TAXATION OF CORPORATE BUSINESS INCOME

The general rules in respect of the computation of taxable income and tax payable apply to all taxpayers including individuals, corporations, and trusts. A corporation is a separate legal entity that is distinct from its shareholders. Therefore, its property, assets, and liabilities belong to the corporation and not to the shareholders.

However, the rate structure and taxation are not the same for an individual as for a corporation. For an individual, all income from various sources is calculated first, and then a tax rate is applied based on the applicable tax bracket for the total income earned. For a corporation, the tax rate applied depends upon the type of corporation, the source of income and the location (province) where the corporation earns its income.

Types of Corporations

The status of a corporation as a Canadian corporation[1], taxable Canadian corporation[2], public corporation[3], private corporation[4] or Canadian-controlled private corporation (CCPC)[5] determines its treatment, and the treatment of its shareholders, for tax purposes.

In particular, a private corporation is a corporation that is resident in Canada, and a CCPC is a private "Canadian corporation" that is not controlled by non-residents, by a public corporation, or by any combination of non-residents and public corporations. The definition of CCPC does not require control by Canadian residents. Rather, it requires lack of control by non-residents. For example, if a private corporation is owned 50% by non-residents and 50% by residents, it will still qualify as a CCPC.

A CCPC may be eligible for the small business deduction (SBD), which allows it to benefit from a lower effective tax rate on its first $500,000 of active business income. Furthermore, individuals who are shareholders of a CCPC may qualify for the lifetime capital gains exemption (LCGE). Upon the sale of qualified assets (e.g., shares of a corporation), it allows them to avoid paying taxes on capital gains up to a certain limit.

[1] S. 89(1) "Canadian corporation"
[2] S. 89(1) "taxable Canadian corporation"
[3] S. 89(1) "public corporation"
[4] S. 89(1) "private corporation"
[5] S. 125(7) "Canadian-controlled private corporation"

Active Business Income

An active business[6] includes any business other than a specified investment business[7] or a personal services business[8]. Thus, when income is generated from a business source[9], it is considered as active business income (ABI). It includes any incidental income that pertains to the business, which is earned through regular business activities[10]. However, ABI typically does not include income from property and investment income since investment income is generally considered passive income.

General Corporation Tax Rates on Active Business Income

Federal Part I rates	Active Business Income
General rate	38.0%[11]
Less: federal tax abatement	10.0%[12]
Net federal tax	28.0%
General reduction	13.0%[13]
Net federal Part I rate	15.0%
Add: provincial rates	8% to 16%
Total general corporate tax rate (combined)	23% to 31%[14]

The basic federal corporate rate of tax on active business income is 38% which is reduced by 10% for federal tax abatement. Therefore, all corporations are nominally taxed at a federal rate of 28%. The 10% abatement does not apply to income that is not earned in Canada.

There is also a general rate reduction of 13% on corporate income (other than a personal services business), which brings the federal rate down to 15%. Adding the provincial rates which vary between 8% to 16%, the general combined corporate tax rate on active business income varies between 23% to 31%, depending on the province.

[6] S. 248(1) "active business"

[7] S. 125(7) "specified investment business" which includes income primarily earned from property, is not considered active business income unless the business employs more than five full-time employees throughout the year.

[8] S. 125(7) "personal services business" which includes income where a shareholder acts as an incorporated employee is not considered active business income and is subject to limited deductions and tax benefits unless the corporation employs more than five full-time employees.

[9] S. 125(7) "active business carried on by a corporation" includes an adventure or concern in the nature of trade (e.g. profession, calling, trade, manufacture or undertaking of any kind).

[10] 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 (S. 129(6)) can qualify as active business income.

