CHAPTER 1

TAXATION— ITS ROLE IN BUSINESS DECISION MAKING

Review Questions

1. If income tax is imposed after profits have been determined, why is taxation relevant to business decision making?

2. Most business decisions involve the evaluation of alternative courses of action. For example, a marketing manager may be responsible for choosing a strategy for establishing sales in new geographical territories. Briefly explain how the tax factor can be an integral part of this decision.

3. What are the fundamental variables of the income tax system that decision makers should be familiar with so that they can apply tax issues to their areas of responsibility?

4. What is an "after-tax" approach to decision making?
Solutions to Review Questions

R1-1 Once profit is determined, the amount of income tax that results is determined by the Income Tax Act. However, at all levels of management, alternative courses of action are evaluated and decided upon. In many cases, the choice of one alternative over the other may affect both the amount and the timing of future taxes on income generated from that activity. Therefore, the person making those decisions has a direct input into future after-tax cash flow. Obviously, decisions that reduce or postpone the payment of tax affect the ultimate return on investment and, in turn, the value of the enterprise. Including the tax variable as a part of the formal decision process will ultimately lead to improved after-tax cash flow.

R1-2 Expansion can be achieved in new geographic areas through direct selling, or by establishing a formal presence in the new territory with a branch office or a separate corporation. The new territories may also cross provincial or international boundaries. Provincial income tax rates vary amongst the provinces. The amount of income that is subject to tax in the new province will be different for each of the three alternatives mentioned above. For example, with direct selling none of the income is taxed in the new province, but with a separate corporation all of the income is taxed in the new province. Because the tax cost is different in each case, taxation is a relevant part of the decision and must be included in any cost-benefit analysis that compares the three alternatives [Reg 400-402.1].

R1-3 A basic understanding of the following variables will significantly strengthen a decision maker's ability to apply tax issues to their area of responsibility.

- Types of Income: Employment, business, property, capital gains
- Taxable Entities: Individuals, corporations, trusts
- Alternative Business Structures: Corporation, proprietorship, partnership, limited partnership, joint ventures, income trusts
- Tax Jurisdictions: Federal, provincial, foreign

R1-4 All cash flow, whether it relates to revenues, expenses, asset acquisitions or divestitures, or debt and equity restructuring, will have an impact on the amount and timing of the tax cost. Therefore, cash flow exists only on an after-tax basis and every decision necessarily has a tax impact whether or not the ultimate result of the decision is successful. An after-tax approach to decision-making requires each decision-maker to think "after-tax" for every decision at the time the decision is being made and to consider alternative courses of action to minimize the tax cost, in the same way that decisions are made regarding other types of costs.

Failure to apply an after-tax approach at the time decisions are made may result in a permanently inefficient tax structure, and provide inaccurate information for evaluation.
CHAPTER 2

FUNDAMENTALS OF TAX PLANNING

Review Questions

1. “Tax planning and tax avoidance mean the same thing.” Is this statement true? Explain.

2. What distinguishes tax evasion from tax avoidance and tax planning?

3. Does the Canada Revenue Agency deal with all tax avoidance activities in the same way? Explain.

4. The purpose of tax planning is to reduce or defer the tax costs associated with financial transactions. What are the general types of tax planning activities? Briefly explain how each of them may reduce or defer the tax cost.

5. “It is always better to pay tax later rather than sooner.” Is this statement true? Explain.

6. When corporate tax rates are 15% and tax rates for individuals are 40%, is it always better for the individual to transfer his or her business to a corporation?

7. “As long as all of the income tax rules are known, a tax plan can be developed with certainty.” Is this statement true? Explain.

8. What basic skills are required to develop a good tax plan?

9. An entrepreneur is developing a new business venture and is planning to raise equity capital from individual investors. Her advisor indicates that the venture could be structured as a corporation (i.e., shares are issued to the investors) or as a limited partnership (i.e., partnership units are sold). Both structures provide limited liability for the investors. Should the entrepreneur consider the tax positions of the individual investors? Explain. Without dealing with specific tax rules, what general tax factors should an investor consider before making an investment?

10. What is a tax avoidance transaction?

11. “If a transaction (or a series of transactions) that results in a tax benefit was not undertaken primarily for bona fide business, investment, or family purposes, the general anti-avoidance rule will apply and eliminate the tax benefit.” Is this statement true? Explain.
**Solutions to Review Questions**

R2-1 There is a distinction between tax planning and tax avoidance. Tax planning is the process of arranging financial transactions in a manner that reduces or defers the tax cost and that arrangement is clearly provided for in the *Income Tax Act* or is not specifically prohibited. In other words, the arrangement is chosen from a reasonably clear set of options within the Act.

In contrast, tax avoidance involves a transaction or series of transactions the main purpose of which is to avoid or reduce the tax otherwise payable. While each transaction in the process may be legal by itself, the series of transactions cause a result that was not intended by the system.

R2-2 Both tax planning and tax avoidance activities clearly present the full facts of each transaction, allowing them to be scrutinized by CRA. In comparison, tax evasion involves knowingly excluding or altering the facts with the intention to deceive. Failing to report an amount of revenue when it is known to exist or deducting a false expense are examples of tax evasion.

R2-3 CRA does not deal with all tax avoidance transactions in the same way. In general terms, CRA attempts to divide tax avoidance transactions between those that are an abuse of the tax system and those that are not. When an action is considered to be abusive, CRA will attempt to deny the resulting benefits by applying one of several anti-avoidance rules in the Income Tax Act.

R2-4 There are three general types of tax planning activities:

- Shifting income from one time period to another.
- Transferring income to another entity.
- Converting the nature of income from one type to another.

Shifting income to another time period can be a benefit if it results in a lower rate of tax in that other period. Even if a lower rate of tax is not achieved, a benefit may be gained from delaying the payment of tax to a future time period. By shifting income to an alternate taxpayer (for example, from an individual to her corporation), the amount and timing of the tax may be beneficially altered.

There are several types of income within the tax system such as employment income, business income, capital gains and so on. Each type of income is governed by a different set of rules. For some types of income both the timing and the amount of income recognized is different from other types. By converting one type of income to another, a benefit may be gained if the timing of income recognition and/or the amount recognized is favorable.

R2-5 The statement is not true. Paying tax later may be an advantage because it delays the tax cost and frees up cash for other purposes. However, the delay may result in a higher rate of tax in the future year compared to the current year. In such circumstances there is a trade off between the timing of the tax and the amount of tax payable.

R2-6 There is not always an advantage to transfer income to a corporation when the corporate tax rate is lower than that of the individual shareholder. While an immediate lower tax rate results, remember that the corporation may be required to distribute some or all of its after-tax income to the shareholder which causes a second level of tax. Whether or not an advantage is achieved depends on the amount of that second level of tax and when it occurs. Other factors may also be relevant such as the tax treatment of a possible business failure or sale.
R2-7 The statement is not true. Knowing the tax rules is, of course, a major element in the tax planning process but it does not guarantee the expected outcome. Planning means that certain steps are taken now in preparation for certain activities that may occur in the future. However, those anticipated activities might not occur and the desired tax result may not be achieved. Tax planning also requires that one must anticipate and speculate on possible future scenarios and relate them to the current tax planning steps. Those scenarios are never certain.

R2-8 To develop a good tax plan, one must be able to:

- Understand the fundamentals of the income tax system.
- Anticipate the complete cycle of transactions.
- Develop optional methods of achieving the desired business result and analyze each of their tax implications.
- Speculate on possible future scenarios and assess their likelihood.
- Measure the time value of money.
- Place the tax issue in perspective by applying common sense and sound business judgment.
- Understand the tax position of other parties involved in the transaction.

R2-9 Yes, the entrepreneur should consider the tax position of the potential investors. They will be taking a risk in accepting the investment. If the entrepreneur knows the tax effect on the investors of each alternative organization structure, the entrepreneur can choose the one that provides investors the most favorable tax treatment (i.e., one that reduces their after-tax loss if the investment fails, or increases their after-tax income if it succeeds). Before making the investment the investor should determine the tax impact on:

- Income earned by the venture.
- Income distributed to the investor.
- Losses incurred by the venture.
- The loss of the investment if the venture fails.
- The gain on the investment when it is eventually sold.

R2-10 A tax avoidance transaction is a term used within the general anti-avoidance rule (GAAR) of the Income Tax Act. An avoidance transaction is a transaction or series of transactions that results in a tax benefit and was not undertaken primarily for bona fide business, investment or family purposes [ITA 245].

R2-11 The statement is not true. In order for the tax benefit to be denied under the general anti-avoidance rule (GAAR), the transaction, in addition to not being primarily for bona fide business, investment or family purposes, must be considered to be a misuse or abuse of the income tax system as a whole. What constitutes a misuse or abuse is not always clear. However, certain avoidance transactions are permitted and others are not [ITA 245(3), IC 88-2].
Key Concept Questions

QUESTION ONE

The *Income Tax Act* contains a general anti-avoidance rule (GAAR) in section 245. Consider each of the following situations and determine whether the GAAR will likely apply. *Income tax reference: ITA 245(2); IC 88-2.*

1. Chris transferred her consulting business to a corporation primarily to obtain the benefit of the low corporate tax rate.

2. Paul owns 100% of the shares of P Ltd. Paul provides services to P Ltd. In the current year he received no remuneration for his services because the payment of a salary to Paul would increase the amount of the loss that P Ltd. will incur in the year.

3. A Canadian-controlled private corporation pays its shareholder/manager a bonus that will reduce the corporation’s income to the amount eligible for the low tax rate. The bonus is not in excess of a reasonable amount.

4. A profitable Canadian corporation has a wholly owned Canadian subsidiary that is sustaining losses and needs additional capital to carry on its business. The subsidiary could borrow the funds from its bank but could not obtain any tax saving in the current year by deducting the interest expense due to its loss situation. Therefore, the parent corporation borrows the funds from its bank and subscribes for additional common shares of the subsidiary. The parent corporation reduces its taxable income by deducting the interest expense. The subsidiary uses the funds to earn income from its business.

QUESTION TWO

John has owned all of the shares of Corporation A and Corporation B since their inception. In the current year, John had Corporation A transfer, on a tax-deferred basis, property used in its business to Corporation B. The reason for the transfer is to enable Corporation B to apply the income earned on the transferred assets against its non-capital losses.

Will the GAAR in ITA 245(2) apply to disallow the tax benefit? *Income tax reference: ITA 245(2); IC 88-2.*
Solutions to Key Concept Questions

KC 2-1

[ITA: 245(2) – GAAR]

The GAAR provision in ITA 245(2) is to be used when specific anti-avoidance provisions do not suffice. For the GAAR to apply, the following four conditions must be met:

1) No other provision of the Act stops the taxpayer from achieving the intended tax advantage,

2) A tax benefit results from a transaction or part of a series of transactions,

3) The transaction is an avoidance transaction, in that, it was not undertaken primarily for bona fide purposes other than to obtain the tax benefit, and

4) The transaction is an abusive transaction, in that, it can reasonably be concluded that the tax benefit would result in a misuse or abuse of the Act, read as a whole.

The transactions described in each of the four situations:

- Are not subject to any other anti-avoidance rule in the Act,
- A tax benefit results in each case, and
- The transactions have been undertaken primarily to obtain a tax benefit and are, for that reason, avoidance transactions.

Therefore, the issue to be determined is whether the tax benefit would result in a misuse or abuse of the Act, read as a whole.

**Situation 1:** There is nothing in the Act that prohibits Chris from incorporating her business. The incorporation is consistent with the Act read as a whole and, therefore, the GAAR would not apply.

**Situation 2:** There is no provision in the Act requiring a salary to be paid to Paul and the failure to pay a salary is, therefore, not contrary to the scheme of the Act read as a whole. The GAAR would not apply to deem a salary to be paid by P Ltd. or received by Paul.

**Situation 3:** The Act recognizes the deductibility of reasonable business expenses which include bonuses. The payment of the bonus is not an abusive transaction and, therefore, the GAAR should not apply to the payment.

**Situation 4:** The borrowing by the parent corporation is for the purpose of gaining or producing income as required by paragraph 20(1)(c) of the Act. The GAAR should, therefore, not apply.
KC 2-2

[ITA: 245(2) – GAAR]

The GAAR provision in ITA 245(2) is to be used when specific anti-avoidance provisions do not suffice. For the GAAR to apply, the following four conditions must be met:

1) No other provision of the Act stops the taxpayer from achieving the intended tax advantage,
2) A tax benefit results from a transaction or part of a series of transactions,
3) The transaction is an avoidance transaction, in that, it was not undertaken primarily for bona fide purposes other than to obtain the tax benefit, and
4) The transaction is an abusive transaction, in that, it can reasonably be concluded that the tax benefit would result in a misuse or abuse of the Act, read as a whole.

In the case of John and his two corporations:

- There is no provision in the Income Tax Act prohibiting the transfer of the property on a tax-deferred basis to a related corporation nor the deduction of the losses by Corporation B,
- The transaction does result in a tax benefit as using the losses will reduce tax, and
- It appears that the transaction was undertaken primarily for the tax benefit.

So, the question that remains is whether the transaction is an abusive transaction.

Since the Act contains specific provisions permitting the transfer of losses between related corporations, the transfer in question is consistent with the scheme of the Act and, therefore, is not an abusive transaction. Thus, the GAAR should not apply.

However, had the transfer of a property been undertaken to avoid a specific rule, such as a rule designed to preclude the deduction of losses after the acquisition of control of a corporation by an arm's length person, such a transfer would be a misuse of the provisions of the Act and be subject to the GAAR [IC88-2].

Where the GAAR applies, the tax benefit that results from an avoidance transaction will be denied. In order to determine the amount of the tax benefit that will be denied, the provision indicates that the tax consequences of the transaction to a person will be determined as is reasonable in the circumstances.
CHAPTER 3

LIABILITY FOR TAX, INCOME DETERMINATION, AND ADMINISTRATION OF THE INCOME TAX SYSTEM

Review Questions

1. Which of the following entities are subject to income tax?
   (a) proprietorship
   (b) individual
   (c) joint venture
   (d) trust
   (e) limited partnership
   (f) corporation
   (g) partnership

2. Describe how the income earned by any of the non-taxable entities listed above is included in the Canadian tax system.

3. How and when does income earned by a corporation affect the tax position of an individual who is a shareholder?

4. In describing who is liable for tax in Canada, the Income Tax Act simply states, “An income tax shall be paid as hereinafter required upon the taxable income for each taxation year of every person resident in Canada at any time in the year.” Accepting that “person” includes both an individual and a corporation, briefly discuss the meaning and ramifications of this statement.

5. In what circumstances are non-residents subject to Canadian income tax?

6. Can a Canadian resident be subject to tax in Canada as well as in a foreign country on the same earned income? If yes, explain how. Also, what mechanism is available to minimize double taxation?

7. Explain the difference between net income for tax purposes and taxable income for the taxable entities.

8. Explain what is meant by the statutory scheme, and describe the scheme’s relevance to the Canadian income tax system.

9. For tax purposes, would you prefer that a financial loss be a capital loss or a business loss? Explain.

10. Explain the difference between income from property and a gain on the sale of capital property.

11. One often hears that “corporations are entitled to more deductions for tax purposes than individuals.” Based on your reading of Chapter 3, is this statement true? Explain.
12. If an individual earns a living as a lawyer, what possible categories of income, for tax purposes, may he or she generate? Describe the circumstances for each possible classification.

13. What types of income for tax purposes may result when a profit is achieved on the sale of property (e.g., land)?

14. Individual A, a Canadian resident, owns and operates a profitable small farm in North Dakota, U.S.A. He also has a large amount of money earning interest in an American bank. Individual B, also a Canadian resident, owns 100% of the shares of an American corporation that operates a profitable small farm in North Dakota. The corporation also has a large amount of money earning interest in an American bank.

Describe and compare the tax positions of these two individuals who conduct the same activities but use different organizational structures.

15. Jane Q owned an apple orchard for 20 years. During that time, she had cultivated a unique brand of apple that was popular with health food fans. Toward the end of the 20X0 growing season, Q became seriously ill and put the orchard up for sale. Q's neighbour agreed to purchase the entire orchard for $250,000. It upset Q to have to sell at that time of year because that year's crop was of high quality and in three weeks would have been ripe for picking.

What types of property might have been included in the total purchase price of $250,000? For tax purposes, what types of income might have been generated from the sale of the orchard? Explain your answer.
Solutions to Review Questions

R3-1 Of the seven entities listed the following are subject to tax:
- individuals
- corporations
- trusts

R3-2 Proprietorships, partnerships, joint ventures and limited partnerships can all earn income as separate entities. However, for tax purposes the income is allocated annually to the owners of the entities and included in their income for tax purposes. The owners are normally one of the taxable entities, individuals, corporations or trusts.

R3-3 A corporation is a separate legal entity distinct from its owners - the shareholders. Consequently a corporation is taxed on its income earned in each taxation year. However, the after-tax corporate profits may be distributed as a dividend to the individual shareholder. Upon receipt of the dividend the individual shareholder has earned property income (return on the share capital) and is subject to tax consequences at that time [ITA 12(1)(j),(k)].

Alternatively, if the corporation does not distribute the after-tax profits but retains them for corporate use, the value of the shares owned by the shareholder will increase in value. If and when the shareholder disposes of the shares a capital gain may result due to the increased share value caused by the corporate earnings retained [ITA 40(1)(a)(i)].

R3-4 This statement is important because it establishes the basic framework of the income tax system, who is liable for tax, and on what income. The statement indicates that tax is calculated on the taxable income of resident persons for each taxation year. By defining each of the relevant terms in the statement the general scope of the tax system is apparent. It is, therefore, necessary to define the terms person, resident, taxable income, and taxation year [ITA 2(1)].

As stated in the question, both individuals and corporations are considered to be persons for tax purposes. Therefore, resident individuals and resident corporations are liable for Canadian tax [ITA 248(1)].

Individuals are resident of Canada if they maintain a continuing state of relationship with the country. Whether or not an individual has a continuing state of relationship is a question of fact determined from the facts of each situation. To establish this relationship the courts consider the time spent in Canada, motives for being present or absent, the maintenance of a dwelling place, the origin and background of the individual, the routine of life, and the existence of social and financial connections. If an individual does not have a continuing state of relationship, the individual may be deemed to be a resident if the individual is present in Canada for 183 days or more in a particular year [ITA 250(1)(a)].

A corporation is a resident of Canada if it has been incorporated in Canada [ITA 250(4)].

Taxable income is defined as the person's net income for tax purposes minus a limited number of deductions. Net income for tax purposes consists of world income derived from five specific sources: employment, business, property, capital gains, and other sources. These sources are combined in a basic formula known as the statutory scheme. If income does not fit one of the above five categories, it is not taxable. Both individuals and corporations determine net income for tax purposes using the same set of rules.
Tax is calculated on taxable income for each taxation year. The taxation year of an individual is the calendar year. The taxation year for a corporation is the fiscal period chosen by the corporation, which cannot exceed one year, 53 weeks to be exact [ITA 249(1), 249.1(1)].

R3-5 A non-resident individual or corporation is subject to Canadian income tax in a manner similar to a Canadian resident on taxable income earned in Canada if they are employed in Canada, carry on business in Canada, or dispose of taxable Canadian property [ITA 2(3)].

In addition, a non-resident who does not have any of the above activities in Canada may be subject to a special withholding tax (a flat tax) on income which has its source in Canada [ITA 212]. (For example, dividends, rents royalties, certain management fees, and so on.)

R3-6 Yes. The resident of Canada is taxed on world income and the foreign country, which is the source of that income, may also impose tax. For example, a Canadian corporation which operates a business branch location in a foreign country will be taxable on the branch profits in both countries. In order to avoid double taxation, the Canadian tax calculation permits a reduction of Canadian taxes for foreign taxes paid on the same income [ITA 126(1), (2)].

R3-7 Net income for tax purposes consists of a taxpayer's combined net income from employment, business, property, capital gains and other sources. The separate sources of income are combined in accordance with an aggregating formula which takes into account any losses from the above sources. Net income for tax purposes is determined by the same set of rules for individuals and corporations.

Taxable income is the base amount upon which the rates of tax are applied, and is determined by reducing a taxpayer's net income for tax purposes (above) by a limited number of specific deductions. While individuals and corporations use the same formula for determining net income, the calculation of taxable income is different. Deductions for individuals include a capital gains deduction on qualified properties, and unused losses of other years. Deductions for corporations include charitable donations, dividends from Canadian corporations and foreign affiliates, and unused losses of other years.

R3-8 The statutory scheme is the fundamental base of the income tax system. It is simply an aggregating formula which establishes the concept of a taxpayer's income for tax purposes in comparison to other concepts of income. The formula defines what types of income are subject to tax and how any related losses affect a taxpayer's income. As the formula is restricted to five basic types of income activities, the scope of the tax system is established. The formula establishes that, although a taxpayer may carry on several separate activities, each separate type of income is not taxed separately but rather forms part of a total concept of income. As a result, with the exception of capital losses, a loss from one activity within a specified time period may be offset against the income derived from other activities.

In spite of the fact that the formula combines several types of income into a single income amount, each type of income is determined in accordance with its own sets of rules. The formula then binds them together and establishes their relationships.
R3-9 A taxpayer would normally prefer that a loss incurred be a business loss as opposed to a capital loss. In accordance with the aggregating formula for computing net income, a business loss can be deducted from any other source of income which increases the opportunity to reduce taxes payable as soon as possible. A capital loss, on the other hand, can only be deducted against a capital gain and, therefore, its ability to reduce taxes payable is considerably restricted. In addition, only one-half of a capital loss is included as part of the aggregating formula [ITA 3(b)].

