Intermediate Canadian Tax

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SURREY, BC

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Introduction

Welcome to our Intermediate Canadian Tax textbook!

In the Spring of 2019 we started a project to create a free tax textbook (for my introductory tax class) harnessing the brainpower of undergraduate tax students at Kwantlen Polytechnic University ("KPU") in British Columbia. We decided to do this for the following reasons:

1. Textbooks are expensive. This one is free!
2. Most information on Canadian tax issues is readily available online and we felt students could access, summarize and synthesize that information
3. We wanted to have our students create something of 'value' rather than a 'disposable' assignment that would be discarded after it was assessed.

We were happy with the introductory tax textbook results and decided to expand to the intermediate tax textbook starting in the Spring of 2020. This is an ongoing experiment and we will continue working on, adding to and editing these books each semester. We want these books to be amazing and, to that end, we need your help. Please use the comments section at the end of each page to identify any concerns you have with the information, any flawed weblinks or citations, better sources you think we should use or other ways you think the information could be presented.

In addition to all the great KPU student tax authors I'd like to briefly recognize a few individuals for their significant contributions to this text:

Rajiv Jhangiani – A tireless advocate for Open Education at KPU. He was the spark that ignited this project.

Your name here – I'd like to thank you as well…because you are going to be creating the textbook this semester.

Thanks in advance for your help with our project and we hope you enjoy the book!

Sam Newton – Instructor, KPU

PART I

ITA RESEARCH AND TAX PAYABLE

1. How and why does tax legislation exist?

SAM NEWTON

Income tax was introduced in Canada in 1917 as a temporary measure to fund the 1st World War. This temporary measure has proven to be remarkably resilient and has stuck around for more than a century. During this time tax rules have grown from 11 pages in 1917 to thousands of pages today.

In the 2016-2017 fiscal year, the Canadian government raised $293 billion dollars in revenue. Of this amount approximately 50% came from individual income tax, 15% from corporate taxation, 12% from GST/HST and 7% from the employment insurance premiums. Personal and corporate taxation play a huge role in funding schools, the Canadian military our national healthcare systems etc.

It is important to understand that there is nothing immutable about taxation and that it is often driven by the political will of the day. For example, left-leaning governments may implement wealth taxes on high net worth individuals or increase taxes paid by higher income earners arguing that this is a way to address wealth imbalance and create a more egalitarian and fairer society. Right-leaning governments, on the other hand, tend to reduce taxes for high income earners and corporations believing that this will increase job creation and help the overall economy.

Again, there is nothing set in stone for taxation. You should consider taxation policies of the various parties whenever you vote. You can make a difference.

2. Who is liable to pay tax in Canada and on what sources of income?

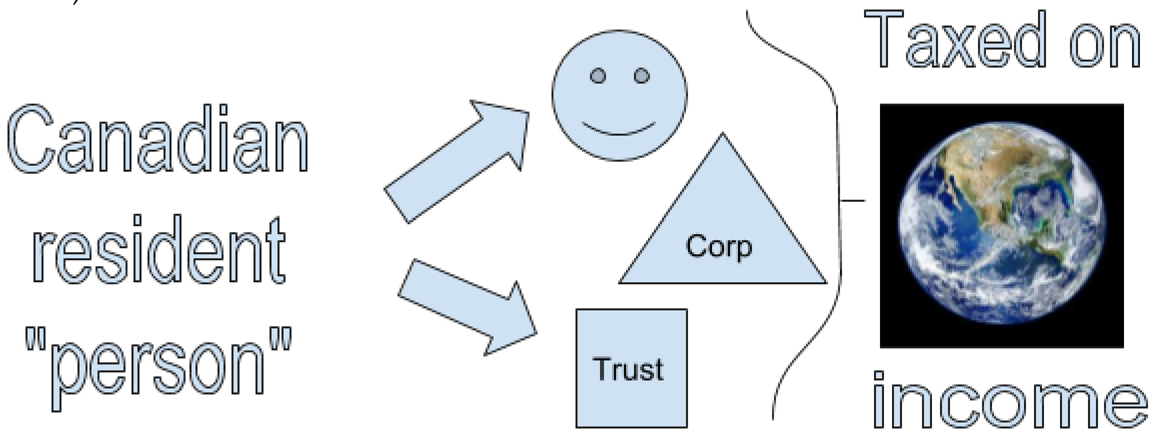
SAM NEWTON

Basically, every person resident in Canada is required to pay income tax on their worldwide taxable income. A "Person" is defined in the Income Tax Act ("ITA") as a corporation, individual or a trust. Here are some relevant sections from the ITA.

ITA 2(1) states that "*An income tax shall be paid, as required by this Act, on the taxable income for each taxation year of every person resident in Canada at any time in the year.*"

ITA 248(1) defines a "*Person*" as a corporation, individual or trust and ITA 3(a) states that a taxpayer's income includes sources "inside or outside Canada". Therefore, Canadian resident corporations, individuals and trusts are taxed on their worldwide income

"Persons" non-resident in Canada are required to pay tax on their Canadian source income, which is basically income earned/generated in Canada (See ITA 2(3) for further details).



Why are residents taxed on worldwide income and non-residents taxed only on Canadian sourced income?

Residents are taxed on worldwide income to discourage individuals and corporations from storing their assets and sourcing revenue in tax havens with low tax rates (like Switzerland or the Cayman Islands) to avoid tax. Since Canadian residents are taxed on worldwide income there may be no point in sourcing your income in a low tax country if you – as a resident of Canada – are still required to pay tax on the amount in Canada.

Non-residents are only taxed on their Canadian source income as it wouldn't seem fair to tax someone on their worldwide income if they aren't resident in Canada.

For example, let's say a software developer resident in Mexico temporarily moves to Canada for 2 months and takes a contract with Hootsuite. Although she would be taxed in Canada on her income earned in Canada for the 2 months, it wouldn't make sense (or be fair) to tax her in Canada on her income earned in Mexico during the rest of the year.

Interactive content (Author: Kokila Sharma, June 2019)

An interactive H5P element has been excluded from this version of the text. You can view it online here: https://kpu.pressbooks.pub/intercdntax/?p=23#h5p-1

References and Resources:

- ITA – 2(1), 2(3), 3(a), 248(1) "Persons"
- Competency map: 6.1.1

January 2019

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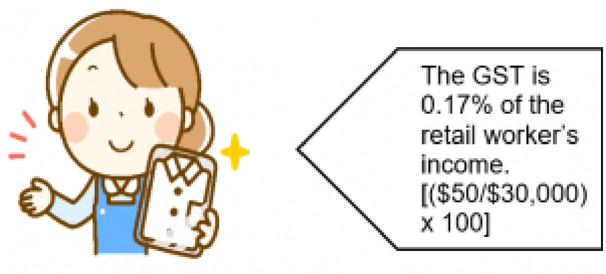
3. Describe the differences between a regressive, progressive and flat tax. Provide some examples of each in Canada.

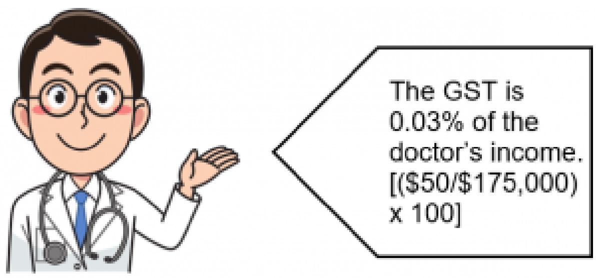
CYNARA ALMENDAREZ AND SUKHMAN BHATHAL

Regressive taxes are applied uniformly, and they do not change based on an individual's level of income. A regressive tax system affects low-income taxpayers more than high-income taxpayers because it takes a higher percentage of their earnings.

A great example of a regressive tax is the 5% Goods and Services Tax (GST). For example, say a doctor earns $175,000 annually and a retail worker earns $30,000 annually. They both purchase a laptop for $1,000, and are charged $50 GST ($1,000 X 5%). Although the $50 GST amount is the same for both the doctor and the retail worker it is a higher percentage of the retail workers overall income. This is known as a regressive tax because it has a larger percentage impact on lower income individuals.



The GST is 0.17% of the retail worker's income



The GST is 0.03% of the doctor's income

Progressive taxes are the opposite of regressive taxes. Progressive taxes increase based on your taxable income. Canada has a progressive income tax system; therefore, high-income taxpayers pay a progressively higher percentage of tax than low-income taxpayers. Using our previous example, because of the doctor's higher annual income, the doctor will have to pay more taxes than the retail worker based on Canada's federal tax rates of 2023.

Tax Rate	Tax Brackets		
15%		up to	$53,359
20.50%	$53,360	to	$106,717
26%	$106,718	to	$165,430
29%	$165,431	to	$235,675
33%	$235,676	and over	

The doctor will have to pay $37,799 in taxes (an average tax rate of 21.6%) while the retail worker will only have to pay $4,500 of taxes (an average tax rate of 15%). Progressive taxes get progressively higher as your taxable income increases.

Doctor

Tax Rate	x	Taxable income in tax bracket	=	Taxes Payable
15%	x	$53,359	=	$8,004
20.50%	x	$53,358	=	$10,938
26%	x	$58,713	=	$15,265
29%	x	$9,570	=	$2,775
		$175,000		$36,983

Teacher

Tax Rate	x	Taxable income in tax bracket	=	Taxes Payable
15%	x	$30,000	=	$4,500
		$30,000		$4,500

A flat tax system applies the same tax rate regardless of an individual's income. For example, if the tax rate is set at 15%, a taxpayer earning $20,000 pays $3,000 (15%) and someone making $300,000 pays $45,000 (15%) worth of taxes. Canada does not have a flat tax system, but at one point, the province of Alberta had a flat provincial tax system from 2001 to 2015. Flat taxes are sometimes referred to as proportional taxes.

Interactive Content (Author: Cynara Almendarez, January 2019).

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https://kpu.pressbooks.pub/intercdntax/?p=30#h5p-2

Interactive Content (Author: Joyce Hards, April 2019)

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https://kpu.pressbooks.pub/intercdntax/?p=30#h5p-3

Interactive content (Author: Matthew Amisano, January 2020)

An interactive H5P element has been excluded from this version of the text. You can view it online here:
https://kpu.pressbooks.pub/intercdntax/?p=30#h5p-206

References and Resources:

- Article – "Canadian Income Tax Rates for Individuals – Current and Previous Years" (Author: Government of Canada)
- Article – "Alberta government may consider bringing back flat tax system, Kenney says"(Author: Tyler Dawson)
- Competency map: 6.1.1

January 2019

4. What are the differences and similarities between a sole-proprietorship, partnership, corporation, and trust?

WAHAJ AWAN

A **sole-proprietorship** has one owner who has unlimited liability for the business.

A **partnership** involves two or more people who combine resources for the business and share profits and losses.

A **corporation** is considered to be a separate legal entity from its shareholders. For tax purposes a corporation is a "Person".

A **trust** or estate usually has beneficiaries that benefit from it. A trust can include an *inter vivos* trust (gifted during one's lifetime) and a *testamentary* trust (given because of someone's death) as explained in ITA 108(1).

The following table outlines some of the similarities and differences of the different tax entities:

	Sole proprietorship	Partnership	Corporation	Trust
Ownership	A single owner	Two or more owners	Usually owned by many shareholders	Owner passes the ownership to a trustee
Profit or losses	All profits go to the sole owner	Profits split equally, or by pre-determined terms amongst the owners	Dividends declared and given to shareholders	Beneficiaries of the trust benefit from the profit
Liability	The owner has unlimited liability	Usually split amongst the owners based on the terms	Limited liability – individuals are not usually directly liable for activities within the corporation	The trustee responsible for operating the trust
Decision-making	All decisions for the firm are made by one owner	Owners in the partnership are responsible for the decisions	Board of director and shareholders	The trustee
Tax	Owner is taxed on his personal income/profit from the company	Owners are taxed on their respective incomes	A corporation is taxed as a "person"	A trust is taxed as a "person"

See ITA – 82(1), 96(1), 104 for an in-depth explanation of how types of entities are taxed.

Interactive content (Author: Wahaj Awan, March 2019)

An interactive H5P element has been excluded from this version of the text. You can view it online here:
https://kpu.pressbooks.pub/intercdntax/?p=32#h5p-4

Interactive content (Author: Simran Sandhu, June 2019)

An interactive H5P element has been excluded from this version of the text. You can view it online here:
https://kpu.pressbooks.pub/intercdntax/?p=32#h5p-5

References and Resources :

- ITA – 98(5), 248(1), 108(1)
- Article – "Sole proprietorship, partnership, corporation…?" (Author: Government of Canada)
- Article – "T3 Trust Guide – 2019" (Author: Government of Canada)
- Competency map: 6.1.1

January 2019

5. Explain the tax concept of "integration"

EVA VIERNES

The concept of integration is intended to eliminate any advantages and disadvantages in the application of tax between individuals, corporations and trusts. Thus, the after-tax cash received by an individual should be the same regardless if it was generated directly (as salary) or paid out as dividends from a corporation.

To achieve integration and to avoid double taxation on dividends received from a corporation, an individual must:

- gross-up dividends received to reflect the corporate pre-tax income
- receive a dividend tax credit (DTC) for the tax deducted at the corporate level

The DTC is the sum of federal and provincial dividend tax credits, and the calculation varies depending on whether the corporation is issuing eligible or non-eligible dividends. Typically, public corporations issue eligible dividends while Canadian-Controlled Private Corporations (CCPCs) issue non-eligible dividends.

Eligible dividends are paid from income that is taxed at a higher corporate rate, while non-eligible dividends are paid from income that is taxed at a lower corporate rate. To offset this inequity (and to create integration) eligible dividends receive more favourable tax treatment than non-eligible dividends.

Here is an illustration showing how integration works for both types of dividends. Notice that the tax paid by the corporation is equal to the DTC that can be claimed by the individual shareholder. The computed tax payable amount and the total after tax cash is the same irrespective of whether it is paid through eligible dividends, non-eligible dividends or received directly as salary.

Non-eligible dividends			**Eligible Dividends**		
Corporate Pre-Tax Income	1,000		*Corporate Pre-Tax Income*	1,000	
Tax @ 13% (assumed)	(130)		Tax @ 27.5% (assumed)	(275)	
Net earnings	870		Net earnings	725	
Individual Shareholder	*Cash*	*Taxable*	*Individual Shareholder*	*Cash*	*Taxable*
Cash dividend received	870		Cash dividend received	725	
Taxable dividend ($870 X 1.15)		1,000	Taxable dividend ($725 X 1.38)		1,000
Individual tax @40% (assumed)	(400)		Individual tax @40% (assumed)	(400)	
Plus DTC $130 (9/13 fed & 4/13 prov)	130		Plus DTC $275 (6/11 fed & 5/11 prov)	275	
Total After Tax Cash	**600**		**Total After Tax Cash**	**600**	
If Income is earned by Individual			*If Income is earned by Individual*		
Business Income Earned	1,000		Business Income Earned	1,000	
Tax payable ($1,000 X 40%)	(400)		Tax payable ($1,000 X 40%)	(400)	
Total After Tax Cash	**600**		**Total After Tax Cash**	**600**	

"DTC" is a Dividend Tax Credit. There is a federal and provincial portion of the credit.
Integration works better as an academic concept as, in real life, provincial tax rates and credits will impact the actual result.

Example of treatment of Non-eligible dividends and eligible dividends

Interactive content (Author, Eva Viernes, March 2019)

An interactive H5P element has been excluded from this version of the text. You can view it online here:
https://kpu.pressbooks.pub/intercdntax/?p=35#h5p-6

Interactive content (Author: Pooja Devi, June 2019)

An interactive H5P element has been excluded from this version of the text. You can view it online here:
https://kpu.pressbooks.pub/intercdntax/?p=35#h5p-7

References and Resources:

- Video – "Integration" (authors: Abjeet Khatra and Gursimran Kohli) – uses 2017 rates
- Competency map: 6.1.1

March 2019

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6. Describe the ITA Section 3 ordering rules formula. How does this tie into Net Income for Tax Purposes (also known as 'Division B' income)?

AMRA BAYASGALAN

Division B income (Net Income for Tax Purposes) is determined by using the ordering rules found in Section 3 of ITA. Under the ordering rules formula, a person's net income for tax purposes would be calculated as follows:

Step 1, ITA 3(a) – Determining income (revenues net of expenses) from employment, business, property and other sources for the year.

Example:	Net employment income	$40,000	
	Net property income	$5,000	$45,000
			$45,000

Step 2, ITA 3(b) – Net taxable capital gains arise when taxable capital gains for the year exceed allowable capital losses for the same year. If allowable capital losses are greater than the current year's taxable capital gains, the net taxable capital gains for the year will be $0, and the difference will become a Net Capital Loss that can be applied against net taxable capital gains in other taxation years.

Example:	Taxable capital gains	$15,000	
	Allowable capital losses	($20,000)	Nil
			$45,000

Note: Taxable Capital Gains = 50% of a Capital Gain. Allowable Capital Losses = 50% of a Capital Loss.

Step 3, ITA 3(c) – At this point, other deductions found in ITA Subdivision e (such as spousal support payments made or moving expenses incurred) are deducted from the subtotal of the amounts in Step 1 and Step 2. If the other deductions exceed the amounts determined in Step1 and Step 2, then the subtotal is $0. It is important to note that many Subdivision e deductions are only deductible in the current year so, if you don't use them in the current year, they disappear.

Example:	RRSP deduction	($7,000)	($7,000)
			$38,000

Step 4, ITA 3 (d) – We then deduct losses incurred in the year (typically from business

or property income). Losses are created when expenses exceed revenues for any given source of income. These losses are then deducted from the Step 3 subtotal. If the total amount is negative, then Net income for Tax Purposes (Division B income) is $0, and the difference becomes a non-capital loss that can be deducted from net income for tax purposes in other taxation years.

Example:	Business loss	($12,000)	($12,000)
Net income for tax purposes (Division B income):			**$26,000**

Note losses are recorded in 3(D) rather than offsetting income in 3(A) so you are able to maximize your 3(C) deductions in the year. Remember that many of the 3(C) deductions expire if they are not used in the year. Therefore by maximizing the income in 3(A) (by leaving losses in 3(D)) you may be able to increase the amount of 3(C) deductions you can use in the year.

Interactive content (Author: Amanjot Gill, June 2019)

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https://kpu.pressbooks.pub/intercdntax/?p=37#h5p-8

References and Resources :

- ITA- Section 3
- Competency map: 6.3.2

January 2019

7. How do you get from Net Income for Tax Purposes to Taxable Income to Tax Payable?

GURVEER BRAR

After determining **Net Income for Tax Purposes** using the Section 3 ordering rules, Division C deductions are subtracted to get to the **Taxable income** (note, don't confuse Division 'C' deductions with section 3(c) deductions). Then Marginal rates are applied to the Taxable Income to calculate the Tax Payable before credits. Lastly, credits are deducted to get to the **Tax Payable**. This is best illustrated with an example using 2023 marginal rates and tax credits.

FORMULA	EXAMPLE		reference
Section 3 ordering rules			
3a. Employment Income	$72,000		
Business Income	$1,200		
		$73,200	
+		$73,200	
3b. (TC Gains > AC Losses)			
Taxable Capital Gains	$4,500		
Allowable Capital Losses	-$700		
		$3,800	
-		$77,000	
3c. RRSP Deduction	-$2,000		
		-$2,000	
-		$75,000	
3d. Loss from Property	-$4,000		
		-$4,000	
		$71,000	ITA 3(a)-3(f)

Net Income for Tax Purposes			**$71,000**
Less: Division C Deductions			
Non-capital Loss	-$6,000		
Net-capital Loss	-$2,000		
		-$8,000	See ITA 109 to
Taxable Income			**$63,000**
Apply Marginal Rates	15% for	$53,359	ITA 117
		$8,004	
	20.50% for	$9,641	
Tax payable before credits		**$1,976**	**$9,980**
Less:			
Personal credits	-$2,250		
EI credits	-$150		
Employment credits	-$205		
CPP credits	-$468		
		-$3,074	ITA 118
Tax Payable (after credits)			**$6,906**

Interactive Content (Author: Anthony Au, June 2019)

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https://kpu.pressbooks.pub/intercdntax/?p=41#h5p-9

Interactive Content (Author: Sam Newton, June 2019)

This is an interactive video walkthrough of a tax payable worksheet originally prepared at BCIT (author unknown).

An interactive H5P element has been excluded from this version of the text. You can view it online here:
https://kpu.pressbooks.pub/intercdntax/?p=41#h5p-10

References and Resources:

- ITA – 3(a)-(f), 109-114, 117, 118
- Competency map: 6.3.2

January 2019

8. What is the difference between tax evasion, tax avoidance, tax planning and tax deferral? Provide some examples.

DEEPALI

Tax evasion occurs when an individual intentionally understates their revenue or overstates their expenses to reduce their tax payable. Tax evasion is considered a crime. Unlike tax avoidance, tax evasion has criminal consequences and the individual may face prosecution in criminal court.

For example, Alex works at an accounting firm and wants to minimize his tax bill, he claims $700 in deductions for fictitious meals and entertainment, moreover he neglects to report $7,000 he earned in cash from renting out a room from his house. Alex is committing tax evasion.

Tax avoidance is associated with tax evasion, but it's not considered a crime. Tax avoidance occurs when a person reduces or eliminates tax within the letter of law but not within the spirit and intent of the law. KPMG's Isle of Mann tax scheme is a good example of a tax avoidance scenario.

If CRA believes there is an avoidance transaction they may challenge your application of tax law under the General Anti-Avoidance Rules (GAAR).

Tax planning is an attempt to reduce one's tax liability, within the framework and spirit of existing tax rules and laws. An individual could reduce their income, increase their deductions and take the advantages of the tax credits through proper tax planning.

Tax deferral is an attempt to use existing tax rules and law to push tax payments/ liability into the future. Tax deferral is not considered a crime.

A good example of both tax planning and tax deferral can be found in a Registered Retirement Savings Plan (RRSP). RRSP deductions reduce tax in the current year and defer it to the future when amounts in the RRSP are withdrawn. If, for example, you withdraw amounts from your RRSP when you are retired you will have achieved deferral (you've pushed taxation of the amount into the future when it was withdrawn) and you may have achieved tax planning/tax reduction if you are in a lower tax bracket during retirement than you were when you were working.