[11] S. 123(1) "Rate for corporations"

[12] S. 124(1) "Deduction from corporation tax"

[13] S. 123.4 "general rate reduction percentage"

[14] Combined 2025 Federal and Provincial/Territorial tax rates

Small Business Deduction and Business Limit

There are, however, special rates that apply to small businesses. The combined federal/provincial tax rate on ABI of "small businesses" that qualify as a CCPC is as follows:

Net federal tax	28.0%
Less: small business deduction (SBD)	19.0%[15]
Net federal small business rate	9.0%
Add: provincial small business rates	2.0% to 3.2%
Total small business tax rate (combined)	11.0% to 12.2%[16]

A CCPC can claim an annual tax credit of 19%. The credit reduces the federal corporate tax payable by a CCPC on its first $500,000 of ABI from 28% to 9%. The provinces then apply their own tax credit to the basic federal rate, which brings the combined federal-provincial rate to 11% to 12.2%[17].

The phrase "small business" refers to a CCPC with active business income of up to $500,000[18]. This small business limit must be shared with associated[19] CCPCs.

In general terms, a CCPC may claim the SBD if it is carrying on a business in Canada throughout the year, and satisfies at least one of the following:

- The business earns ABI rather than income from a specified investment business or a personal services business;
- The business earns income from a specified investment business, or a personal services business, that employs more than five full-time employees throughout the year; or
- The business is a specified investment business and has an associated corporation that provides managerial, financial, administrative, maintenance, or other similar services to the CCPC which is carrying on an active business, and it would hire more than five full-time employees to do the work if the associated corporation did not do it.

The small business limit is reduced[20] for larger CCPCs whose taxable capital employed in Canada exceeds $10 million for the preceding year. If the corporation's taxable capital is between $10 and $50 million, the taxable income eligible for the SBD rate is proportionately reduced. Consequently, it is completely phased out when the CCPCs taxable capital employed exceeds $50 million.

The small business limit also starts to gradually reduce when the adjusted aggregate investment income[21] i.e., passive investment income) of the CCPC exceeds $50,000. Therefore, each dollar above this threshold reduces the business limit by $5. Then, the SBD is completely phased out when the CCPC earns more than $150,000 of passive investment income.

Business Income versus Investment Income

The distinction between business and investment income depends upon several factors including, activity associated with the generation of the income, number and value of transactions, relationship between the income and total income, and relationship between the value of the assets producing the income and total assets.

The general rule of thumb is the greater the volume of activity and the value of transactions, and the closer the relationship between the income earned and the total income, the greater the likelihood that the income is "business income". Otherwise, it is likely considered o be "investment income".

15 S. 125(1.1) "Small business deduction rate"

16 S. 123.4 "general rate reduction percentage"

17 In Quebec, a CCPC is not eligible for the SBD if it does not employ more than three full-time employees throughout the year (equivalent of 5,500 paid hours), which means the combined rate can reach up to 20.5%

18 S. 125(2) "Business limit"

19 S. 125(3) "Associated corporations"

20 S. 125(5.1) "Business limit reduction"

21 S. 125(7) "adjusted aggregate investment income" (i.e. passive income) $5 reduction in small business limit for every $1 of aggregate investment income.

Investment Income

Generally, investment income earned in a corporation is taxed as "passive income". It includes dividend income, interest income, foreign investment income, rental income, royalty income and taxable capital gains. The combined federal/provincial tax rate on investment income is as follows:

Net federal tax	28.0%
Additional refundable tax on investment income	10.67%[22]
Total federal tax	38.67%
Add: provincial rates	8% to 16%
Total investment income tax rate (combined)	46.67% to 54.67%[23]

The amount to be added to a CCPC's Part I tax otherwise payable for a taxation year related to the refundable tax on investment income is 10.67%, which brings the federal rate to 38.67%. Adding the provincial rates which vary between 8% to 16%, the combined investment income tax rate varies between 46.67% to 54.67%, depending on the province.

For an explanation of how passive income is taxed inside a corporation, please refer to the article on "Passive Income".

