providing services and not in the business of renting real property. Accordingly, the business is normally considered to be an active business rather than a specified investment business.

¶ 14. The principal purpose of a corporation's business must be determined annually after all the facts relating to that business carried on by that corporation in that year have been considered and analyzed. Included in this evaluation should be such things as:

(a) the purpose for which the business was originally commenced;

(b) the history and evolution of its operations, including changes in its mode of operation and purpose of existence; and

(c) the manner in which the business is conducted.

¶ 15. The phrase "the corporation employs in the business throughout the (taxation) year more than five full-time employees" is considered to mean that an employer has six or more employees working a full business day (or a full shift) on each working day of the year, subject to normal absences due to illness or vacation. Employees working part-time cannot qualify as full-time employees. A part-time employee is generally a person employed for irregular hours of duty or specific intermittent periods, or both, during a day, week, month, or year and whose services are not required for the normal work day, week, month, or year. Vacancies caused by terminations that temporarily reduce the staff to less than six employees will normally not disqualify the corporation provided immediate action is taken to restore the staff to normal strength and there is no undue delay in filling the vacant positions.

¶ 16. In the following situations, employees of a corporation would not be considered to be full-time employees throughout a taxation year:

(a) Mr. A is employed two days a week, does all the bookkeeping, but is available whenever his services are required;

(b) Mr. B's only activity is to attend board of directors meetings, although he is always available whenever his services are required; and

(c) a corporation employs ten employees full-time for six months in a taxation year and for the remaining six months employs no one as it is inactive.

¶ 17. If a corporation carries on a business as a member of a joint venture, employees working for the joint venture are the employees of its members collectively, but not of any of them individually. In other words, such employees, if full-time, cannot be counted as the full-time employees of the corporation, either in whole or in proportion to its interest in the joint venture. Only those persons (if any) who are employed full-time in the business directly and solely by the corporation can be counted as its full-time employees for the purpose of the "more than five full-time employees" exception in the definition of "specified investment business". The same would apply for other forms of co-ownership of a business. See *Lerric Investments Corp. v. The Queen*, [2001] 2 CTC 84, 2001 DTC 5169. In the case of partnerships, however, see ¶ 20.

Personal Services Business

¶ 18. Pursuant to the definition of "personal services business" in subsection 125(7), a corporation is carrying on a "personal services business" in a taxation year if it is in the business of providing services and:

(a) an individual who performs the services provided to another person or partnership (the entity) on behalf of the corporation (referred to as an "incorporated employee") would, if it were not for the existence of the corporation, reasonably be regarded as an officer or employee of the entity to which the services were provided;

(b) the incorporated employee or any person related to the incorporated employee is a "specified shareholder" of the corporation (see below);

(c) the corporation employs in the business in the year (subject to the comments in ¶ 15) fewer than six full-time employees (see ¶s 15 to 17) including incorporated employees and other employees; and

(d) the fee for the services is not received or receivable by the corporation from a corporation with which it was associated in the year.

A personal services business does not qualify for the small business deduction and is therefore subject to tax at full corporate rates. In addition, paragraph 18(1)(*p*) limits the deductions permitted in computing a corporation's income for a taxation year from a personal services business.

Subject to various deeming provisions in the definition of "specified shareholder" in subsection 248(1), a "specified shareholder" of a corporation in a taxation year is a taxpayer who owns directly or indirectly at any time in the year not less than 10% of the issued shares of any class of the capital stock of the corporation or of any other corporation that is related to the corporation.

¶ 19. The condition stipulated in ¶ 18(a) is not met if, in the absence of the corporation, there would be no common law master-servant relationship and the individual who undertakes to perform the services would be viewed as a self-employed individual carrying on a business. The determination of whether an incorporated employee would otherwise be regarded as self-employed or as an officer or employee of the entity to which the services were provided is a question of fact. The following list of factors, although not exhaustive, are indications of employee status:

(a) the entity to which the services are provided has the right to control the amount, the nature and the direction of the work to be done and the manner of doing it;

(b) the payment for work is by the hour, week or month;

(c) payment by the entity of the worker's travelling and other expenses incidental to the payer's business;

(d) a requirement that a worker must work specified hours;

(e) the worker provides services for only one payer; and

(f) the entity to which the services are provided furnishes the tools, materials and facilities to the worker.