Interactive content, you can select multiple options (Author: Deepali, March 2019)

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https://kpu.pressbooks.pub/intercdntax/?p=43#h5p-11

Interactive content (Author: Swei Liang, April 2019)

An interactive H5P element has been excluded from this version of the text. You can view it online here:
https://kpu.pressbooks.pub/intercdntax/?p=43#h5p-12

References and Resources:

- ITA 245, IC73-10R3 (tax evasion)
- Article – "IC88-2 General Anti-Avoidance Rule – Section 245 of the Income Tax Act" (Author: Government of Canada)
- Competency map: 6.3.2

March 2019

9. How is corporate residency determined in Canada? Why is it relevant?

MASOOD ABDULLAH

The residency status of a corporation – just like an individual – will determine where it is taxed and on what sources of income. If a corporation is considered to be resident in Canada, it will be taxed on its worldwide income. If a corporation is considered to be a non-resident, then it will be taxed on its Canadian source income only. Corporations can be 'deemed' resident or found to be resident under 'common law'.

Deemed Resident

There are several deeming provisions in ITA 250(4) however the most important deeming provision is that any company incorporated in Canada after April 26, 1965 is deemed to be resident in Canada.

Deemed non-resident

According to the Income Tax Act (ITA) Subsection 250(5), a corporation which would be resident of Canada, is deemed to be non-resident if it is considered to be resident in another country based on the tax treaty rules between Canada and the other country. If a corporation is not deemed to be resident under the ITA, it may still be a resident of Canada under common-law. Although there is no proper definition of 'common law' residency rules in the ITA, it is based on the following common-law principles.

Common-law

Unlike the deemed residency rules, Common Law does not take into importance the place where a corporation is incorporated. According to the Common-law, a corporation is considered resident in the country in which *central management is present and control of the corporation is exercised*. The following criteria are considered when assessing whether a corporation is resident under common law:

1. Place where the principal business is done
2. Books and records are present
3. Bank accounts maintained and kept
4. Company seal is present

5. Residence of the directors.
6. It is to be noted that International Tax Treaties override the ITA.

The tiebreaker rules in tax treaties will consider the corporation to be resident of the country where it has continued to operate rather than the country where it was incorporated.

Part year resident

Note that the concept of part-year residency (which may be applicable to individuals) is not relevant to corporations. When a corporation is considered resident in Canada it is considered to be resident for the entire year.

Click on this link to a Corporate and Individual Residency flow chart from "Introduction to Federal Income Taxation in Canada" – by Wolters Kluwer

Interactive content (Author: Simran Gill, January 2020)

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https://kpu.pressbooks.pub/intercdntax/?p=386#h5p-76

An interactive H5P element has been excluded from this version of the text. You can view it online here:
https://kpu.pressbooks.pub/intercdntax/?p=386#h5p-94

References and Resources:

- Income Tax Act (ITA) 248(1), 250(4), 250(5), 250(5.5)
- Article – "Residency of a corporation" (Author: Government of Canada)

January 2020

PART II

BUSINESS AND PROPERTY INCOME

10. How do you determine if something creates business income, property income or capital gain (loss)? Why is this distinction important? (6.3.2)

SAM NEWTON AND GURMEHAR S. GREWAL

One of the most important reasons to differentiate business and property income from capital gains is that 100% of business and property income (and losses) are taxable whereas only 50% of capital gains are taxable. This has a big tax impact (which often ends up in court) and therefore it is important for us to understand how to differentiate business and property income from capital gains.

Business Income vs. Capital Gain.

There is limited specific guideline in the ITA on whether economic activity represents business income. If you look up 'business' in ITA 248(1) it basically says a business is "…an adventure or concern in the nature of trade but does not include an office or employment." This is not particularly helpful guidance as it basically says 'well we don't really know what a business is, but we know it <u>is not</u> office or employment'.

The CRA has filled this void by publishing IT-459 "Adventure or Concern in the Nature of Trade". This Interpretation Bulletin provides guidance to determine whether amounts represent business income or capital gains. In determining whether something is an 'Adventure or Concern in the Nature of Trade' (i.e. business income) the CRA primarily looks at "Taxpayer Conduct", the "Nature of the Property" and the "Taxpayer's Intention"

Taxpayer's Conduct: One of the major considerations is whether the taxpayer is acting in a manner that is consistent with the way other taxpayers would typically act with the same property, goods or services. So, per IT-459, you would compare the activity to what "dealers would do with the same kind of property and what the taxpayer did when he purchased the property, when he sold it and during the time when it was in his possession." If the taxpayer's activity is consistent with what a dealer in the property would typically do, then this would be an indication of business income.

Other elements of the taxpayer's conduct that might indicate business income include the following:

- Evidence that the taxpayer attempted to find a purchaser for the property shortly after the initial purchase
- Evidence that the taxpayer improved the property to increase potential re-sale value.
- The purchaser has a commercial background dealing with similar property.

Nature of the Property: When property is of such a nature that it couldn't create income on its own (for example a building might be able to create rental property income on its own) or be enjoyed by the taxpayer on its own, then it likely would be considered business income. Effectively this criteria is looking at the goods or services themselves and saying 'look, you did a wholesale purchase of 15,000 rolls of toilet paper, the only reason to have this would be for resale and therefore this will create business income.'

Taxpayer's Intention: IT-459 states that "A taxpayer's intention to sell at a profit is not sufficient, by itself, to establish that he was involved in an adventure or concern in the nature of trade. That intention is almost invariably present even when a true investment has been acquired, if circumstances should arise that would make it financially more beneficial to sell the investment than to continue to hold it." So, intention to sell at a profit does not, on its own, indicate business income. If however intention to sell is linked to the other criteria (Taxpayer Conduct, Nature of the Property) then this would provide further support that this is business income.

The CRA will look at both the taxpayer's primary intention and their secondary intention when considering whether activity creates business income or capital gains.

Business Income vs Property Income

The difference between *business* income and *property* income is usually based on the amount of activity needed to generate the income. If it is an active source of income it is typically considered business income whereas a passive source of income would be considered property income.

Interactive content (Author: Gurmehar S. Grewal, March 2019)

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https://kpu.pressbooks.pub/intercdntax/?p=121#h5p-52

Interactive content (Author: Simran Gill, June 2019)

An interactive H5P element has been excluded from this version of the text. You can view it online here:
https://kpu.pressbooks.pub/intercdntax/?p=121#h5p-53

References and Resources:

- IT-459 "Adventure or Concern in the Nature of Trade"
- Competency map: 6.3.2

March 2019

11. Why do we need to reconcile accounting/business income to taxable income? What are some common reconciling items?

JATIN GUPTA

Businesses often follow Generally Accepted Accounting Principles (GAAP) while preparing their own financial statements. The Income Tax Act, however, has a different set of rules for determining business income. The difference between these two sets of rules (GAAP vs ITA) requires us to reconcile business income for accounting to business income for tax purposes when preparing tax returns.

The reconciliation typically starts with accounting business income and then adjusts for all the differences between GAAP and the ITA. Most of the ITA rules for businesses can be found in Sections 9 to 37 of the ITA but some key criteria for business deductions are as follows:

18(1)(a) – States that you are only allowed deductions for expenses that were incurred for the purpose of generating income

20(1) – States that regardless of Section 18, if an item is listed in Section 20 it is deductible.

The relationship between these two sections can be seen in the treatment of accounting deprecation and Capital Cost Allowance ("CCA" – tax depreciation). 18(1)(b) of the ITA states that accounting depreciation is not deductible while 20(1)(a) says that you can deduct CCA. So, to reconcile these amounts you would start with your accounting business income, add back the accounting depreciation and deduct CCA. This revised amount would be your business income for tax purposes.

For Example, say your accounting income was $500,000 and includes $75,000 in depreciation. Your CCA is $85,000. The reconciliation of these amounts to determine business income for tax purposes would be as follows:

Business income for Accounting Purposes	$500,000
Add: -Depreciation ITA 18 (1) (b)	$75,000
Less: – CCA ITA 20 (1) (a)	($85,000)
Business Income for Tax Purposes	$490,000

Here are some of the more common reconciling items look out for:

Particulars	Examples	Citations
Deductions Generally Non- deductible/ Restricted		
	General limitation	ITA 18 (1) (a)
	Accounting depreciation and amortization expenses	ITA 18 (1) (b)
	Recreational facilities and club dues	ITA 18 (1) (l)
Deductions Allowed Generally		
	Capital Cost Allowance	ITA 20 (1) (a)
	Expenses re financing	ITA 20 (1) (e)
	Bad debts	ITA 20 (1) (p)
	Meals and Entertainment	ITA 67.1 (1)

Interactive content (Author: Jatin Gupta, March 2019)

An interactive H5P element has been excluded from this version of the text. You can view it online here:
https://kpu.pressbooks.pub/intercdntax/?p=123#h5p-54

References and Resources:

- ITA 18(1), 20(1), 67.1(1)
- Competency map: 6.3.2

March 2019

12. What are the relevant sections of the ITA that deal with business income? Where does business income go in the S3 ordering rules?

AMANDA LUIES

ITA 9(1) – "*Subject to this Part, a taxpayer's income for a taxation year from a business or property is the taxpayer's profit from that business or property for the year.*"

248(1) "*business*" — "*For purposes of the Act, a business is defined to include a profession, calling, trade, manufacture, or undertaking of any kind whatever, as well as an adventure or concern in the nature of trade. It does not include an office or employment.*"

In accordance with the ordering rules, business income is recorded under Division B S3(a) if revenues are higher than expenses. If a business has a net loss for the year (i.e. revenue is less than expenses) then the net loss will be allocated under S3(d) and recorded as a loss.

When calculating the Net Income for Tax Purposes, business income goes under S3(a) if there is a profit. For example, if you have a restaurant that has revenue of $1,000,000 and expenses of $300,000, then the total income is recorded as a profit of $700,000 under S3(a). However, if the restaurant had expenses greater than revenues then the net loss for that restaurant would be recorded in S3(d)

	Revenue	Expenses	Total Income (Loss)
Restaurant #1	$1,000,000	$300,000	$700,000 under S3(a)
Restaurant #2	$600,000	$650,000	($50,000) under S3(d)

Let's say that in addition to your restaurant, you also have an electronics store that has revenue of $500,000 and has expenses of $1,400,000. This would cause the electronic store to have a total loss of $900,000. The income from the restaurant would still be recorded under S3(a) and the business loss of the electronic store would be recorded under S3(d). These two business incomes would not be combined and are intended to be assessed separately.

In this case, there is a total loss of $200,000, but the Net Income for Tax Purposes will be recorded as $0. The $200,000 loss is added to your non-capital loss balance and can be applied against income for other years.

	Revenue	Expenses	Total Income
Restaurant	$1,000,000	$300,000	$700,000 *under* S3(*a*)
Electronic Store	$500,000	$1,400,000	($900,000) *under* S3(*d*)
Total	$1,500,000	$1,700,000	$0 – NITP

Interactive content (Author: Amanda Luies, March 2019)

An interactive H5P element has been excluded from this version of the text. You can view it online here:
https://kpu.pressbooks.pub/intercdntax/?p=125#h5p-55

References and Resources:

- ITA 9(1), 39(1), 248(1) "business"
- Contingency map: 6.1.1, 6.3.2

January 2019

13. How are eligible, non-eligible and capital dividends taxed in the hands of an individual? Are there any other tax implications? Why do the various dividends have different tax treatments?

WAHAJ AWAN

Eligible dividends are typically paid out by public corporations, from income that has been taxed at a higher corporate tax rate.

Non-eligible dividends are generally paid out by private corporations from income that has been taxed at a lower corporate tax rate. Note public corporations may sometimes declare a portion of their dividends as non-eligible (if some of their income has been taxed at lower corporate rates).

Once eligible or non-eligible dividends have been received by an individual, they are subject to gross-up rates. The grossed-up/taxable dividend is intended to reflect the corporate pre-tax income which is then taxed at the individual's marginal tax rate. The individual is also given a dividend tax credit which is equivalent to the tax paid by the corporation on the dividends. (Refer to the "Integration" topic for an example).

Rates as of **2019**	Gross-up rate	Federal dividend tax credit
Eligible dividends	38%	6/11
Non-eligible dividends	15%	9/13

(These rates can be found in the FITAC>Tax Rates and Tools under the heading "Eligible dividends reference tool")

ITA 83(2) describes **capital dividends** as dividends paid by a corporation on the shares of the corporation's capital stock.

ITA 83(2)(b) states "no part of the dividend shall be included in calculating the income of any shareholder of the corporation". In other words, there is no tax on capital dividends.

Capital dividends are essentially the non-taxable 50% portion of a capital gain, which 'flow-through' tax free to the shareholder.

Suppose a private corporation has a capital gain of $2,000 and is paying out dividends on that amount. The tax treatment for the corporation and in the hands of the individual for this gain is as follows:

Non-eligible dividends		
Taxable portion of capital gain	$ 1,000	
Tax @ 13% (assumed)	$ (130)	
Net earnings	$ 870	
Individual Shareholder	*Cash*	*Taxable*
Cash dividend received	$ 870	
Taxable dividend ($870 X 1.15)		$ 1,000
Individual tax @40% (assumed)	$ (400)	
Plus DTC $130 (9/13 fed & 4/13 prov)	$ 130	
Total After Tax Cash	**$ 600**	
Taxable portion of capital gain if earned directly by individual		
Business Income Earned	$ 1,000	
Tax payable ($1,000 X 40%)	$ (400)	
Total After Tax Cash	**$ 600**	

Non-taxable portion of capital gain		
Non-taxable portion of capital gain	$ 1,000	
Tax @ 0%	$ -	
Net earnings (added to Capital Dividend Account)	$ 1,000	
Individual Shareholder	Cash	Taxable
Cash dividend received (from Cap Dividend Account	$ 1,000	
Capital Dividends are not taxable		$ -
Individual tax @ 0% (cap div not taxable)	$ -	
No DTC since corp not taxed on this portion of cap ga	$ -	
Total After Tax Cash	**$ 1,000**	
Non-taxable portion of capital gain		
Non taxable portion of capital gain	$ 1,000	
Tax payable ($1,000 X 0%)	$ -	
Total After Tax Cash	**$ 1,000**	

Example comparing non-eligible dividends and the non taxable portion of capital gain

In the above example you should note that the after tax cash is the same ($1,000 from the capital dividend and $600 from the non-eligible dividend) regardless of whether the capital gain was earned by the corporation (with dividends paid out to the shareholder) or earned directly by the individual.

Interactive content (Author: Danica McCormack, January 2020)

An interactive H5P element has been excluded from this version of the text. You can view it online here:
https://kpu.pressbooks.pub/intercdntax/?p=393#h5p-77

Interactive content (Author: Dilpreet Grewal, January 2020)

An interactive H5P element has been excluded from this version of the text. You can view it online here:
https://kpu.pressbooks.pub/intercdntax/?p=393#h5p-182

References and Resources:

- ITA – 82(1), 83(2), 89(1), 89(14)
- Video – "Integration" (authors: Abjeet Khatra and Gursimran Kohli) – uses 2017

rates

- Article – "Eligible dividends" (Author: Government of Canada)
- Example provided by Sam Newton

January 2020

PART III

CAPITAL GAINS (LOSSES)

14. What are taxable capital gains and allowable capital losses?

JASMINE MARAHAR

Capital Gains are the profits realized from the sale of Capital Property (see ITA 54 for definition). Although the arguments over whether [transactions create business income, property income or capital gains]() can become pretty complex, in general, if the sale of an asset is a bi-product of its main purpose then it likely creates a capital gain (loss).

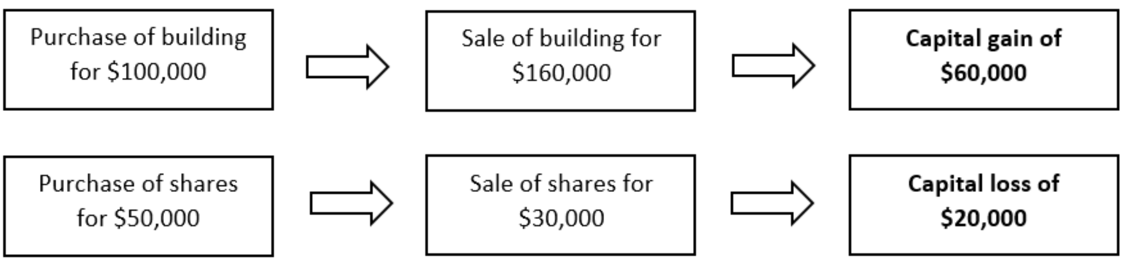
A standard example is an apple tree in an orchard business that sells apples. Typically the ongoing sale of apples would generate business income while the sale of the actual apple tree would create a capital gain.

Only 50% of a Capital Gain is included in income, this is known as the **Taxable Capital Gains** ("TCG"). For example, if the Capital Gain is $30,000, then the TCG would be $15,000 ($30,000 x 50%). Similarly, **Allowable Capital Losses** ("ACL") are equal to 50% of the Capital Loss [ITA 38(b)]. ACL's are deducted against TCG's in the year.

Where do TCG's and ACL's go in the S3 ordering rules? What happens if your ACL > TCG?

In terms of the S3 ordering rules, capital gains and losses recorded in Net Income for Tax Purposes in 3(b). ACL's are netted against TCG's however the amount in section 3(b) cannot be negative. If ACL's are greater than TCG's then 3(b) will be $Nil and the difference becomes a Net Capital Loss that can be applied against net TCG's in other years.

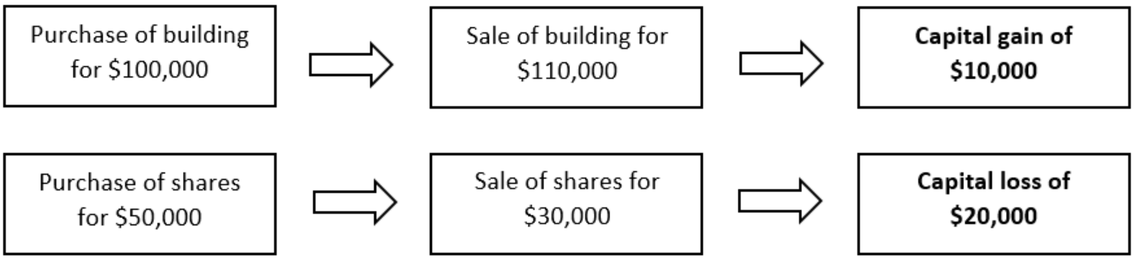
Example: Kylee sold two of her properties last year, a building and some shares, both purchased in 2016. There was no depreciation on the building. The building was bought at a price of $100,000, and sold for $160,000. The shares were bought at $50,000 and sold for $30,000.



The first transaction realized a capital gain of $60,000 and the second transaction realized a loss of $20,000. Kylee's TCG would be ($60,000 x 50%) $30,000 and her

ACL would be ($20,000 x 50%) $10,000. The amount recorded in 3(b) would be $20,000 (TCG-ACL).

Now, let's say Kylee bought the building for $100,000, and sold it for $110,000. The shares she bought for $50,000 and sold for $30,000.



The first transaction realized a capital gain of $10,000, and the second transaction realized a capital loss of $20,000. Kylee's TCG would be ($10,000 x 50%) $5,000. Her ACL would be ($20,000 x 50%) $10,000. ACL>TCG, therefore the amount recorded in 3(b) would be $Nil and the $5,000 difference ($10,000-$5,000) would be added to her Net Capital Loss balance and could be applied against 3b amounts in other years.

Interactive content (Author: Karn Thiara, June 2019)

An interactive H5P element has been excluded from this version of the text. You can view it online here:
https://kpu.pressbooks.pub/intercdntax/?p=129#h5p-56

Interactive content (Author: Afeef Khan, July 2019)

An interactive H5P element has been excluded from this version of the text. You can view it online here:
https://kpu.pressbooks.pub/intercdntax/?p=129#h5p-57

References and Resources:

- ITA 248(1) "capital gain", "property", ITA 38(b),
- Article – "Capital Gains and Losses." (Author: TaxTips)
- Competency map: 6.3.2

January 2019

15. What is the Principal Residence Exemption? How does it impact Taxable Income and what are the basics of the calculation?

AELYSSA BHATTI

The principal residence exemption ("PRE") is an income tax benefit that can reduce or eliminate tax on capital gains realized when you sell your principal residence. The PRE is only available on one property per family unit (this includes your spouse and unmarried children) and, to be designated as a principal residence, your property must be 'ordinarily inhabited' during the year. 'Ordinarily inhabited' is not defined in the ITA but Income Tax Folio S1-F3-C2 states that it can apply "even if a person inhabits a housing unit only for a short period of time in the year."

The PRE represents a potentially huge tax benefit for homeowners in Canada.

***Basics of Calculation*: A- (A x {B/C})-D**

where

A is the individual's total capital gain on the disposition of the principal residence;

B is one plus the number of years the property was designated as the individual's principal residence (and during which the individual was resident in Canada);

C is the number of taxation year-ends that the individual has owned the property (this includes the year of purchase and the year of sale); and

D is a specific rule related to certain houses purchased prior to February 23rd, 1994 and won't be considered for this course.

Example: In 2002, Mr. An acquired vacant land for $50,000. In 2005, he constructed a housing unit on the land, costing $200,000, and started to ordinarily inhabit the housing unit. In 2011, he disposed of the property for $300,000. Calculate exemption amount, TCG.

***Solution*:**

A- $300,000-($200,000+$50,000) =$50,000 (assuming there was no cost of disposition);

B- 7+1=8 (Principal Residence for 2005-2011; 2002-2004 excluded because no one lived there);

C– 10 (tax year-ends from 2002-2011);

D- 0

- **A – {A(B/C)}-D =** $50,000- {$50,000*((7+1)/10)}-0 = $10,000 Capital Gain**.**

TCG ($10,000 * 50%) = $5,000 Taxable Capital Gain

Tax planning: For family units that have two or more properties eligible for the PRE, typically you would apply the PRE to the property with the highest capital gain per year to fully eliminate that capital gain. Any remaining years would then be applied to the other property.

Interactive content (Author: Angel Mo, January 2020)

An interactive H5P element has been excluded from this version of the text. You can view it online here:
https://kpu.pressbooks.pub/intercdntax/?p=397#h5p-93

References and Resources:

- Article – Income tax folio S1-F3-C2, Principal Residence (Author: Government of Canada)
- ITA- 40(2)(b), 54, 110.6(19), 110.6(21).