Tax Deferral

The ability to defer taxes is a significant advantage of operating a business within a corporation as it allows the business to manage its tax liability. Business income earned within a corporation is taxed at two levels: at the corporate level and at the personal level when the income is distributed. As corporate income tax rates are generally lower than personal income tax rates, by keeping the income in the corporation, taxes on those funds are essentially deferred until the earnings are eventually distributed to shareholders at which point personal income taxes apply. Distribution is possible through the payment of a dividend or salary.

As more funds accumulate within the corporation, those funds can be used to invest and earn additional income. The tax deferral advantage is generally higher the longer the funds are left in the corporation. Moreover, the ability to claim the SBD further increases the tax deferral advantage as the corporation is paying less tax on ABI that is less than the small business limit (i.e. < $500,000). In comparison, if the business was operated personally, all of the business income would likely be taxed at higher personal marginal tax rates rather than the lower SBD or general corporate tax rate.

Tax Integration

Tax integration is a principle used in the tax system designed to ensure that an individual should pay the same amount of tax on income, regardless of whether the individual earns the income personally, or indirectly through a corporation. Based on current tax rates and depending on whether the business income was taxed at the small business rate or at the general rate (as well as the province of residence), there may be an advantage or disadvantage to earning business income in a corporation and then distribute it to the individual (i.e., shareholder) versus earning the business income personally.

The tax rate advantage or disadvantage will also vary significantly based on whether the corporation pays out salary or dividends to its shareholders. When a corporation pays a salary or bonus, it is generally[24] eligible for a tax deduction at the corporate level, thereby reducing its taxable income. However, the recipient of the salary/bonus must pay personal income tax on that amount, which may be at a higher rate depending on the individual's total income for the year.

Integration is accomplished through mechanisms such as the "Dividend Gross-Up" and "Dividend Tax Credit" system for dividends paid by corporations to individuals, as well as the "Refundable Dividend Tax on Hand" (RDTOH) and "Capital Dividend Account" (CDA) system for corporations. As corporations may not deduct dividends when calculating its taxable income, shareholders benefit from preferential tax rates on dividends due to the dividend tax credit. As a result, it effectively reduces their overall tax burden compared to salary. While the system attempts to balance the overall tax burden, there are still some disparities due to varying provincial tax rates and other factors (e.g. cash flow needs). Therefore, "perfect" integration is difficult to achieve.

[22] S. 123.3 "Refundable tax- CCPC"

[23] Combined 2025 Federal and Provincial/Territorial tax rates

[24] S. 67 "General limitation re expenses (must be reasonable)"

General Rate Income Pool

The general rate income pool[25] (GRIP) generally applies to a taxable Canadian corporation that is a CCPC in a particular taxation year. The GRIP balance tracks the corporation's ABI that has been subject to the general corporate tax rate (rather than the lower small-business rate). The balance in the GRIP pool can be distributed as eligible dividends, which allow shareholders to benefit from the enhanced dividend tax credit, reducing the shareholder's overall tax. Whereas non-eligible dividends are paid out of income taxed at the small-business rate which carries a lower dividend tax credit. Therefore, the shareholder will have to pay more tax on the dividend. Depending on the province, the top marginal tax rate on non-eligible dividends for the shareholder ranges from 36.82% to 48.96%, compared to the top marginal tax rate on eligible dividends which ranges from 28.33% to 46.20%[26].

Refundable Dividend Tax on Hand

The RDTOH system is designed to prevent tax deferral advantages on investment income earned within a private corporation. RDTOH represents a notional account that tracks the refundable portion of tax paid by a corporation on investment income. When a corporation earns investment income, a portion of taxes that a corporation paid is refundable when the corporation distributes dividends to its shareholders, thus preventing double taxation of investment income that flows out to shareholders as dividends. This refundable tax is tracked in two separate accounts: non-eligible refundable dividend tax on hand[27] (NERDTOH) and eligible refundable dividend tax on hand[28] (ERDTOH).