Specified Partnership Income

¶ 20. As noted in ¶ 2, one of the amounts that enters into the calculation of a corporation's small business deduction is its "specified partnership income" (if any) for the year. This term is defined in subsection 125(7). A corporation's specified partnership income is the aggregate of two components, which are identified as variables A and B.

In general terms, variable A represents the corporation's eligible share of income from partnerships from active businesses carried on in Canada.

More precisely, variable A is the **total** of separate amounts, each of which is an amount with respect to a particular partnership of which the corporation was a member in the year. With respect to each partnership, this amount is the lesser of two amounts:

(i) The first amount is the **total** of separate amounts, each of which is an amount (if positive) with respect to a particular active business which the corporation carried on in Canada as a member of the partnership. With respect to each business, this amount is equal to the corporation's share of the income (if any) of the partnership from the business for the fiscal period (or fiscal periods) ending in the year **plus** any amount included in the corporation's income for the year from the business because of subsection 34.2(5) **minus** all amounts deducted at the partner level in computing the corporation's income for the year from the business (other than amounts deducted in computing the income of the partnership from the business).

(ii) The second amount with respect to each partnership is determined by **dividing** the corporation's share of all the amounts of income of the partnership from active businesses carried on in Canada for fiscal periods ending in the year **by** the total of all such amounts of income of the partnership for such fiscal periods, and **multiplying** the result by $200,000 (or a proportionately smaller amount when the number of days in any such fiscal period is less than 365).

The second component, variable B, of a corporation's specified partnership income is an additional amount to ensure that any losses of the corporation for the year from active businesses carried on by it in Canada are offset first against business income that is not eligible for the small business deduction before reducing the income that would otherwise qualify for the small business deduction.

Variable B is the lesser of two amounts:

(i) the **total** of all amounts each of which is the corporation's loss for the year from an active business carried on by it (other than as a member of a partnership) in Canada **plus** the corporation's "specified partnership loss" for the year (see ¶ 21); and

(ii) the **total** of all amounts each of which is any positive amount for the year that results when amount (ii) for variable A above with respect to any partnership of which the corporation was a member in the year is subtracted from amount (i) for variable A with respect to that partnership.

Variable B is relevant only if the corporation has both losses for the year from an active business carried on by it in Canada (whether as a member of a partnership or otherwise) and income for the year from an active business carried on by it in Canada as a member of a partnership.

For purposes of determining whether a corporation has carried on an active business as a member of a partnership, as referred to in the subsection 125(7) definitions of "specified partnership income" and "specified partnership loss" (see ¶ 21), the following rules should be taken into consideration:

- the subsection 125(7) definition of "active business carried on by a corporation" (see ¶ 3);
- the subsection 125(7) definition of "income of the corporation for the year from an active business" (see ¶s 4 to 6);

- the meaning, in subsection 129(4), of "income" or "loss" of a corporation for a taxation year from a source that is property (see ¶s 4 to 6); and
- the subsection 125(7) definition of "specified investment business" (see ¶s 11 to 15 and ¶ 17) and the exclusion of a business from that definition if there are more than five full-time employees throughout the year (as discussed in ¶s 11, 15 and 17).

A business carried on by a corporation as a member of a partnership is not a "specified investment business" if the partnership employs more than five full-time employees. In other words, the corporation's share of income from the business can be included in the calculation of its "specified partnership income".

Specified Partnership Loss

¶ 21. If a corporation has a "specified partnership loss" for a taxation year, it is used in the calculations in ¶s 2 and 20. The term "specified partnership loss" is defined in subsection 125(7). A corporation's specified partnership loss consists of the following:

- the corporation's share of all the losses from partnerships of which the corporation was a member in the year, for fiscal periods ending in the year, from active businesses carried on in Canada by the corporation as a partnership member;

plus

- the total of all amounts each of which is any positive amount—with respect any particular business carried on by the corporation in Canada as a member of a partnership—that results when the amounts deducted at the partner level in computing the corporation's income for the year from that particular business (other than any amount deducted in computing the income of a partnership) are reduced by the corporation's share of the income from that business for the fiscal period or periods ending in the year and by any amount included in the corporation's income for the year from that business because of subsection 34.2(5).