For example, a taxpayer who has employment income of $30,000 and a business loss of $30,000 has no net income under the aggregating formula and, therefore, no tax liability. However, if the same taxpayer has employment income of $30,000 and a capital loss of $30,000, a tax liability would be incurred because the net income for tax purposes would be $30,000 (from employment) and the capital loss would remain unused.

R3-10 Income from property is the return that is earned on invested capital. For example, dividends earned on shares of a corporation are property income because they represent the return from the ownership of capital property (the shares). On the other hand, a gain derived from the sale of capital property is considered to be a capital gain. Using the previous example, if the shares were sold at a profit the gain from that property would be a capital gain and not property income.

R3-11 Based on the determination of net income for tax purposes, the statement is not true. Both individuals and corporations determine net income for tax purposes in accordance with the same aggregating formula. In addition, an individual who earns business income determines that income in accordance with the same set of rules as a corporation that earns business income.

With respect to the conversion of net income for tax purposes to taxable income, individuals are entitled to a capital gains deduction whereas a corporation is not. In this context an individual receives preferential treatment. In arriving at taxable income, a corporation can reduce its net income by dividends received from other Canadian corporations, whereas, individuals cannot. However, corporate income is ultimately distributed to shareholders who are individuals and, therefore, this corporate advantage is temporary [ITA 110.6, 112(1)].

R3-12 Working as a lawyer, an individual may earn either employment income or business income. If the lawyer provides services to a law firm as an employee in return for a salary, bonus, and fringe benefits, the income would constitute employment income. If the lawyer independently provides services directly to clients on a fee-for-service basis, the income derived is business income [ITA 5(1), 9(1)].

R3-13 A profit derived from the sale of property may be classified as either business income or capital gain. Using the example of property that is land, business income will occur if the land was acquired for the purpose of reselling it at a profit. Alternatively, if the land was acquired, not for resale, but for long term use to generate income or for personal enjoyment, the profit on the sale will be a capital gain.

R3-14 All Canadian residents are taxed on their world income. The world income of individual A includes the business profits from the U.S. farm plus the interest earned from the U.S. bank account. These amounts are, therefore, taxable in Canada in the year earned. The
income would also be taxable in the U.S. but Canadian taxes may be reduced by U.S. taxes on that income.

In comparison, individual B's world income does not include the U.S. farm profits and the U.S. interest. This income belongs to the U.S. corporation and is, therefore, taxed only in the U.S. The foreign corporation is not a resident of Canada and is not subject to Canadian tax. The after-tax profits of the foreign corporation may be distributed to individual B in the form of dividends at some future time. Such foreign dividends would then be part of B's world income and taxed a second time.

Although both A and B conduct the same activities, the organization structure alters the amount and the timing of the related taxes on the income.

R3-15 The sale of the entire orchard for a total price of $250,000 may include the following separate properties:

- land
- the permanent stock of trees
- the almost mature crop of apples

(The student may also recognize the possibility of including equipment and the intangible property of goodwill.)

The sale of the land may result in a capital gain because it is property that was acquired and used to generate income. Similarly the sale of the trees is capital property because the trees are used to produce a regular crop of apples.

The profit on the sale of apples would constitute business income because the apples are being produced for the purpose of resale at a profit. Even though the apples are not mature, they represent inventory in process.
Key Concept Questions

QUESTION ONE

Determine the Canadian residency status for the current year for each of the following taxpayers. *Income tax reference: ITA 250(1), (4); IT-221R3.*

a) Paula was born and lived her life to date in Canada. On November 1st of the current year she left Canada permanently.

b) Al spent the current year in Belgium on temporary work assignment. His family and friends are looking forward to his return to Canada in June of next year.

c) Kimberley lives in Ireland. In the current year she was in Canada throughout the months of February through May and again throughout the months August through October caring for a sick friend.

d) 102864 Limited was incorporated in Canada five years ago. The corporation has always carried on business exclusively in Bermuda since incorporation.

e) Navy Ltd. was incorporated in the United States. In the current year Navy Ltd. carried on business in Canada as well as in the United States.

QUESTION TWO

Bill is *not* a resident of Canada. For the current year Bill has worldwide income of $120,000, including $15,000 of employment income earned in Canada and $2,000 of interest received on Canada savings bonds. The remainder of his income was from sources outside of Canada.

What amount of income must be reported on Bill’s Canadian personal income tax return for the current year? *Income tax reference: ITA 2(3).*

QUESTION THREE

A Ltd. is resident in Canada for tax purposes. In the current year A Ltd. earned interest income of $4,000 in Canada, $6,000 in England, and $8,000 in Bermuda.

What amount of interest income must be reported on A Ltd.’s Canadian corporate income tax return for the current year? *Income tax reference: ITA 2(1), 3(a).*
QUESTION FOUR

The Canadian income tax system includes five specific categories of income. Identify the income category to which each of the following pertains:

1. Interest earned on a bond investment.
2. Pension income.
3. Consulting fees.
4. Profit on the sale of shares of a public corporation. The shares were acquired as a long-term investment.
5. Wages from employment services.
6. Share of profits from a partnership that operates a restaurant.
7. Dividends from the shares of a corporation that carries on a retail business.
8. Tips from customers of an employer’s business.
9. Rents from tenants of a commercial building.
10. Fees for providing piano lessons to several students.
11. Profit on the sale of land that was used by the owner for farming.
12. Profit on the sale of a summer cottage that was used by the owner for personal enjoyment.
13. Profit on the sale of land that was purchased for resale.

QUESTION FIVE

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Calculate net income for tax purposes for each of the three taxpayers. Income tax reference: ITA 3.

QUESTION SIX

Maureen, a resident of Canada, has the following sources of income and losses for tax purposes for the current year.

- Employment income $60,000
- Business X profit 3,000
- Business Y loss 7,000
- Interest income 2,000
- Taxable capital gain on sale of land 18,000
- Allowable capital loss on sale of securities 20,000
- Allowable business investment loss 5,000

Calculate Maureen’s net income for tax purposes for the current year in accordance with Section 3 of the Income Tax Act.
QUESTION SEVEN

What is the filing due date for each of the following income tax returns? Income tax reference: ITA 150(1)(a),(b),(d).

(a) A corporation for its year ending November 30, 20X6.
(b) An individual for the year 20X6. The individual carried on business in 20X6.
(c) An unmarried individual living alone for the year 20X6. The individual did not carry on a business.
(d) An individual for the year 20X6. The individual died on February 21, 20X7.

QUESTION EIGHT

For each of the following individuals, determine when their income tax return for the current year is due and when any balance of tax owing is due. Income tax reference: ITA 150(1), 156.1(4), 248(1) balance-due day.

a) Bob is a bachelor. He has two sources of income, employment income and interest income.
b) Mary is a self-employed lawyer. Her law practice has a December 31 year end.
c) Ron’s only source of income is employment income. Ron is married to Mary. See (b) above.
d) Zeta is married to Leo. Their only source of income is pension income. Zeta died on November 20th of the current year.
e) Sarah died on March 12th of the current year without having filed her tax return for the prior year.

QUESTION NINE

When is the balance of tax due for each of the following entities? Income tax reference: ITA 156.1(4); 157(1)(b).

a) A public corporation, resident in Canada.
b) A Canadian-controlled private corporation, with taxable income less than $400,000, and claiming the Small Business Deduction.
c) An individual who carried on business in the year.
d) An individual where no business is carried on by the individual or the spouse.

QUESTION TEN

For each of the following corporations, determine when the income tax return for the current year is due and when any balance of tax owing is due. Income tax reference: ITA 150(1), 157(1)(b), 248(1) balance-due day.

A Ltd. is a public corporation with a May 30th year end.

B Ltd. is a private corporation with an October 31 year end. All of B’s income is taxed at the high corporate rate.
C Ltd. is a Canadian-controlled private corporation with an October 31 year end. Last year all of C’s income was subject to the low rate of tax from claiming the small business deduction.

D Ltd. is a Canadian-controlled private corporation with a May 30th year end. Last year D had taxable income of $550,000. D claimed the small business deduction this year as well as last year.

**QUESTION ELEVEN**

A taxpayer’s tax liability was $1,000 for 20X1, $12,000 for 20X2, and is expected to be $36,000 for 20X3.

Is the taxpayer required to make tax instalments for 20X3 and if so, what are the amounts and the due dates for each instalment? *Income tax reference: ITA 156(1), 156.1(1),(2), 157(1),(1.1),(1.2),(2.1).*

**QUESTION TWELVE**

The mailing date on the notice of reassessment for the taxpayer’s 20X2 tax return was July 10, 20X7. The mailing date on the original notice of assessment for the taxpayer’s 20X2 tax return was June 20, 20X3.

a) Does the CRA have the right to reassess the 20X2 tax return on July 10, 20X7? *Income tax reference: ITA 152(3.1).*

b) If the taxpayer wishes to dispute the reassessment, by what date must the notice of objection be filed? *Income tax reference: ITA 152(3.1), 165(1).*

**QUESTION THIRTEEN**

Tooblue Ltd., a Canadian-controlled private corporation, filed its tax return for its year ended December 31, 20X6 on June 30, 20X7. The Notice of Assessment was received August 31, 20X7. The mailing date on the Notice of Assessment was August 28, 20X7.

1) Assuming there were no misrepresentations and that a waiver was not filed, how long does the CRA have to issue a reassessment for Tooblue Ltd.’s 20X6 taxation year? *Income tax reference: ITA 152(3.1).*

2) If Tooblue Ltd. wishes to object to the original Notice of Assessment for the 20X6 taxation year, by what date must the Notice of Objection be filed? *Income tax reference: ITA 165(1).*
QUESTION FOURTEEN

Successful Ltd. is a Canadian company with a December 31 year end. The federal income tax return for last year was filed with the CRA on September 30th of this year. The balance of tax owing, $10,000, was paid at the bank on September 30th as well.

Calculate the late-filing penalty for Successful Ltd. *Income tax reference: ITA 162(1).*

QUESTION FIFTEEN

Dee Ltd. is a Canadian company carrying on a clothing wholesale business. For the first quarter of the current year, its financial results were as follows:

<table>
<thead>
<tr>
<th>Revenue:</th>
<th>Sales within Canada</th>
<th>$200,000</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Exports</td>
<td>30,000</td>
</tr>
<tr>
<td>Expenses:</td>
<td>Inventory purchased</td>
<td>50,000</td>
</tr>
<tr>
<td></td>
<td>Salaries &amp; wages</td>
<td>40,000</td>
</tr>
<tr>
<td></td>
<td>Rent</td>
<td>10,000</td>
</tr>
</tbody>
</table>

Calculate the HST to be remitted to the CRA for the first quarter of the year. Assume an HST rate of 13%.
Solutions to Key Concept Questions

KC 3-1

[ITA: 250(1), (4) – Residence]

a) Paula is a part-year resident. She is resident in Canada from January 1 to November 1 and non-resident for the remainder of the year.
b) Al is resident in Canada. Although he is out of the country on a temporary work assignment for the current year, his residential ties remain in Canada.
c) Kimberley is deemed to have been resident in Canada throughout the current taxation year. Although she is not ordinarily resident in Canada, she sojourned (temporary stay) in Canada for more than 182 days, in total, in the current year [ITA 250(1)(a)].
d) 102864 Limited is resident in Canada. Any company incorporated in Canada after April 26, 1965 is deemed resident in Canada [ITA 250(4)(a)].
e) Navy Ltd. is a non-resident corporation.

KC 3-2

[ITA: 2(3) – Tax payable by non-residents]

A non-resident must report three sources of income on a Canadian tax return: employment income earned in Canada, business income from carrying on business in Canada, and gains on the disposal of taxable Canadian property [ITA 2(3)]. In this case, Bill must report on a Canadian tax return his $15,000 of employment earned in Canada.

KC 3-3

[ITA: 2(1), 3(a) – World income reported by residents]

Since A Ltd. is resident in Canada, income earned anywhere in the world must be reported on its Canadian tax return. Therefore, all $18,000 of interest income earned must be included on the Canadian corporate income tax return.

KC 3-4

[Income categories]

1. Property income 8. Employment income
2. Other income 9. Property income
5. Employment income 12. Capital gain
7. Property income
**KC 3-5**

[ITA: 3 – Net income]

<table>
<thead>
<tr>
<th></th>
<th>Taxpayer A</th>
<th>Taxpayer B</th>
<th>Taxpayer C</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>3(a) Employment income</strong></td>
<td>$30,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Business income</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Property income</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other income (pension)</td>
<td>$40,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>3(b) Taxable capital gains</strong></td>
<td>$25,000</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>Allowable capital losses</td>
<td>(0)</td>
<td>(3,000)</td>
<td></td>
</tr>
<tr>
<td><strong>Excess</strong></td>
<td>25,000</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td><strong>3(c) Other deductions</strong></td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td><strong>3(d) Business loss</strong></td>
<td>(20,000)</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Property loss</strong></td>
<td>(1,000)</td>
<td>(0)</td>
<td>(1,000)</td>
</tr>
<tr>
<td><strong>Excess</strong></td>
<td>(20,000)</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Net Income</strong></td>
<td>$39,000</td>
<td>$5,000</td>
<td>$30,000</td>
</tr>
</tbody>
</table>

**KC 3-6**

[ITA: 3 – Net income]

<table>
<thead>
<tr>
<th></th>
<th>Taxpayer A</th>
<th>Taxpayer B</th>
<th>Taxpayer C</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>3(a) Employment income</strong></td>
<td>$60,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Business income</strong></td>
<td>3,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Property income (interest)</strong></td>
<td>2,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>3(b) Taxable capital gain</strong></td>
<td>$18,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Allowable capital loss</strong></td>
<td>(20,000)</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Excess</strong></td>
<td>0</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td><strong>3(c) Other deductions</strong></td>
<td>0</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>3(d) Business loss</strong></td>
<td>(7,000)</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Allowable business investment loss</strong></td>
<td>(5,000)</td>
<td>(12,000)</td>
<td></td>
</tr>
<tr>
<td><strong>Net income</strong></td>
<td>$53,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
KC 3-7

[ITA: 150(1)(a), (b), (d) – Filing due dates]

The filing due dates are as follows:

a) May 31, 20X7 (six months after the year-end of the corporation [ITA 150(1)(a)])

b) June 15, 20X7 [ITA 150(1)(d)(ii)]

c) April 30, 20X7 [ITA 150(1)(d)(i)]

d) August 21, 20X7 (later of six months after death and the normal filing due date [ITA 150(1)(b)])

KC 3-8

[ITA: 150(1), 156.1(4), 248(1) – filing deadline and balance-due day for individuals]

a) Bob’s tax return is due April 30th of the following year [ITA 150(1)(d)(i)]. The balance of tax owing, if any, is due on the same day [ITA 156.1(4), 248(1)].

b) Mary’s tax return is due June 15th of the following year [ITA 150(1)(d)(ii)]. The balance of tax owing, if any, is due on April 30th of the following year [ITA 156.1(4), 248(1)].

c) Ron’s tax return is due June 15th of the following year [ITA 150(1)(d)(iii)]. The balance of tax owing, if any, is due on April 30th of the following year [ITA 156.1(4), 248(1)].

d) Zeta’s tax return is due May 20th of the following year, being the later of April 30th of the following year and 6 months after the date of death [ITA 150(1)(b)]. The balance of tax owing, if any, is due on the same day [ITA 156.1(4), 248(1)].

e) Sarah’s tax return for the current year (the year of death) is due April 30th or June 15th of the following year being the later of the date the return is normally due and 6 months after the date of death. The balance of tax owing, if any, is due on April 30th of the following year. [ITA 156.1(4), 248(1)]. Also note that Sarah’s tax return for the prior year is due September 12th being the later of the date the tax return would normally be due and 6 months after the date of death [ITA 150(1)(b)]. The balance of tax owing, if any, is due on September 12th as well [ITA 156.1(4), 248(1)].

KC 3-9

[ITA: 156.1(4); 157(1)(b); 248 – Balance due day]

The balance of tax is due as follows:

a) Two months after the corporation’s year-end [ITA 157(1)(b), “balance- due day” ITA 248]

b) Three months after the corporation’s year-end [ITA 157(1)(b), “balance- due day” ITA 248]

c) April 30th of the following year [ITA 156.1(4), “balance-due day” ITA 248]

d) April 30th of the following year [ITA 156.1(4), “balance-due day” ITA 248]
Buckwold and Kitunen, Canadian Income Taxation, 2011-2012 Ed.

KC 3-10

[ITA: 150(1), 157(1)(b), 248(1) – filing deadline and balance-due day for corporations]

- A Ltd.’s tax return is due November 30th (6 months after the year end) [ITA 150(1)]. The balance of tax owing, if any, is due July 30th (2 month after the year end) [ITA 157(1)(b), 248].
- B Ltd.’s tax return is due April 30th of the following year (6 months after the year end) [ITA 150(1)]. The balance of tax owing, if any, is due December 31st (2 month after the year end) [ITA 157(1)(b), 248].
- C Ltd.’s tax return is due April 30th of the following year (6 months after the year end) [ITA 150(1)]. The balance of tax owing, if any, is due January 31st of the following year (3 month after the year end) since C Ltd. is a CCPC whose taxable income in the previous year did not exceed the business limit and the small business deduction was claimed [ITA 157(1)(b), 248].
- D Ltd.’s tax return is due November 30th (6 months after the year end) [ITA 150(1)]. The balance of tax owing, if any, is due July 31st (2 month after the year end). Although D Ltd. is a CCPC claiming the small business deduction, it does not qualify for the one month extension since its taxable income in the preceding year exceeded the business limit [ITA 157(1)(b), 248].

KC 3-11

[ITA: 156(1), 156.1(1), (2), 157(1), (2.1) – instalments for individuals and corporations]

If the taxpayer is an individual, instalments are required for 20X3 since the tax liability for 20X3 is expected to exceed $3,000 and the tax liability for 20X2 exceeded $3,000 [ITA 156.1(1)]. The instalments are due the 15th day of March, June, September, and December. The amount payable for each instalment is calculated using one of the following three methods [ITA 156(1)]:

1) $9,000; ¼ x estimated tax payable for 20X3 (1/4 x $36,000)
2) $3,000; ¼ x tax payable for 20X2 (1/4 x $12,000)
3) $250 for the March and June instalments; ¼ x tax payable for 20X1 (1/4 x $1,000); and $5,750 for the September and December instalments; ½ ($12,000 - $500).

The CRA uses method (3) in their instalment notices. Since method (3) results in the taxpayer paying the least amount of tax in March and June, the taxpayer will probably choose this method.

If the taxpayer is a corporation, instalments are required for 20X3 since the tax liability for 20X2 and the estimated tax liability for 20X3 exceed $3,000 [ITA 157(2.1)].

The instalments are generally due at the end of each month. The amount payable for each instalment is calculated using one of the following three methods [ITA 157(1)]:

1) $3,000; 1/12 x estimated tax payable for 20X3 (1/12 x $36,000)
2) $1,000; 1/12 x tax payable for 20X2 (1/12 x $12,000)
3) $83 for the first two instalments; 1/12 x tax payable for 20X1 (1/12 x $1,000); and $1,183 for the remaining ten instalments; 1/10 x ($12,000 - $166).
If the taxpayer is a small-CCPC then quarterly tax instalments are permitted. The quarterly instalments are due the last day of each quarter and are calculated using one of the following three methods [ITA 157(1.1)]:

1) $9,000; ¼ x estimated tax payable for 20X3 (1/4 x $36,000)
2) $3,000; ¼ x tax payable for 20X2 (1/4 x $12,000)
3) $250 for the March instalment; ¼ x tax payable for 20X1 (1/4 x $1,000); and $3,917 for the June, September and December instalments; 1/3 x ($12,000 - $250).

A small-CCP has the following characteristics [ITA 157(1.2)]:
- Taxable income for the current or preceding year does not exceed $500,000,
- Taxable capital for the current or preceding year does not exceed $10 million,
- Claims the small business deduction in the current or preceding year, and
- Has a perfect compliance record for the past 12 months with respect to tax payments and filing of returns.

KC 3-12

[ITA: 152(3.1), 165(1) – Normal reassessment period and notice of objection]

a) Individuals, trusts, and CCPCs can be reassessed within three years of the date the original assessment was mailed. For other corporations, the time limit is extended to four years.

Since the date of mailing of the notice of assessment was June 20th, 20X3, the normal reassessment period expired prior to July 10th, 20X7 for all taxpayers. However, a tax return can be reassessed at any time if the taxpayer has made a misrepresentation that is attributable to neglect, carelessness, or willful default or has committed any fraud in filing the return or supplying information.

b) The notice of objection must be filed by October 8, 20X7. If the taxpayer is an individual, the notice of objection must be filed by the later of April 30, 20X4, being one year after the tax return filing date for the 20X2 year; and October 8, 20X7, being 90 days after the date the reassessment was mailed. For all other taxpayers the notice of objection must be filed by 90 days after the date the reassessment was mailed.

KC 3-13

[ITA: 152(3.1)(b); 165(1)(b) – Normal reassessment period; Notice of objection]

1) The CRA has until August 28, 20X10, being three years from the date of mailing on the Notice of assessment (August 28, 20X7) to issue a reassessment [ITA 152(3.1)(b)].