January 2020

16. What are the 'change in use' rules? What are the tax implications?

MARIAH CAWKELL

The change in use rules are used when a property was originally purchased to generate income but is then used for some other reason or vice versa (i.e. from business/ property to personal use or personal use to business/property use). ITA 45(1) says that for tax purposes, if a change in the use of property occurs, it is assumed the property is disposed of at fair market value (FMV), then immediately re-purchased at this same FMV. Any capital gains (losses) must be recorded in the year of the change in use. Some of the common changes in use (and their tax implications) are stated below.

Business Use to Personal Use

If the change in use is from business to personal use, proceeds from the deemed disposition of the asset will be equal to its FMV. This same FMV will also be equal to the assets re-acquisition capital cost for personal use. Any capital gains (losses), recapture, or terminal loss shall be recorded as normal. ITA 45(1)

Personal Use to Business Use

If the cost of the asset > FMV:

This is treated similarly to Business to Personal Use. According to ITA 45(1), the asset's proceeds from the disposition and the capital cost of reacquisition will be equal to the asset's FMV.

If the FMV > cost of the asset:

Proceeds from the deemed disposition will be equal to the FMV of the asset. The capital cost of the asset will also be equal to FMV when determining capital gain on the deemed disposition. However, ITA 13(7)(b) states that when calculating CCA, the UCC balance of the re-acquired asset will be equal to its original cost + ½ of the difference between its cost and the proceeds from the disposition (FMV). This calculation is to stop 100% of the capital gain from getting deducted as CCA. I.e. you are only taxed on the 50% taxable portion of the capital gain but – without this rule – you would be able to deduct 100% of the increased value as CCA over the life of the asset.

Tax Consequence: Personal to Business FMV > Cost				
Land Original Cost: $100,000				
Land FMV: $250,000				
For Capital Gain Purposes:			**For CCA Purposes:**	
Proceeds of Disposition	$250,000		Original Cost	$100,000
Adjusted Cost Base	$100,000		Bump Up	$75,000
Capital Gain	$150,000		(1/2)($250,000 - $100,000)	
Taxable Capital Gain	$75,000		UCC	$175,000
New Capital Cost:	$250,000			

Principal Residence to Rental Property

This should be treated the same as Personal Use to Business Use. Deemed disposition at FMV and re-acquired at FMV. However, the taxpayer can elect that they have not changed the use of their principal residence to a rental property and therefore do not have to record any capital gains on the property for up to 4 years (and this can be extended further if certain criteria are met). If they elect to do this, they cannot claim any CCA on the property during this time. The rules regarding this election are explained in more detail in this document "Changing All your Principal Residence to a Rental or Business Property".

Rental Property to Principal Residence

A deemed disposition at FMV may trigger capital gains, recapture, and terminal losses. However, ITA 45(3) states the taxpayer can elect out of this disposition as long as they have not taken any CCA on the property since 1984. If this election is made, the taxpayer can assign this property as their principal residence up to 4 years in advance, meaning they are not required to report any capital gains when the change in use occurs. See "Changing All your Rental or Business Property to a Principal Residence".

Interactive content (Author: Zaynab Rashid, January 2020)

An interactive H5P element has been excluded from this version of the text. You can view it online here:
https://kpu.pressbooks.pub/intercdntax/?p=402#h5p-80

Interactive content (Author: Elezer Joseph, January 2020)

An interactive H5P element has been excluded from this version of the text. You can view it online here: https://kpu.pressbooks.pub/intercdntax/?p=402#h5p-95

Interactive content (Author: Taylor Chow, January 2020)

An interactive H5P element has been excluded from this version of the text. You can view it online here: https://kpu.pressbooks.pub/intercdntax/?p=402#h5p-126

Interactive content (Author: Chris Rush, January 2020)

An interactive H5P element has been excluded from this version of the text. You can view it online here: https://kpu.pressbooks.pub/intercdntax/?p=402#h5p-193

References and Resources:

- ITA 45(1)
- Article – "Changing all your rental or business property to a principal residence" (Author: Government of Canada)

January 2020

17. What are the rules on identical properties? Why were these rules created?

SHELVIN CHAND

Identical properties are when each property in the group is the same as all the others. An example would be shares of the same class of the capital stock of a corporation or units of a mutual fund trust.

You may buy and sell several identical properties at different prices over a period of time. If this occurs, you need to calculate the average cost of each property in the group at the time of each purchase to determine your adjusted cost base (ACB).

These rules were implemented to clarify the ACB calculation – and to limit a shareholders ability to manipulate this calculation – when a shareholder sells property.

Under the identical property rules, the ACB is calculated as follows:

1st purchase of property: ACB per unit is equal to the total amount paid for the property divided by the number of units purchased.

2nd purchase of identical property: ACB is equal to the total amount paid for the property (1st and 2nd purchase), divided by the total number of units (1st and 2nd purchase) purchased.

Let's take a look at an example. During year 1, Trevor purchased and sold shares of Matrix Corporation. The chart below shows how the adjusted cost base (ACB) per share changes after each transaction.

Transaction	A: Cost ($)	B: # of Shares	A / B: Adjusted Cost Base per share ($)
January 1, Year 1: Purchased shares at a price of $25.00 per share.	25,000	1,000	25.00
March 31, Year 1: Purchased shares at a price of $22.50 per share.	24,998	1,111	
New Average Cost per Share	49,998	2,111	23.68
June 2, Year 1: Sold shares at a price of $27.50 per share.	23,708	1,001	
New Average Cost per Share	26,290	1,110	23.68
September 15, Year 1: Sold shares at a price of $17.75 per share.	14,447	610	
New Average Cost per Share	11,842	500	23.68
December 27, Year 1: Purchased shares at a price of $16.25 per share.	8,125	500	
New Average Cost per Share	19,967	1,000	19.97

Example of sale and purchase of identical properties

Interactive content (Author: Melany Rivera Moran, January 2020)

An interactive H5P element has been excluded from this version of the text. You can view it online here:
https://kpu.pressbooks.pub/intercdntax/?p=445#h5p-83

References and Resources:

- ITA 47
- Article – "Identical Properties" (Author: Government of Canada)
- Article – "Reporting Capital Gains and Losses From Identical Property" (Author: TurboTax)
- Article – "Capital Gains 2018" (Author: HTK Academy)

January 2020

18. What are the 'replacement property' rules? Why do they exist? What are the tax implications?

TAYLOR CHOW AND JASMINE LEBLANC

What are they?

Replacement property rules allow taxpayers, when applicable, to defer capital gains and/or capital cost allowance when replacing property that was disposed of either voluntarily or involuntarily. Qualifying for replacement property rules lets taxpayers replace disposed assets without having to face immediate tax implications.

Qualifying for replacement property rules:

Voluntary Disposition: Assets that have been voluntarily disposed of can only qualify if it is land and fixtures, and was not a rental property.

Involuntary Disposition: Assets that were not disposed of voluntarily such as being stolen, damaged beyond repair, or expropriated.

Timeframes for replacing property (per "IT Folio S3-F3-C1")

"For involuntary dispositions, the replacement property must be acquired before the later of:

- the end of the second tax year following the initial year; and
- 24 months after the end of the initial year.

For voluntary dispositions, the replacement property must be acquired before the later of:

- the end of the first tax year following the initial year; and
- 12 months after the end of the initial year.

For purposes of the replacement property rules, the **initial year** is the tax year in which an amount has become receivable as POD (proceeds of disposition) for the former property."

Qualifying replacement property:

- The new replacement property must be used to replace the disposed business property.

- The new replacement property must be used in a similar or identical manner as the property it is replacing.
- If the property being replaced was used to earn business income, the new replacement property must also be used to earn business income.

The purpose of the replacement property rule is to allow the taxpayer to defer the capital gains or recapture of CCA when a business property has been disposed of and it is to be replaced with a similar property so that the proceeds can be used to purchase a replacement property.

Example

Brewed Awakening Coffeehouse had been operating in Lower Lonsdale for 3 years until the owners decided to sell the property and relocate. Brewed Awakening has a December 31st year-end. Brewed Awakening was sold on November 26, 2018, for $320,000 and had an adjusted cost base of $105,000. On January 3, 2019, the owners bought a new property for Brewed Awakening in White Rock for $289,000. How much capital gains, if any, would the owners of Brewed Awakening have to report for the 2018 taxation year?

Capital Gains to be reported, lesser of:

Actual capital gain (Proceeds from Sale – Adjusted Cost Base)

$320,000 – $105,000 = $215,000

Proceeds not reinvested (Proceeds from Sale – Cost of Replacement Property)

$320,000 – $289,000 = $31,000

The owners of Brewed Awakening would have to report capital gains of $31,000.

Impact on Taxable Income

The purpose of the replacement property rule is to allow the taxpayer to defer the capital gains or recapture of CCA when a business property has been disposed of and it is to be replaced with a similar property so that the proceeds can be used to purchase a replacement property. In the example above, the taxpayer is able to defer $184,000 of capital gains as they reinvested that amount when purchasing the replacement property. This results in a lower taxable income for the taxpayer in the year of disposition.

Interactive content (Author: Shelvin Chand, January 2020)

An interactive H5P element has been excluded from this version of the text. You can view it online here:
https://kpu.pressbooks.pub/intercdntax/?p=259#h5p-114

Interactive content (Author: Melany Rivera Moran, January 2020)

An interactive H5P element has been excluded from this version of the text. You can view it online here:
https://kpu.pressbooks.pub/intercdntax/?p=259#h5p-115

Interactive content (Author: Panveer Kaur, January 2020)

An interactive H5P element has been excluded from this version of the text. You can view it online here:
https://kpu.pressbooks.pub/intercdntax/?p=259#h5p-84

Interactive content (Author: Chris Rush, January 2020)

An interactive H5P element has been excluded from this version of the text. You can view it online here:
https://kpu.pressbooks.pub/intercdntax/?p=259#h5p-192

References and Resources

- ITA – 44(5), 13(4.1)
- Article – "Income Tax Folio S3-F3-C1, Replacement Property" (Author: Government of Canada)
- Article – "Replacement Property Rules" (Author: HTK Academy)
- Graphic – "Moving Boxers Mover Moving Truck" (Creative Commons)

January 2020

19. What is a capital gains reserve? How is it calculated? Why does it exist?

POOJA DEVI

What is a Capital Gain Reserve?

A capital gain reserve can be utilized when you make a sale of capital property but don't receive full payment. In most cases, you receive full payment on the capital property, but sometimes you may not receive the full refund at the time of sale. The capital gains reserve is intended to help defer tax on the capital gain until payment has been received. Note that there is a 5-year limit on the reserve to restrict people from deferring the gains indefinitely.

Who can claim a reserve

Although there are some restrictions – largely for non-residents, participants in related party transactions and for individuals who are exempt from paying tax – in general, most individuals and corporations can claim the reserve when they dispose of capital property. See ITA 40(2) for further information regarding limitations on who can claim the capital gains reserve.

How do you calculate the capital gains reserve?

The reserve is calculated each year and then brought back into income the following year. The reserve is based on the lesser of the following amounts:

1. Proceeds not yet received / Total proceeds X Capital Gain
2. 20% of the gain X (4 – number of preceding years ending after disposition)

This 2nd calculation effectively forces you to bring in a minimum of 20% of the gain multiplied by the number of years since the date of sale. I.e. By the 3rd you would need to have cumulatively recognized a minimum of 60% of the gain.

The reserve is optional. All or any of the existing reserve may be claimed each year. Remember that the prior year reserve is brought into income in the current year and then a new reserve is calculated.

Here is an example:

Mr. John sold a capital property for $500,000 on December 31, 2017. $50,000 was paid immediately in cash, $200,000 is payable on December 31, 2018, and $250,000 on

December 31, 2019. The adjusted cost base of the property was $150,000 and the selling costs were $20,000. What is the capital gain reserve?

2017: Cost = $500,000; ACB = ($150,000); Selling Cost= ($20,000); Gain = $330,000

Less 2017 reserve, the lessor of:

20% calculation	$ amount calculation
330,000 (20%) (4-0) 330,000 * 80% = $264,000(lessor)	330,000*450,000/ 500,000 = $297,000
Capital Gain = $66,000 ($330,000-$264,000) Taxable Capital Gain (1/2) = $33,000	

2018: Inclusion of 2017 reserve of $264,000

Less 2018 reserve, the lessor of:

20% calculation	$amount calculation
330,000 (20%) (4-1) 330,000 * 60% = $198,000	330,000*250,000/500,000 = $165,000 (lessor)
Capital Gain = $99,000 ($264,000 – $165,000) Taxable Capital Gain (1/2) = $49,500	

2019: Inclusion of 2018 reserve of $165,000

Less 2019 reserve, the lessor of:

20% calculation	$amount calculation
330,000 (20%) (4-2) 330,000 * 40% = $132,000	330,000*0 /500,000 = $Nil (lessor)
Capital Gain = $165,000 Taxable Capital Gain (1/2) = $82,500	

Interactive content (Author: Harman Sandhu, January 2020)

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https://kpu.pressbooks.pub/intercdntax/?p=418#h5p-85

Interactive content (Author: Sheila Lai, January 2020)

An interactive H5P element has been excluded from this version of the text. You can view it online here:
https://kpu.pressbooks.pub/intercdntax/?p=418#h5p-204

References and Resources:

- Article – "Claiming a capital gains reserve" (Author: Government of Canada)
- ITA – 40(1)(iii) and 40 (2)

January 2020

20. What is a business investment loss? What is the impact on Taxable Income? Why does it exist?

BHANVI GHAI

A Business Investment Loss ("BIL") arises when you invest in certain types of small businesses in Canada (either through buying shares or providing loans) and lose your investment. The BIL is more flexible than a normal capital loss and provides a tax incentive for people to invest in small businesses in Canada.

Just as an Allowable Capital Loss represents the deductible 50% portion of a Capital Loss, an Allowable Business Investment Loss ("ABIL") represents the deductible 50% portion of a BIL. When calculating net income for tax purposes, ABIL's are deducted in 3(d) in the year they occur. Any unused portion of the ABIL becomes a Non-Capital Loss which can be applied against all sources of income and carried back 3 years and forward 10 years.

If the ABIL cannot be deducted within 10 years, then it becomes a Net–Capital Loss that can be carried on indefinitely and can only be claimed against Taxable Capital Gains.

For example: If you purchase $20,000 shares in a public corporation and the corporation goes bankrupt, this would create a $20,000 Capital Loss. 50% of this amount ($10,000) would be your Allowable Capital Loss and could only be applied against Taxable Capital Gains.

The same investment with an eligible small Canadian corporation would create a $20,000 BIL. 50% of this amount ($10,000) would be your ABIL and could be applied in 3(d) against ALL sources of income. As mentioned earlier, any unused amount would initially be added to your non-capital loss balance.

This whole concept exists so that if a taxpayer loses money on this type of investment, they are rewarded with a much more flexible type of loss. This special tax treatment encourages people to invest more in Canadian small businesses.

Interactive content (Author: Lam Lewis, January 2020)

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https://kpu.pressbooks.pub/intercdntax/?p=422#h5p-86

An interactive H5P element has been excluded from this version of the text. You can view it online here:
https://kpu.pressbooks.pub/intercdntax/?p=422#h5p-87

Interactive content (Author: Jasneet Kakkar, January 2020)

An interactive H5P element has been excluded from this version of the text. You can view it online here:
https://kpu.pressbooks.pub/intercdntax/?p=422#h5p-183

References and Resources:

- Article – "Lines 21699 and 21700 – Business investment loss" (Author: Government of Canada)
- S4-F8-C1 Income tax folio

January 2020

21. What are the superficial loss rules? What are the tax implications? Why do these rules exist?

JASON GILL

There are many ways in which a person can try to avoid taxes on various things, one of these ways includes creating a loss just to reduce the taxable income. However, the Income Tax Act has rules to prevent people from deducting such false losses, these losses are also known as **superficial losses**.

Without the superficial loss rule a shareholder might sell shares at the end of the year to trigger losses to offset taxable capital gains in the year then immediately re-purchase the same shares. The superficial loss rules were added in the Income Tax Act to help address these 'fake' sales.

ITA-54 states that a **superficial loss** occurs when the taxpayer (or an affiliated person as defined in 251.1(1)) has a loss from disposing a particular (capital) property, and then that taxpayer or any person affiliated(associated) with the taxpayer buys or has a right to buy the same or identical property (also known as "substituted property") between the period of 30 days before to 30 days after the disposition of the particular property. (**Identical/substituted property** is any property which is the same in all material respects, and therefore there wouldn't be a difference if one was to be substituted for the other)

However, in certain situations, the loss from a disposition of the property may not be considered a superficial loss. Situations such as:

- The property was sold because the taxpayer became or ceased to be a resident of Canada
- The property was sold because the property's use was changed
- The property is sold because the owner passed away
- The property was sold due to the expiry of an option
- The property is sold to a shareholder due to the company/corporation shutting down.

If the loss is determined to be a superficial loss, the taxpayer cannot deduct it from their calculation of taxable income for the year. However, the superficial loss amount is added to the Adjusted Cost Base ("ACB") of the identical property that was purchased. By adding the superficial loss to the ACB the loss is deferred until the shares are permanently sold.

Let's look at the tax impact of two identical scenarios with, and without, the superficial loss rules being applied

Illustration 1: The superficial loss rule is not applied

Date	Transaction	Gold Bars	Price	Adjusted Cost Base	Capital Gain/(loss)
2019-01-21	BUY	10	$ 100	$ 1,000	–
2019-12-31	SELL	10	$ 70	$ 1,000	**$ (300)**
2020-01-21	BUY	10	$ 70	$ 700	–
2020-02-20	SELL	10	$ 130	$ 700	**$ 600**

Illustration 2: The superficial loss rules is applied.

Date	Transaction	Gold Bars	Price	Adjusted Cost Base	Capital Gain/(loss)
2019-01-21	BUY	10	$ 100	$ 1,000	–
2019-12-31	SELL	10	$ 70	$ 1,000	**$Nil ($300 superficial loss)**
2020-01-21	BUY	10	$ 70	**$ 1,000**	–
2020-02-20	SELL	10	$ 130	$ 1,000	**$300**

In the second illustration you'll see that the initial $300 loss is deferred and added to the ACB of the shares. This reduces the gain when the shares are finally sold.

Interactive content (Author: Manpreet Singh, January 2020)

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Interactive content (Author: Jasmine LeBlanc, January 2020)

An interactive H5P element has been excluded from this version of the text. You can view it online here:
https://kpu.pressbooks.pub/intercdntax/?p=425#h5p-188

References and Resources:

- ITA – 54, 248(12)
- Article – "What is a superficial loss" (Author: Government of Canada)
- Article – "Meaning of Identical Properties" (Author: Government of Canada)
- Article – "Non-superficial losses" (Author: Government of Canada)
- Article – "What Is a Superficial Loss?" (Author: TurboTax Canada)

January 2020

PART IV
OTHER PERSONAL TAX ISSUES

22. What is a non-arm's length transaction and what are the tax implications?

VIANNA TRAN

CRA defines a non-arm's length transaction as "a relationship or transaction between persons who are related to each other."

ITA 251(2)(a) describes related persons as "individuals connected by blood relationship, marriage or common-law partners or adoption" with 251(6) elaborating on what is meant by "blood relationship".

Why is the government concerned about non-arm's length transactions?

ITA 248(36) states that fair market value should be applied to the transaction of the property. However, in a non-arm's length transaction it is not always relied on that fair market value was used. In a related party transaction the related individuals may be able to work together to set the property below or above fair market value to their tax advantage.

ITA 69(1)(a) describes inadequate considerations as "where a taxpayer has acquired anything from a person with whom the taxpayer was not dealing at arm's length at an amount in excess of the fair market value thereof at the time the taxpayer so acquired it, the taxpayer shall be deemed to have acquired it at that fair market value." Effectively, the ITA 69 rules state that non-arm's length transactions that are not recorded at fair value will result in extra taxation. For the seller they do this by recording the transaction at the greater of FMV and actual proceeds therefore maximizing the potential capital gain. For the purchaser they do this by recording the transaction at the lesser of FMV and actual proceeds thereby minimizing potential future CCA claims or maximizing capital gains on future sales of the asset.

Non-Arm's Length Transactions (ITA 69)

Actual Proceeds	Deemed Proceeds	ACB to Purchaser	Double Taxation
= FV	Actual	Price Paid	No
= Nil (Gift)	FV	FV	No
> FV	Actual	FV	Yes
< FV	FV	Price Paid	Yes

Tax implications for the buyer and the seller depending on the selling price compared to the fair value

You could be subject to double taxation if you are dealing in a non-arm's length transaction, and the CRA thinks you may be selling (or buying) something for not the fair market value to gain some kind of advantage for tax purposes.

Example (*Proceeds < Fair Market Value by Manmeet Kaur*):

Assume Manmeet bought a rental property in 2019 for $500,000. Two years later, she sold it to her brother, Isaac for $600,000 even though the fair value was $800,000. They made the sale at the reduced price so that Manmeet could minimize her capital gain.

How does 'extra' taxation take place in this scenario and to what extent?

As per ITA 69, Manmeet is deemed to have sold the property at the $800K fair value (rather than the $600,000 selling price) which will result in a $300,000 capital gain. Her brother Isaac, however, will only be able to record the cost base at the actual selling price ($600,000) which will increase his capital gain (or reduce the amount of tax depreciation he can claim) if he were to sell it in the future.

Ultimately, Manmeet and her brother are double/extra taxed as they didn't record their non-arm's length transaction at fair value.

Interactive content (Author: Ishneet Sehgal, June 2019)

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https://kpu.pressbooks.pub/intercdntax/?p=170#h5p-75

References and Resources:

- ITA – 69(1)(a), 251(2)(a), 248(36)
- Article – "Non-arm's length transactions" (Author Government of Canada)
- Article – "Definitions for letter N (Business)" (Author: Government of Canada)
- Competency map: 6.3.2

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23. What are the spousal rollover provisions and why do they exist?

SIMRAN GILL

A spousal rollover is the transfer of retirement funds (RRSPs/ RRIFs) and/or capital property to a spouse, common-law partner or to a trust for a spouse or common- law partner. This can be a transfer between living partners ("inter vivos") covered under ITA 73(1), or it can be a transfer upon death of one of the partners which is covered under ITA 70(6). The goal of these spousal rollovers is that the transfers can occur with no immediate tax consequences.