The NERDTOH account tracks refundable taxes paid on investment income that generates non-eligible dividends. NERDTOH accumulates 30.67% of the corporation's investment income and Part IV tax on certain non-eligible dividends received from non-connected Canadian corporations (e.g., portfolio dividends). NERDTOH can only be recovered by paying non-eligible dividends at a rate of 38.33% of dividends paid.

The ERDTOH account tracks refundable taxes paid on eligible Canadian portfolio dividends and certain connected[29] corporation dividends. ERDTOH accumulates Part IV tax (38.33%) on eligible dividends received from non-connected corporations and Part IV tax on eligible dividends received from connected corporations. ERDTOH can be recovered by paying either eligible or non-eligible dividends.

However, there are specific ordering rules which require that a corporation paying a non-eligible dividend must exhaust its NERDTOH account before claiming a refund from its ERDTOH account through non-eligible dividend payments. If the non-eligible dividends paid exceed the available NERDTOH balance (i.e., the 38.33% of non-eligible dividends paid is greater than the NERDTOH balance), and there is a positive ERDTOH balance, the excess portion of the dividend can then generate a refund from the ERDTOH account. When a corporation pays an eligible dividend (assuming there is sufficient GRIP), it will generate a refund only from its ERDTOH account, up to the balance available in that account. However, there is a key limitation that eligible dividends paid when the corporation only has a NERDTOH balance will not result in a dividend refund. To maximize tax efficiency (due to the lower personal tax rate on eligible dividends), eligible dividends could be prioritized and paid first to utilize the ERDTOH account fully before drawing from the NERDTOH account, and non-eligible dividends could be paid next to use the NERDTOH account.

Part IV tax

The ITA provides for a special tax under Part IV on the dividend income of private corporations, which prevents tax deferral by high-income individuals. The Part IV tax on dividend income is fully refundable to the corporation when it pays taxable dividends to shareholders, so that there is no double taxation[30].

When a private corporation receives eligible dividends, it pays Part IV tax at 38.33% of the dividend amount, which creates an ERDTOH balance. When it receives non-eligible dividends, the Part IV tax creates a NERDTOH balance. This mechanism ensures that the refundable tax system tracks through multiple corporation tiers-- the tax paid becomes fully refundable when the receiving corporation eventually pays dividends to its shareholders.

[25] S. 89(1) defines "general rate income pool"

[26] Combined 2025 Federal and Provincial/Territorial tax rates

[27] S. 129(4) defines "non-eligible refundable dividend tax on hand"

[28] S. 129(4) defines "eligible refundable dividend tax on hand"

[29] A "connected" corporation is a corporation that is "controlled" by the other corporation (i.e. if the dividend-paying corporation controls the recipient corporation according to subsection 186(2) definition of "control"); or has more than 10% intercorporate cross-ownership (i.e. if the dividend-receiving corporation owns more than" (i) 10% of the payer corporation's voting shares; and (ii) 10% of the fair market value of the payer corporation's issued shares)

[30] S. 129(1) "Dividend refund to private corporation"

Capital Dividend Account

A capital dividend is a tax-free dividend. As with all dividends, there is no deduction for the corporation paying the dividend; however, this type of dividend is not taxed in the hands of the recipient shareholder if he/she is a tax resident of Canada.

A corporation can pay a capital dividend to its shareholders if there is a positive balance in its capital dividend account[31] (CDA), which is a notional account. At any given time, the CDA balance of a private corporation is equal to the total of the non-taxable portion of capital gains that exceed the non-deductible portion of capital losses, as well as other amounts such as capital dividends received or paid by the corporation and certain life insurance proceeds received in excess of the policy's adjusted cost base. As such, a tax-free capital dividend can be paid out to the corporation's shareholders when there's a positive balance in the CDA.

The CDA does not appear on the corporation's financial statements, but its balance needs to be calculated and tracked in order to pay out this type of dividend. For an explanation of how to calculate the CDA and payment of a capital dividend by a corporation, please refer to the article on "Capital Dividend Account".