2) If Tooblue Ltd. wishes to object to the Notice of assessment, the Notice of objection must be filed by November 26, 20X7, being 90 days after the mailing date on the Notice of assessment [ITA 165(1)(b)].
KC 3-14

[ITA: 162(1) – Late filing penalty]

The late filing penalty is $800, being $10,000 x 8% (5% + 1% x 3 months). The tax return was filed three complete months late.

KC 3-15

[HST remittance]

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales within Canada</td>
<td>$200,000</td>
</tr>
<tr>
<td>Inventory purchased</td>
<td>$50,000</td>
</tr>
<tr>
<td>Rent</td>
<td>10,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$60,000</strong></td>
</tr>
<tr>
<td>HST remittance</td>
<td><strong>$18,200</strong></td>
</tr>
</tbody>
</table>

Rent $60,000 x 13% = $7,800
PROBLEMS

PROBLEM ONE

John Day and Carol Knight conduct similar financial activities. Each is employed and has a portfolio of investments, and during the current year, each started a separate small business. Their financial results for the year ended December 31, 20X1, are identical, as follows:

- Employment income: $40,000
- Interest income from investment portfolio: $15,000
- Loss from new small business operation: $(20,000)

The only difference between Day and Knight is that Day operated his business as a proprietorship, whereas Knight operated her business from a wholly owned corporation.

Required:

1. Assuming that individual tax rates are 40%, compare the tax liability of Day with that of Knight for 20X1.

2. How and when may Knight utilize her business loss to reduce her tax liability?

3. What impact may the difference in tax treatment have on Day’s and Knight’s wealth accumulation and on their long-term returns on investment?
Solution to P 3-1

1. Tax liability of Day:

<table>
<thead>
<tr>
<th>Income Type</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employment Income</td>
<td>$40,000</td>
</tr>
<tr>
<td>Property Income</td>
<td>$15,000</td>
</tr>
<tr>
<td></td>
<td>$55,000</td>
</tr>
<tr>
<td>Less business loss</td>
<td>(20,000)</td>
</tr>
<tr>
<td></td>
<td>$35,000</td>
</tr>
<tr>
<td>Tax @ 40%</td>
<td>$14,000</td>
</tr>
</tbody>
</table>

   Tax liability of Night:

<table>
<thead>
<tr>
<th>Income Type</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employment Income</td>
<td>$40,000</td>
</tr>
<tr>
<td>Property Income</td>
<td>$15,000</td>
</tr>
<tr>
<td></td>
<td>$55,000</td>
</tr>
<tr>
<td>Tax @ 40%</td>
<td>$22,000</td>
</tr>
</tbody>
</table>

2. Knight’s business loss belongs exclusively to the corporation as a separate taxable entity. The loss in the corporation is preserved and can be offset against future profits of the business, if they occur within 20 years [ITA 111(1)(a)]. Alternatively, Knight may dispose of the shares of the corporation at a reduced value and may recognize a capital loss of which only one-half is available for tax purposes. Assuming the corporation is a small business corporation, the loss is an allowable business investment loss which can be offset against other sources of income, but not until the year in which the shares are disposed. Therefore, both the timing and amount of loss which can be used to reduce income are affected [ITA 38, 39(1)(c)].

3. Impact on return on investment: because Day’s tax liability is $8,000 less in year 20X1, Day has a greater cash flow which can be used for reinvestment. This increased cash flow may provide a greater long-term return on investment than can be achieved by Knight (who may reduce taxes from the loss at some future time). In addition, if Knight recognizes the loss from a sale of shares, a lesser amount of tax savings will be received as only one-half of the loss is deductible.

   Because Day has higher cash flow than Knight in the first year, Day can use this cash flow to fund the loss of the business thereby reducing the risk of a complete business failure. Consequently, Day may achieve greater and more immediate success from the business. In other words, the increased cash flow may reduce the risk of business failure.
PROBLEM TWO

[ITA: 2(1); 2(3); 3(a); 114; 115(1)(a)(ii); 212(1)(b); 250(1)(a); 250(4)]

To what extent, if any, are the following individuals or corporations liable for tax in Canada?

1. An individual who lives and works in Canada received an inheritance from an uncle in France. The inheritance consists of shares, bonds, and French real estate. During the year, the investments generated interest, dividends, and rents, which were retained in France and reinvested.

2. A large corporation based in Alabama operates a branch in Winnipeg that employs Canadian staff, holds a supply of inventory, and sells to the Canadian market.

3. An American citizen who normally resides in New York and has extensive American income, for health reasons takes an extended vacation of six-and-a-half months in Banff, Alberta in the current calendar year.

4. A Manitoba corporation is controlled and managed by its British parent corporation.

5. A Canadian individual, who is a student at the University of Saskatchewan, earns income during the summer by operating a street-vending unit in Boulder, Colorado.

6. An individual has been employed in Canada by a large Canadian corporation. He accepts a transfer to manage, on a permanent basis, the corporation's operations in Denver, Colorado. He leaves Canada with his family on March 31, 20X0.

7. An individual who resides in England receives annual dividend income from an investment in a Canadian corporation.
Solution to P3-2

1. The individual is a resident of Canada and taxed on world income. Therefore, the interest, rents and dividends are taxable in Canada [ITA 3(a)].

2. The Alabama corporation is not a resident of Canada. However, as a non-resident it carries on business in Canada from a branch location in Winnipeg. It is, therefore, liable for Canadian tax on the branch profits only [ITA 2(3), 115(1)(a)(ii)].

3. Even though the individual does not have a continuing state of relationship with Canada, he/she is deemed to be a Canadian resident throughout the current year because of his/her presence in Canada for 183 days or more (6 1/2 months) and is, therefore, taxable in Canada on world income which includes the U.S. income [ITA 2(1), 250(1)(a)].

4. The Manitoba corporation is a resident of Canada because it is incorporated in Canada. It is taxable in Canada on its world income [ITA 2(1), 3(a), 250(4)].

5. The student has a continuing relationship with Canada, is a resident and taxable on world income including the summer business income from the U.S. [ITA 2(1), 3(a)].

6. The individual ceases to be a Canadian resident on March 31, 20X0 and is taxable on world income in Canada only up to March 31, 20X0 [ITA 2(1), 114].

7. The individual is not a resident of Canada. Therefore, the Canadian dividend income is NOT reported on a Canadian tax return. The Canadian corporation paying the dividend is required to withhold tax and remit the tax withheld to the Canadian government. The rate for the withholding tax specified by the Income Tax Act is 25% [ITA 212(2)].
PROBLEM THREE

[Min Shan Shih v the Queen 2000 DTC 2072 – Residence]

Read the Tax Court of Canada case Min Shan Shih v the Queen 2000 DTC 2072 and explain in your own words the reason for the decision in the case.

Solution to P3-3

The taxpayer was found not resident in Canada for the years in question because when all of the facts were considered, the taxpayer never became a resident of Canada. His normal routine of daily living remained in Taiwan (i.e., his work, parents, social ties, etc.). The taxpayer’s wife and children became resident in Canada so that the children could be educated in Canada.

Facts supporting the position that the taxpayer was resident in Canada throughout the years in question, 1997, 1998, and 1999:

- Taxpayer owned a house in Canada, readily available to him at all times,
- Taxpayer’s wife and children lived in Canada in the family home throughout the years in question,
- Taxpayer filed a Canadian tax return for each of the years,
- Taxpayer gave the family home in Canada as his address on his tax returns,
- Taxpayer had applied for permanent residence status in Canada for himself and his family,
- In 1996 the taxpayer and his family were admitted to Canada as landed immigrants,
- Taxpayer maintained a bank account in Canada jointly with his wife,
- Taxpayer owned a car in Canada,
- Taxpayer obtained an Ontario driver’s license and an Ontario health card,
- Taxpayer was the sole shareholder of a Canadian corporation,
- In 2000 the taxpayer’s wife and children became citizens of Canada, and
- The family home in Taiwan was sold prior to coming to Canada.

Facts supporting the position that the taxpayer was not resident in Canada throughout the years in question:

- Taxpayer was employed in Taiwan throughout the years in question,
- Taxpayer maintained an apartment in Taiwan,
- Taxpayer’s pay (employment income) was deposited into his Taiwanese bank account,
- Taxpayer had a Taiwanese driver’s license and pharmacist’s license,
- All of the taxpayer’s club, church and professional association memberships were in Taiwan,
- Taxpayer visited Canada only twelve times during the span 1996 – 1999,
- Taxpayer spent a great deal more time in Taiwan than in Canada,
- The education of the taxpayer’s children was the reason for coming to Canada and applying for landed immigrant status,
- Taxpayer never had a permanent connection with Canada,
- Taxpayer had always lived in Taiwan,
- Taxpayer was a citizen of Taiwan,
• The purpose of the taxpayer’s visits to Canada during 1996 – 1999 were to visit his wife and children,
• Taxpayer had strong family ties in Taiwan, his parents.

Based on the facts, the taxpayer was found to be resident in Taiwan during the years in question. Since an individual may be resident in more than one country at the same time, one must question whether he was also resident in Canada. Apart from the presence of his wife and children in Canada, the taxpayer did not have other connections to Canada which would cause him to be resident. The taxpayer did not change his life pattern in Taiwan after he was admitted to Canada as a landed immigrant.

If the taxpayer had been found resident in Canada, then his world income, including his Taiwan employment income, should have been reported on his Canadian tax returns for the years in question.
PROBLEM FOUR

Indicate the category of income under the Income Tax Act into which each of the following items falls:

1. Annual stipend received by an individual for serving as a director of a public corporation.
2. Receipt of alimony (spousal support) payments.
3. Receipts from an employer's registered pension plan.
4. Dividends received from a foreign corporation.
5. Proceeds from the sale of land acquired for resale.
6. Loss from a loan to a small business corporation.
7. Moving expenses.
8. Gain from the sale of shares of a public corporation.
9. Fees received for providing legal services.
10. Alimony (spousal support) paid.
11. Gain on the sale of an automobile purchased for resale.
12. Bonus from an employer.

Solution to P3-4

[Income categories]

1. Employment income
2. Other income
3. Other income
4. Property income
5. Business income
6. Allowable business investment loss
7. Other deductions
8. Capital gain
9. Business income
10. Other deductions
11. Business income
12. Employment income
PROBLEM FIVE

[ITA: 3]

A taxpayer has the following financial results for a particular year:

- Business profit—A Enterprise $10,000
- Business loss—B Enterprise 3,000
- Other sources of income—pension 12,000
- Property income—interest 5,000
- Allowable capital losses on sale of land 20,000
- Allowable business investment loss 2,000
- Taxable capital gains on sale of securities 15,000
- Other deductions—alimony payments (spousal support) 3,000
- Employment income 30,000

Required:

Determine the taxpayer's net income for tax purposes in accordance with the statutory scheme formula.

Solution to P3-5

The statutory scheme formula is found in Section 3 of the ITA.

3(a) Employment income $30,000
   Business income - Enterprise A 10,000
   Property income 5,000
   Other sources 12,000
   Total income 57,000

3(b) Taxable capital gains $15,000
   Allowable capital losses (20,000) 0
   Total capital gains (5,000)
   Total income 52,000

3(c) Other deductions (3,000)
   Total income 49,000

3(d) Losses:
   Business Loss - Enterprise B (3,000)
   Allowable Business Investment Loss (2,000) (5,000)
   Total losses (8,000)
   Net income for tax purposes $49,000
PROBLEM SIX

[ITA: 3]

Meadows Enterprises Ltd. is a Canadian corporation located in Regina. The company operates a retail business that has shown consistent profits for several years. Cash generated from those profits has been used to acquire investments. The company prefers two types of investments: real estate and shares in other corporations. Unfortunately, in 20X1 the investments resulted in some losses.

A summary of the corporation’s 20X1 financial results is given below.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retail sales</td>
<td>$1,240,000</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>868,000</td>
</tr>
<tr>
<td>Gross profit</td>
<td>372,000</td>
</tr>
<tr>
<td>Retail administrative expenses</td>
<td>191,000</td>
</tr>
<tr>
<td>Income from operations</td>
<td>181,000</td>
</tr>
<tr>
<td>Net loss from real estate rentals</td>
<td>(22,000)</td>
</tr>
<tr>
<td>Net loss on the sale of shares of other corporations</td>
<td>(170,000)</td>
</tr>
<tr>
<td>Net loss for the year</td>
<td>(11,000)</td>
</tr>
</tbody>
</table>

The real estate investments include several small commercial buildings that are rented to retail tenants. In 20X1, one of those tenants ceased operations, and a replacement tenant could not be found until the current year. That is the main reason for the $22,000 loss in real estate rentals.

The net loss of $170,000 on shares of other corporations arose from two sale transactions in 20X1, which are summarized below.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Selling price</td>
<td></td>
</tr>
<tr>
<td>Sale 1</td>
<td>$72,000</td>
</tr>
<tr>
<td>Sale 2</td>
<td>$10,000</td>
</tr>
<tr>
<td>Original cost of shares</td>
<td></td>
</tr>
<tr>
<td>Sale 1</td>
<td>65,000</td>
</tr>
<tr>
<td>Sale 2</td>
<td>187,000</td>
</tr>
<tr>
<td>Gain (loss)</td>
<td></td>
</tr>
<tr>
<td>Sale 1</td>
<td>$7,000</td>
</tr>
<tr>
<td>Sale 2</td>
<td>$(177,000)</td>
</tr>
</tbody>
</table>

Both investments, which were in public corporations, had been owned for several years.

An accountant has just completed Meadows’ 20X1 tax return and has informed the president that Meadows owes $23,850 in income taxes for 20X1. The president is upset by this and exclaims, “That’s impossible! Our company lost 11,000 dollars last year, so it can’t owe $23,850 in income taxes! I know that the corporate tax rate for my company is 15%, and 15% of nothing is nothing.”

**Required:**

Briefly explain why the company owes $23,850 in income tax for 20X1. Show your calculations.
Solution to P3-6

While the company lost $11,000 during the year, the calculation of income for tax purposes is considerably different. There are two reasons for this. First, the gain and loss on the sales of public corporation shares are capital gains and only 1/2 of the actual amounts are applicable for tax purposes.

Second, in accordance with the aggregating formula, the capital loss on sale #2 can only be deducted to the extent of taxable capital gains earned in the year. This treatment is different from other types of losses (like the loss on real estate rentals) which can be offset against all other sources of income [ITA 3].

The tax calculation is as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>3(a) Business income</td>
<td>$181,000</td>
</tr>
<tr>
<td>3(b) Taxable capital gain (1/2 of $7,000)</td>
<td>$ 3,500</td>
</tr>
<tr>
<td>3(b) Allowable capital loss (1/2 of $177,000)</td>
<td>(88,500)</td>
</tr>
<tr>
<td>3(c) Other deductions</td>
<td>0</td>
</tr>
<tr>
<td>3(d) Loss from real estate rentals</td>
<td>(22,000)</td>
</tr>
</tbody>
</table>

Net Income: $159,000

Special deductions: (0)

Taxable income: $159,000

Tax payable (15% x $159,000): $ 23,850
PROBLEM SEVEN

[ITA: 12(1)(l); 96(1)(f); 150(1)(d); 249(1)(b)]

Pierre X owns 100% of the shares of Corporation X. Corporation X owns 50% of the shares of Corporation XY, which holds several investments. The investments in Corporation XY consist of bonds, rental real estate, and a 40% interest in a partnership that operates a chain of retail stores. The remaining 50% of the shares of Corporation XY are owned by Corporation Y. Corporation Y is wholly owned by John Y.

The partnership and all three corporations account for their income on an annual basis at the following fiscal year ends:

<table>
<thead>
<tr>
<th>Entity</th>
<th>Fiscal Year End</th>
</tr>
</thead>
<tbody>
<tr>
<td>Partnership</td>
<td>March 31</td>
</tr>
<tr>
<td>Corporation XY</td>
<td>February 28</td>
</tr>
<tr>
<td>Corporation X</td>
<td>January 31</td>
</tr>
<tr>
<td>Corporation Y</td>
<td>December 31</td>
</tr>
</tbody>
</table>

The partnership and all three corporations distribute their profits to the owners on the last day of the fiscal year. In April 20X0, the partnership earned an unusually high monthly profit.

Required:

1. Prepare a diagram of the financial structure of these entities from the information provided above.

2. Which entities within the structure are subject to income tax?

3. Based on the activities described, which types of income for tax purposes will be earned by each entity?

4. Individuals, not carrying on a business, must report their income by filing a tax return within four months of the taxation year end. Based on each entity’s distribution policy, what is the last date on which Pierre X can report the unusually high profits earned by the partnership in April 20X0? Provide a brief analysis tracing the April profits through the organizational structure.
Solution to P3-7

1. Diagram of financial structure:

```
Pierre X                      John Y

100%                             100%
  Corporation X                  Corporation Y

50%                              50%
  Corporation XY

40%
  Partnership
```

2. The taxable entities are Pierre X, John Y, Corporation X, Corporation Y, and Corporation XY. The partnership is not taxable but its income is allocated to the partners at the end of the partnership's fiscal period [ITA 12(1)(l), 96(1)(f)].

3. Types of income earned by each entity are as follows:

- The partnership will have business income from the retail store chain of which 40% is allocated to Corporation XY as a partner.

- Corporation XY will earn business income for tax purposes (allocated from the partnership) and property income from interest on bonds and rents from the rental real estate.

- Corporation X and Corporation Y will earn property income in the form of dividends received from Corporation XY.

- Pierre X and John Y will earn property income from dividends received from Corporation X and Corporation Y, respectively.

4. The last date on which Pierre X can report the profits earned by the partnership in April 20X0 is April 30, 20X4.

- The unusually high profits earned by the partnership in April 20X0 will form part of the partnership's fiscal year ending March 31, 20X1. The partnership profits of April 20X0 are, therefore, allocated to the partners on March 31, 20X1.

- The partner, Corporation XY, has a fiscal period of February 28 and, therefore, the partnership allocation of March 31, 20X1 will form part of the fiscal period ending February 28, 20X2. On February 28, 20X2, Corporation XY will distribute its income as a dividend to Corporation X and Corporation Y.

- Corporation X has a fiscal period ending on January 31 and, therefore, the dividend received on February 28, 20X2 will form part of its fiscal year ending January 31, 20X3. On January 31, 20X3, Corporation X distributes its income as a dividend and it
is received by Pierre X. Pierre X must use a taxation year ending on December 31 [ITA 249(1)(b)], therefore, the dividend from Corporation X will be part of Pierre X's December 31, 20X3 taxation year. A tax return must be filed by April 30, 20X4 [ITA 150(1)(d)].

- Corporation Y has a fiscal year end of December 31, therefore, the dividend received from XY on February 28, 20X2 is part of its December 31, 20X2 taxation year. As Corporation Y pays a dividend on December 31, 20X2, John Y will include the dividend in the taxation year ending December 31, 20X2 and must file a personal tax return by April 30, 20X3 [ITA 150(1)(d)].
CASE

Bendana Corporation

[ITA: 2(1), (3); 3(a); 114; 126(2); 128.1(4)(b), (c); 212(1)(b), (d); 212(2); 250(1)(a); 250(4)]

Bendana Corporation is a Canadian company that specializes in the construction of sports facilities. Although its head office is in Edmonton, final approval of all major construction projects is given by the executive officers of Bendana’s parent company, Holdings Limited.

Holdings Limited is incorporated in the United Kingdom, and all of its shares are owned by British residents. Holdings owns 100% of Bendana’s shares. The president of Bendana has called for a meeting next week to discuss the company’s expansion to the United States. The executives are considering two basic options for the American organization. One is to open an administrative office in Chicago. The office would bid on all American contracts and service those contracts by hiring American staff and leasing all equipment from American companies. Alternatively, Bendana has an opportunity to acquire the shares of a small construction company that already has an experienced staff and good basic equipment. The president is hopeful that the meeting will settle the issue so that a plan of action can be set in motion.

Whichever option is chosen, Carl Peters, a senior vice-president, will move to Chicago to head the American operation. Peters intends to leave Edmonton in October 20X0 and rent an apartment in Chicago. His wife and two children will follow in late December when the school break begins. A third child, Carla, will remain in Edmonton to complete her remaining two years at university. Carla will reside at their house near the university until she graduates, at which time the house will be put up for sale. The house is owned by Mrs. Peters. Carla intends to have two boarders staying at the house, who will pay rent monthly to Mrs. Peters.

Peters holds 10% of the shares of a Canadian private corporation. The majority shareholder of that corporation is his brother Jason. The company pays regular quarterly dividends. Peters has agreed to sell the shares to Jason early in 20X1. The sale will result in a small profit for Peter. Jason will pay 40% of the purchase price in cash and the balance over two years, with interest at 7%.

Bendana has recently been awarded a contract to build a soccer stadium in Regina. The company has asked the British parent company to send its soccer field expert to Regina to consult on the project. Feiffer Thompson will arrive in Regina on November 1, 20X0, and remain there until August 20X1, by which time the project will be substantially finished. She will be paid a salary by Bendana while she is in Canada. Feiffer’s husband will remain in the United Kingdom to manage her large investment portfolio, which was left to her by her late father, the Earl of Feiffdom.

Sally Watkins, Bendana’s financial expert, works out of the company’s Toronto office. Watkins left last month for the Sudan, where she will arrange the financing for a large project of the Sudanese government. Basically, Watkins is on loan to that government. She is excited about taking a break from her normal duties and pleased to hear that the Sudan does not levy any income tax. She has kept her apartment in Toronto, as she plans to be away only until November 20X1. While she is away, her sister will occupy her apartment.