Note, for purposes of this discussion, spouse, common-law partner and trust will be referred to jointly as "spouse".

Property Transfers

The basic idea under ITA 70(6) and ITA 73(1) is as follows:

- The original ACB and UCC of the assets transfer to the receiving spouse.
- The spouse must be resident in Canada when the property is transferred
- the spousal rollover is automatic
- You need to file paperwork to elect out of these rules if you don't want them to apply. You might do this if, for example, you wanted a capital gain on the transfer to be triggered to utilize some available capital losses

This results in the receiving spouse being able to defer any capital gains or recapture until they die or sell the property. The transfer itself does not generate a capital gain or loss, recapture, or terminal loss.

Let's look at an example. Assume Kim has depreciable assets with a FMV of $70,000 an ACB of $50,000 and a UCC of $40,000. If she sold these assets to a 3rd party she would likely trigger a $20,000 capital gain ($70,000 – $50,000) and $10,000 in recaptured depreciation ($50,000 – $40,000). If Kim transfers these same assets to her husband Kanye, the spousal rollover provisions allow these assets to transfer at their original ACB and UCC with no immediate tax consequences.

Note that income, gains or losses on these transferred assets may need to be recorded in the hands of the transferring spouse (i.e. Kim) when the income is received or the gains/losses realized in the future. This will be discussed in the section on attribution.

It is possible that Kim could have a bunch of non-capital and net-capital losses that she wants to utilize, in which case Kim and Kanye could jointly elect out of 73(1), in which case this would be treated as a non-arm's length transaction rules under 69(1).

Inadequate Considerations

As mentioned above, the 69(1) rules apply if the spouses 'elect-out' of the spousal rollover rules in 70(6) or 73(1). In this case the transfer is treated like any other non-arms length sale.

Here are the tax rules for FMV transfers (as explained in ITA 69):

ITA 69: Non- Arm's Length Transfers		
Transfer Price	**Adjusted Cost Base for Transferee**	**Proceeds of Dispositions For Transferor**
FMV:	FMV	FMV
Above FMV:	FMV	Actual Proceeds
Below FMV:	Actual Proceeds	FMV
Gift (NIL):	FMV	FMV

Interactive content (Author: Jacob Stanworth, January 2020)

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https://kpu.pressbooks.pub/intercdntax/?p=501#h5p-96

Interactive content (Author: Yasi Lu, January 2020)

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https://kpu.pressbooks.pub/intercdntax/?p=501#h5p-108

References and Resources:

- ITA – 69, 70(3), 70(5), 70(6), 73(1)
- Article – "Inadequate Considerations" (Author: Government of Canada)
- Article – "Transfers of Property to Your Spouse…" (Author: Government of Canada)

January 2020

24. What are the attribution rules and why do they exist?

DILPREET GREWAL

Due to the progressive nature of the Canadian income tax system, there is a built-in tax incentive to spread income around the family unit. For example, let's say Charles has $100,000 of interest income on some of his investments and is taxed at a very high marginal rate. If he can somehow transfer a portion of these investments to his young unemployed children, Harry and William, then the tax on the entire family unit will be lower (as they are, presumably, taxed at much lower marginal rates). The attribution rules are intended to address income splitting schemes like this.

The attribution rules are a complex set of laws which are used to handle various income-splitting scenarios. Attribution rules ensure that any income earned, or (in the case of transfer to a spouse) capital gains or losses realized are taxed to the transferor and not the transferee.

Let's get back to the example above. Suppose Charles transferred all of his investments to Harry and William at an amount other than FMV. In this scenario, even though the children own the assets, the $100,000 of income would still be attributed back to Charles and included on his tax return.

Note that the attribution rules apply to transfers to children under the age of 18 and to spouses. For transfers to children only the income earned after the initial transfer is attributed back to the transferor. For transfers to spouses the income AND capital gains/losses (after the initial transfer)are transferred back.

The attribution rules **don't apply** if:

- income earned or lost is realized in a period following death of either the transferor or transferee
- the transferor is not a Canadian resident
- the transferee ceases to be a spouse of the transferor within a time period
- spouses are separated at the time of transfer
- where the transferor receives fair market value on the property which is transferred or through interest-bearing loans

Note, that if the transferor receives fair market value on the property, the payment (or loan) must be from the transferee's own funds.

Attribution Rules Summary Table

Transferee	**Property gifted or sold for an amount other than FMV**
Minor child or non-arm's length child: individual under the age of 18 at time of transfer; child, niece, nephew ITA 74.1 (2), 75.1 (2)	Income or losses* are attributable. Capital gains or losses are not attributable. *Exclude business income
Trust ITA 74.3 (1)	Capital gains or losses are attributable.
Spouse or common-law partner ITA 74.1 (1)	Both income or losses* and capital gains or losses are attributable. *Exclude business income

Referenced from: RBC Wealth Management article "Income splitting and the attribution rules" (author Karim F. Visram, CFA, CGA, CFP, FMA)

Interactive content (Author: Jessica Thao, January 2020)

An interactive H5P element has been excluded from this version of the text. You can view it online here:
https://kpu.pressbooks.pub/intercdntax/?p=508#h5p-97

Interactive content (Author: Diane Macutay, January 2020)

An interactive H5P element has been excluded from this version of the text. You can view it online here:
https://kpu.pressbooks.pub/intercdntax/?p=508#h5p-98

References and Resources:

- ITA – 74.1 (1), 74.1 (2), 74.3 (1), 74.2, 75.1 (2), 74.5 (12)
- Video – "What are the attribution rules? – Tax Tip Weekly" (author: Allan Madan)
- Article – "Income splitting and the attribution rules" (author: Karim F. Visram, CFA; CGA, CFP; FMA)

January 2020

25. What is the Tax on Split Income? What are the tax implications? Why does it exist?

LOVELLEN CHEEMA AND NATASHA DUTT

ITA S.120.4 – Tax on Split Income (TOSI), is an anti-avoidance method that is designed to prevent private corporations from splitting income with adult and/or minor family members. The TOSI rules are complex but, in general, TOSI applies to "split income" received by a "specified individual" from a "related business". These terms will be defined further below.

Currently, the TOSI applies the highest marginal tax rate of 33% on the following who receive split income:

- minors under the age of 18,
- children age 18 and over, and
- certain other related adult individuals (including spouses or common-law partners, grandparents, and grandchildren, but not aunts, uncles, nephews, or nieces).

A *specified individual*, for a taxation year, means an individual (other than a trust) who is either resident in Canada or, if the individual has not attained the age of 17 years before the year, has a parent resident in Canada at any time in the year.

A *related business* generally exists when a related person is active in the business on a regular basis or owns at least 10% of the fair market value of the shares in a corporation that carries on the business.

Split income generally includes income derived directly or indirectly from a related business, such as taxable dividends, shareholder benefits, or interest income, but not salary, paid in respect of the individual and certain capital gains unless the amount is an "excluded amount".

Excluded amounts are income received by an individual that TOSI will not apply to, and some examples include amounts received on:

- Inherited property
- The death of a spouse/common-law partner before end of the year

- As a result of breakdown of marriage or common-law partnership;
- Taxable capital gains deemed to be realized on death;

Example:

Natasha is 5-years old. Her mother owns a CCPC and last year she gave Natasha shares in the company. This year the company pays Natasha $10,000 in non-eligible dividends. What is the tax implication?

***Answer*:**

Natasha's federal tax is calculated using the highest marginal rate of 33% instead of the normal 15%. Her total federal tax on this income is $11,500 ($10,000 + 15% grossup) x 33% = $3,795.

If Natasha had been taxed at the normal federal tax rate of 15%, her tax would have been $11,500 x 15% = $1,725. Natasha would've paid less than half in taxes if TOSI was not in place. It's also important to note that TOSI restricts the tax credits that can be claimed. Only the dividend tax credit, foreign tax credit (related to the TOSI income) and the disability tax credit can be applied. She wouldn't even be able to use her Basic Personal Amount credit against the tax payable on the TOSI income.

Interactive content (Author: Karn Thiara, January 2020)

An interactive H5P element has been excluded from this version of the text. You can view it online here: https://kpu.pressbooks.pub/intercdntax/?p=518#h5p-201

References and Resources:

- [Article – "Federal tax on split income" (Author: Government of Canada)]()

26. What are the available income splitting opportunities with family members?

ANITA KARTAWIDJAJA

What is income splitting?

Income splitting is a tax saving strategy where you basically allocate income from one family member who has higher income, to another family member who has lower income. The point of this is so that the higher income family member can transfer a portion of their income to another family member who has lower income, and that way they can report their own income at a reduced amount on their tax return, so that they can be taxed at a lower tax bracket. This will usually help reduce the entire family's overall tax bill.

Pension Income Splitting

There is an income splitting strategy called Pension Income Splitting. This is where individuals can split their eligible pension income (monthly income in retirement) with a spouse or a partner, if all the requirements are met. ITA s. 60.03 states that the individual that receives the pension, can transfer up to 50% of their eligible pension income to their spouse or partner. This is also beneficial in that it can possibly create or increase the pension income tax credit for the spouse so they can deduct this amount from their taxes payable (see ITA s.118(3) for more on pension income tax credit).

Ex.

	Pension Income per Month	Total Income Assumed (prior to transfer)	Transfer of 50% Pension Income	New Income (after transfer)
Fred	$2,400	$55,000	$14,400	$40,600
			[(2,400 x 12 months) x 0.50)	(55,000-14,400)
Marginal Tax Rate (%)		*20.50%*		***15%***
Wilma	$1,700	$23,000	-	$37,400
				(23,000+14,400)
Marginal Tax Rate (%)		*15%*		***15%***

Figure 27.1 Income splitting. [Image Description]

Contribute to a spousal RRSP

If an individual believes that they will have a higher income than their spouse upon retirement, this income splitting opportunity would be very beneficial in the year of withdrawal, in terms of tax saving. The higher income individual can contribute to their spouse's RRSP, and when the funds are withdrawn, it would be taxed under the spouse's name (with the lower income) instead of the contributor's name (with the higher income).

Loaning money to your spouse or child (Prescribed Rate Loan)

If one spouse or partner is in a higher tax bracket than the other, they could lend money to the lower income spouse and/or to one of their children. It is suggested that a promissory note be written for the loan to secure it. Also, the loans must charge interest at the prescribed rate for benefits (or the commercial lending rate if it is lower) and this interest amount must be **paid** by January 30th of each year. The lower income family member can use the loaned funds to purchase investments (e.g. dividend-paying stocks), and the income will be taxed and paid at a lower marginal rate by the lower income family member. Another thing the lower income family member can do is use a portion of the dividend income they earned to pay the interest on the loan to the higher income family member. The prescribed rate on benefits is usually pretty low (2% as of January 2020) so, as long as the investment has a higher return than the prescribed rate, your income splitting strategy is a success.

Prescribed Rate Loan Example:

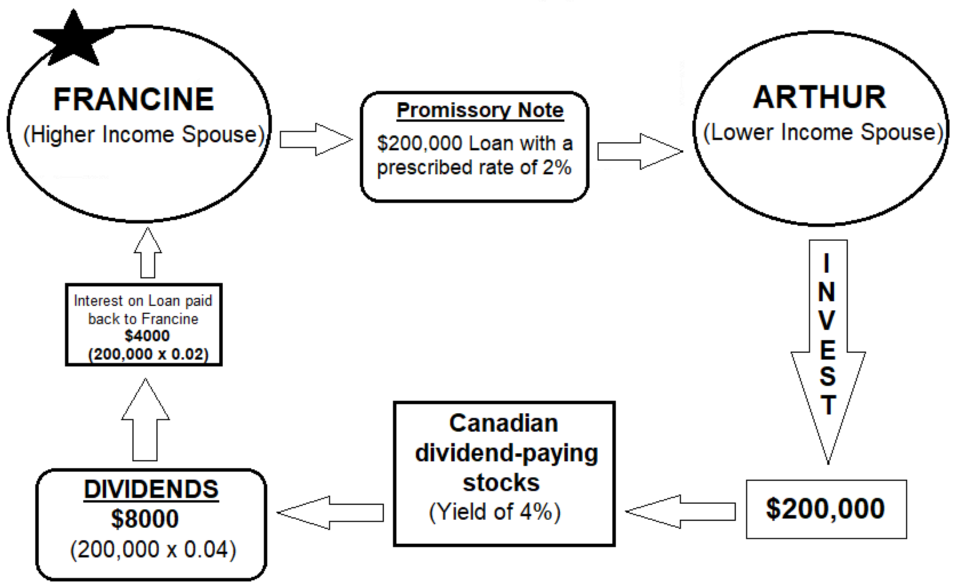

Figure 27.2 Prescribed Rate Loan [Image Description]

Image: Anita Kartawidjaja (January 2020)

There are many more income splitting strategies other than the ones listed here, but these are few of the more common examples that tax savers take advantage of.

interactive content (Author: Masood Abdullah, January 2020)

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https://kpu.pressbooks.pub/intercdntax/?p=556#h5p-205

References and Resources:

- ITA – 60.03, 74.5(1)
- Article – "Pension income splitting" (Author: Government of Canada)
- Article – "Here are your income splitting options now that the private corporation avenue is dead" (Author: Jamie Golombek)
- Article – "Lend Money to Your Spouse or Child" (Author: TaxTips.ca / Boat Harbour Investments Ltd.)

January 2020

Image Description

Figure 27.1 Image Description: Fred's pension income per month is $2,400 with a total income of $55,000. Wilma's pension income per month is $1,700 with a total income of 23,000. Fred plans to transfer 50% pension income to his partner [(2,400 x 12 months) x 0.50]. His new income would become $40,600 (55,000-14,400) and his partners would become 37,400 (23,000+14,400). [Return to Figure 27.1]

Figure 27.2 Image Description: Francine is loaning $200,000 to her spouse Arthur with a prescribed rate of 2%. Arthur decides to invest the money into a Canadian dividend-paying stocks at 4%. He earned $8000 as a dividend (200,00 x 0.04). Then he paid the interest of the loan back to Francine of $4000 (200,000 x 0.02). [Return to Figure 27.2]

PART V

CAPITAL COST ALLOWANCE

27. What is the purpose of CCA? How is it calculated? Why are items typically 'pooled' into the same CCA class?

DALJINDER NIJJAR

Capital Cost Allowance ("CCA") is the depreciation mechanism used for tax purposes. Unlike accounting depreciation, CCA can be deducted from income for tax purposes. Capital assets require depreciation because the capital assets wear out over time. Undepreciated Capital Cost (UCC) is the capital cost of an asset minus the CCA claimed in previous years.

How is it calculated?

CCA is usually calculated based on the Declining Balance Method. Let's consider the following example: Assume Alpine Industries has machinery with an Undepreciated Capital Cost (UCC) of $40,000 at the start of 2016. The machinery falls under class 53 and has a 50% CCA rate. In this situation CCA is calculated as UCC multiplied by the CCA rate. The following examples shows CCA in 2016, 2017 and 2018.

Year	UCC	CCA
2016	$40,000	$40,000 X 50% = $20,000
2017	$40,000 - $20,000 = $20,000	$20,000 X 50% = $10,000
2018	$20,000 - $10,000 = $10,000	$10,000 X 50% = $5,000

CCA is also impacted by other tax laws such as the half-year rule, short fiscal year rule, available for use rule, recapture and terminal losses which will be addressed in subsequent sections of this text. The rates for different classes can be found in the Income Tax Regulations 1100(1). In general, the rates are intended to reflect the anticipated depreciation of the related assets. So, for example buildings, which tend to have a long useful life, will have a relatively low CCA rate (usually 4%) whereas computer software, which tends to depreciate quickly, has a much higher CCA rate (up to 100%).

Why are items typically 'pooled' into the same CCA class?

Assets are pooled into certain classes largely because the government believes they depreciate in a similar manner. For example, tools, medical and dental instruments, and kitchen utensils are grouped together in class 12. Similarly, roads, parking lots, sidewalks, airplane runways, storage areas or similar surface construction are pooled into class 17. The assets in these classes really don't have much in common other than the belief that they depreciate the same way.

Interactive question (Author: Daljinder Nijjar, March 2019)

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https://kpu.pressbooks.pub/intercdntax/?p=137#h5p-58

Interactive question (Author: Amarpreet Kaur, June 2019)

An interactive H5P element has been excluded from this version of the text. You can view it online here:
https://kpu.pressbooks.pub/intercdntax/?p=137#h5p-59

References and Resources:

- ITR 1100(1)
- Video – "CCA Part 1 2015" (Author: BCC Education)
- Article – "Income Tax Folio S3-F4-C1, General Discussion of Capital Cost Allowance" (Author: Government of Canada)
- Article – "CCA classes" (Author: Government of Canada)
- Competency map: 6.3.2

January 2019

28. What is a Terminal Loss? What is Recapture? How are they recorded in net income for tax purposes?

GURTAJ PANNU

Terminal loss

According to TaxTips the author states that, "W*hen a depreciable fixed asset is sold, its capital cost allowance* (CCA) *class is reduced by deducting the lower of its original cost, or its proceeds of sale. If all the assets in a class have been sold, but at the end of the fiscal year there is still a balance of undepreciated capital cost* (UCC) *remaining in the class, this balance can be fully written off against business or property income as a "terminal loss".*"

So, if you have disposed of all the assets in a specific CCA class but there is still a remaining UCC balance in the class, effectively it means you didn't claim enough CCA in previous years. The ITA addresses this by allowing you to claim a Terminal Loss on this remaining balance in the current year. The Terminal Loss is deducted from your business or property income and reduces the remaining UCC balance in the class to $Nil.

Recapture

According to TaxTips, the author states that, "W*hen a depreciable fixed asset is sold, its capital cost allowance* (CCA) *class is reduced by deducting the lower of its original cost, or its proceeds of sale. If, at the end of a fiscal year, the balance of the class is negative, a gain has occurred. This gain is referred to as a "recapture" of* CCA *and must be included in business or property income for the year.*"

If we sell an asset and the balance in the class is negative at the end of the fiscal year, we have created Recapture. This means we have claimed too much CCA in the past. The ITA addresses this by adding back the Recapture amount to the business or property income in the year.

	Terminal Loss	Recapture
UCC, beginning of year	$6,000	$6,000
Sold asset for…	$4,000	$9,000
Terminal Loss	$2,000 ($6,000 – $4,000)	Not applicable
Recapture	Not applicable	$3,000($6,000-$9,000)
Note: Terminal losses are only recorded when there are no other assets in the CCA class.		

Remember, Terminal Losses are subtracted from your business or property income, and Recapture is added to your business or property income.

Now let's look at how the above example would impact our "GAAP to Tax" business reconciliation. Assume the individual had GAAP net income of $10,000 and CCA of $500 (from assets in a different CCA class than in the example above).

Business Income Statement

		ITA Citation	Notes
GAAP Net Income	$10,000	ITA 9(1)	Taxpayer's Income for the Year
Terminal Loss	($2,000)	ITA 20(16)	Deduction from Business Income
CCA	($500)	ITA 20(1)(a)	Deduction from Business Income
Recapture	$3,000	ITA 13(1)	Inclusion in Business Income
Business Income for Tax Purposes	$10,500	Amount will be placed in Section 3a (Business Income)	As the Business Income for Tax Purposes is positive It will be placed in Section 3a

(Example by: Clarissa D'Souza)

Interactive content (Author: Swei Liang, July 2019)

An interactive H5P element has been excluded from this version of the text. You can view it online here:
https://kpu.pressbooks.pub/intercdntax/?p=139#h5p-60

Interactive content (Author: Gurtaj Pannu, March 2019)

An interactive H5P element has been excluded from this version of the text. You can view it online here:
https://kpu.pressbooks.pub/intercdntax/?p=139#h5p-61

References and Resources:

- Article- "Terminal Loss" (Author: TaxTips)
- Article- "Recapture" (Author: TaxTips)
- Article- "Example for the calculation of recapture of CCA and terminal loss" (Author: Government of Canada)
- Competency map: 6.3.2

March 2019

29. What is the purpose of the half-year rule?

DAVID REN

The half-year rule reduces the amount of CCA (tax depreciation) that can be claimed in the year that you purchase an asset.

Income Tax Regulation subparagraph 1100(1)(b)(i) states "*If the capital cost of the property was incurred in the taxation year and after* November 12, 1981, (B) *if the property is not an accelerated investment incentive property and is not described in any of subparagraphs (b)(iii) to (v) of the description of R in subsection (2), 50 per cent of the amount for the year calculated in accordance with Schedule III.*"

Effectively it says 'we are going to pretend you bought the asset halfway through the year and therefore you are only going to be able to claim CCA on half of the purchase amount this year…don't worry you can claim the remaining CCA in future years.'

How the half-year rule works

The half-year rule temporarily cuts the cost of an asset purchased during the year in half. This lower amount is then used to calculate CCA for the year.

For example, say I bought a $25,000 car during the year for my new car-rental business. I checked on the CCA "classes list" and determined the new car would be recorded in CCA class 10 which has a 30% CCA rate. I add the $25,000 car to my class 10 pool but then must reduce this amount by $12,500 for the half-year rule. In the 1st year I can claim $3,750 in CCA ($12,500 X 30%).

I then add the $12,500 back to my UCC balance and will be able to claim $6,375 CCA on the remaining balance in the following year (($25,000 cost – $3,750 1st year CCA) X 30% CCA rate). CCA on the full remaining amount in the next year as follows:

Original purchase	Capital Cost Allowance	Accumulated CCA	UCC
			$25,000
1st year	$25,000*50%* 30%=$3,750	$3,750	$21,250
2nd year	$21,250*30%=$6,375	$10,125	$14,875

You can find the appropriate CCA class and rates for a given asset in the "Classes list" in the FITAC under "tax rates and tools"

Why do we use the half-year rule?

The half-year rule allows taxpayers to claim CCA regardless of the actual purchase date of the asset. Without this rule, taxpayers would have an incentive to buy assets at the end of the year and claim CCA for the whole year. In addition, half-year rule creates convenience to both taxpayers and CRA, because this method makes the calculating process of CCA a lot easier, as the actual purchase date of the property does not matter.