Intercorporate Dividends

A corporation generally includes in its income all taxable dividends that it receives from other corporations[32]. However, dividends received by a corporation from a "taxable Canadian corporation or a resident corporation that it controls"[33], are deductible in computing its taxable income.

The intercorporate dividend deduction is intended to permit income earned by a corporation subject to Canadian tax to flow between corporations tax-free. Therefore, the income will be taxed in Canada at two levels only: at the corporate level as earned, and at the individual and non-resident shareholder level as received or credited.

The effect is that dividends between Canadian corporations flow through Part I tax-free and are not subject to double taxation. The tax-free flow through applies to an entire chain of intercorporate holdings. Hence, there is no additional Part I tax until the corporate earnings are paid out to individual shareholders.

Life Insurance Held by a Private Corporation

Holding a life insurance policy within a private corporation offers the following tax advantages:

Life insurance premiums

Life insurance premiums are generally non-deductible[34] for corporate tax purposes, but if a private corporation owns the policy and pays premiums, it's done with corporate after-tax dollars, which are taxed at a lower rate than personal income which results in significant savings over time compared to personally paying premiums.

Tax-free death benefit and CDA

When a private corporation is named as a beneficiary of a life insurance policy, the death benefit received by the corporation is not taxable to the corporation. Upon death, the death benefit is credited to the CDA by an amount equal to the excess of the proceeds of a life insurance policy[35] over the ACB of the policy immediately before death of the life insured.

As the ACB is generally negligible or nil at the time of death, the full amount of the death benefit may be distributed to the shareholders or the deceased's estate as tax-free capital dividends. Hence, life insurance is an effective option that allows for a tax-free distribution of corporate funds to beneficiaries or surviving shareholders.

The calculation of the ACB of a life insurance policy[36] includes things such as premiums or deposits made into the policy which increase the ACB of the policy. The ACB is also increased by repaying policy loans, purchasing paid-up insurance, purchasing term enhancements and policy gains. It can also be reduced by factors such as the net cost of pure insurance[37] (NCPI) at the end of the calendar year, by taking policy loans, paying dividends under a participating policy and partial dispositions.

[31] S. 89(1) defines "capital dividend account" and S. 83(2) defines "capital dividend"

[32] Paragraphs 12(1)(j) "dividends from resident corporations"; 12(1)(k) "foreign corporations, trusts and investment entities"

[33] S. 112(1) "Deduction of taxable dividends received by corporation resident in Canada"

[34] S. 18(1)(a) "general limitation"

[35] S. 148(9) "proceeds of the disposition"

[36] S. 148(9) "adjusted cost basis"

[37] Reg 308(1) "net cost of pure insurance"

Tax-deferred growth

The policy's cash value accumulates on a tax-sheltered basis inside the policy, which can serve as a corporate investment alternative with tax-deferred accumulation, especially for surplus corporate funds that would otherwise be taxed on investment income.

Furthermore, corporate-owned life insurance policies are not subject to the passive income rules in terms of SBD eligibility.

Takeaways

In a corporation, the tax rate depends on the type of income generated. Across Canadian provinces, active business income (ABI) is generally taxed between 23% and 31%. If the corporation qualifies for the small business deduction (SBD), the tax rate on ABI drops to between 9% and 12.20%. Passive income, such as investment income, is taxed at significantly higher rates, ranging from 46.67% to 54.67%[38].

Many components and strategies can be analyzed to enhance a corporation's financial and tax effectiveness, including the use of tax accounts and corporate-owned life insurance.

This overview is for general informational purposes and does not constitute tax, legal, or financial advice. Please be advised that clients should consult an independent and qualified professionals to tailor appropriate financial and tax planning strategies based on their specific circumstances.

[38]Combined 2025 Federal and Provincial/Territorial tax rates