TAXABLE INCOME LIMIT – PARAGRAPH 125(1)(*b*)

¶ 22. In computing the small business deduction of a CCPC, paragraph 125(1)(*b*) requires the determination of the corporation's taxable income for the taxation year in excess of the total of:

- 10/3 of the corporation's foreign tax credit deductible under subsection 126(1) for the year without reference to sections 123.3 and 123.4;
- 10/4 of the corporation's foreign tax credit deductible under subsection 126(2) for the year without reference to section 123.4; and
- any portion of the corporation's taxable income for the year that is exempt from tax under Part I because of an Act of Parliament.

The amounts deducted from the corporation's taxable income represent income on which no Canadian income tax was paid because the income is exempt from tax or because of the foreign tax credit.

BUSINESS LIMIT – PARAGRAPH 125(1)(*c*)

Amount of Limit

¶ 23. Generally, under subsection 125(2), the business limit for a CCPC is $200,000 if the corporation is not associated in the year with one or more other CCPCs and its taxation year is not less than 51 weeks. If two or more CCPCs are associated with one another in a taxation year, the small business deduction must be shared, by allocating the annual business limit of $200,000 amongst the corporations for the taxation year. Corporations may file an agreement (T2, Schedule 23, *Agreement Among Associated Canadian-Controlled Private Corporations to Allocate the Business Limit*) annually making this allocation (see ¶ 24). If the taxation year of the CCPC is shorter than 51 weeks in duration, see ¶s 27 and 28. In addition, if a CCPC has a Part I.3 large corporations tax liability for the preceding year, the corporation's business limit for the year may be reduced or eliminated (see ¶ 29).

In calculating a CCPC's business limit, the provisions of section 125 should be applied in the following order:

- subsections 125(2) to (4) (subsections 125(3) and (4) are discussed in ¶s 24 to 26);
- subsection 125(5) (see ¶s 27 and 28); and
- subsection 125(5.1) (see ¶ 29).

Agreement Filed by Associated CCPCs

¶ 24. All CCPCs that, under section 256, are associated with each other in a taxation year, may in accordance with subsection 125(3) allocate amongst themselves, the annual business limit amount. If this allocation is made in accordance with the requirements described in ¶ 25, and the total of the amounts allocated is $200,000, the business limit for the taxation year of each corporation is the amount allocated to it, as indicated on the agreement filed in prescribed form.

¶ 25. In order to allocate the $200,000 business limit for a taxation year amongst the corporations referred to in subsection 125(3), the following must be done:

(a) an agreement in prescribed form (T2, Schedule 23) must be filed by each corporation in the group of associated corporations; and

(b) the duly completed agreement must be signed on behalf of each corporation in that group.

A new agreement must be filed for each taxation year. If another corporation that is not an initial signatory to the agreement is considered to be associated with the corporations that did sign the agreement, that corporation must also sign the agreement. If an agreement has not been signed by all the corporations that originally filed as being

associated, or if it is not signed (upon request) by another corporation that is considered to be associated, subsection 125(4) may be applied. Normally, an assessment will not be made based on an incomplete agreement.

Where Effective Agreement Not Filed

¶ 26. If any one of the CCPCs that are associated with each other in a taxation year fail to file or refuse to be a signatory to an agreement under subsection 125(3) (T2, Schedule 23) within 30 days after written notice has been issued to any of them of such a requirement, the Minister shall, under subsection 125(4), allocate $200,000 in total to one or more of them and the amount so allocated to any particular corporation shall be the corporation's business limit for the year.

Taxation Year Less Than 51 Weeks

¶ 27. The business limit for a CCPC for a taxation year of less than 51 weeks duration is, under paragraph 125(5)(*b*), that proportion of the corporation's business limit as otherwise determined that the number of days in the taxation year is of 365.

Multiple Taxation Years in the Same Calendar Year

¶ 28. A CCPC may have two or more taxation years ending in a calendar year in which it is associated with another CCPC. In this situation, the CCPC's business limit (for purposes of paragraph 125(1)(*c*)), for each second or subsequent taxation year that ends in the calendar year, is determined under paragraph 125(5)(*a*)—subject to the rule in paragraph 125(5)(*b*) (see ¶ 27)—to be the lesser of the following two amounts:

- subparagraph 125(5)(*a*)(i)—the amount allocated to the corporation under subsection 125(3) or (4), as its business limit for its first taxation year that ended in that calendar year; and
- subparagraph 125(5)(*a*)(ii)—the amount allocated to the corporation under subsection 125(3) or (4), for that particular taxation year ending in that calendar year.