Interactive content (Author: David Ren, March 2019)

An interactive H5P element has been excluded from this version of the text. You can view it online here:
https://kpu.pressbooks.pub/intercdntax/?p=141#h5p-62

Interactive content (Author: Diane Macutay, June 2019)

An interactive H5P element has been excluded from this version of the text. You can view it online here:
https://kpu.pressbooks.pub/intercdntax/?p=141#h5p-63

References and Resources:

- Article – "Income Tax Folio S3-F4-C1, General Discussion of Capital Cost Allowance" (Author: Government of Canada)
- Article – "PART XI Capital Cost Allowances – DIVISION I – Deductions Allowed" – 1100(1)(b)(i) (Author: Government of Canada)
- Competency map: 6.3.2

January 2019

30. What is the purpose of the short-fiscal period rule?

GURVIR SAHOTA

ITA 249(2) (a)- A "Fiscal Period" is the time when a new taxation year is beginning and the current taxation year is ending (See ITA 249.1(1) for further explanation).

A fiscal period is the time between a start of a business and its year-end which is usually the calendar year. A fiscal period cannot be more than 12 months; however, it can be shorter than 12 months also known as a "short-fiscal period". For example, if Gary opens a business on June 1st and his fiscal periods ends on December 31st then his fiscal period would consist of 214 days instead of 365 days. This would be known as a "short-fiscal period for Gary's business. A business reports its income based on the fiscal period. A business that goes bankrupt prior to its fiscal year-end would also have a "short-fiscal period".

How the short-fiscal period relates to capital cost allowance?

CCA rates are based on a full year. Therefore, an adjustment is made to the CCA of a business that was in operation for less than a year.

If one has a short-fiscal period that consists of less than 365 days, they take into consideration the days the business was operating. For example, Tim shuts down his tire company on September 1st and his CCA would have been $4,000 for the full year. Because Tim had a short-fiscal period of 243 days, his actual CCA would be calculated as $2,663 ($4,000 x (243/365)). Therefore, the CCA has to be prorated, as the CCA claim is based on the days in your fiscal period.

Interactive content (Author: Gurvir Sahota, January 2020)

An interactive H5P element has been excluded from this version of the text. You can view it online here:
https://kpu.pressbooks.pub/intercdntax/?p=143#h5p-64

References and Resources:

- ITA- 249(2) (a) "Fiscal Period"
- Article- "Fiscal Period – Government of Canada" (author: Government of Canada)
- Competency map: 6.3.2

January 2019

31. Can you have a capital loss on depreciable property? If not, why not?

POOJA SEHGAL

No, we cannot have a capital loss on depreciable property.

A "**Capital loss**" occurs when a non-depreciable asset (such as land) is sold for less than its original cost. However you cannot have a Capital Loss on "**depreciable property**", i.e. items whose value declines over time such as cars, buildings, houses etc.

Why can't you have a capital loss on depreciable property?

You can have a "*Capital **gain** on depreciable property if you sell it for more than its adjusted cost base plus the outlays and expenses incurred to sell the property*" (Canada Revenue Agency, 2018). But, "*A loss from the sale of the depreciable property is not considered to be a capital loss. However, you may be able to claim a terminal loss*" (Canada Revenue Agency, 2018). Depreciable assets are considered a part of the activities of your business and property; therefore, they are better integrated with your business or property through tax depreciation (CCA) and Terminal Losses than as a Capital Loss. Generally, a Terminal Loss is generated when you sell assets for less than their tax carrying value (UCC), and there are no other assets remaining in the CCA class.

When we buy a non-depreciable asset like land for example, and we sell it for less than what we paid for it, there is a Capital Loss. When we buy a depreciable asset like a car, there is no Capital Loss at the time of sale. Instead, we can claim CCA during the lifetime of that asset, and if it sells for less than the remaining UCC balance, we can claim a Terminal Loss (as a reduction to our business or property income) assuming there are no other assets remaining in the CCA class.

Let's say we bought a table for $1,000. We claimed $200 in CCA (tax depreciation) over the last 3 years and its UCC is now $800. The table is subsequently sold for $700 and there are no other remaining assets in the CCA class. The difference between the sale price ($700) and the UCC ($800) creates a $100 Terminal Loss. The Terminal Loss represents additional tax depreciation we can claim in the year.

Original Cost	$1,000	(1,000-800) $200 CCA (Tax depreciation) (800-700) $100 UCC (Terminal loss)
UCC	$800	
Selling Price	$700	

Interactive content (Author: Pooja Sehgal, March 2019)

> *An interactive H5P element has been excluded from this version of the text. You can view it online here:*
> *https://kpu.pressbooks.pub/intercdntax/?p=145#h5p-65*

Interactive content (Author: Alicia Mitchell, June 2019. The third slide is by Afeef Khan, July 2019)

> *An interactive H5P element has been excluded from this version of the text. You can view it online here:*
> *https://kpu.pressbooks.pub/intercdntax/?p=145#h5p-66*

References and Resources:

- Article – "Depreciable property – 2018, January 03" (Author: Government of Canada)
- Competency map: 6.3.2

January 2019

32. What is the Accelerated Investment Incentive and how does it work?

PANVEER KAUR

Accelerated Investment Incentive (AII) allows businesses to claim one and a half times CCA on net eligible property additions in the first year of purchase of the property. The property will qualify as an eligible property if that is acquired after November 2018 and becomes available for use before 2028. This rule is only applicable to arm's length transactions.

Furthermore, Accelerated Investment Incentive also allows businesses to deduct 100% of the capital cost of **Class 53**, **Classes 43.1, and 43.2** assets in the year of acquisition of these assets.

Under accelerated investment incentive, businesses will add the 50% of net eligible property additions to adjust UCC to claim one and a half times CCA, whereas, under the half-year rule, businesses used to deduct 50% of net additions in the first year of purchase. This incentive will allow businesses to claim larger CCA in the first year without changing the total amount of CCA that can be claimed over the life of the asset.

Example:

3C's Inc has the UCC balance of $100 at the beginning of 2018 of Class 10 and purchased an additional property of $200 in January. In 2019, it purchased additional eligible asset of $200. In 2020, it acquired an eligible asset of $300 and disposed the property for $150, which has a capital cost of $200.

Calculation Steps	2018	2019	2020
UCC, beginning of year (A)	$100	$240	$278
Additions	$200	$200	$300
Disposition during the year: Lessor of Proceeds of Disposition Capital cost	–	–	($150)
Net Additions during the year (B)	$200	$200	$150
50% of net eligible additions as per AII rules (C)	N/A	$100	$75
Half-year rule (D)	($100)	N/A	N/A
Adjusted UCC for CCA calculation(A+B+C-D)	$200	$540	$503
CCA= 30% * adjusted UCC	($60)	($162)	($151)
Less: 50% of net eligible additions as per AII rules	N/A	($100)	($75)
Add: 50% of Half year rule deductions	$100	N/A	N/A
UCC, end of year	$240	$278	$277

(Example by Mathew Andrews):

Andrews Ltd. acquired the following assets in 2018 and 2019. The 2018 asset was acquired prior to November.

2018:

- – A new building intended to act as a warehouse for $400,000.

2019:

- – New office desks for $4,000.
- – A general-purpose computer for $2,000, which the office manager bought from his brother.
- – A zero-emission Tesla Cybertruck for delivery purposes for $60,000.

How would each asset be treated in terms of CCA in the years they were acquired? Consider the half-year rule and/or accelerated investment incentive for each item.

Building: Class 1

Because the building was acquired before November of 2018, it is not eligible for the accelerated investment incentive. The building would fall under class 1 (see ITR Schedule II, Class 1 (q)) and would likely have a CCA rate of 4% (there are lots of specific rules on the CCA rates for buildings but they are beyond the scope of this example). Since it does not qualify for the accelerated investment incentive, it will also be subject to the half-year rule. The first year CCA would be calculated as follows:

(400,000 / 2) * 4% = $8,000

Office Desks: Class 8

Because the office desks were acquired after November of 2018, they are eligible for the accelerated investment incentive and therefore will not be subject to the half year rule. The desks, being furniture, fall under Class 8 (see ITR Schedule II Class 8 (i)) and will have a CCA rate of 20% per the calculation below:

(4,000 * 1.5) * 20% = $1,200

Computer: Class 50

It is notable that the computer was purchased from a blood relative of the office manager. Because of this, the transaction was not dealt at arm's length. Since the accelerated investment incentive doesn't apply to non arms-length transactions, the computer is subject to the half-year rule. As a class 50 asset (see ITR Schedule II, Class 50), CCA will be calculated as per below.

(2,000 / 2) * 55% = $550

Cybertruck: Class 54

Because the Cybertruck is a zero emission vehicle and is not intended to be rented out, it is classified under class 54 and has a limited prescribed CCA amount of $55,000. Class 54 assets are also eligible for the accelerated investment incentive which for the class is an immediate write-off of 100% of the asset. This is calculated as below:

55,000 * 100% = $55,000

Interactive content (Author: Wahaj Awan, January 2020)

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https://kpu.pressbooks.pub/intercdntax/?p=897#h5p-127

Interactive content (Author: Danica McCormack, January 2020)

An interactive H5P element has been excluded from this version of the text. You can view it online here:
https://kpu.pressbooks.pub/intercdntax/?p=897#h5p-190

References and Resources:

- Article – "Accelerated Investment Incentive" (Author: Government of Canada)

January 2020

33. What are some common CCA classes and what is their tax treatment?

SHEILA LAI AND DENISE BAETA ABRUNHOSA

The following chart shows some of the common CCA classes and their tax rates. Note that most of these assets would be eligible for the new Accelerated Investment Incentive:

Class	Depreciate property	Rate
1	Most buildings acquired after 1987. Note the rules around buildings are complex and the CCA class (and rates) is dependent on the type of building, how it is used and when it is purchased.	4% (varies)
8	Furniture, fixtures and miscellaneous capital property. This is a bit of a dumping ground for assets that can't find another CCA class.	20%
10	Most automobiles and other automotive equipment (if not in class 10.1 or 16)	30%
10.1	Passenger vehicles that cost more than the prescribed amount ($30,000 prior to 2022; $34,000 in 2022; $36,000 in 2023). Some unique rules related to class 10.1: • Each vehicle is entered into its own separate CCA class; • The cost (for CCA purposes) is capped at the prescribed amount (see above for prescribed amounts); • There is no recapture or terminal loss on sale; • Can claim 1/2 of the normal CCA amount in the year of disposal	30%
12	Property such as tools, medical or dental instruments, and kitchen utensils that cost less than $500. Basically small, inexpensive items that, for simplicity sake, are expensed (through CCA) really quickly.	100%
16	Taxis and vehicles you use in a daily car rental business. There is a higher depreciation rate here than for class 10 or 10.1 due to the higher usage by taxi companies and car rental businesses.	40%
43.1 and 43.2	Clean energy equipment has a CCA rate of 30% (43.1) or 50% (43.2) depending on when the equipment was acquired. Under the temporary full expensing rules, new equipment in this class purchased after November 20, 2018 will be expensed 100% in the year of acquisition. This temporary rule will be phased out starting in 2024. Note, these assets are not eligible for the Accelerated Investment Incentive.	30% 50% 100 %
50	Computer hardware and systems software for that equipment, including ancillary data processing equipment that is acquired after March 18, 2007.	55%

53	Machinery and equipment that is acquired after 2015 and before 2026 to be used in Canada primarily in the manufacturing or processing of goods for sale or lease. Under the temporary full expensing rules, new equipment in this class purchased after November 20, 2018 will be expensed 100% in the year of acquisition. This temporary rule will be phased out starting in 2024. Note, these assets are not eligible for the Accelerated Investment Incentive.	50%

You can find a great CCA list (by item and by class) in the FITAC by first going to "Tax rates and tools" and then "Capital cost allowance"

In general, Leasehold Improvements, if the costs are borne directly by the landlord, are capitalized to the building, usually Class 1. However, when a tenant makes a capital improvement to a leased property, these leasehold improvements will be allocated to Class 13. Class 13 CCA is calculated as follows:

As per Schedule III, the maximum deduction is the lesser of;

- 1/5 of the capital cost of the improvement or;
- The capital cost of the lease improvement/lease term (including the first renewal option, up to 40 years)

Accelerated Inventive Investment (AII) replaced the half-year for any leasehold improvements after November 2018.

Example:

Friendship Marketing leased the building on January 1, 2018, with a lease term of 10 years, and an option to renew for an additional 2 successive 5-year periods. Friendship Marketing spent $50,000 renovating the premises in 2018. In 2021, they required further changes to incorporate the growing team and spent another $30,000 renovating the space. They have a December 31st year-end. Calculate the maximum amount of Class 13 CCA that they can deduct for 2021 and 2022:

CCA for 2021

2018	Lesser of • ⅕ x $50,000 = $10,000 • ($50,000/(10yrs+5 yrs)) = **$3,333**	$3,333
2021	Lesser of • ⅕ x $30,000 x 1.5 = $9,000 • ($30,000 / (7 yrs + 5 yrs)) x 1.5= **$3,750**	$3,750
	Total CCA for 2021	**$7,083**

CCA for 2022

2018	Lesser of • ⅕ x $50,000 = $10,000 • ($50,000/(10yrs+5 yrs)) = **$3,333**	$3,333
2021	Lesser of • ⅕ x $30,000 = $6,000 • ($30,000 /12 yrs) = **$2,500**	$2,500
	Total CCA for 2022	**$5,833**

Interactive content (Author: Angel Mo, January 2020)

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Interactive content (Author: Aelyssa Bhatti, January 2020)

An interactive H5P element has been excluded from this version of the text. You can view it online here:
https://kpu.pressbooks.pub/intercdntax/?p=588#h5p-125

Reference and Resources:

- Article – "Classes of depreciable property." (Author: Government of Canada)

January 2020

34. How are goodwill and intangibles depreciated for tax purposes?

LEWIS LAM

Intangible assets are largely broken into two separate classes for CCA purposes as follows:

Intangible assets with a limited useful life (like most patents and franchises) are put into class 14 and depreciated on a straight-line basis over their estimated useful life. Class 14 assets are subject to the new Accelerated Investment Incentive ("AII") rules and claim an additional 50% CCA in the year of purchase (with 50% less CCA in the final year of its useful life).

Intangible assets with an unlimited (or unknown) useful life (Goodwill, customer lists etc) are put into class 14.1 and depreciated using the declining balance method at 5% per year.

Class 14.1 is a relatively new CCA class resulting from significant changes to the depreciation rules for Eligible Capital Property ("ECP") which were implemented on January 1, 2017. Class 14.1 assets are subject to the new AII rules (i.e. no half-year rule and an additional 50% CCA can be claimed in the first year).

Let's look at how CCA would be calculated in class 14 vs class 14.1 under the new AII rules:

Class 14 (straight line)	**CCA**	**Class 14.1 (declining balance)**	**CCA**
Purchased a patent for $200,000 with an estimated 5 year useful life		Purchased Goodwill for $200,000 with an unknown useful life	
Year 1 – $200,000 / 5 years. $40,000 annual CCA * 1.5 in year 1 due to AII	$60,000	Year 1 – $200,000 * 1.5 AII * 5% CCA rate	$15,000
Year 2 – Annual CCA of $40,000	$40,000	Year 2 – $185,000 UCC * 5% CCA rate	$9,250
Year 3 – Annual CCA of $40,000	$40,000	Year 3 – $175,750 UCC * 5% CCA rate	$8,787
Year 4 – Annual CCA of $40,000	$40,000	Year 4 – $166,963 UCC * 5% CCA rate	$8,348
Year 5- Annual CCA of $40,000 * 50% to reflect AII rule in final year	$20,000	Year 5 – $158,615 UCC * 5% CCA rate	$7,931

The example is used to illustrate the different CCA mechanism under class 14 (straight line) and class 14.1 (declining balance) intangible assets. Note that the depreciation of the class 14 is dramatically higher in the above example largely because of its shorter useful life.

Interactive content (Author: Mariah Cawkell, January 2020)

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https://kpu.pressbooks.pub/intercdntax/?p=592#h5p-112

Interactive content (Author: Zaynab Rashid, January 2020)

An interactive H5P element has been excluded from this version of the text. You can view it online here:
https://kpu.pressbooks.pub/intercdntax/?p=592#h5p-113

Reference and Resources:

- FITAC -Personal Tax Guide Planner 2019-2020
- FITAC – Commentary “CCA – General Rules”

January 2020

35. What are the 'available for use' rules and what are the tax implications?

SAM NEWTON

"AVAILABLE FOR USE" RULES

Under ITA Section 13(26), you can start claiming CCA in the year that an asset is 'available for use' which means, broadly, the time you were able to commence using the asset as it was intended.

The rules regarding when an asset is considered to be available for use vary slightly depending on whether the asset is a building (see ITA 13(28)) or an asset other than a building (see ITA 13(27)). The overall goal is the same however, you can start claiming CCA (and applying the half-year rule) in the year that the asset can be used as intended.

Interactive content (Author: Bhanvi Ghai, January 2020)

An interactive H5P element has been excluded from this version of the text. You can view it online here:
https://kpu.pressbooks.pub/intercdntax/?p=621#h5p-119

Interactive content (Author: Jasneet Kakkar, January 2020)

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https://kpu.pressbooks.pub/intercdntax/?p=621#h5p-184

References and Resources:

- S3-F4-C1 Income Tax Folio
- ITA 13(26) through (32)
- Article – "Available for use rules" (Author: Government of Canada)

January, 2020

36. What are 'inducements' and what are the tax implications?

DIANE MACUTAY

Purpose of Inducements

Lease inducements, also known as tenant inducements, are used by landlords to attract tenants or to retain existing ones to their property. This usually occurs when there are more properties available than tenants in the market, and therefore landlords offer inducements in exchange for a signed lease. There are several different forms of inducements: non-cash inducements such as a lease buy-out, rent-free period or rent reduction, and cash inducements such as cash payments directly or for property improvements.

Tenant's Perspective

ITA s 12(1)(x) states that inducements are **fully taxable** at the time they were received. If a cash payment is received from the landlord solely as an exchange for a signed lease, the entire amount must be included in the tenant's business income for that year.

However, if a cash payment is received for the purpose of improving the property, the tenant can file an **election**, as long as the original capital cost is greater than or equal to the inducement received. This allows the tenant to use the elected amount against the cost of the property improvement (Class 13 – leasehold improvements), eliminating the income inclusion. If the tenant does not file an election, the entire amount must be included in the tenant's business income for the year.

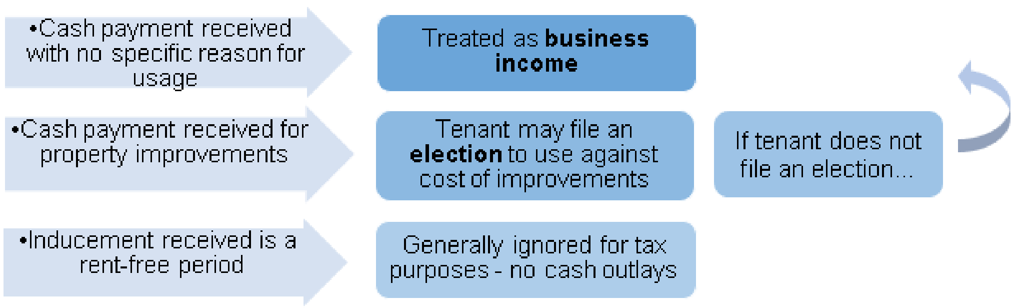

Figure 36.1 Tenant's perspective [Image Description]

Filing an Election to CRA

Since there is no specific form for filing an election, the taxpayer can simply prepare a letter attached to his or her income tax return. The election is due the same time the income tax return is due for that year. The letter must include the following:

- ITA section under which the election is made – s 13(7.4)
- Amount elected
- Amount of inducement and date received
- The date the property was acquired
- The original cost of the property (before reduction)

Landlord's Perspective

When landlords offer inducements, depending on the situation, these inducements can result in:

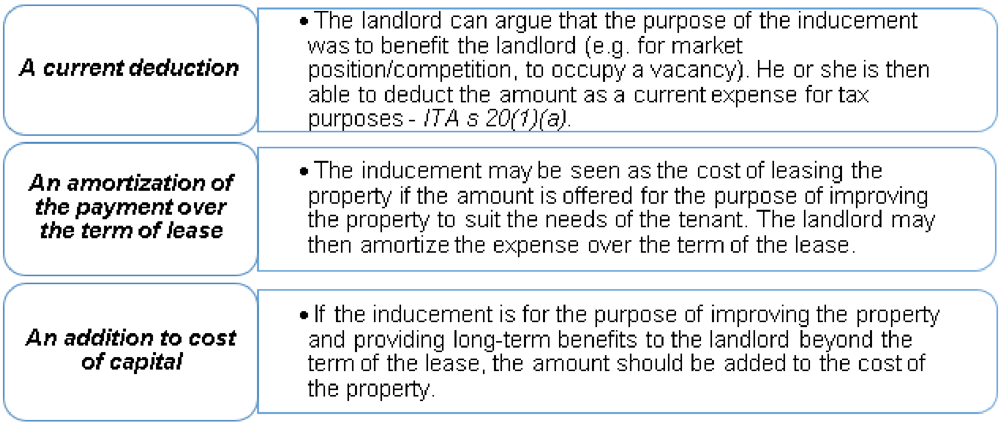

Figure 36.2 Landlord's Perspective [Image Description]

Interactive content (Author: Pooja Devi, January 2020)

An interactive H5P element has been excluded from this version of the text. You can view it online here:
https://kpu.pressbooks.pub/intercdntax/?p=615#h5p-117

Interactive content (Author: Harman Sandhu, January 2020)

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An interactive H5P element has been excluded from this version of the text. You can view it online here:
https://kpu.pressbooks.pub/intercdntax/?p=615#h5p-195

References and Resources:

- ITA – 12(1)(x), 20(1)(a), 20(1)(hh), 53(2)(s)
- Article – "Canadian Income Tax Treatments of Leasehold Inducement Agreements" (author: Chris Munn)
- Article – "What is a Lease Inducement?" (author: Lillian Teague)

January 2020

Image Description

Figure 36.1 Image Description: Cash payments received with no specific reason treated as business income. Cash payment received for property improvements tenant may file an election to use against cost of improvements. Inducements received as a rent-free period are generally ignored for tax purposes. [Return to Figure 36.1]

Figure 36.2 Image Description: Landlord can argue the purpose of the inducement was to help the business. Thus, they can deduct the amount as a current expense. If the inducement is seen as the cost of leasing the property if the amount is offered for the purpose of improving the property. The landlord may then amortize the expense over the term. If the inducement is for the purpose of improving the property and providing long-term benefits, the cost should be added to the cost of property. [Return to Figure 36.2]

37. What are the specific rules on the disposition of land and building? Why are these rules created?

BUSHRA MANGHAT

When there is a disposition of real property, the allocation of the proceeds between land and building can have a significant impact on the sellers taxable income. A large amount allocated to the land will create or increase the capital gain, with only half of this amount being taxable. At the same time, by manipulating the proceeds and allocating a smaller amount to the building you could potentially end up with a large terminal loss, which is fully deductible. The ITA 13(21.1) rules are intended to patch this loophole.