Required:
Describe briefly how each of the above activities will be affected by Canadian tax laws.
Solution to Case - Bendana Corporation

- Bendana Corporation is a resident of Canada because it was incorporated in Canada [ITA 250(4)] and, therefore, taxable on its world income [ITA 2(1), 3(a)].
- Holdings Limited is not resident because it is a U.K. corporation.
- Dividends, if any, paid from Bendana to Holdings are subject to Canadian withholding tax [ITA 212(2)].
- Expansion to U.S.:
  - Office in Chicago: income is part of Bendana's world income and taxed in Canada. The income may also be taxed in the U.S. but receives a foreign tax credit in Canada [ITA 3(a), 126(2)].
  - Purchase of U.S. Corp.: U.S. Corp. is not resident of Canada and its income is not taxed in Canada [ITA 2(3)]. Dividends paid to Canada may be subject to U.S. withholding tax.

Carl Peters:

- Makes a clean break either in October or December 20X0 depending on how much weight is put on the fact that the spouse is remaining in Canada a short time.
- Taxed on world income to date of departure [ITA 2(1), 114].
- Dividends from the private corporation will be subject to Canadian withholding tax after departure [ITA 212(2)].
- On departure, Peters is deemed to have sold his private corporation shares at fair market value and to reacquire them at that same amount [ITA 128.1(4)(b), (c)]. (See Chapter 8). When the shares are sold in 20X1, when Peters is a non-resident, the gain will not be taxable in Canada since the private corporation shares are not taxable Canadian property, assuming the value of the private company shares is not derived principally from real estate located in Canada [ITA 248(1)].
- Interest of 12% on deferred payments from the sale proceeds on the shares is subject to Canadian withholding tax since the interest is being paid to a related person (brother) [ITA 212(1)(b)].

Mrs. Peters:

- Receives rental income after departure on her house that is subject to a withholding tax [ITA 212(1)(d)].
- The house is exempt from the deemed disposition rules on departure [ITA 128.1(4)(b)(i)].

Feiffer Thompson:

- 20X0 - Not a permanent resident (no continuing ties). Therefore, as a non-resident employed in Canada in 20X0 she is taxed on employment income earned in Canada [ITA 2(3)].
- 20X1 - Present in Canada for more than 182 days and is, therefore, deemed resident [ITA 250(1)(a)] and taxed on world income (including investment income from U.K.) [ITA 2(1), 3(a)].

Sally Watkins:

- Doesn't appear to have made a clean break (plans to return). Therefore, she continues to be resident and, therefore, subject to tax on her world income [ITA 2(1), 3(a)].
CASE TWO

Greg & GK Ltd

[ITA: 150(1)(a), (d); 150(1.1), (2); 152(3.1), (4); 156(1); 156.1(1), (2),(4); 157(1), (1.1), (1.2),
(2.1); 161(1), (2), (2.2), (4.01)(d), (11); 162(1); 163.1; 165(1)(2)]

Greg is the sole shareholder of GK Ltd., a Canadian-controlled private corporation carrying on an active business, with a December 31 fiscal year end. Greg met with you on January 6, 20X6 (the current year) about a number of issues.

On August 1, 20X5, Greg received a demand to file a tax return for the 20X3 taxation year. Greg did not file a tax return for 20X3, because salary from GK Ltd. was his only income for the year. The payroll clerk at GK Ltd. was careful to ensure that the correct amount of tax was withheld from Greg's pay and remitted to the CRA monthly. Thus, Greg is looking for confirmation that he is not required to file a tax return for 20X3.

In 20X4, Greg won $500,000 in a lottery which he invested wisely. Because of the investment income, he prepared a tax return for 20X4. He personally delivered the tax return, together with a cheque in the amount of $9,200 for the balance of tax owing, to the CRA on September 30, 20X5. According to Greg's calculations, he will owe $12,000 in tax on his investment income earned in 20X5, so he plans to file his 20X5 tax return on time. He did not make any tax instalments in 20X5, as he did not receive an instalment notice from the CRA. Greg wonders whether he should make instalments for 20X6. He estimates that the tax on his 20X6 investment income will be $16,000.

GK Ltd.’s total federal tax liability was $18,000 in each of 20X3 and 20X4. It increased to $26,200 for 20X5. GK Ltd. made monthly federal tax instalments of $1,500 on the last day of each month in 20X5. Greg wants to ensure that the corporate tax return for 20X5 is filed on time and that all taxes owing are paid by the due date so as to avoid paying interest.

GK Ltd. received a notice of reassessment for the 20X1 taxation year, dated December 6, 20X5, stating that the corporation was assessed additional tax for the 20X1 year in the amount of $42,000. Greg is convinced that the reassessment is in error. Greg has the original notice of assessment for 20X1, dated February 21, 20X3, which indicated that the return was assessed as filed.

Greg is married and has three children. His wife is a self-employed computer consultant.

Required:

Prepare a memo to Greg providing advice on the issues. Assume the prescribed rates of interest under Reg. 4301 for computing taxable benefits are 3% for the first, third and fourth quarters, and 2% for the second quarter of 20X5.
Solution to Case Two – Greg & GK Ltd

Greg - Demand to file tax return for 20X3:

Every individual must file a tax return for a year [ITA 150(1.1) and (2)] if

- there is tax payable for the year,
- there is a taxable capital gain,
- there was a disposition of capital property,
- there is a positive balance in the individual’s HBP or LLP, or
- the Minister issues a demand for the return.

In Greg’s case, even though he has paid his tax, he is required to file a tax return for 20X3 because he is liable for Part I tax for the year. Since the Minister issued a demand for the return, it must be filed by the end of such reasonable time as may be stipulated in the demand. Interest and late-filing penalties are not applicable, as there is no balance due for the year.

Greg - 20X4 tax return:

The due date for filing a tax return is, in the case of individuals [ITA 150(1)(d)],

- April 30 of the following year,
- June 15 of the following year if the individual (or the individual’s spouse) carried on a business in the year (other than a business whose expenditures are primarily a capital cost allowance claim in respect of tax shelters), or
- in the case of a demand, by the end of such reasonable time as may be stipulated in the demand.

Greg’s tax return for 20X4 was due June 15, 20X5, because his wife, a self-employed computer consultant, carried on business in the year.

The tax return was not filed until September 30, 20X5. Therefore, Greg will be assessed a late filing penalty equal to 8% of the balance owing at June 15, 20X5 [ITA 162(1)].

- The initial penalty rate of 5% is increased by 1% for each complete month after June 15, 20X5 that the return remains unfiled, to a maximum penalty of 17% (5% + 12%).

The penalty is $736 ($9,200 x 8%).

The balance of tax due for 20X4 was due April 30, 20X5 [ITA 156.1(4), 248(1) definition of balance-due day].

The unpaid tax and penalty each attract interest, compounded daily [ITA 248(11)], on the unpaid balance [ITA 161(1) and (11)].

- The interest rate used in the computation is prescribed [Reg. 4301(a)] and fluctuates quarterly. For balances owing, the prescribed rate is increased by 4%. Thus, the prescribed rates applicable in this case for the period April 30 to September 30, 20X5 are as follows:

<table>
<thead>
<tr>
<th>Period</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>May 1 - June 30:</td>
<td>6% (2% + 4%)</td>
</tr>
<tr>
<td>July 1 - September 30:</td>
<td>7% (3% + 4%)</td>
</tr>
</tbody>
</table>
Greg - 20X5 tax return:

To avoid interest and penalties for 20X5, Greg should ensure that his balance of tax payable for 20X5 is paid by April 30, 20X6 and that his tax return is filed by June 15, 20X6.

Greg - Instalments for 20X6:

Income tax instalments are required for Greg for the current year, if his net tax owing exceeds $3,000 for the current year (20X6) and one of the 20X5 and 20X4 taxation years. Net tax owing includes provincial tax, and is reduced by taxes withheld at source [ITA 156.1]. The tax instalments are due quarterly, March 15, June 15, September 15, and December 15 [ITA 156(1)]. If mailed, it is sufficient that the instalment be sent by first class mail and postmarked by the due date [ITA 248(7)(a)].

The instalments required for the current year are the least of [ITA 156(1)]:

(a) the combined instalment base, which is
   • for March 15 and June 15, 20X6, each, one-quarter of his 20X4 tax payable;
   • for September 15 and December 15, two equal payments which, after subtracting the March and June amounts, will bring the total amount paid for 20X6 by December 15 up to his total tax payable for 20X5;
(b) four equal payments of one-quarter of his tax payable for the 20X5 year; or
(c) four equal payments of one-quarter of the estimated tax payable for 20X6.

Greg should use the combined instalment base method which results in payments of
• March 15 and June 15 - 1/4 of 20X4 tax of $9,200, or $2,300 each time;
• for September and December 15: 1/2 x ($12,000 - 2 x $2,300) = $3,700 each time.

Because Greg will owe more than $12,000 in 20X6, the remainder will be payable April 30, 20X7.

Interest will be charged on late or deficient instalments. Instalment interest is calculated only to the balance-due day for the year, i.e., April 30, 20X7 [ITA 161(2)]. If the instalment interest owing exceeds the greater of $1,000 and 25% of the instalment interest owing, if no instalments had been paid, a penalty of 50% of the excess is charged [ITA 163.1].

Non-refundable credit interest can be earned to offset late-paid instalments. For example, if the March 15 instalment is paid June 15, then an early payment of the September 15 instalment on June 15 will earn credit interest which would go towards offsetting the late-paid March 15 instalment [ITA 161(2.2)].

The CRA sends out notices based on the combined instalment base method. If Greg pays, when due, the amount on these notices (which normally would be the amounts set out above, if Greg had filed a 20X4 tax return on time), CRA will not charge any instalment interest. Since Greg did not receive such a notice from the CRA for 20X5, he will not be charged deficient instalment interest for 20X5 [ITA 161(4.01)(d)].
GK Ltd.: Tax return and payment of tax for 20X5:

A corporation is required to file a tax return for each taxation year, regardless of whether there is tax payable. The tax return is due six months after the taxation year end of the corporation, which in the case of GK Ltd. is June 30, 20X6 [ITA 150(1)(a)].

Corporations are required to make tax instalments if taxes payable for the current and preceding year exceed $3,000 [ITA 157(2.1)]. The instalments are due on the last day of each month. Corporate instalments will only be considered to have been received on time, if received by the due date; i.e., postmarks will not suffice [ITA 248(7)].

GK Ltd. must compute the instalments for 20X5 on one of the following bases [ITA 157(1)]:
• 1/12 x estimated tax payable for 20X5 ($26,200),
• 1/12 x tax payable for 20X4 ($18,000), or
• 1/12 x tax payable for 20X3 ($18,000) for the first two months, plus 1/10 (tax payable for 20X4 ($18,000) - the first two month’s instalments).

It appears that GK Ltd. has made its instalments for 20X5 correctly.

Small - CCPCs are allowed to make instalments on a quarterly basis, calculated using one of the following three methods [ITA 157(1.1)]:

4) $6,550; ¼ x estimated tax payable for 20X5 (1/4 x $26,200)
5) $4,500; ¼ x tax payable for 20X4 (1/4 x $18,000)
6) $4,500 for the March instalment; ¼ x tax payable for 20X3 (1/4 x $18,000); and $7,233 for the June, September and December instalments; 1/3 x ($26,200 - $4,500).

To be eligible to use the quarterly method, the CCPC must have had a perfect compliance history, and must meet each of the following three tests in either the current year or the preceding year [ITA 157(1.2)]:

1) claim the small business deduction
2) taxable income (together with associated corporations) not in excess of the business limit $500,000, and
3) taxable capital employed in Canada of $10,000,000 or less.

The balance of tax owing for a corporation is generally due two months after the end of the taxation year. However, for Canadian-controlled private corporations that claimed the small business deduction in the current or preceding year and with taxable income not exceeding $500,000 in the preceding year, the balance of tax is not due until three months after the end of the taxation year [ITA 157(1)(b), 248(1) definition of balance-due day].

It appears that GK Ltd. probably meets the requirements for the balance-due day to be three months after the end of the taxation year, which in the case of GK Ltd. is March 31, 20X6.
GK Ltd.: 20X1 Reassessment - Normal reassessment period:

The normal reassessment period for most corporations ends four years after the day of mailing of either an original notice of assessment or a notification that no tax is payable for the year. However, for Canadian-controlled private corporations, the normal reassessment period is reduced from four years to three years [ITA 152(3.1)]. Nevertheless, the CRA can reassess any taxpayer at any time where there is either

• a misrepresentation attributable to neglect, carelessness or wilful default, or fraud in filing the return or supplying any information, or
• a waiver on a specific item, filed in prescribed form before the end of the normal reassessment period described above [ITA 152(4)].

In the case of GK Ltd. the normal reassessment period for the 20X1 taxation year ends February 21, 20X6, being three years after the date of mailing on the notice of assessment, February 21, 20X3. Thus the CRA has the right to issue a reassessment for 20X1 at this time.

GK Ltd.: Notice of objection:

GK Ltd. can object to the reassessment on or before March 6, 20X6, i.e., 90 days after the date of mailing of the reassessment notice (90 days + December 6, 20X5 in this case) [ITA 165(1)].

The Notice of Objection -
• must be in writing,
• must set out the reasons for the objection and all relevant facts,
• must be addressed to the Chief of Appeals in a District Office or Taxation Centre of the CRA [ITA 165(2)],
• can be mailed by ordinary mail or delivered to that office, and
• need not be filed on a prescribed form.

GK Ltd. should proceed with filing a Notice of Objection on or before March 6, 20X6.
CHAPTER 4

INCOME FROM EMPLOYMENT

Review Questions

1. Explain this statement: “It is not the nature of the service that determines whether or not one is employed but, rather, the relationship which exists between the individual providing the service and the entity receiving the service.”

2. Distinguish between:
   a. individual A (a student), who spent the summer painting three houses. The contract for one house provided for a fixed fee; the contracts for the other two provided for a fee per hour and materials costs; and,
   b. individual B, who worked for a painting company and received a wage of $10 per hour for painting three houses.

3. “Income from employment for tax purposes includes the gross earnings from employment less expenses incurred to earn that income.” Is this statement true? Briefly outline the fundamental rules for establishing income from employment.

4. An individual begins employment on December 16, 20X0. The employer pays salaries monthly on the 15th day of each month. The individual receives her first salary payment of $3,000 on January 15, 20X1. How much, if any, of the $3,000 is taxable in 20X0? How much in 20X1? Explain.

5. An employer follows the policy of awarding bonuses to employees for their exceptional efforts. Bonuses are awarded on the last day of each calendar year but are not paid until two years later. Does this policy benefit the employer and the employee? Explain.

6. In addition to salaries, wages, and commissions, an employer may provide a wide range of benefits to employees. Describe the general tax treatment to the employee of benefits received from an employer, and explain how the value of these benefits is determined for tax purposes. If an employee is permitted to operate an employer’s automobile for personal use, does the treatment of this benefit conform to the general treatment of benefits? Explain.

7. From the employee’s perspective, what benefits, if any, receive preferential tax treatment? Explain briefly and compare the tax treatment these different benefits receive.

8. Distinguish between an allowance and a reimbursement.

9. What effect does the receipt of an allowance have on an employee’s ability to deduct expenses incurred to earn employment income?

10. With respect to deductions from employment income, compare the general tax treatment of an employee who is a salesperson and earns commissions with that of an employee who earns a fixed salary.
11. Can employees who earn commission income and are required to pay their own expenses to generate that income incur losses from employment for tax purposes? Explain.

12. When an employee is entitled to deduct particular expenses incurred to earn employment income, what restrictions, if any, are placed on the amount of expenses that can be deducted?

13. Why is it important for an employer to be familiar with the marginal tax rates that apply to its employees?

14. A number of indirect compensation benefits are considered to be taxable benefits to the employee. What advantage can the employer and/or the employee gain by including such benefits as part of a compensation package?

15. When an employer provides a taxable benefit to an employee at a cost that is lower than the normal retail price, what amount is included in the employee’s income for tax purposes?

16. Certain indirect forms of compensation are deductible by the employer but not taxable to the employee. Does this special tax treatment provide a benefit to the employee or to the employer? Explain.

17. How should the employer describe the value of benefits provided in a compensation package to an employee?

18. What is deferred compensation? How can it be of value to the employee?

19. An employer contributes $2,000 annually to a deferred profit-sharing plan on behalf of an employee for 10 years. The plan invests the funds and earns an annual return of 12%. What is the pre-tax annual salary equivalent of such a benefit for an employee who is subject to a marginal tax rate of 40%?

20. Explain what benefits the employer and the employee can achieve by establishing:
   a. a stock option plan;
   b. a stock purchase plan; and
   c. a stock bonus plan.
Solutions to Review Questions

R4-1 In order for an individual to derive employment income, an employer/employee relationship must exist. This relationship normally exists when a person agrees to provide their services at the full direction and control of the employer in return for a specific salary or wage. This relationship contemplates that the employer decides when, where, and what work is to be done. In comparison, an individual may provide services as an independent contractor in return for a fee for service. In such circumstances, the individual is not subject to the same direction and control. Income earned in this fashion is business income.

For example, an individual may provide accounting services as either an employee or as a business activity. The distinction rests with the manner in which the service is provided as determined by the relationship between the parties and not the type of service.

R4-2 Individual A contracts on a fee for service basis (either a fixed fee or an hourly rate) and bears full risk for the quality of work, how it is performed, and the collection of the fee. As an independent contractor the income earned is business income.

Individual B is under the direction and control of the painting firm which in turn contracts with the customer. Individual B receives a wage and is not responsible to the customer for quality of work or collection of the fees. Therefore, B is employed and earns employment income.

R4-3 This statement is not entirely true. While employment income consists of the gross earnings minus the deduction of expenditures, not all remuneration is taxable and not all expenses incurred to earn that income are deductible. Income from employment is determined from the following basic rules:

a) Gross employment income includes the salary, wages, commissions and gratuities earned, all benefits which are received or enjoyed by virtue of the employment, and all allowances received from the employer [ITA 5(1), 6(1)(a) & (b)].

b) By exception, a limited number of benefits and allowances are excluded from income [ITA 6(1)(a) & (b)].

c) As a general rule, no deductions are permitted in arriving at employment income except a limited number of specifically listed items [ITA 8(1)].

Consequently, certain income earned from employment is not taxable and certain expenses incurred to earn that income are not deductible.

R4-4 The taxation year of an individual is the calendar year ending on December 31 [ITA 249(1)]. Income from employment is included for tax purposes only when received [ITA 5(1)]. Therefore, even though a part of the salary is earned in 20X0 and a part is earned in 20X1, it is all included in the 20X1 taxation year when it was received.

R4-5 Normally an employer deducts expenses for tax purposes on an accrual basis - when incurred, not when paid. However, if the remuneration is not paid before 180 days following the end of the taxation year, the deduction for tax purposes is delayed until the year in which the payment is made [ITA 78(4)] (in this case two years). While this is a disadvantage, the employer has the advantage of increased cash flow for two years which may increase profits.
for the business. Even if the employer pays interest on the obligation they should still be able
to generate a higher return from the use of the funds.

The bonus is employment income to the employee and is therefore taxable on a cash basis
when it is received [ITA 5(1)] (after two years). This may be advantageous if the employee
receives interest on the deferred bonus as he/she will be earning a return on amounts that
otherwise would have been paid out for tax. If interest is not paid then no advantage will occur
unless the future tax rate (after two years) is lower than the tax rate in the year the bonus was
awarded.

There is also a possibility that the tax rate after two years will be higher than the current rate
which will be a disadvantage to the employee. The employee must therefore consider the
potential returns that can be achieved from the use of the bonus and the applicable tax rates
before it can be determined if the delayed payment is an advantage or disadvantage.

R4-6 As a general rule, an employee must include in income the value of any benefit received or
enjoyed by virtue of their employment. While the term value means fair market value, CRA
will, in some circumstances, accept the cost incurred by the employer to provide the benefit as
the value to be included in the employee's employment income [ITA 6(1)(a)].

The benefit derived from the personal use of an employer's automobile may not always
conform to the general rule. Two types of benefits can occur. The employer may provide the
use of the car and may also pay for its operating expenses. The benefit derived from the
payment of operating expenses is based upon an arbitrary amount of 24¢ (2011 prescribed
amount) for each kilometer driven for personal use [ITA 6(1)(k)(v)]. If the employment use is
greater than 50%, the employee has the option of determining the operating benefit as one-
half of the standby charge [ITA 6(1)(k)(iv)].

The benefit from use of the car itself, referred to as a standby charge, is calculated from a
strict formula which allocates a portion of the car's cost or lease amounts to the employee
based on its availability for personal use rather than on its actual use. For example, a leased
car used by the employee 60% for personal use and 40% for employer business requires that
2/3 of the lease cost be included as a taxable benefit if the car was available for personal use
throughout the period [ITA 6(1)(e), 6(2)]. Therefore, in this case, the taxable benefit is greater
than the actual benefit. Similarly, if the car is used 100% for personal use, only 2/3 of the
lease cost is considered a taxable benefit providing an advantage to the employee.

R4-7 Although the general rule requires that all benefits are taxable as employment income, a
number of specific exceptions are permitted [ITA 6(1)(a)]. These are:

- Employer contributions to a registered pension plan
- Employer contributions to a deferred profit sharing plan
- Premiums for group sickness or accident insurance plans
- Premiums for private health insurance
- Payments for supplementary unemployment insurance plans
- Counseling services relating to mental or physical health, or to the re-employment or
  retirement of the employee.
The benefits derived from the above insurance plans are normally not taxable to the employee. However, benefits for lost wages under the group sickness or accident insurance plans are taxable as employment income to the extent that they exceed the accumulated amount of any premiums paid by the employee [ITA 6(1)(f)]. The benefits from contributions to a pension plan and DPSP are not taxable until they are paid out of the plans to the employee.