The intent of subparagraph 125(5)(*a*)(ii) is to ensure that the total determined for the business limit for a group of associated CCPCs does not exceed $200,000 for any second or subsequent taxation year.

Example

At all relevant times, Y Ltd. and Z Ltd. were associated CCPCs. Both had taxation years ending September 30, 2001, neither of which was a short taxation year. Of the business limit of $200,000, Y Ltd. and Z Ltd. allocated to themselves $50,000 and $150,000, respectively, pursuant to subsection 125(3), for the year ended September 30, 2001.

On October 1, 2001, X Ltd. became associated with Y Ltd. and Z Ltd. X Ltd. had a fiscal year end of November 30, 2001, and this was not a short taxation year. Y Ltd. and Z Ltd. changed their fiscal year end to November 30. The associated group of companies allocated the $200,000 business limit, pursuant to subsection 125(3), for the year ended November 30, 2001, as follows:

- $150,000 to X Ltd.,
- $25,000 to Y Ltd., and
- $25,000 to Z Ltd.

However, because Y Ltd.'s year ended November 30, 2001 was its second taxation year in the 2001 calendar year, paragraph 125(5)(*a*) limited Y Ltd.'s business limit for that taxation year to the lesser of the following two amounts:

- $50,000 (subparagraph 125(5)(*a*)(i)); and
- $25,000 (subparagraph 125(5)(*a*)(ii)).

The result, $25,000, was then subject to the rule in paragraph 125(5)(*b*) (see ¶ 27): $25,000 × 61/365 = $4,178.

Therefore, Y Ltd.'s business limit for the year ended November 30, 2001 was $4,178.

Similarly, the business limit for Z Ltd. for the year ended November 30, 2001 was $4,178 (i.e., the lesser of $150,000 and $25,000, multiplied by 61/365).

The $150,000 allocated under subsection 125(3) to X Ltd. as its business limit for the year ended November 30, 2001 did not change, for these reasons:

- Since X Ltd.'s taxation year ended November 30, 2001 was its only taxation year in the 2001 calendar year, paragraph 125(5)(*a*) had no application to it.
- Since X Ltd.'s taxation year ended November 30, 2001 was not a short taxation year, paragraph 125(5)(*b*) had no application to it.

Reduction of the Business Limit for Large Corporations

¶ 29. A CCPC's access to the small business deduction is restricted by subsection 125(5.1) through the reduction of its annual business limit. The amount of the reduction is calculated as follows:

$$\text{the corporation's business limit for the year (before reduction)} \times \frac{\text{its Part I.3 tax liability for the preceding year}}{\$11{,}250}$$

The calculation of the corporation's Part I.3 tax liability referred to above excludes any deduction provided under subsection 181.1(2) or (4) from Part I.3 tax otherwise payable.

Any reduction in the business limit under the rule in subsection 125(5.1) would increase proportionately with any increase in tax payable under Part I.3. For a discussion of Part I.3 tax, see the current version of IT-532, *Part I.3 – Tax on Large Corporations*.

If the corporation is associated with one or more corporations (whether CCPCs or not) in the year, it is required to take into account, in the numerator of the above fraction, its own Part I.3 tax liability and that of each associated corporation (in all cases, calculated without any deduction under subsection 181.1(2) or (4)), for the last taxation year ending in the preceding calendar year.

Example

At all relevant times XYZ Ltd. was a CCPC and was not associated with any other corporation. For the taxation year ended September 30, 2001, XYZ Ltd.'s business limit was $200,000 and its Part I.3 tax liability (before any deduction under subsection 181.1(2) or (4)) was $4,000. XYZ Ltd. changed its fiscal period end to December 31. For the taxation year ended December 31, 2001, XYZ's business limit was calculated as follows:

STEP 1: Since this was a short taxation year, paragraph 125(5)(*b*) reduced the business limit for this year to the following amount:

$$\$200{,}000 \times \frac{92}{365} = \$50{,}411$$

STEP 2: The application of subsection 125(5.1) further reduced the $50,411 business limit by the following amount:

$$\$50{,}411 \times \frac{\$4{,}000}{\$11{,}250} = \$17{,}924$$

XYZ Ltd.'s business limit for the taxation year ended December 31, 2001 was therefore $50,411 – $17,924 = $32,487.