Example: Yasmeen Ltd. owns some land with a building on it. During 2018, the company sells the land and building for $610,000 and allocates the proceeds as follows:

Proceeds Of Disposition Allocation	
Estimated Values:	
Land	$ 400,000
Building	210,000
Total Proceeds Of Disposition	610,000
Adjusted Cost Base of Land	$ 300,000
Original Cost Of Building	275,000
UCC Class 1	250,000

Figure 38.1 Proceeds of Disposition Allocation. [Image Description]

As mentioned earlier, there is an incentive for Yasmeen Ltd. to allocate more of the proceeds to the land (creating a capital gain that is only 50% taxable) and to minimize the amount allocated to the building (to create a 100% deductible terminal loss)

Being aware of this incentive, ITA 13 (21. 1) (a) contains a provision that can serve to limit the amount of any terminal loss that might arise on the disposition of real property. Applying this to the example this would require deemed proceeds of disposition for the building to be determined as the lesser of the two values:

Proceeds of disposal of building equal lessor of (A and B below):				
A	(i) FMV of land and building			$610,000
	minus			
	(ii) Lesser of			
		- ACB of land	$300,000	($300,000)
		- FMV of land	$400,000	
				$310,000
B	The greater of			
	(i)	- FMV of building	$210,000	
		- lesser of capital cost ($275K) and UCC ($250K) of building	$250,000	250,000

Figure 38.2 Proceeds of Disposal [Image Description]

By allocating $250,000 to the building you eliminate any terminal loss (as the $250,000 deemed proceeds equals the UCC). The remaining amount of the proceeds ($360,000) is then applied to the land which creates a smaller capital gain.

Interactive content (Author: Jason Gill, January 2020)

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Interactive content (Author: Manpreet Singh, January 2020)

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https://kpu.pressbooks.pub/intercdntax/?p=632#h5p-200

References and Resources:

- ITA 13 (21. 1) (a)

January 2020

Image Description

Figure 38.1 Image Description: Total proceeds of disposition = $610,000 Adjusted cost base of land = $300,000 Original cost of building = $275,000 UCC class 1 = $250,000. [Return to Figure 38.1]

Figure 38.2 Image Description: Proceeds of disposal of building = (A) FMV of land and building minus lessor of ACB of land and FMV of Land. (B) the greater of FMV of building or lessor of capital cost and UCC of building. [Return to Figure 38.2]

PART VI

CORPORATE TAXABLE INCOME AND TAX PAYABLE

38. What are the similarities and differences between how tax payable is determined for individuals and corporations? (Overview)

SAM NEWTON

What are the similarities and differences between how tax payable is determined for individuals and corporations?

Calculating Net Income For Tax Purposes (NITP) and, to some extent, Taxable Income is very similar for both individuals and corporations. The biggest differences show up in the way Taxable Income is actually taxed. We'll look into these similarities and differences in more detail below.

Similarities

NITP – Corporations and individuals both follow the Section 3 ordering rules. The only real difference when calculating NITP is that some types of income and expenses really only relate to individuals (spousal support, employment income, child care expenses) and we wouldn't expect them to be part of a corporate tax return.

Taxable Income – Division 'C' deductions, which get us from NITP to Taxable Income, are also very similar although there are a few key differences as follows:

Item	**Personal tax treatment**	**Corporate tax treatment**
Charitable donations	Personal tax credit (ITA 118.1)	Division 'C' deduction (ITA 110.1(1))
Capital Gains Deduction	Division 'C' Deduction (ITA 110.6)	Not available to corporations
Dividends from Canadian Corporations (other than capital dividends)	Included in property income (NITP) and receive dividend tax credit	Division 'C' deduction (ITA 112), then dividends are taxed under Part IV of the ITA

Tax Rates and Process

The key difference between corporate and individual tax returns is how taxable income is actually taxed. For individuals, taxable income (regardless of the type of income) is grouped together and taxed using the progressive tax brackets. For corporations, the **type and amount** of items included in taxable income matters and is taxed as follows:

Taxable Income Element	**Corporate Tax Process**
Active Business Income (ABI) <= the Small Business Deduction Threshold	Taxed at a very low rate to encourage small businesses.
Active Business Income (ABI) > the Small Business Deduction Threshold	Taxed at a moderate rate
Passive income (interest, some rental income etc.)	Taxed at an extremely high rate to discourage having passive income in a corporation. The intention is for corporations to focus on active business and flow any extra cash/ passive items out to shareholders.

Note, the above elements apply primarily to Canadian Controlled Private Corporation (CCPC's). Public corporations (and non-CCPC's) are not eligible for some of these items (like the Small Business Deduction)

Here are the corporate tax rates based on the type and amount of income. These specific elements will be addressed in more detail later on in the book.

	CCPC ABI<= SBD	CCPC ABI > SBD	CCPC Passive income	Non CCPC	ITA
Basic Rate	38%	38%	38%	38%	123(1)(a)
Provincial Abatement	(10%)	(10%)	(10%)	(10%)	124(1)
Small Business Deduction	(19%)	NA	NA	NA	125(1) & 125(1.1)
General Rate Reduction	NA	(13%)	NA	(13%)	123.4(2)
Additional Refundable Tax	NA	NA	10.7%	NA	123.3
Total federal tax rate	**9%**	**15%**	**38.7%**	**15%**	

As you can see, for CCPC's, Active Business Income below the Small Business Deduction limit is taxed at a very low rate (9%), passive income is taxed at a very high rate (38.7%), and all other income is taxed at 15%. This stratification and different tax treatment of the various types of income is the main difference between the taxation of corporations and individuals.

Interactive content (Author: Karn Thiara, January 2020)

An interactive H5P element has been excluded from this version of the text. You can view it online here:
https://kpu.pressbooks.pub/intercdntax/?p=300#h5p-202

Reference: FITAC > Tax Rates and Tools > Corporate Income Tax Rates – Federal Components

January 2020

39. What are the similarities and differences between the various types of corporations (private, CCPC, public). (6.2.1)

JESSICA THAO

The status of a corporation whether it's private, public, or a canadian-controlled private corporation (CCPC) will affect the tax treatment of its shareholders and the corporation itself. The similarities and differences are shown below:

	CCPC	Other Private corporation	Public corporation
Definition	• Private corporation • Not controlled by a non-resident	• Private corporation • May be controlled by a non-resident	• Corporation listed on a public stock exchange
Net tax rate (corporate tax rates)	• 9% Active Business Income (ABI) <= Small Business Deduction (SBD) • 15% for other ABI • 38.67% for investment income	15%	15%
Eligible for RDTOH	Yes (CRA 'refundable dividend tax on hand)		No
Additional refundable tax	Yes, on passive income	No	No
Small business deduction	Yes, for ABI up to the $500K SBD threshold.	No	No
Other tax benefit	– Enhanced investment tax credits – Capital gain exemption for shareholders on the sale of shares – Research & development tax credit	No	No

Interactive content (Author: Emily Yeung, January 2020)

An interactive H5P element has been excluded from this version of the text. You can view it online here:
https://kpu.pressbooks.pub/intercdntax/?p=640#h5p-124

References and Resources:

- Article – "Small business deduction rules" (Author: Goverment of Canada)
- Article "T2 corporation income tax guide chaoter 6″ (Author: Government of Canada)
- Article "Corporations" (Author: Government of Canada)

January 2020

40. What are the similarities and differences between the basic stakeholder relationships (affiliated, associated, connected, non-arm's length, related)? (6.2.1)

ANTHONY AU

The Income Tax Act uses many different terms to refer to specific stakeholder relationships. Although they may have the same connotation, these terms are legally distinct from each other and carry different tax implications. This text provides only a brief overview as to what constitutes a specific relationship and the relevant tax treatment. For more information, refer to the Income Tax Act sections referenced.

Affiliated Persons – ITA 251.1 (relevant to superficial losses)

Individuals that are married or in a common-law partnership are affiliated.

Corporations that are under the control of affiliated persons or groups of affiliated persons are affiliated (each member of each group must be affiliated with at least one member of the other group).

Affiliated persons are subject to superficial loss rules. When a loss is realized on the disposal of capital property, it is deemed superficial and no deduction can be made if the following conditions are met:

- The seller or 'affiliated person' sells the property
- The seller of 'affiliated person' re-acquires the property 30 days before or after the sale

Associated Persons – ITA 256(1) (relevant to small business deductions)

Corporations are associated under any of the following scenarios:

- A corporation has control over the other
- Each corporation is under the control of the same person or group of persons
- Each corporation is under the control of a different person, the persons are related, and either of those persons owns at least 25% of shares of both

corporations

Association impacts a corporation's ability to claim a small business deduction. A Canadian-controlled private corporation (CCPC) is entitled to a reduction in corporate taxes on annual active business income up to the corporation's business limit ($500,000 as of 2019). However, if the corporation is associated with another CCPC, the business limit is reduced to zero. If the associated corporations file an agreement with the minister, then the small business deduction can be shared among the associated corporations. This treatment stops individuals from claiming multiple deductions by setting up and splitting income across multiple corporations.

Related Persons – ITA 251(2) (relevant to non-arm's length transactions and lifetime capital gain exemptions)

Individuals connected by a blood relationship or marriage/common-law partnership are related. A blood relationship refers to a relationship between parent and child (including adopted children, stepchildren, and children-in-law) or other descendants (ex. grandchildren). It also refers to a relationship between siblings.

A corporation and its controller(s) or any person related to its controller(s) are related.

Corporations are related if they have the same controller or if their controllers are related.

Related persons are automatically deemed to be dealing at **non-arm's length** with each other.

For non-arm's length transactions that aren't at FMV (or a gift), the seller must record the transaction at the greater of FMV and actual selling price, and the buyer must record the transaction at the lesser of FMV and actual price. This treatment maximizes capital gains for the seller and minimizes CCA deductions or maximizes future capital gains for the buyer.

Related persons can also reduce their capital gains through the lifetime capital gain exemption (LCGE). Capital gains can be tax-exempt if it arose from the disposition of qualified small business corporation shares or qualified farm or fishing property. During the period from 24 months before to the time of disposal, the property must have been owned by the seller or a person related to the seller.

Connected Persons – ITA 186(4) (relevant to inter-corporate dividends)

Corporations are connected under any of the following scenarios:

- A corporation has control over the other
- A corporation owns more than 10% of issued share capital of the other
- A corporation owns more than 10% FMV of all issued shares of the other

Whether a corporation is connected or not has a significant impact on the way the inter-corporate dividends are taxed. This will be addressed later on in the textbook.
Interactive content (Author: Daljinder Nijjar, January 2020)

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Interactive content (Author: Manu Grewal, January 2020)

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References and Resources:

- ITA s.54 Definitions – superficial loss
- ITA s.110.6 Capital gains deduction
- ITA s.125 Small business deduction
- ITA s.186 Part IV tax on taxable dividends received by private and subject corporations
- ITA s.251 Arm's length and related persons
- ITA s.251.1 Affiliated persons
- ITA s.256 Associated corporations and acquisition of control

January 2020

41. What are some significant differences for the treatment of Division 'C' deductions for individuals and corporations?

PRABPREET BADYAL

There are several differences for the treatment of division 'C' deductions for individuals and corporation. Some of the major differences are listed in the table below:

<table>
<tr><th colspan="2">Division ‘C’ Deductions</th></tr>
<tr><th>INDIVIDUALS</th><th>CORPORATIONS</th></tr>
<tr><td>Lifetime Capital Gain Deduction
Capital gains deductions available is the lifetime maximum for the capital gains deduction, less any amounts that have been used in preceding years. ITA 110.6</td><td>Lifetime Capital Gain Deduction
N/A</td></tr>
<tr><td>Donations
Individuals receive a credit for donations.
ITA 118.1</td><td>Donations
Corporations receive a deduction for a donation under Division ‘C’ rather than receiving a credit.
Deduction cannot be greater than 75% of division B income
Can be carried forward for 5 years.
ITA 110.1(1)</td></tr>
<tr><td>Dividends
Individuals receive a dividends credit for a gross up of 38% for eligible dividends and 15% for non-eligible dividends.
ITA 82 and 121</td><td>Dividends
From Canadian corporations and foreign affiliates – Division ‘C’ deduction (ITA 112), then dividends are taxed under Part IV of the ITA
Other foreign dividends are included in Taxable income and taxed as Passive income.</td></tr>
<tr><td colspan="2">Loss carryovers
Net Capital Loss for individuals and corporations are carried forward indefinitely and carried back 3 years. ITA 111(1)
Non-Capital Loss for individuals and corporation are carried forward 20 years and carried back 3 years. ITA 111(5.4)</td></tr>
</table>

Refer to ITA 110- 114.2, as well as ITA sections listed above for an in-depth explanation on Division 'C' deductions.

Interactive content (Author: Paul Jhajj, January 2020)

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Interactive content (Author: Balkaran Nijjar, January 2020)

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https://kpu.pressbooks.pub/intercdntax/?p=677#h5p-142

References and Resources:

- Article – "T2 Corporation – Income Tax Guide – Chapter 3: Page 3 of the T2 return" (Author: Government of Canada)
- Article – "T2 Corporation – Income Tax Guide – Chapter 8: Page 8 of the T2 return" (Author: Government of Canada)

January 2020

42. What is Active Business Income and Aggregate Investment Income?

SAM NEWTON

Corporate tax rates are based upon the type of income rather than focussing on the amount of income (as we see with the progressive tax rates used on individuals). In general, the Canadian government would like to see corporations used for active business activities (like manufacturing, processing, selling things etc.) rather than passive income activities (like receiving interest revenue or dividends). To achieve this goal, the government taxes Active Business Income (ABI) at a very low rate and Aggregate Investment Income (AII) at a very high rate (albeit some of this amount is refundable).

Here is a brief definition of ABI and AII

Active Business Income

Per ITA 125(7), active business income "means any business carried on by the corporation other than a specified investment business or a personal services business…". For purposes of achieving the most favourable Canadian tax rates (see 'Small Business Deduction" later in this book), this Active Business Income must be generated in Canada.

Aggregate Investment Income

AII is basically all your passive income that isn't being taxed under Part IV. ITA 129(4) "Aggregate Investment Income" has the details of the AII calculation, but the basic formula is as follows:

- Taxable capital gains net of allowable capital losses for the year. I.e. the amount in 3(b) when calculating NITP – 129(4)(a)(i) & (ii)
  - Less: Net capital losses deducted under Division 'C' – 129(4)(a)(iii)
- Property income for the year (Canadian and Foreign) – 129(4)(b)
  - Less: Dividends deducted under Division 'C' – 129(4)(b)(iii)
  - Less: Property losses for the year – 129(4)(b)

This Aggregate Investment Income will be used in calculating the Additional Refundable Tax discussed later in this book.

March, 2020

43. How is tax payable calculated for a corporation and why is the source of the income (ABI, AII, Specified Investment Business Income etc.) important?

AMER BASSI

Public corporations are not impacted by the Additional Refundable Tax or the Small Business Deduction. Assuming a public corporations income is earned in Canada it is taxed at 15%. The calculation for a CCPC is a bit more complex.

Tax payable calculation for a CCPC:

Basic Part I tax – ITA 123(1)	(38%)(Taxable income)
Less: Federal abatement for provincial tax, ITA 124(1) Income earned outside of Canada is not eligible for the abatement	(10%)(Taxable income earned in Canada)
Add: Additional refundable tax (ART) on CCPC Aggregate Investment Income (AII), ITA 123.3	10 2/3% * Passive income
Less: General rate reduction, ITA 123.4 General rate reduction applies to active business income not eligible for SBD	(13%)(Taxable income not impacted by SBD or AII)
Less: Small business deduction, ITA 125(1). Available for ABI eligible for the SBD	(19%)(Taxable Income eligible for SBD)
Part I tax payable	$ ___________

As you can see, clearly identifying the different types of income (ABI <= SBD, ABI > SBD, passive income) is imperative when calculating a corporation's tax payable. Each source of income determines what should be applied when calculating the tax payable for a corporation.

Interactive content (Author: Saundarya Pradhan, January 2020)

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Interactive content (Author: Shawn Jhajj, January 2020)

An interactive H5P element has been excluded from this version of the text. You can view it online here:
https://kpu.pressbooks.pub/intercdntax/?p=308#h5p-131

References and Resources:

- ITA 123(1), 124(1), 123.3, 123.4, 125(1), 125(7), 129(1)
- "Taxation Primer", 2019 edition, author: CPA Canada, p.39-41.

January 2020

44. What is the General tax rate and the General rate reduction?

JERRED FLYNN

What is the Basic Corporate Rate?

The Basic Corporate Rate is the base tax rate that applies to businesses in Canada. This is a permanent rate, which is then altered by other devices: the Small Business Deduction, the Additional Refundable Tax, and the General Rate Reduction to get your overall corporate tax rate for each type of income. The Basic Corporate Rate is 38%, as of 2022 (ITA 123. (1)(a)).

What is the General Rate Reduction?

The General Rate Reduction (GRR) is applied to Active Business Income not eligible for either the Small Business Deduction or the Additional Refundable Tax. At its core, it is designed to incentivize businesses to focus on generating Active Business Income rather than Investment Income, since the GRR does not apply to Aggregate Investment Income.

How Does It Work?

In short, income that is neither Aggregate Investment Income (which has the Additional Refundable Tax applied to it) nor claimed under the SBD is eligible for the GRR. As of 2022, the GRR is a 13% reduction of the Basic Corporate Rate (ITA 123.4). This is a number that is subject to change periodically, to increase or decrease the income tax that corporations pay.

For example, a new board game design and development company, Game Heretics Designs, has Taxable Income of $50,000. Contained in that Taxable Income is $7,500 of investment income. Additionally, only $20,000 of the income earned is eligible for the Small Business Deduction, as their associated manufacturing company claimed most of the Business Limit. With these conditions, their tax formula would look like the following (assuming all their income was earned in Canada):

	Passive Investment Income	Active Business Income eligible for SBD	Active Business Income Ineligible for SBD	Total Tax Owing
Basic Tax Rate	38% * $7,500	38% * $20,000	38% * $22,500	$19,000
Provincial Abatement	(10%) * $7,500	(10%) * $20,000	(10%) * $22,500	($5,000)
SBD	N/A	(19%) * $20,000	N/A	($3,800)
ART	10.7% * $7,500	N/A	N/A	$802.50
GRR	N/A	N/A	(13%) * $22,500	($2,925)
Effective Tax Rate/Tax Owing	38.7% * $7,500 =$2,902.50	9% * $20,000 =$1,800	15% * $22,500 =$3,375	$2,902.50 +1,800 +3,375 $8,077.50

As this example illustrates, the ability of the government to adjust the functional tax rate by adjusting the General Rate Reduction is much more effective than adjusting the Basic Tax Rate, since doing so would require them to adjust the Small Business Deduction, Provincial Abatements, Additional Refundable Tax, *and* the General Rate Reduction to ensure that the preference given to Active Business Income earned in Canada remains intact. This is also important for public corporations, as their **entire** income earned in Canada is taxed at the same functional rate as a CCPC's active business income which is ineligible for SBD (i.e. the 15% GRR rate as of 2022).

Note that as the M&P deduction rate (13%) is the same as the GRR (13%) we typically don't worry about the M&P rate in this course as the tax payable amount would be the same under either method.

Interactive content (Author: David Ren, January 2020)

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https://kpu.pressbooks.pub/intercdntax/?p=310#h5p-132

References: ITA 123.4(1) "General Rate Reduction Percentage", 123.4(2)

January 2020

45. How is a 'permanent establishment' determined and how does it impact the provincial abatement?

ANEESH DHAUMYA

The permanent establishment of a corporation is usually a fixed place of business in a province or territory. This can include an office, branch, oil well, farm, timberland, factory, workshop, warehouse, or mine. Sometimes the corporation does not have a fixed place of business. In this case, the permanent establishment is the place in which the corporation conducts business the most.

If the corporation conducts business through an employee or an agent who is established in a particular place, it is considered to have a permanent establishment in that place if the employee or agent can contract for the corporation, or regularly fills orders received on merchandise owned by the corporation.

A corporation is eligible for the 10% federal tax abatement on income that is earned within Canada. This federal abatement is intended to reduce your federal tax and provide room for provincial taxation. As a result, income earned outside Canada is not eligible for this abatement.

If the corporation has permanent establishments in more than one province or territory, the corporation's allocation of taxable income is calculated by first calculating the percentage of revenue incurred in one province or territory relative to the total revenue earned by the corporation, then adding this number to the percentage of salaries and wages incurred in the same province or territory relative to the total salaries and wages incurred by the corporation, and then dividing the sum of both numbers by two. The result is the percentage that is used to allocate the total taxable income to that province or territory. After repeating this process for every province or territory the corporation has a permanent establishment in, the taxable income of the corporation should be proportionately allocated to every province or territory that is appropriate. The total taxable income earned in provinces and territories is subject to the 10% abatement, which is a deduction on the corporation's tax payable.

For example, suppose Fake Business Limited has permanent establishments in BC, Alberta, and California, and the company has taxable income of $150,000. The company's taxable income would be attributed to each province as follows

	Gross Revenue($)	Gross Revenue(%)	Salaries ($)	Salaries (%)	Average %
BC	$ 250,000	33.8%	$ 75,000	35.7%	(33.8% + 35.7%) / 2 = 34.75%
Alberta	$ 315,000	42.6%	$ 85,000	40.5%	(42.6% + 40.5%) / 2 = 41.55%
Subtotal	$ 565,000	76.4%	$ 160,000	76.2%	(76.4% + 76.2%) / 2 = 76.3%
California	$ 175,000	23.6%	$ 50,000	23.8%	
Total	$ 740,000	100%	$ 210,000	100%	

The taxable income of $150,000 is then allocated as follows:

BC: 34.75% of $150,000 = $ 52,125

Alberta: 41.55% of $150,000 = $ 62,325

Total taxable income earned in a province or territory = $ 114,450

The abatement is calculated as $114,450 x 10% = $11,445, and the remaining $35,550 (i.e., $150,000 – $114,450) of taxable income is not eligible for the abatement because this income was not earned in a province or territory in Canada.