R4-8 An allowance is a fixed amount paid to an employee on a regular basis to cover certain undetermined expenses which may be incurred by the employee. For example, the monthly receipt of $400 for travel expenses is an allowance and the employee may or may not incur that amount of expenses. Normally, an allowance is taxable [ITA 6(1)(b)].

A reimbursement is the repayment to an employee by an employer of specific costs incurred by the employee on behalf of the employer. For example, if an employee incurs travel costs for an employer and is repaid for the exact cost of those expenses the repayment is a reimbursement and not an allowance. A reimbursement is not taxable to the employee.

R4-9 Payment of an allowance to employees presumes that they will use the allowance to pay for certain expenses they incur to perform their duties. Whether or not the expenses can be deducted for tax purposes by the employee may depend on the tax treatment of the related allowance received to assist in the payment of those expenses.

Although the general rule is that allowances are taxable, specific exceptions permit certain allowances to be received tax free [ITA 6(1)(b)]. For example, travel allowances may be tax free if certain conditions are met. When an employee receives a tax free travel allowance she/he is not entitled to deduct the following expenses:

- If the employee is a salesperson, no deductions are permitted for any costs incurred to earn the commissions. Therefore, the tax-free travel allowance removes the ability to deduct travel expenses as well as a number of other expenses such as promotion, advertising and so on. On the other hand, if the travel allowance received is unreasonable (too high or too low) the allowance is taxable and all expenses can then be deducted [ITA 8(1)(f)].

- If the employee is not a salesperson, the tax-free travel allowance will eliminate the right to claim only travel expenses incurred by the recipient [ITA 8(1)(h)].

R4-10 The general rule relating to deductions from employment income is that no deductions are permitted except those provided in a limited list of exceptions [ITA 8(2)]. The exceptions for a salesperson are different from those of other employees.

By exception, a salesperson is permitted to deduct all expenses incurred to earn commission income to a maximum of the commissions earned [ITA 8(1)(f)]. Therefore, a sales person, meeting certain conditions, can deduct cost such as accounting and legal fees, advertising and promotion, automobile expenses, food and beverages, entertainment, parking, supplies, licences, lease payments for computers, cell phones, copy machines and other equipment, salaries for an assistant, office rent, training costs, travel, work-space-in-the-home expenses (including a portion of house insurance and property tax), and union and professional dues.

On the other hand, employees who are not salespeople are permitted only a limited number of specific types of expenses. For example, of the above mentioned expenses, only the legal, automobile, office rent, parking, supplies, salaries for an assistant or substitute, travel, parking
and work-space-in-the-home expenses (limited to utilities and maintenance), and union and professional dues are permitted as a deduction for employees who are not salespeople and who meet specific conditions [ITA 8(1)(h), (h.1), (i)].

R4-11 A salesperson is entitled to deduct expenses incurred for the purpose of earning employment income to a maximum of the commissions earned in any particular year. In addition, the salesperson can, as separate deductions, deduct supplies consumed, union & professional dues and capital cost allowance and interest on an automobile (also an airplane) to the extent they are incurred in the performance of their duties of employment [ITA 8(1)(i), (j)]. Therefore, to the extent that these expenses exceed the commission income, a loss from employment can occur.

R4-12 There are several general restrictions imposed:

- A permitted expense is deductible only to the extent that it is reasonable under the circumstances [ITA 67].
- The amount of capital cost allowance on a vehicle is limited to 30% on a declining balance basis [Reg. 1100(10)]. The maximum cost of an automobile available for capital cost allowance is $30,000 plus tax [ITA 13(7)(g)].
- The maximum deductible lease cost of a leased automobile is $800 plus tax per month [ITA 67.3].
- Interest on a loan to acquire an automobile is restricted to a maximum of $300 per month [ITA 67.2].
- Only 50% of the actual cost of meals and enjoyment of entertainment is permitted [ITA 67.1].

R4-13 Employees are subject to progressive tax rates. Therefore, the after-tax value of additional compensation varies for employees subject to different tax rates. For example, a 10% wage increase for an employee in the 40% tax bracket results in only a 6% increase in his or her disposable income, whereas, the same increase for a person in a 26% bracket increases disposable income by 7.4%. Certain forms of compensation offer either reduced tax costs, tax deferrals, or are tax free. Analyzing the applicable tax rates of all employees helps to identify which and how many employees within the organization would prefer alternate forms of compensation that minimize their tax and increase disposable income.

R4-14 Taxable indirect employee benefits include such items as the use of an employer's car for personal use, low interest loans, life insurance coverage and so on. Advantages can be gained if the employee would normally acquire these items on their own from after-tax income and if the employer can obtain the benefits (because of volume buying) at a cost that is lower than what the employee would have to pay on their own. The value of this cost saving can be kept by the employer exclusively for their advantage, or it can be passed on to the employee in whole or in part to provide greater after-tax income value at no extra cost to the employer.

R4-15 The value of the benefit that must be included in the employee’s income is the cost amount of that benefit to the employer. For example, if an employer can purchase group term life insurance for a premium cost of $600 compared to the normal retail cost of $800 that the employee would pay on their own, the taxable amount to the employee is only $600. (Note that the employer’ cost is the market price for the product when purchased in a group environment.)
R4-16 The special tax treatment can provide a benefit to either the employee, the employer, or be shared by them. For example, a $2,000 salary increase for an employee would cost the employer (who is subject to a 25% tax rate) only $1,500 after-tax ($2,000 - 25% tax saving) and would provide an employee (in a 34% tax bracket) with an after-tax value of $1,320 ($2,000 - tax cost of 34%). If the employer instead provided $2,000 of tax-free benefits, the employer's cost would remain at $1,500 after-tax, but the after-tax value to the employee would increase to $2,000 from $1,320. In this case, the full value of the tax treatment is passed on to the employee.

Alternatively, the employer could provide the employee with $1,320 of tax-free benefits which is equivalent to a $2,000 fully taxable salary (above). The employer's after-tax cost is then only $911 ($1,320 - 25% tax saving) compared to $1,500 for a $2,000 salary. In this case, the preferential tax treatment is fully retained by the employer as a cost reduction.

As a third alternative, the employer could provide tax-free benefits that are less than $2,000 but greater than $1,320 in which case both parties benefit from the special tax treatment.

R4-17 Benefits provided to employees as an alternative to direct salary should be described to employees in terms of their pre-tax salary equivalents in order that they can appreciate the real value of the compensation package. For example, the receipt of a $1,000 tax-free benefit (such as private medical insurance coverage) is the same as receiving a salary amount of $1,667 for an employee in a 40% tax bracket ($1,667 - tax @ 40% = $1,000). This is especially important when wage settlements are being negotiated in order to obtain cost efficiencies. In addition, providing an annual statement of the value of an employee's total compensation package in terms of pre-tax salary equivalents can have a positive impact on employee relations and future wage demands.

R4-18 Deferred compensation is a form of compensation that establishes a certain amount of remuneration for an employee in a particular year, but the payment of that amount is delayed until some future time. As such income is taxed only when received, the payment of tax is also delayed. The benefits from this form of compensation can be significant if the delayed payment is invested on behalf of the employee in a manner that the investment returns also accumulate on a tax deferred basis, such as when the funds are invested in a registered pension plan or a deferred profit sharing plan.

The compounding of investment returns on a pre-tax basis combined with the possibility that future tax rates may be lower if the invested funds are not paid out until retirement, will provide a substantially higher wealth accumulation than receiving annual taxable salaries and investing the after-tax proceeds.

R4-19 The $2,000 paid annually into a DPSP will earn interest at 12% without tax until the accumulated amount is distributed after 10 years. Its value is as follows:

| Future value of regular deposits of $2,000 earning 12% | $39,309 |
| Less tax on distribution (40%) | (15,724) |
| **Total** | **$23,585** |

In comparison, an annual salary is taxable annually as received and only the after-tax amount is available for investment. The investment returns are also taxable annually leaving only
7.2% available for reinvestment (12% - 40% tax = 7.2%). The pre-tax salary equivalent required to accumulate $23,585 after 10 years is as follows:

Regular deposits for 10 years required, and invested at 7.2%, to yield $23,585 = $1,577

\[
x - .40x = 1,577 \\
x = \frac{1,577}{.60} = $2,628
\]

Therefore, a $2,000 contribution to a DPSP is equal to direct salary of $2,628.

R4-20 A **stock option plan** permits an employee to purchase shares directly from the corporation at a specified price for a certain time period. It is attractive to the employer because it does not result in a cash cost. In fact, the company's cash resources are increased by the issue of shares. It also stimulates employees to be concerned about the long-term profitability of the business. For the employee, an advantage occurs from the fact that the share option price is fixed for a time period even though the stock value may continue to grow. Therefore, any growth in value accrues to the employee even though the stock has not yet been purchased.

When the stock is purchased, a taxable benefit occurs equal to the difference between the value of the shares at the time of purchase and the preferential purchase price.

If the stock value at the date the option was granted is the same as (or less than) the option price, the employee is entitled to claim the stock option deduction (one-half of the taxable benefit) in arriving at taxable income.

If the employer is a CCPC, the same taxable benefit occurs but is taxable to the employee when the shares are sold. Where the employer is a CCPC, the employee is entitled to the stock option deduction even if the options price is below the value of the shares at the date the option is granted provided the employee holds onto the shares for at least two years.

A **stock purchase plan** is simply a funding program of the employer permitting the employee to purchase shares in the employer's corporation by providing a loan. There is no cash cost for the employer because the funds loaned are returned immediately for the issued shares. The benefits for the employer are similar to the stock option plan above. For the employee, the stock purchase plan provides an investment opportunity without a financial burden.

A **stock bonus plan** means that an employer issues shares to an employee at no cost in lieu of a cash bonus. While this may be beneficial to an employer because it requires no cash payment, it does not provide a significant benefit to the employee as the full value of the shares received is taxable as if it were received as a salary.
Key Concept Questions

QUESTION ONE

Carol received salary of $60,000 during the current year. In addition she earned commission income of $25,000 of which she received $15,000 in the current year. She received the remaining $10,000 in the first quarter of the following year.

Determine Carol’s employment income for the current year. *Income tax reference: ITA 5(1).*

QUESTION TWO

Mike’s employer has a generous benefit program. During the current year his employer provided him with the following benefits:

- A contribution to the company RPP of $6,000.
- Group term life insurance coverage of $100,000. The premium for the coverage was $400.
- Group sickness or accident insurance coverage. The premium paid was $550.
- A private health services plan that provided Mike with dental, vision, prescription drugs, and private-hospital room coverage. The premium was $800.
- Mental health counselling for Mike’s daughter. The psychologist’s fee was $1,500.
- Fitness club membership for Mike’s personal enjoyment. The membership dues were $900.
- Public transit pass for city bus. The annual cost was $800.

Determine the amount to be included in Mike’s employment income for tax purposes. *Income tax reference: ITA 6(1)(a), 6(4).*

QUESTION THREE

Jennifer’s employer provided her with the following gifts and awards in 20X9:

- Golf shirt with the employer logo (cost amount) $15
- Birthday gift – monetary restaurant gift certificate 75
- Reward for meeting sales performance – holiday weekend 400
- 10-year anniversary award (golf club). Her last anniversary award was on her 5th anniversary with the employer 275
- Wedding gift (cutlery) 300
- Innovation and excellence award (tickets to a concert) 250
- Holiday season gift (artwork) 150

Briefly describe the tax consequences to Jennifer for the above gifts and awards. *Income tax reference: ITA 6(1)(a); CRA Income Tax Technical News (June 11, 2009)*
QUESTION FOUR

On September 1 of the current year, Teresa will have worked for A Ltd. for three years and will be entitled to a company car as of that date. For A Ltd. to purchase the car that Teresa wants they will have to pay $48,000, including tax. If the car is leased, the monthly lease cost will be $950, including tax. In either case, A Ltd. will pay all of the operating costs for the car which are expected to be $2,500 annually. Teresa anticipates that she will drive the car 2,000 km per month of which 200 km will be for employment purposes. *Income tax reference: ITA 6(1)(e), (k), 6(2).*

A. Determine the amount to be included in Teresa’s employment income for the current year (i) if A Ltd. purchases the car, and (ii) if A Ltd. leases the car.

B. If in the following year, Teresa drives the car 12,000 km for employment purposes and 8,000 km for personal use, determine the amount to be included in her income for tax purposes, assuming the car is purchased by A Ltd.

QUESTION FIVE

On March 1 of the current year, Len received a $100,000 loan from his employer. The loan bears interest at 1% per year. The interest is payable monthly. The principal is repayable at the end of five years. Len used $90,000 of the loan toward the purchase of his home. The $10,000 that was left over, he used to purchase investments. Assume the prescribed interest rates for the current year were 4% for the first quarter and 5% for the remainder of the year.

A. Determine the amount to be included in Len’s employment income for tax purposes for the current year. *Income tax reference: ITA 6(9), 80.4(1), (4), (6), 80.5, 20(1)(c).*

B. Assume Len purchased the home because of an eligible relocation. Calculate the home relocation loan deduction. *ITA 110(1)(j).*

QUESTION SIX

In Year 1, Kayla, an employee of a public company, was granted an option to acquire 100 shares from the company’s treasury at a price of $12 per share. At the date that the option was granted, the shares were trading on the stock market at $22 per share. In Year 2, Kayla exercised the option and acquired 100 shares. At that time the shares were trading at $40 per share. In Year 6, Kayla sold the shares for $66 per share.

Discuss the income tax consequences of Kayla’s transactions (show calculations). *Income tax reference: ITA 7(1).*

QUESTION SEVEN

How would Kayla’s tax consequences change in Question Six (above) if her employer was a Canadian-controlled private corporation? *Income tax reference: ITA 7(1.1), 110(1)(d.1).*
QUESTION EIGHT

In Year 1, a public company granted an employee resident in Canada an option to purchase 1,000 common shares of the employer company for $10 per share. The fair market value of the shares at the date the option was granted was $8 per share. No other stock options were granted to this employee during Year 1. In Year 2, when the shares were worth $16 per share the employee exercised the option and purchased all 1,000 shares.

In Year 5, the employee sold the 1,000 shares for $38 per share. The shares do not have any special dividend rights or restrictions.

Discuss the income tax consequences to the employee from these transactions (show calculations).


QUESTION NINE

Richard earned a salary of $40,000 plus commissions of $6,000 in the current year as a salesperson employed by B Ltd. He incurred the following expenses to earn his income:

<table>
<thead>
<tr>
<th>Expense</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Car expenses</td>
<td>$2,500</td>
</tr>
<tr>
<td>Transportation (other than car) &amp; accommodation</td>
<td>5,000</td>
</tr>
<tr>
<td>Client entertainment meals</td>
<td>600</td>
</tr>
<tr>
<td>Advertising and promotion</td>
<td>2,000</td>
</tr>
<tr>
<td><strong>Total expenses</strong></td>
<td><strong>$10,100</strong></td>
</tr>
</tbody>
</table>

Determine the maximum deduction that Richard is entitled to claim in computing his employment income for the current year. Income tax reference: ITA 8(1)(f), (h), (h.1), 67.1.

QUESTION TEN

Julie is required to use her own automobile and pay for all her travelling expenses in carrying out her duties of employment. She purchased a new car on January 2nd of the current year for $45,000 (plus tax) and incurred the following expenses during the year:

- Gasoline $2,100
- Repairs and maintenance 400
- Parking (employment related) 100
- License and insurance 2,300
- Interest on loan to acquire car (12 months) 4,100

Julie drove her car 20,000 km in the current year of which 8,000 km were driven in carrying out her duties of employment.

Calculate the maximum tax deduction available to Julie for her car for the current year. (The CCA rate for automobiles is 30%, except in the first year when it is only 15%.) Income tax reference: ITA 8(1)(h.1),(j), 13(7)(g), 67.2.
QUESTION ELEVEN

Howard is employed as a computer programmer and is required by his employment contract to maintain an office in his home. There is only one telephone line in Howard’s home. He estimates that 40% of the usage of his telephone is employment related (all local calls). He purchased a new computer for his office on September 1 of the current year. He estimates that he uses the computer 90% for employment purposes. Howard works in his home office four days each week and attends meetings at his employer’s place of business on the fifth day. The office occupies 10% of the square footage of his home.

He incurred the following costs in the current year:

<table>
<thead>
<tr>
<th>Cost</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mortgage interest (10%)</td>
<td>$1,200</td>
</tr>
<tr>
<td>Property taxes (10%)</td>
<td>340</td>
</tr>
<tr>
<td>House insurance (10%)</td>
<td>120</td>
</tr>
<tr>
<td>Utilities (10%)</td>
<td>420</td>
</tr>
<tr>
<td>Maintenance (10%)</td>
<td>200</td>
</tr>
<tr>
<td>Telephone (40%)</td>
<td>210</td>
</tr>
<tr>
<td>New computer (100% of cost)</td>
<td>1,300</td>
</tr>
</tbody>
</table>

What is the maximum amount that Howard can claim in the current year for the costs he has incurred in respect of his home office? Income tax reference: ITA 8(1)(i), 8(13).
Solutions to Key Concept Questions

KC 4-1

[ITA: 5(1) – Cash basis for employment income]

Carol’s employment income for the current year is $75,000. Only the amount she received in the current year is included (salary of $60,000 + commission of $15,000) [ITA 5(1)(a)].

KC 4-2

[ITA: 6(1)(a), 6(4) – Taxable benefits]

Mike must include $2,100 in his income for tax purposes.

Employer-paid premium for life insurance coverage [ITA 6(1)(a), 6(4)] $ 400
Club membership dues, not principally for the employer’s benefit [ITA 6(1)(a), T4130 page 23]. 900
Public transit pass 800

The following benefits are excluded from income for tax purposes:

- Employer’s contribution to the RPP [ITA 6(1)(a)(i)]
- Employer-paid premium for group sickness or accident insurance coverage [ITA 6(1)(a)(i)]
- Employer-paid premium for a private health insurance plan [ITA 6(1)(a)(i)] and
- Counselling services for mental health for Mike or his relatives, paid for by his employer [ITA 6(1)(a)(iv)].

KC 4-3

[ITA: 6(1)(a); CRA Income Tax Technical News, June 11, 2009 – Taxable Benefits]

Tax consequences in accordance with CRA published administrative policy:

- The golf shirt is not a taxable benefit since it is of an immaterial/nominal value.
- The gift certificate is a taxable benefit since it is a near-cash gift.
- The weekend holiday given to the employee for meeting the sales performance target is a taxable benefit. Performance-related rewards are considered to be a form of remuneration and are taxable.
- The 10-year anniversary award in not a taxable benefit. Jennifer has not received an anniversary award for the past five years of service and the total value of the gift was no in excess of $500.
- The total value of the remaining gifts and awards (wedding, innovation and excellence and holiday season) amount to $700. Jennifer will be considered to have received a taxable benefit in the amount of $200 ($700 – $500).

Note that although the 10-year service/anniversary award was $225 less than the allowable
$500 threshold, this shortfall cannot be applied to offset the taxable benefit arising as a result of the excess value of the annual gifts and awards over $500.

**KC 4-4**

[ITA: 6(1)(e), (k), 6(2) – Automobile benefits]

A. (i) A Ltd purchases the car for $48,000:

- Standby charge [ITA 6(1)(e), 6(2)]
  
  \[ $48,000 \times 2\% \times 4 \text{ months} \]
  
  \[ $3,840 \]

- Operating benefit [ITA 6(1)(k)]
  
  \[ 0.24 \times 7,200 \text{ personal km} \]
  
  \[ 1,728 \]

\[ (2,000 \text{ km} – 200 \text{ km} = 1,800 \times 4 \text{ months} = 7,200) \]

\[ $5,568 \]

(ii) A Ltd leases the car for $950 per month:

- Standby charge [ITA 6(1)(e), 6(2)]
  
  \[ \frac{2}{3} \times 950 \times 4 \text{ months} \]
  
  \[ $2,533 \]

- Operating benefit [ITA 6(1)(k)]
  
  \[ 0.24 \times 7,200 \text{ personal km} \]
  
  \[ 1,728 \]

\[ (2,000 \text{ km} – 200 \text{ km} = 1,800 \times 4 \text{ months} = 7,200) \]

\[ $4,261 \]

B. A Ltd purchases the car for $48,000 and Teresa drives more than 50% of the km in the year for employment purposes:

- Standby charge [ITA 6(1)(e), 6(2)]
  
  \[ $48,000 \times 2\% \times 12 \text{ months} \times \frac{8,000}{1,667 \times 12 \text{ mo}} \]
  
  \[ $4,607 \]

- Operating benefit [ITA 6(1)(k)] - lesser of
  
  - \[ 0.24 \times 8,000 \text{ personal km} = $1,920 \]
  
  - \[ \frac{50\% \times 4,607 = $2,304}{\text{50\% of the standby charge}} \]

\[ 1,920 \]

\[ $6,527 \]

Note that since the car was driven more than 50% of the total km for employment purposes, the standby charge is reduced and Teresa has the option of calculating the operating benefit as 50% of the standby charge.
**KC 4-5**

[ITA: 6(9). 80.4(1), (4), (6), 80.5, 20(1)(c) – Employee loans]

**Part A**

Employee loan interest benefit [ITA 6(9), 80.4(1), (4)]

<table>
<thead>
<tr>
<th></th>
<th>House Loan</th>
<th>Investment Loan</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prescribed interest -</td>
<td></td>
<td></td>
</tr>
<tr>
<td>March 1 to March 31 – 31 days @ 4%</td>
<td>$306</td>
<td>$34</td>
</tr>
<tr>
<td>April 1 to December 31 - 275 days @ 4%</td>
<td>2,712</td>
<td></td>
</tr>
<tr>
<td>April 1 to December 31 - 275 days @ 5%</td>
<td></td>
<td>377</td>
</tr>
<tr>
<td>Less interest @ 1% for the year paid by 30 days after the end of the year – 306 days</td>
<td>(755)</td>
<td>(84)</td>
</tr>
<tr>
<td></td>
<td>$2,263</td>
<td>$327</td>
</tr>
</tbody>
</table>

The prescribed interest rate for the investment loan changed throughout the year whereas the prescribed interest rate for the home loan remained at 4%, the rate at the time the loan was received. Home loans benefit from this prescribed rate protection. If the prescribed rate declines, the lower rate can be used. However, if it increases, the rate at the time the loan was made will be used, for a maximum of five years [ITA 80.4(4), (6)].