Revised Agreement

¶ 30. After associated CCPCs have filed a valid agreement under subsection 125(3) allocating the $200,000 business limit among themselves for a particular taxation year, there may be a change in the taxable income for the year of one or more of the corporations, which might cause the corporations to want to revise the allocation. The Canada Customs and Revenue Agency (CCRA) will accept a revised allocation agreement as long as it does not change the amount allocated to any corporation for a taxation year that is statute-barred for purposes of an assessment, reassessment or additional assessment.

Example

At all relevant times CCPCs A Ltd., B Ltd., C Ltd., D Ltd. and E Ltd. were associated with each other and no other corporations were associated with any of them.

The five corporations filed a valid agreement under subsection 125(3) allocating the $200,000 business limit for a particular taxation year as follows:

A Ltd. – $ nil

B Ltd. – $50,000

C Ltd. – $50,000

D Ltd. – $50,000

E Ltd. – $50,000

A Ltd. was not assessed any tax for the year, based on its return reporting no taxable income for the year. Each of the other corporations was assessed for the year on the basis that its business limit was the amount allocated to it under the agreement.

Subsequently, A Ltd. filed an amended return reporting an amount of taxable income for the year, and the five corporations filed a revised agreement allocating the $200,000 business limit as follows:

A Ltd. – $40,000

B Ltd. – $40,000

C Ltd. – $40,000

D Ltd. – $40,000

E Ltd. – $40,000

The CCRA indicated, however, that it would not accept the revised agreement so filed because a reassessment for E Ltd. for the year in question was by that time statute-barred (its year-end being different from that of the other corporations).

Instead, the CCRA accepted a revised agreement filed by the five corporations allocating the $200,000 business limit for the year as follows:

A Ltd. – $37,500

B Ltd. – $37,500

C Ltd. – $37,500

D Ltd. – $37,500

E Ltd. – $50,000

The revised agreement on this basis was accepted by the CCRA because there was no change to the amount allocated to E Ltd.

IMPACT OF THE SMALL BUSINESS DEDUCTION ON THE ACCELERATED TAX REDUCTION FOR CCPCs AND ON ANY GENERAL TAX REDUCTION CLAIMED BY A CCPC

¶ 31. Subsection 123.4(3) provides for a reduction (referred to in this bulletin as the "accelerated tax reduction") from a CCPC's tax otherwise payable under Part I of the Act. Generally, a CCPC's accelerated tax reduction is 7% (after 2000) on up to an additional $100,000 of its income—

between $200,000 (the paragraph 125(1)(*c*) "business limit" for the small business deduction) and $300,000—from an active business carried on in Canada. More specifically, the base that is used for a CCPC's accelerated tax reduction is calculated by means of a "least of" formula, taking into account the amounts (subject to certain adjustments) determined under paragraphs 125(1)(*a*), (*b*) and (*c*) with respect to the CCPC's small business deduction. The base for the CCPC's accelerated tax reduction is then reduced by the base used for its subsection 125(1) small business deduction as well as other portions of its taxable income that have benefited from various special effective tax rates provided under the Act, such as, for example, the base for its subsection 125.1(1) manufacturing and processing profits (M&PP) deduction (if any). If two or more CCPCs are associated with one another, they must effectively share the above-mentioned additional $100,000 limit—because the upper limit for each CCPC is actually 3/2 of its paragraph 125(1)(*c*) "business limit", which is subject to the rules for the allocation thereof among associated CCPCs as discussed in ¶s 23 to 30.

Subsection 123.4(2) provides for a general reduction to a corporation's tax otherwise payable under Part I, by a percentage—which increases in stages from 1% in 2001 to 7% after 2003—of the corporation's "full rate taxable income". In general terms, a corporation's "full rate taxable income" is that part of its taxable income that has not benefited from any of various special effective tax rates provided under the Act. Thus, a CCPC's "full rate taxable income" (the calculation of which differs from the "full rate taxable income" of other corporations) does not include, among other things, the base used for its subsection 125(1) small business deduction or the base used for its subsection 123.4(3) accelerated tax reduction.

Example 1

At all relevant times, A Ltd. was a CCPC and was not associated with any other corporation. A Ltd.'s taxable income for the year ended December 31, 2001 was $400,000, all of which was derived from the manufacturing in Canada of goods for sale.

A Ltd.'s subsection 125(1) small business deduction for the year was 16% of $200,000 (its paragraph 125(1)(*c*) business limit for the year) = $32,000.