Alternative calculation:

Another option is to change the abatement rate rather than the taxable income. In the example above 76.3% of the taxable income will be allocated to provinces in Canada. Therefore you can calculate the abatement as follows:

10% fed abatement X 76.3% = 7.63% adjusted federal abatement

7.63% adjusted fed abatement X $150,000 TI = $11,445

Interactive content (Author: Gurkaran Sidhu, January 2020)

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Interactive content (Author: Gurleen Kaur, January 2020)

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https://kpu.pressbooks.pub/intercdntax/?p=689#h5p-135

References and Resources:

- Article – "T2 Corporation – Income Tax Guide – Chapter 8: Page 8 of the T2 return" (Author: Government of Canada)
- Article – "T2 Corporation – Income Tax Guide – Chapter 7: Page 7 of the T2 return" (Author: Government of Canada)

January 2020

46. What is the Small Business Deduction and how is it determined?

PUNEET BERING

Small Business Deduction ITA 125

Small business deduction (SBD) ITA 125 (1.1) is referred to a reduction in tax which is payable by a Canadian controlled private corporation in a taxation year.

SBD is equal to SBD rate of (19%) for the taxation year multiplied by lessor of:

1. active business income of the corporation in Canada (excluding certain income and exceeding certain losses) – **ITA 125(1)(a)(i)**
2. taxable income of the corporation for the year less estimated foreign income (see below for details) – **ITA 125(1)(b)**
3. business limit of the corporation for the year – **ITA 125(1)(c)**

Taxable income less foreign income – ITA 125 (1)(b) – The foreign income calculation in this formula is based on the foreign tax credit rather than the actual foreign income and changes depending on whether the foreign income is business related as follows:

- – foreign income is estimated at 100/28 of the foreign tax credit for foreign non-business income
- – foreign income is estimated at 4 X the foreign tax credit for foreign business income

Business limit ITA 125(2) for a corporation is $500,000 for a taxation year unless it is associated with another CCPC. If a CCPC is associated with one or more corporations in a taxation year, then the business limit can be split amongst the associated corporations. CCPC's can assign all or a part of their business limit to another CCPC for a taxation year.

Business Limit Reduction ITA 125 (5.1) A CCPC's business limit is reduced by the greater of taxable capital business limit reduction and passive income business limit reduction.

Taxable capital business limit reduction – Large CCPC's with more than $15M do not qualify for SBD. The business limit is reduced on a straight-line basis for corporations that have taxable capital between $10M to $15M in previous years.

Passive income business limit reduction – A CCPC's business limit is reduced if the corporation or any other associated corporation combined earn $50,000 to $150,000 from passive investments.

References and Resources:

- ITA – 125
- Article – "Small business deduction rules" (Author: Government of Canada)
- Article – "T2 Corporation – Income Tax Guide – Chapter 4: Page 4 of the T2 return" (Author: Government of Canada)

47. What are the associated company rules? How do they impact the small business deduction? Why do they exist?

AMANEET DHUDWAL

Associated Companies:

The $500,000 business limit must be shared amongst associated CCPC's. If this rule did not exist, then corporations would max their small business deduction (SBD) limit at $500,000 then open and transfer excess active business income into another corporation and max their SBD deduction there.

One corporation is associated with another in a taxation year if: (ITA 256(1))

- One of the corporations is controlled indirectly or directly by the other corporation – ITA 256(1)(a)
- Both of the corporations were controlled indirectly or directly by the same person or group of persons – ITA 256(1)(b)
- Each of the corporations were controlled indirectly or directly by a person; and the person who controlled one of the corporations was related to the person who controlled the other; and one of them has to own at least 25% of the shares of each corporation – ITA 256(1)(c)
- One of the corporations were controlled indirectly or directly by a person; and that person was related to each member of a group of persons that controlled the other corporation; and that person owns at least 25% of the shares of the other corporation – ITA 256(1)(d)
- Each of the corporations was controlled indirectly or directly by a related group; and each member of one of the groups was related to all the other members of the other group; and one or more persons who are members of both related groups (either alone or together) own at least 25% of the shares of each corporation – ITA 256(1)(e)

These rules are put into place to prevent companies from taking advantage of the small business deduction.

Example 1: If associated company rules did not exist:

Corporation X has $1,000,000. They would be able to use the maximum business limit of $500,000 with Corporation X and then set up a subsidiary corporation (ex. Corporation Y) and transfer up to half of their business ($500,000) to the subsidiary corporation to double-dip on the Small Business Deduction.

Illustration 1:

CORPORATION X
Amount: $1,000,000

Corporation X	Corporation Y
$500,000	$500,000

With the association rules, Corporation X and Y are associated (as Corp X directly control Corp Y) and must decide how they want to allocate the $500,000 Small Business Deduction limit. i.e. Corporation X could take $300,000 and Corporation Y could take $200,000. This can be shared however they like, but the total amount amongst the associated companies cannot exceed $500,000.

Interactive content (Author: Navjot Lalli, January 2020)

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https://kpu.pressbooks.pub/intercdntax/?p=696#h5p-138

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https://kpu.pressbooks.pub/intercdntax/?p=696#h5p-139

Interactive content (Author: Spencer Sin, January 2020)

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https://kpu.pressbooks.pub/intercdntax/?p=696#h5p-197

References and Resources:

- ITA – 256(1)

January 2020

48. What is a Small Business Corporation? Explain any tax advantages of being a Small Business Corporation.

MORGAN CAMPBELL

What is a Small Business Corporation?

According to ITA 248(1) a small business corporation (SBC) is essentially a corporation that is a Canadian Controlled Private Company (CCPC) that has all or substantially all (90% or more) of the fair market value of its assets engaged in:

- Being used to carry on active business (primarily) in Canada or by a related corporation
- Shares or debts of related corporations that used to be small business corporations
- A combination of the two

What is a Qualified Small Business Corporation?

It is important to note that while all Qualified Small Business Corporations (QSBC's) are SBC's not all SBC's are QSBC's. In order for small business corporation shares to be a QSBC they must satisfy all of the following criteria according to ITA 110.6(1):

- At the time the shares are sold, it was a share of the capital stock of a small business corporation and owned by the taxpayer or their spouse or common-law partner, or a partnership of which the taxpayer is a member.
- For 24 months before the share was sold it remained a share of a CCPC with primarily (50% or more) in active Canadian business and satisfies the requirements of being a Small Business Corporation.
- For 24 months before the share was sold, no one owned the share other than the taxpayer, or member of a partnership

What are the tax implications of being a Small Business Corporation (particularly how does it tie into Business Investment Losses and the Lifetime Capital Gains Exemption)?

Having a business that meets the criteria of a small business corporation can present several desirable tax advantages.

One of the most apparent is the Lifetime Capital Gains Exemption. This permits the sale of shares in an applicable company tax free, for up to $850,000. However, it is important to note that according to ITA 80.03(8) a corporation MUST meet the criteria of a qualified small business corporation in order to receive this exemption.

Another advantage for owners of small business corporation is business investment losses. For example, if an owner sells shares of his small business corporation at a loss (at arm's length) a business investment loss is created. Half of that loss qualifies as an allowable business investment loss (ABIL). As opposed to an allowable capital loss an ABIL can be deducted against ANY sources of income, for the taxpayer.

Interactive content (Author: Shelley Lavigne, January 2020)

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https://kpu.pressbooks.pub/intercdntax/?p=318#h5p-140

References and Resources:

- ITA 80.03(8), 248(1), 110.6(1)
- "Definitions for capital gains deduction" (Author: Government of Canada)
- "Canada: Qualified Small Business Corporation and Lifetime Capital Gains Exemption" (Author: Mondaq)
- "Income Tax Folio S4-F8-C1, Business Investment Losses" (Author: Government of Canada)

49. Part I corporate tax - the 'lesser of' calculations

SAM NEWTON

When calculating Part I and Part IV tax you will encounter a series of 'lesser of' calculations. Here is a quick walkthrough of the basic elements of these calculations (Note, these are simplified, refer to the ITA for further details):

Small Business Deduction (SBD) is 19% of the <u>lesser of</u> the following:

- Canadian Active Business Income – 125(1)(a)
- Taxable Income less taxed foreign income – 125(1)(b)
- The corporation's business limit for the year – 125(1)(c)

Additional Refundable Tax (ART) is 10 2/3% of the <u>lesser of</u> the following:

- Aggregate Investment Income – 123.3(a)
- Taxable income less the amount eligible for the SBD – 123.3(b)

General Rate Reduction (GRR)

Although not a 'lesser of' calculation, it is important to understand that the GRR (13%) will typically be applied to taxable income not impacted by the SBD or ART. i.e. you would take your taxable income and deduct the amount eligible for the SBD and ART, the remaining amount would be eligible for the GRR.

Foreign Tax Credits (FTC)

The foreign tax credit calculations are complicated, and you are encouraged to review ITA 126(1) and (2) for further details. The basic calculations, however, are as follows:

- Business FTC is the <u>lesser of</u>
  - Foreign income tax paid on foreign business income – 126(2)(a)
  - Tax that would be ("otherwise") payable in Canada on that foreign business income – 126(2)(b) & 126(2.1)
  - Basic federal tax less the GRR – 126(2)(c)

- Non-Business FTC is the <u>lesser of</u>

- Foreign income tax paid on foreign non-business income – 126(1)(a)
- Tax that would be ("otherwise") payable in Canada on that foreign non-business income – 126(1)(b)

Here is a brief video walkthrough of these calculations
https://youtu.be/fJYNCit-RDA
March, 2020

PART VII

CORPORATE TAXATION OF PASSIVE AND INVESTMENT INCOME

50. What is the Additional Tax on Personal Services Business Income and How is it Determined? Why does this Additional Tax Exist?

LOVY GILL

The Personal Services Business income rules are intended to prevent employees (or at least limit any tax benefits) from ceasing their employment, incorporating and then providing the same services back to their former employer through an incorporated company.

Personal services business income is taxed at the full corporate rate plus an additional 5% surtax. This income is not eligible for the Small Business Deduction or the General Rate Reduction. According to ITA 125(7), a corporation falls under a personal services business if it meets the following criteria:

- Income is earned through services provided by an individual on behalf of the incorporated employee.
- An individual who provides services on behalf of the corporation, or any person related to the incorporated employee, is a shareholder of the corporation.
- Does not hire more than five full-time employees throughout the year.
- "The services of the corporation are not being provided to an associated corporation." (BDO, 2018)
- Incorporated employee is regarded as an officer/employee of the person to who the services are provided.

To be classified as a personal services business is not a favourable outcome for tax purposes. As mentioned earlier, a personal services business is not eligible for the small business deduction or the general rate reduction to 13% and, in fact, gets an additional 5% surtax.

Furthermore, under ITA 18(1)(p), deductions for a personal services business are severely limited to the wages and benefits to the "incorporated employee" and similar costs that would be deductible if that individual had remained a regular employee. Ultimately, the ITA says "fine, you incorporated, but you are going to be taxed at a really high rate on your income and you aren't going to have access to many business deductions"

Interactive content (Author: Puneet Tugnait, January 2020)

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> *https://kpu.pressbooks.pub/intercdntax/?p=722#h5p-143*

References and Resources:

- ITA 123.5, ITA 18(1), 18(1)(p), & 125(7)
- Article – PSB Rules Case Study (Author: BDO)

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51. What is the Additional Refundable Tax and how is it determined? Why does it exist?

MANU GREWAL

The Additional Refundable Tax (ART) is a refundable tax on the investment income of a Canadian Controlled Private Corporation (CCPC). The ART was introduced to ensure that federal/provincial tax on investment income was high enough to discourage the use of corporations to save taxes on passive income. Basically, the government would like excess income to be flushed out to shareholders or reinvested in business activities rather than sitting passively in a corporation.

To successfully discourage the use of corporations to save taxes on passive income, the combined tax rate for corporations had to be higher (at least temporarily, before dividend refunds) than the rate applicable to high net worth individuals.

Per ITA 123.3, the ART is calculated as 10 2/3% of the lesser of:

- Corporations "aggregate investment income" for the year
- The amount, if any, by which the corporations Taxable Income for the year exceeds the amount that is eligible for the Small Business Deduction.

The ART becomes part of the Refundable Dividend Tax on Hand balance (to be discussed later in this book) and is refunded to the corporation when sufficient dividends have been paid out. So, in many ways, the ART is a temporary tax intended to encourage corporations to pay out excess funds to shareholders.

Interactive content (Author: Karshigul Turdimuradova, January 2020)

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https://kpu.pressbooks.pub/intercdntax/?p=728#h5p-145

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Interactive content (Author: Rachel Magdanz, January 2020)

An interactive H5P element has been excluded from this version of the text. You can view it online here:
https://kpu.pressbooks.pub/intercdntax/?p=728#h5p-147

References and Resources:

- Article – "T2 Corporation – Income Tax Guide – Chapter 7: Page 8 of the T2 return" (Author: Government of Canada)
- "Canadian Tax Principles", 2016-2017 edition, authors: Byrd and Chen, publisher: Pearson, p. 608-609.
- ITA 123.3

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52. What is the Refundable Part IV tax and how is it determined? Why does it exist?

PAUL JHAJJ

Refundable Part IV tax applies to certain dividends received by private corporations in Canada. It is intended to prevent some corporate tax deferral opportunities as well as addressing double taxation problems that might occur when dividends are paid from corporation to corporation. It even ties into the overall tax concept of integration. The refundable part IV tax is calculated as follows ITA 186(1):

- Dividends Received from "portfolio dividends" from non-connected corporations (own less than 10% of voting shares): Part IV tax equals 38 1/3% of the total dividend received.
- Dividends received from connected corporations (own more than 10% of voting shares): Part IV tax equals the recipient's ownership % of the payor corporation x the dividend refund received by the payor corporations

Example: Opal Ltd., a Canadian controlled private corporation, received the following amounts of dividends during the year ending December 31, 2020

- Dividends on Various Portfolio Investments: $14,000
- Dividends on Emerald Inc: $41,500
- Dividends From Ruby Inc: $18,000

Opal Ltd. Owns 100 percent of the voting shares of Emerald Inc. and 30 percent of the voting shares of Ruby Inc. (which approximates the fair value of Opal's ownership as well). As a result of paying the $60,000 dividend, Ruby Inc. received a dividend refund of $15,000. Emerald Inc. received no dividend refund for its dividend payment.

How much Part IV Tax must Opal Ltd. pay as a result of receiving these dividends?

Solution:

The amount of Part IV Tax Payable would be calculated as follows:

- Tax On Portfolio Investments [38 1/3%) ($14,000)] $5,367
- Tax on Emerald Inc. Dividends $Nil

- Tax On Ruby Inc. Dividends [(30%) (15,000)] $4,500
- Part IV Tax Payable $9,867

Interactive content (Author: Vick Manak, January 2020)

> *An interactive H5P element has been excluded from this version of the text. You can view it online here:*
> *https://kpu.pressbooks.pub/intercdntax/?p=734#h5p-149*

Interactive content (Author: Everret Wilson, January 2020)

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> *https://kpu.pressbooks.pub/intercdntax/?p=734#h5p-148*

January 2020

53. What is RDTOH? How is it determined? Why does it exist?

NATASHA PLAMONDON

Refundable dividend tax on hand (RDTOH) is a way for corporations to be able to keep track of the taxes that will be eligible for a refund on the dividends. The Eligible and Non-Eligible RDTOH accounts, which show the amount available for refund at the end of the year, are tracked separately as follows:

TO CALCULATE AVAILABLE RDTOH:

	129(4) "Eligible Refundable Dividend Tax on Hand"		129(4) "Non-Eligible Refundable Dividend Tax on Hand"
1.	RDTOH opening balance	1.	RDTOH opening balance
2.	LESS: Eligible Dividend refund from the prior year	2.	LESS: Non-Eligible Dividend refund from the prior year
3.	ADD: Part IV tax paid on eligible dividends received	3.	ADD: Refundable Part I Tax: Lessor of:
			– 30 2/3% of Aggregate Investment Income
			– 30 2/3% X (Taxable Income minus Small Business Deduction etc.)
			– Part I Tax Payable
		4.	ADD: Part IV tax paid on non-eligible dividends received.

When your corporation subsequently pays out dividends, you can claim a dividend refund at the lessor of:

- – 38 1/3% of the dividend paid
- – The RDTOH balance available for that type of dividend.

Example:

Aloha Inc. is a Canadian Controlled Private Corporation with a December 31 year-end. With the information below find Aloha's 2020 non-eligible RDTOH closing balance and their dividend refund:

- RDTOH balance on December 31, 2019: $29,000
- Air rewards Ltd. non-eligible dividends received (not connected): $16,000
- 2019 dividend refund: $4,500
- Taxable income: $29,500
- Dividend paid: $9,000
- Part I tax payable: $5,450
- Aggregate investment income: $14,250
- Small business deduction: $10,750

Solution:

Aloha Non-Eligible RDTOH			
Dec 31, 2019, RDTOH Balance			$29,000
LESS: 2019 Dividend refund			($4,500)
ADD: Refundable Part I Tax: Lessor of:			
– 30 2/3% of Aggregate Investment Income	30 2/3% X $14,250	$4,370	
– 30 2/3% X (Taxable Income minus Small Business Deduction etc.)	30 2/3% X ($29,500 – $10,750)	$5,750	
– Part I Tax Payable		$5,450	$4,370
ADD: Part IV Tax Payable:			
	38 1/3% x $16,000		<u>$6,133</u>
RDTOH Dec 31, 2020, Balance			**$35,003**

Dividend Refund:

Lessor of			
– 38 1/3% of Non-eligible dividends paid	38 1/3% X $9,000	$3,450	
– RDTOH balance		$35,003	
Dividend Refund			**$3,450**

There is a YouTube video on RDTOH that does a great job on explaining this topic if you are having any trouble:

https://www.youtube.com/watch?v=Pp6T4BoFefw

Interactive content (Author: Gurpal Yadav, January 2020)

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Interactive content (Author: Rumabel Mateo, January 2020)

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https://kpu.pressbooks.pub/intercdntax/?p=744#h5p-151

References:

- ITA 129(4)
- https://htkacademy.com/refundable-taxes-part-i-refundable-tax-part-iv-refundable-tax-refundable-dividend-tax-on-hand-rdtoh-dividend-refund/

54. How do the various corporate tax rates tie into the concept of integration?

CHANPREET KANG

The idea behind integration is that regardless of how you earn your income (through a corporation or directly) the ultimate amount of after tax cash should be the same. This should be true regardless of whether a corporation earns active or passive income or pays out eligible, non-eligible or capital dividends. This is illustrated below:

Eligible Dividend		**Non-Eligible Dividend**		**Capital Dividend**	
Income	$2,000.0	Income	$2,000.0	Income	$2,000.0
Tax Rate (27.54%)	$ 550.8	Tax Rate (13.79%)	$ 275.8	Tax Rate (0%)	
Net Income	$1,449.2	Net Income	$1,724.2	Net Income	$2,000.0
Cash Dividend Received	$1,449.2	Cash Dividend Received	$1,724.2	Cash Dividend Received	$2,000.0
Gross Up(138%)	$2,000.0	Gross Up(116%)	$2,000.0	Gross Up(0%)	
Personal Tax Rate(15%)	$ 300.0	Personal Tax Rate(15%)	$ 300.0	Personal Tax Rate(0%)	$ -
Dividend Tax Credit	$ 550.8	Dividend Tax Credit	$ 275.8	Dividend Tax Credit	$ -
Cash After Tax	$1,700.0	Cash After Tax	$1,700.0	Cash After Tax	$2,000.0
Employment Income					
Income	$2,000.0				
Personal Tax Rate(15%)	$ 300.0				
Cash After Tax	$1,700.0				

Note: There is a minor mathematical issue in the non-eligible dividend portion of the table above. The corporate tax rate should be slightly lower, the gross up should be 115% rather than 116% and the dividend tax credit would be slightly lower.

This figure shows that you end up with the same amount of after tax cash (for a given income type) regardless of whether it was earned directly or received through corporate dividends. This applies to capital dividends as well as they are flowed through tax free to the shareholder (to represent the tax free portion of capital gains).

Passive or aggregate investment income is taxed very differently compared to the other forms of income. It is taxed at a very high rate and a large amount of this tax goes into the non-eligible RDTOH account. Ultimately this amount is refunded to the corporation when they subsequently pay out non-eligible dividends. The tax rate on aggregate investment income less the dividend refund (when dividends are subsequently paid out) bring the net amount of tax paid on AII to an amount similar to Active Business Income eligible for the Small Business Deduction. For this reason, AII creates non-eligible dividends even though it is initially taxed at a very high rate.

Interactive content (Author: Alicia Mitchell, January 2020)

An interactive H5P element has been excluded from this version of the text. You can view it online here:
https://kpu.pressbooks.pub/intercdntax/?p=892#h5p-153

References and Resources:

- Article – taxable amount of dividends (eligible and other than eligible) from taxable Canadian corporations, (Author: Government of Canada)
- Article – Income Tax Folio S3-F2-C1, Capital Dividends, (Author: Government of Canada)
- Article – Federal Dividend Tax Credit, (Author: Government of Canada)
- Article – T2 Corporation – Income Tax Guide – Chapter 7: Page 8 of the T2 return (Author: Government of Canada)

January 2020

55. How are capital dividends treated for tax purposes? How does this tie into the concept of integration?

GURLEEN KAUR

The Capital Dividends are tax-free dividends that are paid out to the shareholders of the corporation as a form of return on investment. The tax-free surpluses of the corporations are accumulated in the capital dividend account (CDA). The balance in CDA is also increased by Capital dividends received.

A corporation can issue capital dividends up to the amount in the capital dividend account. For example, Breeze Co. has a capital gain of $52,000. One-half of this gain would be a taxable capital gain i.e. $52,000 x 50%= $26,000, and the other half ($26,000) is the non-taxable portion of the capital gain which goes into the CDA account.

Capital Dividends and Integration:

The goal of tax integration is that an individual should have the same amount of after-tax cash regardless of whether the income was earned directly or through a corporation. Since capital dividends are tax-free dividends, the tax rate at the corporate level and individual level is the same (i.e. they are tax free).