Len will be entitled to deduct interest paid of $411 (actual interest paid $84 + low-interest benefit $327 deemed to be interest paid [ITA 80.5] in computing his investment income for tax purposes [ITA 20(1)(c)].

**Part B**

The home relocation loan deduction is $838, calculated as the least of the following three amounts [ITA 110(1)(j)]:

(i) Imputed interest benefit on the home relocation loan $2,263

(ii) $25,000 x 4% x 306/365 days = $838

(iii) Imputed interest benefit on all employee loans ($2,263 + $327) = $2,590

The home relocation deduction is a deduction from net income in computing taxable income, not employment income.

A home relocation loan is defined as a low-interest or interest-free loan received by an employee and used buy a new home, where the individual has commenced employment at a new work location in Canada, and because of the new work location has moved such that it is 40 kms (at least) shorter to go to work at the new work location from the new home than it would be from the old home [ITA 248(1)].
No benefit is recognized for tax purposes in Year 1 when the option is granted.

Year 2 (shares purchased):

- Value of shares at date acquired (100 @ $40) $4,000
- Option purchase price (100 @ $12) 1,200
  
  **Employment income** [ITA 7(1)] 2,800

Year 6 (shares sold):

- Selling price (100 @ $66) $6,600
- Value at share purchase date (100 @ $40) 4,000
- Capital gain 2,600
  
  **Taxable capital gain** 1,300

The difference is in the timing of the recognition of the employment income. In KC 4-6, the stock option benefit was recognized when the shares were purchased. In KC 4-7, the stock option benefit is recognized when the shares are sold. The value of the benefit remains the same.

Year 6 (shares sold):

- **Employment income** -
  - Value of shares at date acquired (100 @ $40) $4,000
  - Option purchase price (100 @ $12) 1,200
    
    **Employment income** [ITA 7(1.1)] 2,800

- **Taxable capital gain** -
  - Selling price (100 @ $66) $6,600
  - Value at share purchase date (100 @ $40) 4,000
  - Capital gain 2,600
    
    **Taxable capital gain** 1,300

- **Stock option deduction** (taxable income calc.)
  - (½ x $2,800 employment inclusion) $(1,400)

In computing **taxable income**, Kayla qualifies for the stock option deduction because she meets the following conditions [ITA 110(1)(d.1)]:

She did not dispose of the shares within 2 years after acquiring them. Her employer is a CCPC, dealing at arm’s length with Kayla when the stock option agreement was entered into.
KC 4-8

[ITA: 7(1), 110(1)(d) – Stock options]

In this case, the employee qualifies for the stock option deduction in computing taxable income, since the shares are ordinary common shares, the employee was at arm’s length with the employer when the option was granted and the value of the shares when the stock option agreement was entered into did not exceed the exercise price of the option [ITA 110(1)(d)].

Year 2 (shares purchased):

\[
\begin{align*}
\text{Employment income} - \\
\text{Value of shares at date acquired (1,000 x $16)} & = \$16,000 \\
\text{Option purchase price (1,000 x $10)} & = (10,000) \\
\text{Employment income [ITA 7(1)]} & = \$6,000 \\
\end{align*}
\]

\text{Stock option deduction (taxable income calc.)} \\
(1/2 x $6,000 employment benefit) \\
\$3,000

Year 5 (shares sold):

\[
\begin{align*}
\text{Selling price (1,000 x $38)} & = \$38,000 \\
\text{Value at share purchase date (1,000 x $16)} & = (16,000) \\
\text{Capital gain} & = \$22,000 \\
\text{Taxable capital gain} & = \$11,000 \\
\end{align*}
\]

KC 4-9

[ITA: 8(1)(f), (h), (h.1), 67.2 – Employment deductions]

The maximum deduction that Richard is entitled to claim is $7,500.

There is only one provision of the Act that permits an employee to deduct advertising and promotion and entertainment expenses. That provision is the salesperson’s provision [ITA 8(1)(f)]. This provision allows employees to deduct all expenses incurred to earn employment income subject to a limit, that limit being commission received in the year or a bonus based on sales volume. Entertainment expenses are only 50% deductible for tax purposes [ITA 67.2].

Since Richard has commission income, he can claim up to $6,000 of expenses under the salesperson’s provision [ITA 8(1)(f)], the $6,000 being the amount of commission income received in the year.

Alternatively, Richard could claim his travel expenses of $5,000 under the travel provision [ITA 8(1)(h)] and his car expenses of $2,500 under the car provision [ITA 8(1)(h.1)]. These provisions have no limits. Therefore, Richard’s total deduction would be $7,500.

No deduction under the salesperson’s provision [ITA 8(1)(f)] is allowed if a deduction is claimed under the travel expense provision [ITA 8(1)(h)] or the car provision [ITA 8(1)(h.1)]. Thus the entertainment expenses and advertising and promotion cannot be deducted.
**KC 4-10**

[ITA: 8(1)(h.1), (j), 13(7)(g), 67.2 – Automobile deductions]

The maximum tax deduction available to Julie for her car is $5,494, calculated as follows:

<table>
<thead>
<tr>
<th>Automobile operating costs [ITA 8(1)(h.1)]:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Gasoline</td>
<td>$2,100</td>
</tr>
<tr>
<td>Repairs &amp; maintenance</td>
<td>400</td>
</tr>
<tr>
<td>License and insurance</td>
<td>2,300</td>
</tr>
<tr>
<td></td>
<td>4,800</td>
</tr>
<tr>
<td>prorate for employment use</td>
<td>x 8/20</td>
</tr>
<tr>
<td></td>
<td>1,920</td>
</tr>
<tr>
<td>Parking (all employment)</td>
<td>100</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Automobile – CCA and Interest expense [ITA 8(1)(j)]:</th>
</tr>
</thead>
<tbody>
<tr>
<td>CCA $33,900 * x 15%</td>
</tr>
<tr>
<td>Interest on car loan – limited [ITA 67.2]:</td>
</tr>
<tr>
<td>o $300 x 12 months = $3,600</td>
</tr>
<tr>
<td>o actual $4,100</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>prorate for employment use</td>
</tr>
<tr>
<td></td>
</tr>
</tbody>
</table>

*$*$ The maximum cost of an automobile available for CCA is $30,000 plus applicable taxes. The applicable taxes are assumed to be HST of 13%. Therefore, CCA is calculated on $33,900 ($30,000 x 1.13) even though the car cost $45,000 plus tax.

**KC 4-11**

[ITA: 8(1)(i), 8(13) – Home office]

The maximum tax deduction for Howard with respect to his home office expenses is $620.

Howard is entitled to a deduction for home office expenses under ITA 8(1)(j). The deduction in not denied by ITA 8(13) since Howard’s home office is the place where he principally performs his duties of employment. He works 4 days out of 5 in his home office. Howard’s deductible expenses consist of utilities $420 plus maintenance $200.

**Comments:**

Mortgage interest is never deductible in computing employment income. It can be deducted in computing business and property income [ITA 20(1)(c)].

Property taxes and house insurance are not deductible by a regular employee as they are not consumed. They can be deducted by a salesperson, subject to commission limitation [ITA 8(1)(f)].

The CRA takes the position that where there is only one telephone line in the home, the costs incurred for the service are personal. If Howard had incurred long distance charges for employment purposes, he could have deducted those charges [ITA 8(1)(i)].
The cost of the computer is not deductible because it is capital in nature as opposed to a supply consumed. Employees are permitted a deduction for interest and CCA on two capital items only – cars and airplanes [ITA 8(1)(j)].
Problems

PROBLEM ONE

Bill Watkins is a chartered accountant. He carried on a professional business as a tax consultant for 12 years. By the end of 20X0, the practice had grown very large. Watkins was overworked and under pressure to hire additional staff or take a partner. Watkins was interested in education and several years earlier had contracted with a publisher to write a book on taxation for university students. Because of the pressures of his practice, this project made little progress.

To optimize his work life, Watkins decided to close his professional practice and enter into an arrangement with Anthony and Anthony, a national firm of chartered accountants. According to the agreement, he would work a minimum of 600 hours per year for the firm; he would also be free to pursue his writing and other interests. He would provide the 600 hours mainly during the winter months and would not be expected at the office every day of the week.

Anthony and Anthony made a formal announcement in the newspaper that Watkins was now associated with their firm and provided him with business cards stating both his name and the firm’s. The firm did not give him a specific title, though most of its employees had one, whatever their level. The firm did provide him with an office (of the same size as was given to partners) and a secretary at no cost to him.

As a tax consultant, Watkins met with the clients of the firm and corresponded with them under the firm’s letterhead. Jobs were assigned to him by any partner who required his services. Usually, he charged any time spent on a client directly to the particular partner’s account; that partner, in turn, billed the client and collected the fees.

Anthony and Anthony charged clients for Watkins’s time at $150 per hour. The agreement stated that he was to be paid $100 for each hour charged to a client whether the client paid the fee or not. At the end of each month, Watkins prepared an invoice requesting that the firm pay $100 for each hour charged that month.

Throughout the year, Watkins paid for his own parking and for his own subscriptions to several tax services, the latter being necessary for him to carry out his duties. Whenever the firm held a social function, Watkins was invited. In 20X1, he gave three speeches to various business groups and was always introduced as “Bill Watkins, a tax consultant with Anthony and Anthony.”

In 20X1, Watkins worked 820 hours for the firm. He spent the balance of his working time writing his book and giving tax seminars to various professional groups.

Required:

Was Watkins employed or self-employed in 20X1? Give reasons to support your conclusions and reasons to support the opposing view.
Solution to P 4-1

Whether a person is employed or self-employed and earning business income is a question of fact judged by the circumstances of each situation.

When it is not clear whether a person is employed or self-employed as an independent contractor, the courts consider four factors which should be used as guidelines.

1. Economic Reality or Entrepreneur Test

   (a) Control: the control test determines whether the individual is directed by someone who is in a position to order or require not only what is to be done but how, when and where it is to be done

   (b) Ownership of Tools: this test determines who supplies the equipment and tools for the work, with the value of the investment in these items being considered.

   (c) Chance of Profit, Risk of Loss: this test determines whether the worker has the chance of making a profit; risks incurring losses due to bad debts, damage to equipment or materials, unforeseen delivery delays, and other operating costs

2. Integration or Organization Test

   This test examines whether the worker is economically dependent on the payer organization and how integral to the business is the worker. Evidence of the worker receiving the economic rights, privileges and benefits normally enjoyed by employees would be facts supporting employment status. Benefits normally enjoyed by employees include paid vacation and statutory holidays and access to existing employee benefit plans. Evidence of the worker having other clients (or the ability to have other clients) would support self-employed status. See, for example, W.B. Pletch Co. v. R, 2005, TCC 400 and Dynamic Industries v. R, 2005 FCA 211, two recent PSB cases.

3. Specific Result Test

   Where an individual agrees that certain specified work will be done without an agreement that the individual provide continuing personal services, it may be inferred that a self-employment relationship exists.

4. Common Understanding of the Relationship

   The partie’s intention and the existence of a written contract as evidence of their intention as long as the contact is in accordance with the facts and not a sham. [See, for example, Wolf, and Royal Winnipeg Ballet v. MNR, 2006 FCA 87 as well as more recent cases dealing with the employment status of individuals.]

In this case the relationship between Watkins, who provides the service, and A&A who receives the service is difficult to establish.
Factors supporting an employee/employer relationship:

- Watkins closed his professional practice and now provides service to only one entity.
- Public was informed that he is part of the A&A organization.
- A&A provides Watkins with an office and secretary similar to other employees.
- Watkins corresponds with A&A clients under the firm’s letterhead.
- He works for several partners of the firm and charges time to their accounts as directed.
- He is not responsible for collecting fees. He is paid for client work even if the client fails to pay the firm.
- Participates in firm’s social activities as if he is a member of the firm.
- Makes speeches as a representative of the firm.
- Holds business cards as a representative of the firm.

All of the above factors indicate that Watkins and A&A have an employer/employee relationship. In summary, he is presented as a member of the A&A firm.

Factors supporting an independent service relationship:

- Watkins is not a partner, nor is he designated in any of the employee ranks with A&A
- He has committed only 600 hours of service but can do more at his option.
- Free to pursue other professional interests outside of the firm.
- Not required to report to work every day or at certain times as other employees do.
- Uses an office of the style normally designated to partners.
- Was paid in the form of a fee by providing a bill indicating the hours of service and the related fee.
- Watkins pays for his own parking and tax journals.

All of the above factors indicate that Watkins has a different relationship than any employee of A&A and is an independent contractor.

Conclusion:

Although Watkins is not a partner, it is the opinion of the authors that he is an independent contractor. His special relationship with A&A is sufficiently different from that of all other employees and this factor appears predominant.

However, it is recognized that the opposite view is also arguable.
PROBLEM TWO

[ITA: 5(1); 6(1)(e); 6(2)]

Jennifer Ratushny is a middle-level manager at a New Brunswick–based advertising agency. Her contract of employment requires her employer to provide her with an automobile for personal use. Two years ago, the employer purchased for her an automobile that cost $23,000. All costs to operate the vehicle are paid by Ratushny. She is not required to use the vehicle for any of her employment duties.

The employment contract also stipulates that Ratushny may, if she chooses, purchase the vehicle from the employer at any time for a price equal to the depreciated value of the car. The automobile's depreciated value is now $14,000.

Ratushny is thinking of purchasing the car from her employer. Her bank is willing to loan her the money for it at 8%. The car is in good condition. If she makes the acquisition, she intends to use the car for at least three more years. A friend of hers, who is in the automobile business, has informed her that, subject to any mechanical problems, the car should have a resale value of $8,000 three years from now.

Ratushny earns a high salary; her marginal income tax rate is 45%.

Required:

Should Ratushny purchase the car at this time, or should she continue to use it as an employer-owned vehicle?
Solution to P4-2

**Keeps present arrangement:**

If she continues to use the employer’s car she will pay tax annually for three years on the value of the standby charge. Assuming a 10% discount rate, the present value of these costs is $6,864 as follows:

- Annual standby charge ($23,000 \times 2\% \times 12 \text{ months}) = $5,520
- Annual tax cost (45\% \times $5,520) = $2,484
- Present value ($2,484 \text{ for 3 yr at } 8\%) = $6,400

**Purchases the car:**

If she buys the car, her immediate cash cost will be reduced by $8,000 when the car is sold after three years. The net cost of this option is $7,680 as follows:

- Cost of car = $14,000
- Less present value resale amount:
  - (PV of $8,000 @ 8\% \text{ for 3yr}) = (6,320)

  $ 7,680

The outcome suggests that she should not purchase the car. However, keep in mind that the resale value of the car is uncertain. It could sell for more or less. To make the two options the same, the purchased car would have to sell for about $9,620.
PROBLEM THREE

[ITA: 5(1); 6(1)(a), (e); 6(2); 6(9); 80.4(1), (4); IT-470R]

Charles and Cathy are employed by different companies. They earn the same amount of income and share a similar lifestyle. However, each receives a different type of remuneration.

Charles earns a total of $50,000, which is paid in the form of a monthly salary. His annual personal expenses (excluding income tax) are shown in table A.

Cathy also earns $50,000 annually. Her remuneration is as shown in table B. Her personal expenses (excluding income tax) are shown in table C.

Both Charles and Cathy pay income tax at a rate of 40%. Both invest any savings in an effort to build up a substantial investment portfolio.

Required:

1. For the current year, compare Cathy’s after-tax cash flow with that of Charles, and determine the amount each has available to add to an investment portfolio.

2. What amount of salary would Charles have to receive in order to have the same amount of cash available as Cathy for his investment portfolio?

TABLES

A. Life insurance ($100,000) $ 1,000
   Lease payments on automobile 6,000
   Interest on house mortgage (10% on $70,000) 7,000
   Family private medical insurance 1,000
   Golf club dues 2,000
   Automobile operating expenses 3,000
   Other personal living expenses 9,000
   $29,000

B. Salary $39,000
   Private medical insurance 1,000
   Group term life insurance ($100,000) 1,000
   Lease payments on company automobile used personally by Cathy 6,000
   Low-interest (5%) loan of $20,000:
       Prescribed interest rate (10%) $ 2,000
       Actual interest charged (5%) (1,000) 1,000
   Paid golf club dues (benefits employer) 2,000
   $50,000

C. Interest on house mortgage (10% of $50,000) $ 5,000
   Interest on employee loan used to acquire house 1,000
   Automobile operating costs 3,000
   Other personal living expenses 9,000
   $18,000
Solution to P4-3

1. Both Charles and Cathy earn remuneration of $50,000 from their employers. Both have identical living expenses, drive the same cars, belong to the same club, have the same debts, and hold the same insurance policies. Their comparative after tax cash flow is as follows:

Charles:

Income for tax purposes:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>ITA 5(1) Salary</td>
<td>$50,000</td>
</tr>
<tr>
<td>Tax @ 40%</td>
<td>$20,000</td>
</tr>
</tbody>
</table>

Cash flow:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salary received</td>
<td>$50,000</td>
</tr>
<tr>
<td>Less Tax</td>
<td>(20,000)</td>
</tr>
<tr>
<td>Personal expenses (as listed)</td>
<td>(29,000)</td>
</tr>
<tr>
<td>Excess cash for investment</td>
<td>$1,000</td>
</tr>
</tbody>
</table>

Cathy:

Income for tax purposes:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>ITA 5(1) Salary</td>
<td>$39,000</td>
</tr>
<tr>
<td>Benefits</td>
<td></td>
</tr>
<tr>
<td>ITA 6(1)(a) Private medical insurance premium</td>
<td>0</td>
</tr>
<tr>
<td>ITA 6(1)(a) Group life insurance premium</td>
<td>1,000</td>
</tr>
<tr>
<td>ITA 6(1)(e), 6(2) Leased auto 2/3 of $6,000</td>
<td>4,000</td>
</tr>
<tr>
<td>ITA 6(9); 80.4(1) Low interest loan</td>
<td></td>
</tr>
<tr>
<td>(4) $20,000 x 10% =</td>
<td>$2,000</td>
</tr>
<tr>
<td>ITA 80.4(1)(a) $20,000 x 5% = (1,000)</td>
<td>1,000</td>
</tr>
<tr>
<td>(assuming the $1,000 interest is paid within 30 days after the end of the year)</td>
<td></td>
</tr>
<tr>
<td>ITA 6(1)(a) Club dues, since Cathy being a member of the club benefits her employer’s business, the benefit is not taxable by administrative policy [IT-470R].</td>
<td>0</td>
</tr>
</tbody>
</table>

Employment income

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax @ 40%</td>
<td>$18,000</td>
</tr>
</tbody>
</table>

Cash flow:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salary received (cash)</td>
<td>$39,000</td>
</tr>
<tr>
<td>Less tax</td>
<td>(18,000)</td>
</tr>
<tr>
<td>Personal expenses (as listed)</td>
<td>(18,000)</td>
</tr>
<tr>
<td>Excess cash for reinvestment</td>
<td>$3,000</td>
</tr>
</tbody>
</table>
Cathy's higher cash flow results from the following:

- Medical insurance premiums paid by the employer are not taxable.
- Only 2/3 of the auto benefit is taxable even though the car is used entirely for personal use.
- Lower mortgage interest rate minus the tax on the benefit.
- Club dues are not taxable in Cathy's case.

2. For Charles to have the same cash flow as Cathy ($3,000) he would have to earn a salary of $53,334 calculated as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salary</td>
<td>$53,334</td>
</tr>
<tr>
<td>Tax @ 40%</td>
<td>(21,334)</td>
</tr>
<tr>
<td></td>
<td>$32,000</td>
</tr>
<tr>
<td>Personal expenses as listed</td>
<td>(29,000)</td>
</tr>
<tr>
<td>Excess cash</td>
<td>$ 3,000</td>
</tr>
</tbody>
</table>

Therefore Cathy's remuneration package which amounts to $50,000 is equivalent to a straight salary of $53,334.
PROBLEM FOUR

[ITA: 7(1), 110(1)(d)]

Pasqual Melo is employed by a public corporation. On January 1, 20X0, she was given an option to purchase 1,000 shares of the public corporation for $8 per share (the option extended for two years).

On December 15, 20X0, she exercised her option and bought 1,000 shares at $8 per share (total = $8,000).