A Ltd.'s subsection 125.1(1) M&PP deduction for the year was 7% of the difference between $400,000 (its manufacturing and processing profits) and $200,000 (the base for its small business deduction) = 7% of $200,000 = $14,000.

A Ltd. had no subsection 123.4(3) accelerated tax reduction or subsection 123.4(2) general tax reduction for the year, because the full amount of its $400,000 taxable income had already received the benefit of tax reductions, the first $200,000 having been used in the base for the small business deduction and the next $200,000 having been used in the base for the M&PP deduction.

Example 2

At all relevant times, B Ltd. was a CCPC and was not associated with any other corporation. B Ltd.'s taxable income for the year ended December 31, 2001 was $400,000, all of which was derived from carrying on a business as a wholesaler of goods in Canada.

B Ltd.'s subsection 125(1) small business deduction for the year was 16% of $200,000 (its paragraph 125(1)(*c*) business limit for the year) = $32,000.

B Ltd.'s subsection 123.4(3) accelerated tax reduction for the year was 7% of the difference between $300,000 (i.e., 3/2 of its paragraph 125(1)(*c*) "business limit") and $200,000 (i.e., the base used for its subsection 125(1) small business deduction) = 7% of $100,000 = $7,000.

B Ltd.'s subsection 123.4(2) general tax reduction for the year was 1% of the difference between $400,000 (its taxable income) and $300,000 (i.e., the $200,000 base used for the small business deduction and the $100,000 base used for the accelerated tax reduction) = 1% of $100,000 = $1,000.

Explanation of Changes

Introduction

The purpose of the *Explanation of Changes* is to give the reasons for the revisions to an interpretation bulletin. It outlines revisions that we have made as a result of changes to the law, as well as changes reflecting new or revised interpretations of the CCRA.

Reasons for the Revision

We have revised the bulletin primarily to reflect the impact of the *Lerric Investment Corp.* case and to expand the scope of the bulletin to cover the subject of a revised agreement to allocate the business limit among associated CCPCs.

Legislative and Other Changes

¶ 1 was revised to delete the comments on the meaning of "Canadian-controlled private corporation" and instead refer to the current version of IT-458, *Canadian-Controlled Private Corporation*, which covers this topic.

In ¶ 2, clarifying changes were made in (a) and more general wording was used in (b) because the details of the rules described therein are covered in ¶ 22.

In ¶ 4 and ¶ 6, historical rules were removed and clarifying changes were made.

¶ 11 was revised to reflect the fact that the proposed amendments previously referred to in a note at the end of that paragraph were enacted as law. Also, clarifying changes were made in ¶ 11.

The comments in ¶ 17 (formerly ¶ 16) on the "more than five full-time employees" rule in a situation involving a joint venture or co-ownership of a business were revised because of the Federal Court of Appeal's decision in the *Lerric Investments Corp.* case. The discussion of the "more than five full-time employees" rule with respect to a business carried on by a corporation as a member of a partnership has been moved from former ¶ 16 (now ¶ 17) to the end of ¶ 20.

In ¶ 18, a minor wording change was made in (c) for purposes of clarification.

¶s 20 and 21 were considerably revised for purposes of clarification and to remove historical coming-into-force rules. Also, the discussion of the "more than five full-time employees" rule with respect to a business carried on by a corporation as a member of a partnership has been moved from former ¶ 16 (now ¶ 17) to the end of ¶ 20.

In ¶ 22, historical rules were removed, changes were made to reflect amendments consequential on the addition to the Act of section 123.4, and other minor rewording changes were made for purposes of clarification.

¶s 23, 25 and 26 were revised to refer to the correct form that associated CCPCs should currently be using for purposes of allocating the business limit. Minor wording changes were also made in ¶s 23 and 26, for purposes of clarification.

In ¶ 28, clarifying changes were made in the text and the example. The example was also revised to reflect current dates.

¶ 29 was revised to delete historical coming-into-force rules, and to delete the explanation of Part I.3 tax and instead refer to the current version of IT-532, *Part I.3 – Tax on Large Corporations*, which covers this topic. Also in ¶ 29, clarification changes were made and the example was revised to reflect more realistic facts and current dates.

¶ 30 was added to cover the subject of a revised agreement to allocate the business limit among associated CCPCs.

¶ 31 was added to cover the impact of the small business deduction on the accelerated tax reduction for CCPCs and any general tax reduction claimed by a CCPC.