The table below illustrates the concept of tax-free dividends tied with integration. For Breeze Co., half of the capital gain i.e. the non-taxable portion, is paid out to the corporation's shareholders tax-free resulting in the pre-tax earnings amount to be the same as the post-tax amount (at Corporate level). Similarly, at the individual level, since the capital dividends are paid out tax-free, when the dividends are received by the shareholders, both the pre-tax and post-tax amounts are the same. Hence, the net earnings paid out at the corporate level and individual level is the same, eliminating the problem of double taxation.

• Capital Dividends- Non-taxable portion of the capital gains which are paid out to the shareholders tax-free.	$52,000 X 50% =$26,000
CORPORATION	
Capital Dividend paid-out	$26,000
Less: Corporate Tax (Capital dividends are Tax-free)	$ –
Net earnings	$26,000
INDIVIDUAL SHAREHOLDER	
Capital Dividends received	$26,000
Less: Individual Income Tax (Capital dividends are Tax-free)	$ –
Net earnings	$26,000

So, in the example above, the shareholder would receive a capital dividend and after tax cash of $26,000 (on the non-taxable portion of the capital gain). This is the same amount of after tax cash the individual would have received if the taxable capital gain was taxed directly (and not through a corporation).

Interactive content (Author: Anthony Au, January 2020)

An interactive H5P element has been excluded from this version of the text. You can view it online here:
https://kpu.pressbooks.pub/intercdntax/?p=759#h5p-154

References and Resources:

- Article- "Income Tax Folio S3-F2-C1, Capital Dividends" (Author: Government of Canada)
- ITA 89(1) capital dividend account (a)

January 2020

56. How are foreign tax credits treated when calculating the tax payable of a corporation? Why does this treatment exist?

BALKARAN NIJJER AND PRAB BADYAL

According to ITA 126, any income tax paid to a foreign country's government by a corporation or individual (that was a resident in Canada anytime during the year) on business and non-business income, can be used to determine the amount to be claimed as a Foreign Tax Credit against income tax to be paid in Canada.

This treatment exists as a result of Canada having tax treaties with other countries to avoid double taxation and prevent tax evasion. If this treatment did not exist, the taxpayer would have to pay full tax to both Canada and the other country. For example, a corporation that has a residence in Canada but also paid income tax in the USA will avoid being double-taxed when they claim this credit on their Canadian tax return. The foreign tax credits are calculated as follows:

Foreign Non-Business Income Tax Credit

Is the lesser of :

- Foreign non-business income tax paid (on foreign non-business income); and
- (Foreign non-business income/Adjusted Division B Income) X tax otherwise payable.
    - The 2nd calculation is estimating the amount of tax you would pay in Canada on the foreign income.

Foreign Business Income Tax credit

Is the least of:

- Foreign business income tax paid (on foreign business income) ; or
- (Foreign business income/Adjusted Division B Income) X tax otherwise payable (basic corporate amount less general rate reduction) ; or
- Tax otherwise payable (above) less foreign non-business income tax credit taken.

Example: Foreign Non-Business Income Tax Credit Calculation

In the year 2020, Singh International Corp. has Net Income for Tax Purposes of $120,000 of which $84,000 is foreign non-business income. The corporation paid the US government $26,000 in taxes. The corporation's Canadian tax otherwise payable is $35,000.

The amount for the Foreign Tax Credit would be the *lesser of*:

1. (Foreign Non-Business Income/Adjusted Division B Income) x Tax Otherwise Payable.= ($84,000 / $120,000) x $35,000 = $24,500

Or

2. Foreign Non-Business Income Tax Paid (on Foreign Non-Business Income) = $26,000

The Foreign Non-Business Income Tax Credit would be the lesser of $24,500 and $26,000. Therefore, the Foreign Non-Business Income Tax Credit would be $24,500.

Interactive content (Author: Prab Badyal, January 2020)

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Interactive content (Author: Bal Nijjer, January 2020)

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https://kpu.pressbooks.pub/intercdntax/?p=336#h5p-176

References and Resources:

- IT Folio S5-F2-C1
- ITA 126(1),126(2)
- Article – "Foreign Tax Credit" (Author: Government of Canada)

- Article – "Canada's Foreign Income Tax Credit" (Author: Turbo Tax Canada)
- Article – "Tax treaties" (Author: Government of Canada)
- Article – "Income Tax Folio S5-F2-C1, Foreign Tax Credit" (Author: Government of Canada)

January 2020

PART VIII

OWNER MANAGER REMUNERATION & PURCHASE (SALE) OF A BUSINESS

57. As an owner of a company, when is it beneficial to claim employment income (salary) rather than dividends (and vice versa)?

NAVJOT LALLI

In chapter 2, we learned the theory of integration. However, perfect integration rarely exists due to different provincial personal and corporate tax rates as well as differing tax credits. Therefore, as an owner of a company you can choose the most tax-efficient type of remuneration for you and your company. To determine which remuneration is most beneficial, calculate both the corporation's and owner-manager's after-tax position using the appropriate provincial tax rates and credits and compare the two accordingly.

Note, the tax rates and dividend tax credits for BC and Ontario – in the following examples – are intended to be illustrative (to show how the various provincial tax rates can impact salary vs. dividend decisions) and are not necessarily intended to accurately reflect the actual tax rates in those provinces. Also, we are ignoring some elements (like CPP and most personal tax credits) to focus on the key salary vs dividend concepts.

Table 1 illustrates the outcome of paying an owner-manager a salary or dividend income of $100,000 from a small CCPC that generated $300,000 in active business income.

Table 1: Corporation's after-tax position (2019 rates)

	British Columbia		Ontario	
	Salary	**Dividend**	**Salary**	**Dividend**
Active business income	$300,000	$300,000	$300,000	$300,000
Less: Salary & CPP	(100,000)	–	(100,000)	–
Corporate taxable income	200,000	300,000	200,000	300,000
Less: Corporate tax (11% in BC and 12.5% in Ontario)	(22,000)	(33,000)	(25,000)	(37,500)
Less: Dividend to shareholder (Non-eligible dividend)	–	(100,000)	–	(100,000)
Retained earnings	$178,000	$167,000	$175,000	$162,500

Table 2 illustrates the owner-manager's after-tax position from the scenario above. Here, dividend income results in greater net income for the owner-manager but receiving dividend income does not allow the owner to contribute into CPP or build RRSP contribution room.

Table 2: Owner-manager's after-tax position (2019 rates)

	British Columbia		Ontario	
	Salary	Dividend	Salary	Dividend
Salary	$100,000	–	$100,000	–
Non-eligible dividends	–	$100,000	–	$100,000
Non-eligible dividend gross-up (1.15)	–	15,000	–	15,000
Taxable income	100,000	115,000	100,000	115,000
Less: Income tax (22.6% avg in BC and 23.6% avg in Ont)	(22,600)	(25,990)	(23,600)	(27,140)
Dividend Tax Credit – In this example Ontario has a better DTC than BC. Note, other personal tax credits have been ignored.		14,500		15,500
After tax cash (Cash dividend – tax + dividend tax credit)	$77,400	$88,510	$76,400	$88,360

Table 3 illustrates a summary of both the corporation's and owner-manager's after-tax position. Ultimately, receiving employment income provides slightly greater total earnings than dividend income in both provinces, but this will not always be the case due to differing provincial tax rates and credits.

Table 3: Summary of corporation's and owner-manager's after-tax position

	British Columbia		Ontario	
	Salary	Dividend	Salary	Dividend
Corporate retained earnings	$178,000	$167,000	$175,000	$162,500
Owner-manager's after tax cash	77,400	88,510	76,400	88,360
Total earning and after tax cash	$255,400	$255,510	$251,400	$250,860

So, in these examples there are more retained earnings (and cash) within the corporation by paying out salaries and more after tax cash in the hands of the individual by paying out dividends. This is a very simplified example, if you were doing tax planning with your client you would need to consider the specific after tax cash needs, the specific tax rates and dividend tax credits for your province, personal tax credits available etc.

Interactive content (Author: Saundarya Pradhan, January 2020)

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https://kpu.pressbooks.pub/intercdntax/?p=765#h5p-191

January 2020

58. What are the Shareholder Loan Rules and Why do They Exist?

SHELLEY LAVIGNE

Shareholder Loans are debts owed to corporations from shareholder employees or partners. Normally, any amount received from a corporation to a shareholder is added to the shareholder's income and taxed. Shareholder loans are different because they have potential for being paid back so they aren't necessarily brought into income. This benefit is enticing, particularly for owner-managers of a corporation who want tax-free personal advances, so rules are in place to ensure shareholder loans are taxed appropriately.

General Rule A loan to a shareholder (other than a corporation that is a shareholder), as defined in ITA 15(2), will be included in income unless one of the exceptions in ITA 15(2.2) to (2.6) are met.

Exception	Criteria	Why
Loans between non-residents ITA 15(2.2)	If the corporation and shareholder are both non-residents, the loan is not included in income under 15(2)	There is no tax liability for debts between non-residents, so the income inclusion is not necessary.
Loan given to a non-specified employee ITA 15(2.4)	If the shareholder is an employee and owns less than 10% of the corporation's shares or deals at arms length, this is considered a non-specified employee and the loan is not included in income under 15(2).	In this case the assumption is that the loan was received by virtue of employment rather than shareholdings.
Loans are given as normal business transaction ITA 15(2.3)	Corporations that provide loans as a business (for example, a bank) are exempt under ITA 15(2.3)	In this case the assumption is that the loan was received by virtue of the company's normal business practices rather than the shareholders ownership of the company
Repayment of the loan within one year after the year end ITA 15(2.6)	This rule allows loans which are repaid within a relatively short period of time to be exempt under ITA 15(2.6). Receipt and repayment of a series of loans is not allowed.	This rule allows normal short term loans to be exempt from the income inclusion. This rule prevents numerous loans being taken and paid by borrowers without any tax paid.

If the exemptions are not met, the loan is included in the shareholders income in the year received and subsequent repayments are deducted from the shareholders income in the year of repayment.

Imputed Interest Benefit – ITA 80.4(2) – may apply when your loan is not brought into income due to one of the exceptions listed above from ITA 15(2). In this case, that individual could be granted a benefit if the loan is issued below the prescribed rate. The benefit is calculated as follows:

(Amount of Loan x Prescribed Interest Rate) – Amount of Interest Paid in Year

Refer to Article-"Example of Calculating the Taxable Benefit" (author: Government of Canada) for a helpful example on how to calculate this benefit.

References:

- ITA 15(2), IT-119R4

January 2020

59. What are the tax implications of some compensation alternatives (stock options, bonuses, fringe benefits)?

LIANGJIAN LIN

Here is a summary of some other common compensation alternatives.

Stock Options – ITA 7(1), 110(1)(d)

- Public company – Income inclusion when options are exercised
- CCPC (Canadian controlled private corporations) – Income inclusion when acquired shares are sold

Employee can claim a one-half deduction of the taxable benefit if the conditions are met:

- When the option is issued, the option price >= market price; or
- If CCPC – Available if shares held for two years without regard to option price.

Bonuses – 78(4), IT-109R2

For most bonuses, the recipient doesn't have to include it in income until it is actually received. Here are some specific rules

- Standard bonus – Bonus is paid within 180 days of the business year end NOT from when the bonus was declared.
  - Deductible to the business when declared
  - included in the taxpayer's income when received.
- Other bonus – Bonus is paid more than 180 days after employer's year end but prior to 3 years after December 31st of the year in which the bonus was earned
  - Deductible to the business when paid.
  - included in the taxpayer's income when received.
- Salary deferral arrangement – It is determined that the salary was earned in the year but just 'pushed back' to a subsequent period to defer taxes. Also applies to unpaid bonuses within 3 years after the year-end the service was provided.
  - Deductible to the business in the year declared.

- included in the taxpayer's income in the year declared.

Example: On July 25, 2019, Jones Ltd ("Jones") declares a bonus of $50,000 in favour of one of its employees. Jones has a December 31st fiscal year end and the bonus is paid on January 15th, 2020. As this is paid within 180 days of Jones fiscal year-end, the bonus is deductible to the corporation in 2019 (when it was declared) and taxable in the hands of the employee in 2020 (when it was received).

Fringe benefits

Fringe benefits are non-salary benefits given to employees for various purposes such as employee motivation and incentive to stay with the company. The general rule is that any benefit received during the year by virtue of your employment is a taxable benefit, unless the primary beneficiary is the employer rather than the employee (See ITA 5(1) and 6(1)(a)). There are numerous exceptions however, see Income Tax Folio S2-F3-C2 for a detailed discussion on this topic.

Interactive content (Author: Aneesh Dhaumya, January 2020)

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Interactive content (Author: Gurkaran Sidhu, January 2020)

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https://kpu.pressbooks.pub/intercdntax/?p=775#h5p-165

References and Resources:

- ITA – 6(1)(a), 7(1)

- [Article – "What is a security (stock) options taxable benefit" (Author: Government of Canada)]

January 2020

60. What are the pros and cons of selling the assets of a business vs selling the shares of the corporation?

RACHEL MAGDANZ

When selling a business, the owner has the option to choose between selling the assets of their business or selling the shares of their business. Generally, a buyer will prefer to buy the assets of a business, while the seller will prefer to sell the shares of the business. The following tables present each option in terms of its pros and cons for both the buyer and the seller:

Selling the Assets of a Business

	Seller	Buyer
Pros	– The owner has the freedom to set sale prices for assets as they desire.	– The buyer can purchase the specific assets they want.
	– This type of sale allows the owner to remain in legal control of the business.	– The buyer can record depreciated assets at an increased fair value.
	– Asset sales have the potential to incur a terminal loss which can be used to offset business income.	– Asset purchases protect the buyer from inheriting any liabilities of the existing business onto themselves.
Cons	– Asset sales have the potential to create a recapture of CCA, which must be included in income.	– The transaction for the purchase of assets can be complex and time-consuming. Assets must be reassigned to the new buyer, and if there are numerous assets to negotiate, this can be a lengthy process.
	– The seller loses out on the tax benefits available to them through the lifetime capital gains exemption.	

Selling the Shares of the Corporation

	Seller	Buyer
Pros	– If the corporation is eligible to use the lifetime capital gains exemption, then they can apply it to capital gains made on the sale of the business shares, as per ITA 80.03(8). The limit of the exemption for 2019 is $866,912 (the amount is indexed to inflation yearly). – Share sales are much simpler.	– Through a share purchase, the buyer becomes the owner of the entirety of the business, including all assets and liabilities. This transaction can be much simpler and more straightforward.
Cons	– The owner loses the legal control of the corporation.	– The buyer will inherit any past legal or tax liabilities of the corporation.

Interactive content (Author: Jaskirat Sihota, January 2020)

An interactive H5P element has been excluded from this version of the text. You can view it online here:
https://kpu.pressbooks.pub/intercdntax/?p=781#h5p-166

References and Resources:

- ITA – 80.03(8), 110.6(1)
- Article – "Example for the calculation of recapture of CCA and terminal loss" (Author: Government of Canada)
- Article – "What is the capital gains deduction limit?" (Author: Government of Canada)

January 2020

61. What are the tax implications of selling the assets of a business, winding up a corporation and distributing the profits to the shareholders?

VICK MANAK

The sale of the assets of a business and subsequent windup (closing) of the corporation can be broken into 3 steps:

- Sale of assets of the business.
    - Sell the assets of the business and record the tax implications (recapture, terminal loss, capital gains etc.).
    - Have the corporation file a tax return and pay tax on these amounts.
    - Settle any remaining liabilities.
    - Now the corporation should really only have cash, retained earning and share capital remaining. Time to close down the business and pay out the remaining cash to your shareholders.
- Distribution of remaining cash to shareholders
    - Deemed dividend equal to the funds available for distribution less the Paid Up Capital (PUC, the initial amount paid into the corporation for the shares). This amount is further reduced by any capital dividends to get the shareholder's taxable deemed dividend
- Calculation of the capital gain or loss
    - This is basically the difference between the PUC of the shares and the ACB of the shares. These amounts would only be different if the shares were purchased or sold by an individual after they were initially issued by the corporation.
        - PUC > ACB = Capital Gain
        - PUC < ACB = Capital Loss

Here are some terms you may find useful when addressing the windup of a corporation:

Capital gains or losses are the appreciation or depreciation of any capital positions in a corporation for each taxation year. (39(1))
Adjusted Cost Basis (ACB) is the cost of the property plus any additional expenses and investments of the financial asset for the investor, this is used to assess the amount of capital gains or losses. (ITA 54)
Paid Up Capital represents the cost of a corporations shares when they were initially issued. ACB will equal PUC if the shares have never been resold after initially being issued by the corporation.
A deemed dividend is a dividend paid out by a corporation while it is being wound-up, its paid in capital is reduced, its shares are cancelled by activity other than open market, or the paid in capital is increased without an increase in net assets or a decrease in liabilities. (84(1))

References and Resources:

- Income Tax Act Section 89(1),39(1),54,84(1),84(2)
- Article – "ARCHIVED – Meaning of "Winding-up"" (Author: Government of Canada)
- Article-Adjusted Cost Basis (Author: Government of Canada)

January 2020

62. What is the Lifetime Capital Gains Deduction? How does it impact Taxable Income and what are the basics of the calculation?

RUMABEL MATEO

The lifetime capital gains exemption (LCGE) is provided by Canada to encourage individuals who are residents of Canada to start small businesses (a great generator of income!)

The LCGE is used to offset capital gains that arise from the disposition of certain types of properties: qualified small business corporation shares (QSBC's), and qualified farm and fishing properties (QFFP). For this course, we will be focusing on QSBC's.

To qualify as a QSBC the following criteria must be met:

- The corporation must be a Small Business Corp (SBC) at the time of sale;
  - An SBC is a CCPC where all (or substantially all) of its assets are used to generate Active Business Income in Canada.
- The QSBC's shares must be owned by either the individual claiming the LCGE or a partnership, spouse, or common-law partner related to the individual during, and 24 months, preceding the determination time.
- The corporation must have been a CCPC for the 24-months prior to the sale;
- More than 50% of the fair value of the company's assets must have been used principally in the generation of Active Business Income carried on primarily (90% or more) in Canada.

As of 2019, the lifetime capital gains exemption is $866,912 (indexed to inflation). That means you could eliminate up to $866,912 of capital gains on the sale of QSBC shares. This potentially provides huge tax savings, so you want to make sure you understand when, how and to whom the LCGE would apply.

The calculation itself is fairly complex and is based on the lesser of the following three items:

- The unused lifetime deduction – The lifetime deduction is 50% of the exemption

(currently $866,912) less any amounts you have claimed as a deduction in prior years.
- The annual gains limit – This basically limits the amount of the Lifetime Capital Gains Deduction to the net taxable capital gain in 3(b) in a year. Note, this is a tricky calculation that looks at ABIL's and Net Capital Losses, for further details see ITA 110.6(1)
- Cumulative gains limit – This looks at prior year usage of the capital gains deduction and considers the Cumulative Net Investment Loss. This is another tricky calculation, see ITA 110.6(1) for details.

Here is the process you would follow to apply your Lifetime Capital Gains Deduction:

1. Determine if you are eligible for the lifetime capital gains exemption
2. Calculate the taxable capital gain on the sale of your QSBC
3. Calculate the Capital Gains Deduction (using the 'lesser of 3' items listed above)
4. Claim this amount as a Division 'C' deductions.

For example:

In 2019, you disposed of qualified small business corporation shares of $1,000,000 that you purchased for $100,000 in 2018. You are eligible for your first-time use of the lifetime capital gains exemption and have access to the full amount. To claim this deduction,

Step 1: Determine if you are a QSBC…we'll assume that is the case here.

Step 2: Determine the amount of the taxable capital gain in 3(b). In this case there is a $450,000 taxable capital gain (50% X ($1M – $100K).

Step 3: Determine the amount of the Lifetime Capital Gains Deduction. Will assume that it is 100% available and therefore the Lifetime Capital Gains Deduction is $433,456 ($866,912 X 50%)

Step 4: Claim your lifetime capital gains deduction of $433,456 as a division 'c' deduction to offset your taxable capital gain in S3(b).

Interactive content (Author: Rumabel Mateo, February 2020)

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https://kpu.pressbooks.pub/intercdntax/?p=790#h5p-179

References and resources:

- ITA 80.03(8)

- [Article — “The Lifetime Capital Gains Exemption” (Author: TurboTax Canada)]
- [Article — “What is the capital gains deduction limit?” (Author: Government of Canada)]

January 2020

63. What tax issues accompany the acquisition of control of a corporation?

ALICIA MITCHELL

In terms of definition, acquisition of control can be the change of control to a single person or a group of individuals. IT-302R3 defines control of a corporation as "ownership of such a number of shares as carries with it the right to a majority of the votes in the election of the board of directors."

Per the Income Tax Act section 249(4), the taxation year end is implemented or deemed to be immediately prior to the change of the acquisition of control. So, a tax return needs to be filed at this deemed year-end when there is a change in control.

The second issue comes from the Income Tax Act sections 111(5)(a) and 251.2(2). Previous non-capital losses from the corporation cannot be carried forward once the corporation ownership has been changed. This rule has two exceptions,

- There is an intention of making a profit as the business continues to operate.

» The losses carried forward must be used against income from the same business or another business with the same goods and services being sold, under the corporation.

- The loss can only be used to bring the profit of the corporation to $NIL for that particular tax year.

In addition to the change in control, per IT-302R3, "losses incurred after an acquisition of control cannot be carried back and deducted in a taxation year ending before control was acquired."

Per section 111(4)(a) and (b), net capital losses cannot be used by the acquirer regardless of the exceptions above.

For example, if majority shares of a corporation were taken over on January 20th the deemed year end would be the same date. Prior to January 20th, the corporation had net capital losses of $35,000 and non-capital losses of $15,000. As the acquirer has the intention of carrying on a similar business to make a profit, they are allowed to carry forward the $15,000 non-capital losses. The corporation has taxable income of $10,000 in the following year and was therefore able to use $10,000 non-capital losses to bring their taxable income to NIL.

Interactive content (Author: Loveleen Gill, January 2020)

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Interactive content (Author: Puneet Tugnait, January 2020)

An interactive H5P element has been excluded from this version of the text. You can view it online here:
https://kpu.pressbooks.pub/intercdntax/?p=793#h5p-175

References and Resources:

- Income Tax Act – 111(4)(a) & (b), 111(5)(a), 249(4), 251.2(2)
- Government form – "IT-302R3 – Losses of a Corporation" (Author: Government of Canada)

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