On June 15, 20X3, she sold the 1,000 shares. The value of the shares at the particular dates was as follows:

<table>
<thead>
<tr>
<th>Date option granted</th>
<th>$ 8.50</th>
</tr>
</thead>
<tbody>
<tr>
<td>Date option exercised</td>
<td>10.00</td>
</tr>
<tr>
<td>Date shares sold</td>
<td>14.00</td>
</tr>
</tbody>
</table>

Required:

1. Determine the amount and type of income received by Melo and when that income was taxable.

2. How would your answer change if the value of the shares at the date the option was granted was $8 rather than $8.50?

3. How would your answer change if the employer were a Canadian-controlled private corporation?
Solution to P4-4

1. In 20X0, the year in which the option was exercised and the shares purchased the following employment income would be earned for tax purposes [ITA 7(1)]:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Value of shares on purchase date</td>
<td>$10,000</td>
</tr>
<tr>
<td>Cost of shares acquired</td>
<td>($8,000)</td>
</tr>
<tr>
<td>Employment Income</td>
<td>$  2,000</td>
</tr>
</tbody>
</table>

In 20X3, the year the shares are sold -

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Selling price</td>
<td>$14,000</td>
</tr>
<tr>
<td>Value of shares at purchase date</td>
<td>($10,000)</td>
</tr>
<tr>
<td>Capital Gain</td>
<td>$  4,000</td>
</tr>
<tr>
<td>Taxable capital gain (1/2)</td>
<td>$  2,000</td>
</tr>
</tbody>
</table>

2. Since the option is not in the money at the grant date (i.e., the option price is not less than the grant date value), in 20X0, one-half of the employment income from the stock option (1/2 x $2,000 = $1,000) can be deducted from net income in computing taxable income as a stock option deduction [ITA 110(1)(d)].

3. If the employer was a Canadian-controlled private corporation the answer in part 1 would change in two ways:

   a. The timing of the recognition of the stock option benefit for tax purposes. The employment income of $2,000 [(1,000 x $10) – (1,000 x $8)] is included in the taxpayer’s 20X3 income for tax purposes (the year the shares were sold) rather than in 20X0 (the year the shares were acquired) [ITA 7(1.1)].

   b. The stock option deduction. Because the employee held the shares for at least two years, when computing taxable income in 20X3, one-half of the employment income from the stock option (1/2 x $2,000 = $1,000) can be deducted as a stock option deduction [ITA 110(1)(d.1)].

Note that the taxable capital gain, in this case, may be eligible for the capital gains deduction as the shares may be qualified small business corporation shares if all or substantially all of the corporation’s assets are used in an active business [ITA 110.6(1)].
PROBLEM FIVE

[ITA: 5(1); 6(1)(a), (b), (c), (e), (g), (k); 6(2); 7(1); 6(9); 80.4(1); 7(1), (8); 110(1)(d); IT-470R]

Carol Posh is a senior advertising executive with a large Winnipeg company. With winter fast approaching, Posh is seriously considering an offer of employment from Westcoast Promotions Inc. (WPI), a large public company in Vancouver. Although housing costs are high in Vancouver, the climate and opportunities for career advancement would be better.

Posh has received a letter outlining a proposed remuneration package. The package is attractive but she is uncertain of the tax consequences. She has asked you to advise her. WPI recognizes the problem of housing costs and begins its letter with an offer to loan Posh $150,000, interest-free, to help finance a new house. In addition, WPI will reimburse her for 75% of her moving costs.

In addition to an annual salary of $120,000, WPI has offered the following benefits:

1. Posh will be appointed a director of the company’s American subsidiary in California; this will require her to travel to Los Angeles three times a year for board meetings. Posh will be paid a director’s fee of $5,000 directly from the American company. Company policy permits spouses to take these trips as well. When a director takes his or her spouse, all travel expenses are paid for by the company.

2. A luxury automobile will be provided for her personal use, even though she will never require the car for business. The company will pay all of the operating costs—approximately $3,200 per year—as well as the monthly lease cost of $850. Posh will drive the car approximately 20,000 kilometres per year.

3. WPI will include Posh in its group term life insurance program and pay the premium, which provides coverage for $75,000. It will also pay the premiums for a private health plan, a dental plan, and a drug plan.

4. The company has a deferred profit-sharing plan, for which Posh will qualify. The maximum contribution will be made to this plan only when the company’s profit for the year is greater than 12% of the stated balance sheet equity.

5. Posh will be eligible for an annual bonus of up to $40,000, with the actual amount to be based on her productivity. The bonus will be awarded on November 30 of each year (the company’s year-end) but will not be paid until May 31 of the following year. Of the above-mentioned bonus, 25% will be retained in an employee benefit plan for five years. The investment income earned by the plan will be distributed to Posh each year.

6. WPI will provide Posh with a monthly allowance of $800 to cover any expenses she may incur. In addition, she will be reimbursed for travel costs to attend the annual advertising convention in Paris.

7. All WPI employees are entitled to participate in a stock-option plan. The available shares are non-voting but do participate fully in profits. The option price is $12 per share; this price is guaranteed for three years and will then increase to $14 per share. Currently, the shares are trading at $12 per share; they are expected to rise significantly within two years.

8. Posh will be provided with club memberships in the “better” social clubs in the area for relaxation purposes. This will help her be more productive in her work.
Required:

Prepare a brief report for Posh.
Solution to P4-5

The issues that should be reviewed in the report are summarized below:

**Interest Free Loan:**
Creates a taxable benefit annually equal to the amount by which the prescribed interest on the loan exceeds the actual interest paid on the loan by 30 days after the end of the year [ITA 80.4(1); 6(9)]. Because the loan is interest-free the benefit is equal to the prescribed interest.

Since the loan will be used by Posh to buy a home, the prescribed rate used to calculate the taxable benefit, for five years, will not exceed the prescribed rate in effect at the time the loan is made [S.80.4(4)]. S.80.4(6) deems the loan to be renewed every five years.

Since Posh will have an eligible relocation, the loan qualifies as a home relocation loan and, thus, Posh will be entitled to a deduction in computing her taxable income for the first five years of the loan effectively equal to the prescribed rate applied to a $25,000 loan [S.110(1)(j)].

The loan to Posh will be a "home relocation loan" [ S.248(1)], because:

- Posh will commence work at a new work location in Canada
- she will move from a former residence to a new one
- the move will bring her at least 40 kilometres closer to her new work location (measured as the difference between the distances travelled from the new work location to each of the old and new homes)
- the loan will be received in her capacity as employee
- the loan proceeds will be used to buy a home to be occupied by her
- the loan will be designated by her as a home relocation loan, and
- there will be no other “home relocation loans” in connection with the move or outstanding at the time.

The home relocation loan deduction is calculated under S.110(1)(j) as the least of:

- the imputed interest benefit on the home relocation loan
- $25,000 x the prescribed rate
- the imputed interest benefit on all loans from her employer

The deduction is available for the first five years of the loan, or for the period to the date the loan is extinguished, if shorter.

**Reimbursement of Moving Costs:**
Although this is a benefit, it is not considered to be taxable by administrative policy [IT-470R].

**Director’s Fee from US Company:**
Is fully taxable as employment income [ITA 6(1)(c)]. As a resident of Canada, Carol is taxable on her world income.

**Amounts Paid for Spouse Travel:**
Is a taxable benefit to Carol Posh under the general rule that benefits of any kind whatever are
taxable as employment income [ITA 6(1)(a)].

**Automobile for Personal Use:**
Both an operating and capital benefit will result:

| ITA 6(1)(k) | Operating benefit 20,000 km x 24¢ | $ 4,800 |
| ITA 6(1)(e) | Capital portion (standby charge): | 6,800 |
| ITA 6(2)    | 2/3 x $850 x 12 months             | $11,600 |

**Life Insurance Premium:**
The full premium paid by the employer is a taxable benefit [ITA 6(1)(a)].

**Private Health Plans:**
Although a benefit, private health plans are specifically excepted and are not taxable [ITA 6(1)(a)].

**Contribution to DPSP:**
By exception to the general rule on benefits, DPSP contributions are not taxable when they are contributed to the plan [ITA 6(1)(a)(i)]. Both the contributions and the investment returns on the contributions remain not taxable until the year in which they are paid out to Posh.

**Bonus Plan:**
Employment income is recognized for tax purposes on a cash basis when received [ITA 5(1)]. In this case, 75% of the bonus will be taxable in the year following the award. The remaining 25% paid into the benefit plan will be taxable to Carol when it is paid out of the plan after five years [ITA 6(1)(g)]. The annual interest earned from the benefit plan is taxable annually as received [ITA 6(1)(h)].

**Allowance:**
The allowance does not appear to be for any specific use (e.g., travel, etc.). Therefore, by the general rule for employment income the allowance of $9,600 annually is fully taxable [ITA 6(1)(b)].

**Reimbursement for Travel:**
Assuming that the convention is attended on the company's behalf, the reimbursement is not a taxable benefit.

**Stock Option:**
Carol will receive an employment benefit equal to the amount by which the fair market value of the stock at the purchase date exceeds the price paid for the stock as stipulated in the option agreement. Because the $12 option price is not less than the stock’s market value when the option was granted, Carol can deduct a stock option deduction, equal to one-half of the employment benefit, from net income in computing taxable income [ITA 110(1)(d)].

If the option is exercised immediately, the taxable benefit is NIL per share (FMV of $12 minus the cost of $12). If the stock grows in value after the purchase, a capital gain (of which one-half is taxable) will occur in the year the stock is sold.

If Carol delays the purchase, as is her right under the option agreement, and the stock continues to rise in value as predicted, a greater amount will be included as employment income when the stock is eventually purchased and a lesser amount of capital gain will result on sale. However, because Carol qualifies for the stock option deduction in computing her taxable income, delaying the exercise date changes the nature and timing of the income inclusion but not the amount taxable.
Club Dues:
Club dues paid by an employer are considered to be a taxable benefit under the general rule for the tax treatment of benefits [ITA 6(1)(a)]. By administrative policy it will not be considered as a taxable benefit if it can be shown that the membership is principally for the employer's advantage [IT-470R]. In this case it does not appear to be so; thus, the benefit is taxable.
PROBLEM SIX

[ITA: 5(1); 6(1)(a), (b), (k), (e); 8(1)(f), (i), (m); 8(2); IT-470R]

Paul Fenson is employed as a shipping supervisor. In the evenings and on weekends, he holds a second job as a real estate salesman for a national real estate firm. His financial information for 20X0 is as follows:

1. His salary from his day job is $30,000 per annum. However, the employer deducts a number of items from his salary, and so his net take-home pay is only $20,400. The following amounts were deducted in 20X0:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income tax</td>
<td>$3,900</td>
</tr>
<tr>
<td>Union dues</td>
<td>600</td>
</tr>
<tr>
<td>Canada Pension Plan</td>
<td>1,310</td>
</tr>
<tr>
<td>Employment Insurance premiums</td>
<td>560</td>
</tr>
<tr>
<td>Registered pension plan contribution</td>
<td>3,000</td>
</tr>
<tr>
<td>Reimbursement for personal use of employer’s car</td>
<td>600</td>
</tr>
<tr>
<td>Charitable donations remitted to United Way</td>
<td>800</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$10,770</strong></td>
</tr>
</tbody>
</table>

The employer paid the following amounts on behalf of Fenson:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Canada Pension Plan</td>
<td>$1,310</td>
</tr>
<tr>
<td>Employment Insurance premiums</td>
<td>790</td>
</tr>
<tr>
<td>Registered pension plan</td>
<td>3,000</td>
</tr>
<tr>
<td>Premiums for a mandatory provincial health insurance plan</td>
<td>600</td>
</tr>
<tr>
<td>Group term life insurance premiums ($50,000 coverage)</td>
<td>1,200</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$6,900</strong></td>
</tr>
</tbody>
</table>

Fenson used the employer’s summer camp for a one-month holiday and paid the employer $200 rent. When not being used by employees, the summer camp is rented for the normal amount of $600 per month.

Although Fenson owned his own automobile, he was provided with a company car. The car cost the company $23,000. During the year, he drove a total of 20,000 km, of which 14,000 was for personal use. The employer also paid all of the operating costs, which amounted to $3,000.

During the year, Fenson attended a shipping conference in Toronto. His wife travelled with him at the company’s expense ($1,000). The employer permitted staff to purchase merchandise from its retail outlet at the company’s cost. During the year, Fenson purchased for $800 merchandise with a retail value of $1,200.
2. As a real estate salesman, Fenson earned a base salary of $8,000 and received commissions of $7,000. In relation to his real estate work, he incurred the following expenses:

<table>
<thead>
<tr>
<th>Expense</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dues to a local real estate association</td>
<td>$400</td>
</tr>
<tr>
<td>Fee for a three-day seminar on how to be an effective salesperson</td>
<td>$800</td>
</tr>
<tr>
<td>Advertising—calendars and pens</td>
<td>$1,700</td>
</tr>
<tr>
<td>Automobile operating costs</td>
<td>$4,000</td>
</tr>
<tr>
<td>Promotion (meals and drinks for clients)</td>
<td>$2,800</td>
</tr>
<tr>
<td>Personal meals (during in-town business)</td>
<td>$400</td>
</tr>
<tr>
<td>Purchase of a portable telephone</td>
<td>$2,000</td>
</tr>
</tbody>
</table>

Fenson used his own automobile for his real estate activities. The car has an undepreciated capital cost for tax purposes of $10,000. During the year, he drove a total of 30,000 km, of which 27,000 was related to selling real estate. His employer provided him with a monthly car allowance of $200 ($2,400 per year).

**Required:**

Determine Fenson’s net income from employment for the particular year.
Solution to P4-6

Fenson's income from employment is as follows:

Items of Income:
- ITA 5(1) Salary - Day job $30,000
- ITA 5(1) Salary – Real estate salesman 8,000
- ITA 5(1) Commissions - Real estate salesman 7,000

Benefits:
- ITA 6(1)(a) Provincial health insurance premium (Note 1) 600
- ITA 6(1)(a), 6(4) Group term life insurance 1,200
- ITA 6(1)(a) Summer camp ($600 - $200) 400
- ITA 6(1)(e), 6(2) Automobile - standby charge $5,520
- ITA 6(1)(k) Automobile operating expense benefit 24¢ x 14,000 personal km 3,360
  Less reimbursement paid to employer (600) 8,280
- ITA 6(1)(a) Spouse's travel costs 1,000
- ITA 6(1)(b)(v) Travel Allowance (Note 2) 2,400

58,880

Deductions from Income:
- ITA 8(1)(m) Registered pension plan contributions (RPP) $3,000
- ITA 8(1)(i) Union dues 600
- Sales expenses (Note 3) 9,700 (13,300)

Employment income $45,580

(Note 1)
The public medical insurance plan premium was included as a benefit because it was assumed that the employer's contribution was not mandatory. It would not be taxable if the employer was required by law to pay a portion of the premium (such as an employer health tax).

(Note 2)
The car allowance of $200 per month received from the real estate employer is deemed not to be a reasonable allowance since it is not based on the number of kilometers for which the car is used for employment purposes [ITA 6(1)(b)(x)]. Therefore, the allowance is taxable [ITA 6(1)(b)(v)]. Because the allowance is taxable, it permitted the taxpayer to deduct the numerous expenses incurred to earn the commissions. If the travel allowance had been reasonable, the $2,400 would be excluded from income but the $9,700 of employment expenses would then not be permitted as a deduction, and Fenson's net income would increase accordingly [8(1)(f)(iv)].
(Note 3)

Expenses relating to real estate sales:

ITA 8(1)(f) Limited expenses:

- Dues to real estate association $400
- Advertising 1,700
- Automobile operating costs
  - 27,000 km/30,000 km = 90% x $4,000 3,600
- Promotion – meals & drinks (50% of $2,800) 1,400

Limited to a maximum of commission earned $7,100

(Non-limited expenses:

ITA 8(1)(j) Capital cost allowance

$10,000 x 30% = $3,000 x 27,000 km/30,000 km 2,700

$9,700

(Note 4)

The following items were excluded from income:

- Company portion of Canada Pension and Employment Insurance premiums. These items are a tax on the employer.
- Company RPP contributions are specifically exempted [ITA 6(1)(a)(i)].
- Merchandise discounts. Under CRA's administrative policy discounts offered to all employees (but normally not below the employer's cost) are considered non-taxable [IT-470R].

The following expense items were not deducted:

- Canada Pension Plan, Employment Insurance premiums, and charitable donations are not deductible because they are not specifically exempted from the general rule that no deductions are permitted. Each of these items, however, is eligible for a tax credit (Chapter 10).
- Fees for a three day seminar on becoming an effective salesperson. The permitted salesperson's deductions do not include any expenditure of a capital nature. The seminar will provide a long term benefit to Fenson and, therefore, is a capital item [ITA 8(1)(f)(v)].
- Meals (in town). The deduction of personal meals is only permitted when traveling outside of the municipality in which the employer is located and when the taxpayer's duties require the taxpayer to be away for 12 hours or more [ITA 8(4)].
- Portable telephone. This is a capital item because it has a long term benefit and therefore is not deductible [ITA 8(1)(f)(v)].
PROBLEM SEVEN

[ITA:  5(1); 7(1); 8(1)(i),(m); 8(4); 8(13); 38; 40(1)]

Riley Fontaine has requested that you review the calculation of his 20X1 net income for tax purposes. He has provided you with the following information:

1. His salary consists of the following:

   Basic salary $92,000
   Bonus 6,000
   $98,000

   The bonus of $6,000 was awarded to him on December 31, 20X1, and was paid on January 15, 20X2.

2. His employer deducted the following items from his salary and remitted them to the appropriate party on his behalf:

   Canada Pension Plan $2,217
   Employment Insurance premiums 787
   Registered pension plan 4,400
   Income tax 26,000
   Charitable donations (United Way) 3,500

3. Fontaine is employed by Remco, a Canadian public corporation. Two years ago, Remco granted Fontaine an option to purchase 1,000 of its common shares at $16 per share. At the time the option was granted, Remco’s shares were trading at the same value of $16 per share. On January 31, 20X1, Fontaine purchased 1,000 shares of Remco (trading value at purchase date—$22 per share). On November 30, 20X1, he sold all of the shares at $24.

4. Remco requires that Fontaine work out of his home from time to time. Remco has supplied him with a computer and modem for this purpose; however, Fontaine must pay for his own supplies. His house is 2,000 square feet and his workstation is a room of about 200 square feet. He also uses the room as a den and guest room. Utility costs for his home for 20X1 amounted to $1,200.

5. Fontaine travels out of town from time to time to his employer’s manufacturing plant. Remco reimburses him for all travel costs, except meal costs. The plant is only 90 km from the head office, and he always returns home the same day after working a normal eight-hour day.
6. Fontaine has calculated his net income for tax purposes as follows:

<table>
<thead>
<tr>
<th>Employment income</th>
<th>$98,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salary and bonus</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Deductions</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Registered pension plan</td>
<td>4,400</td>
</tr>
<tr>
<td>Employment expenses:</td>
<td></td>
</tr>
<tr>
<td>Meal costs while out of town: $300 50%</td>
<td>150</td>
</tr>
<tr>
<td>Office at home:</td>
<td></td>
</tr>
<tr>
<td>Minor repairs</td>
<td>340</td>
</tr>
<tr>
<td>Utilities (200/2,000 x $1,200)</td>
<td>120</td>
</tr>
<tr>
<td>Office supplies and stationery</td>
<td>410</td>
</tr>
<tr>
<td>Computer software (word processor)</td>
<td>220</td>
</tr>
<tr>
<td></td>
<td>92,360</td>
</tr>
</tbody>
</table>

| Capital gains (Remco shares)           |         |
| Selling price (1,000 x $24)           | $24,000 |
| Cost (1,000 x $16)                     | 16,000  |
| Gain                                   | 8,000   |
| Taxable (1/2 of $8,000)                | 4,000   |
| Net income                             | $96,360 |

**Required:**

Advise Fontaine whether his calculation of 20X1 net income for tax purposes is correct. If it is not, recalculate a revised 20X1 net income for tax purposes, and briefly explain the changes you made.
Solution to P4-7

The revised net income for tax purposes is:

**Employment:**

- **Salary [ITA 5(1)]** $92,000
- **Stock option benefit [ITA 7(1)]:**
  - value at purchase date ($22 x 1,000) $22,000
  - option purchase price ($16 x 1,000) 16,000
  - difference 6,000
  - total $98,000

**Deductions from employment income:**

- **Pension contribution [ITA 8(1)(m)]** (4,400)
- **Office supplies [ITA (8(1)(i))]** (410)
  - total $93,190

**Capital gain (Remco shares) [ITA 40(1)]:**

- **Proceeds ($24 x 1,000)** $24,000
- **Adjusted cost base ($22 x 1,000)** (22,000)
- **Capital gain** $2,000
- **Taxable gain ($2,000 x ½) [ITA 38]** 1,000
  - net income $94,190

**Summary of changes:**

1. The bonus was excluded - it was not received in 20X1. Employment income is taxed on a cash basis, therefore the bonus is included in employment income in 20X2, the year received [ITA 5(1)].

2. The capital gain on the stock option shares should be calculated as the excess of the proceeds over the value of the shares at the time they were acquired [ITA 53(1)(j)]. The excess of the value at the acquisition date over the purchase price is employment income [ITA 7(1)]. Because the option price was not less than the share value at the date the option was granted, a stock option deduction of $3,000 (½ x $6,000 employment benefit) can be claimed when arriving at taxable income [ITA 110(1)(d)].

3. The home office expenses (repairs of $340 and utilities of $120) were excluded because Fontaine does not meet either of the two tests in ITA 8(13) –
   1. the home office is not the place where he principally performs his duties of employment. (He is required to work from his home from time to time.)
   2. the office was not used exclusively for employment purposes and was not used on a regular basis for meeting customers or other persons in carrying out his duties of employment.

4. The cost of meals incurred as a travel expense ($300) was excluded because the daily trips were less than 12 hours [ITA 8(4)].

5. The computer software ($220) was excluded because there is no provision in section 8 for such a deduction. It is also a capital item. ITA 8(1)(j) & (p) permit an employee a CCA deduction on a car, an airplane and a musical instrument, only.
PROBLEM EIGHT

[ITA: 5(1); 6(1)(a), (b), (e), (k); 6(2), (4); 7(1.1); 8(1)(i), (j), (m); 8(2); 110(1)(d.1)]

On January 2, 20X3, Sheldon Bass, a professional engineer, moved from Calgary to Edmonton to commence employment with Acco Ltd., a large public corporation. Because of his new employment contract, Bass requires assistance in determining his employment income for tax purposes. He has provided the following financial information:

1. Bass’s salary in 20X3 was $95,000. From this, Acco deducted Employment Insurance premiums of $787, Canada Pension Plan contributions of $2,217, registered pension plan payments of $6,000, and charitable donations of $1,200 as well as income tax.

2. Acco provides its executives with a bonus plan. Bass’s 20X3 bonus was $20,000, of which $5,000 was received in December 20X3 and the balance in March 20X4.

3. In November 20X3, Bass asked his employer to loan him $12,000 so that he could acquire an investment. Acco advised him that it was company policy not to make loans to employees. However, they gave him the $12,000, stipulating that it was an advance against his 20X4 salary, which would be reduced accordingly.

4. In 20X3, Bass was provided with a company car, which he drove 14,000 km for employment duties and 8,000 km for personal use. The car was leased at $500 per month. The total operating costs of $7,000 were paid by Acco. The car was available for personal use throughout the year.

5. Bass’s moving expenses to transport his belongings to Edmonton were $3,000. Acco paid this cost directly to a moving company on Bass’s behalf.

6. Bass travels extensively for Acco. In December 20X3, he and his spouse used some of the travel points he had accumulated from this travel to attend his father’s funeral in Toronto. As a result, he saved the normal airfare of $400 per ticket.

7. Acco paid the following additional amounts for Bass:
   - Allowance ($300 per month) for acquiring executive apparel $3,600
   - Investment counsellor fees as part of Acco’s counselling program 600
   - Golf club dues (Bass rarely uses the club to conduct business) 1,500

8. In 20X3 Bass paid for the following:
   - Dues to the engineers’ association $ 800
   - Laptop computer and printer 2,200
   - Computer supplies (paper, etc.) 100

   Acco had asked each senior executive to acquire a laptop computer at his or her own expense for work during travel.

9. In 20X3, Bass sold 1,000 shares of Kolex Ltd. (his former employer) at $10 per share. Kolex is a Canadian-controlled private corporation. The shares were purchased under a stock-option plan in 20X0 at $3 per share. Appraised value at that time was $5 per share.

Required: Determine Bass’s net income from employment for the 20X3 taxation year.
Solution to P4-8

Employment Income 20X3:

Salary [ITA 5(1)] $  95,000
Bonus – received [ITA 5(1)] 5,000
Salary advance [ITA 5(1)] 12,000
Standby charge – ($500 x 2/3 x 12) x 8000km/(1,667km x12) [ITA 6(1)(e); 6(2)] 1,600
Auto operating benefit [ITA 6(1)(k)] - lesser of
(8,000 personal km x 24¢ = $1,920); or
(50% of standby charge = $800) 800
Allowance for clothing [ITA 6(1)(b)] 3,600
Investment counsellor fees 600
Club dues- not for the benefit of employer's business [ITA 6(1)(a)] 1,500
Stock option – CCPC (20X0 purchase)
1,000 x ($5 - $3) [ITA 7(1.1)] 2,000

122,100

Deduct:
RPP [ITA 8(1)(m)] $6,000
Dues [ITA 8(1)(i)] 800
Computer supplies [ITA 8(1)(i)] 100 (6,900)

Employment income $115,200

The payment for moving expenses is not a taxable benefit [IT-470R]. However, Bass cannot deduct moving expenses as other deductions [ITA 62] unless they exceed the $3,000 paid by the employer.

Travel points are not a taxable benefit. Effective for 2009, the CRA no longer requires employees to include in their income the value of any benefits received under a loyalty points program if:

- the points are not converted to cash; or
- the plan or arrangement is not indicative of an alternative form of remuneration, or is not for tax avoidance purposes.

Charitable donations, CPP and EI are not deductible from employment income [ITA 8(2)] but will result in a tax credit when calculating income tax.

The computer and printer are capital assets. CCA on these assets is not deductible in computing employment income [ITA 8(2); 8(1)(j) & (p)].

The sale of the Kolex shares results in a taxable capital gain of $2,500 (½ x 1,000 x ($10 - $5)) [ITA 38; 53(1)(j)]. Since Kolex is a CCPC and Bass did not dispose of the shares within two years after the date he acquired them, a deduction of $1,000 ( ½ x $2,000 employment benefit) can be deducted in computing taxable income [ITA 110(1)(d.1)].
PROBLEM NINE

[ITA: 5(1); 6(1)(a), (b); 6(4); 8(1)(h), (h.1), (f), (j); 8(2)]

Barry Yuen is district sales manager for a Vancouver-based distribution company. He has requested that you help him establish his employment income for tax purposes for the 20X3 taxation year. He has provided the following information:

1. Yuen’s base salary in 20X3 was $78,000. As sales manager, he is entitled to a small commission on the sales made by staff under his supervision. He received $7,200 in such commissions in 20X3, which included $1,000 of commissions earned in late 20X2. The December 20X3 commissions had been computed as $1,800 and were received in January 20X4. The employer deducted the following from his salary in 20X3:

   - Canada Pension Plan contributions $2,217
   - Employment Insurance premiums 787
   - Private medical plan premiums 300

2. In addition to the above, the employer paid the following to Yuen or on his behalf:

   - Travel allowance $2,400
   - Group term life insurance premiums for $50,000 coverage 600
   - Premiums for a private medical insurance plan 300

3. Yuen’s wife died in late 20X2, leaving him to support three children. In 20X3, he hired a person at a cost of $9,000 to provide baby-sitting services for the two youngest children. Following his wife’s death, Yuen suffered from depression. As a result, his employer paid the cost of $3,000 for counselling services and also provided him with airline tickets costing $2,300 so that he and the children could attend a relaxation resort.

4. Yuen uses his own vehicle for employment duties. The vehicle (class 10.1) had an underdepreciated capital cost of $14,000 at the end of 20X2. Yuen paid $4,000 in 20X3 to operate the car and used it 70% of the time for employment duties.

5. Yuen incurred the following additional costs relating to his employment:

   - Promotion (meals) $ 800
   - Purchase of a cellular phone 1,200
   - Lease costs for laptop computer 700
   - Golf club dues 1,000
   - Hotel costs—out-of-town travel 4,300

6. When not travelling, Yuen works from an office at his employer’s place of business. Increasingly, he has been taking home work to do in the evenings and on weekends. He intends to set aside a specific room in his house that he will use only for this purpose. His house costs include property taxes, insurance, utilities, and mortgage interest. He will also purchase a work desk and chair.

Required:

1. For the 20X3 taxation year, determine Yuen’s net income from employment for tax purposes.

2. Briefly explain the tax treatment of the intended home-office expenses.
Solution to P4-9

Part 1
Income from employment 20X3:
Salary [ITA 5(1)] $78,000
Commissions [ITA 5(1)] 7,200
Travel allowance (Note 1) [ITA 6(1)(b)(v)] 2,400
Group term life insurance [ITA 6(1)(a); 6(4)] 600
Travel tickets [ITA 6(1)(a)] 2,300

90,500
Deduct:
CCA on car [ITA 8(1)(j)]
$14,000 x 30% = $4,200 x 70% (2,940)
Salesperson expenses [ITA 8(1)(f)]:
Travel (hotel) $4,300
Car (operating) - $4,000 x 70% 2,800
Promotion - $800 x 50% 400
Computer lease 700
$8,200
Limited to commission income (7,200) $80,360

Notes:
1. The travel allowance is unreasonably low compared to Yuen’s actual employment related travel expenses. Therefore, the travel allowance is taxable [ITA 6(1)(b)(v)].
2. Yuen has the option of not claiming any deductions under ITA 8(1)(f) and deducting travel and car operating expenses under ITA 8(1)(h) & (h.1). His deductions would be $100 less in this case.
3. Items not included in the calculation of employment income:
   - The $1,800 of commission earned in December, 20X3 is excluded from income because it was not received until 20X4 [ITA 5(1)].
   - The private medical insurance premiums of $300 and the $3,000 of counselling services are specifically excluded as taxable benefits under ITA 6(1)(a).
   - The child care expenses are not an employment expense [ITA 8(2)] but rather are deducted (subject to limitations) as other deductions [ITA 63] in the aggregating formula in section 3.
   - The golf club dues are specifically not permitted as a deduction. [ITA 8(1)(f) and 18(1)(l)]. The purchase of a cellular phone is not deductible because as it is a capital item [ITA 8(1)(f)] and capital cost allowance is not permitted [ITA 8(1)(j)] & (p).
   - CPP & EI premiums are not deductible [ITA 8(2)]. A credit is available in computing tax payable [ITA 118.7].

Part 2
No deduction will be permitted for the home office expenses because the home office will not be the place where Yuen principally performs his duties of employment nor will it be used exclusively to earn employment income and on a regular and continuous basis for meeting customers, etc. [ITA 8(13)].
PROBLEM TEN

[ITA: 5(1); 6(1)(a), (e), (f), (k); 6(2); 7(1); 8(1)(b), (f), (h.1),(m); 8(2); 110(1)(d)]

Charles Ebo was terminated from his employment with QR Ltd. in July 20X6. In November 20X6, he began work as a commission salesperson for AP Ltd., a Canadian public corporation.

Ebo has asked you to help him prepare his 20X6 tax return. Information regarding his employment is outlined below.

1. Ebo’s employment with QR was terminated on July 31, 20X6. His salary to that date was $56,000. Besides income tax, QR had deducted the following amounts from his salary:

   - Registered pension plan $4,000
   - CPP and EI contributions 3,004
   - Group sickness and accident insurance plan premium 500
   - Reimbursement for personal use of employer auto 800

   QR also contributed $4,000 to an RPP and $500 to a group sickness and accident insurance plan on Ebo’s behalf.

   Ebo took a medical stress leave from January 10 to March 15, 20X6. His salary was not paid during the leave. However, he received $4,500 for loss of earnings from the group sickness and accident insurance plan. In previous years, Ebo had paid a total of $3,000 in premiums to the plan.

2. On July 31, 20X6, Ebo returned the company car to QR, which had been available for his personal use. The car had an original cost of $35,000 and a book value of $24,000. Ebo had driven the car 20,000 km in 20X6, of which 8,000 km was for employment purposes. QR paid the operating expenses of $2,900.

3. In December 20X6, Ebo sold 4,000 shares of AP Ltd. at $10 per share. He had acquired them in November 20X6 under a stock-option plan at $6. At the time of acquisition, the shares were valued at $8 per share. When the option was granted, the shares were valued at $6 per share.

4. When his employment was terminated, Ebo paid a lawyer $800 to settle compensation issues. As a result, he received additional holiday pay of $1,000 and a retiring allowance of $6,000 for his 10 years of service.

5. Ebo collected employment insurance of $5,400 before starting his employment with AP on November 1, 20X6. Besides a base salary of $1,000 per month, Ebo receives commissions on sales. Ebo’s commission is 4% of sales. His first sales were made in late December 20X6 and totalled $150,000. The related commission was received on January 15, 20X7. On December 1, 20X6, AP paid Ebo $1,500 as an advance against commissions. AP certified that Ebo was required to pay his own car and other expenses. On November 1, 20X6, he leased a car at $960 per month (including tax). Operating expenses for November and December were $900 in total. The car was used 70% of the time for employment purposes. Ebo incurred the following additional expenses:

   - Entertainment—meals and beverages $600
   - Promotion—gift calendars for customers 200
   - Purchase of a cellular phone 500
Required:

Determine Ebo's net income from employment for the 20X6 taxation year.
Solution to P4-10

Employment income 20X6:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>ITA 5(1) Salary - QR Ltd.</td>
<td>$56,000</td>
</tr>
<tr>
<td>ITA 5(1) Salary - AP Ltd.</td>
<td>2,000</td>
</tr>
<tr>
<td>ITA 5(1) Holiday pay</td>
<td>1,000</td>
</tr>
<tr>
<td>ITA 5(1) Commission advance</td>
<td>1,500</td>
</tr>
<tr>
<td>ITA 6(1)(f) Insurance receipts</td>
<td>1,000</td>
</tr>
<tr>
<td>ITA 6(1)(e) Standby charge - 35,000 x 2% x 7 months</td>
<td>$4,900</td>
</tr>
<tr>
<td>ITA 6(1)(k) Auto operating benefit</td>
<td>2,880</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>less reimbursement</td>
<td>(800)</td>
</tr>
<tr>
<td>ITA 7(1) Stock option benefit</td>
<td>8,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employment expenses</td>
<td></td>
</tr>
<tr>
<td>ITA 8(1)(m) RPP</td>
<td>(4,000)</td>
</tr>
<tr>
<td>ITA 8(1)(b) Legal - salary dispute</td>
<td>(800)</td>
</tr>
<tr>
<td>ITA 8(1)(h.1) Auto lease - $904 x 2 months (Note 3)</td>
<td>$1,808</td>
</tr>
<tr>
<td>Auto operating costs</td>
<td>900</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employment portion - 70%</td>
<td>(1,896)</td>
</tr>
</tbody>
</table>

Net employment income: $69,784

Notes:

1. The commission earned in 20X6 but not received until 20X7 is included in employment income in 20X7 [ITA 5(1)].

2. The employer’s contribution to the RPP ($4,000) and the $500 premium for group sickness and accident insurance paid by the employer are not taxable benefits. They are specifically excluded [ITA 6(1)(a)(i)].

3. Ebo paid car lease payments of $960 per month. Automobile lease payments for tax purposes are limited to $800 (plus tax) per month. Therefore, the monthly amount recognized for tax purposes is $800 x 1.13 = $904 (assumes the tax paid is HST at 13%).

4. The retiring allowance and employment insurance receipts are not employment income but are classified as other sources of income for purposes of the aggregating formula in section 3 of the Income Tax Act.

5. The purchase of the cellular phone is a capital item and cannot be deducted under section 8. Capital cost allowance is not permitted [ITA 8(2); 8(1)(j) & (p)].

6. Ebo has the option of deducting car expenses ($1,896) under ITA 8(1)(h.1) which has no limit, or deducting entertainment ($300) and promotion ($200) expenses together with car expenses ($1,896) under ITA 8(1)(f). The total deduction under ITA 8(1)(f) is limited to his commission income ($1,500). Therefore, he is better off claiming the deduction under ITA 8(1)(h.1). This means that the entertainment and promotion expenses cannot be deducted.
7. Because the option price was not less than the share value at the date the option was
granted, a stock option deduction of $4,000 (½ x $8,000 employment benefit) can be
deducted from net income when computing taxable income [ITA 110(1)(d)].
PROBLEM ELEVEN

[ITA: 5(1); 6(1)(a)]

After a recent staff evaluation, Susan Pearson’s employer offered her the following alternative remuneration proposals:

1. A salary increase of $2,500 per annum, from $40,000 to $42,500.

2. A contribution of $2,000 per year to the company’s deferred profit-sharing plan.

Pearson’s living expenses are modest, and if she accepts the salary increase she intends to invest the additional cash flow in secure 10% bonds. Coincidently, the company’s deferred profit-sharing plan also achieves an average investment return of 10%.

Pearson plans to retire in 30 years, and her intention is to use the remuneration increase to help fund her retirement. Currently, she pays tax at a marginal rate of 40%.

**Required:**

Assuming that investment returns and tax rates remain stable at 10% and 40%, respectively, which alternative should Pearson prefer? You may also assume that if she accepts the deferred profit-sharing plan, it will be paid to her in a lump sum at the end of 30 years.
Solution to P4-11

If Susan accepts a salary increase of $2,500 per year, the increase will be subject to an annual tax of $1,000 (40% of $2,500) leaving only $1,500 available for investment. The investment return of 10% is also taxable at 40% providing a 6% after-tax return (10% less 40% tax on the 10%).

Although the deferred profit sharing plan alternative provides a lower absolute amount ($2,000 vs. $2,500) it is not taxable as employment income on an annual basis. Therefore the plan has $2,000 annually for investment at 10%. The investment returns within the plan also are not taxable and, therefore, accumulate at 10%. However, when the funds are withdrawn, the full amount is taxable (i.e., in year 30).

Susan is better off choosing the deferred profit sharing plan because it will provide approximately $91,000 in additional funds after 30 years calculated as follows:

```
Salary Option ($2,500 annually):
$1,500 for 30y @ 6% = $125,702

DPSP Option ($2,000 annually):
$2,000 for 30y @ 10% = $361,887
less tax on lump sum payout (40%) (144,755)
Net value $217,132
Benefit of DPSP (note) $91,430
```

Note: The above calculation assumes that the DPSP investment is made at the beginning of each year rather than at the end of each year.
PROBLEM TWELVE

[ITA: 5(1); 6(1)(a), (b); 6(19), (20), (21), (22); 7(1); 8(1)(f), (h), (h.1), (i), (j); 8(2); 6(9); 80.4(1); 80.5]

Carla Ram is a professional engineer. In 20X1, she sold her consulting business in Hamilton, Ontario, and moved to Vancouver, British Columbia, where she was employed by an equipment-manufacturing business. The following financial information is provided for the 20X1 taxation year:

1. Ram began her employment on February 1, 20X1, and during the year, received a salary of $90,000, from which the employer deducted income tax of $30,000 and CPP and EI of $3,004. In addition to her salary, Ram earned a commission of 1% of sales obtained by salespeople under her supervision. At December 31, 20X1, these sales amounted to $1,000,000, for which she had received $6,000 by year end, with the balance received in January 20X2. Ram also received an annual clothing allowance of $1,500 to maintain a professional dress standard. During the year, she spent $1,800 on clothing for work.

2. Ram’s employer does not have a company pension plan; instead, the employer contributed $13,000 directly to her RRSP in 20X1.

3. In December 20X1, Ram received a payroll advance of $3,000 against her January 20X2 salary to help fund a family holiday.

4. Ram is required to use her automobile for employment purposes and to pay certain other employment expenses. In 20X1, she incurred the following costs:

   - Meals and drinks for customer entertainment $  1,600
   - Golf club dues used to entertain customers 1,100
   - Travel—airfares and hotel lodging 3,000

   Purchase of a cell phone 800
   Cell phone bill—pay-as-you-go plan (employment related) 1,200

   Automobile expenses:
   - Operating costs 3,800
   - Parking 100
   - Interest on car loan 2,200
   - Purchase of new automobile in Ontario 37,000

   The automobile was used 60% of the time for business.

5. In 20X1, Ram took advantage of her employer’s counselling services. She received personal financial planning advice valued at $400, and her 14-year-old son received mental health counselling valued at $800.

6. Ram purchased a new home in Vancouver in 20X1 and incurred qualified moving expenses of $18,000 to transport her family and household effects to Vancouver. Her new employer reimbursed her for $10,000 of these costs and also paid her $20,000 for the loss incurred on the sale of her former residence.

7. In early 20X2, Ram intends to borrow $20,000 from her employer for the purpose of acquiring shares in the employer’s corporation. A low interest rate of 2% per annum will be payable on the loan.
Required:

1. Determine Ram’s *minimum net income from employment* for the 20X1 taxation year.
2. Briefly describe the tax implications from the intended employee loan to Ram.
Solution to P4-12

1. Employment income 20X1:
   ITA 5(1)  Salary $ 90,000  
   ITA 5(1)  Commission received 6,000  
   ITA 6(1)(b)  Clothing allowance 1,500  
   ITA 6(1)(a)  Contribution to RRSP 13,000  
   ITA 5(1)(a)  Payroll advance 3,000  
   ITA 6(1)(a)  Financial planning 400  
   ITA 6(1)(a); 6(20)  Reimbursement for loss from sale of house – 1/2 ($20,000 - $15,000) = 2,500  
   116,400

   Employment deductions:
   ITA 8(1)(i)  Cell phone air time (1,200)  
   ITA 8(1)(f)  Salesperson expenses:
   Travel $3,000  
   Auto operating - 60% x $3,800 2,280  
   Parking 100  
   5,380
   Meals and drinks - 50% x $1,600 800  
   Golf club dues - not permitted 0  
   Cell phone - capital item 0  
   6,180
   Limited to commission income 6,000
   ITA 8(1)(j)  Auto capital costs:
   Interest (limit $300/month) $2,200  
   CCA - Class 10.1 – (see note below) $5,085  
   $7,285
   Employment usage 60% (4,371)

   Net employment income $104,829

Notes:

- Cell phone – the cost of employment related cell phone calls is deductible (airtime consumed). As well, CRA policy with respect to fixed monthly plans is that the percentage of the airtime expenses for a cellular telephone that reasonably relates to earning employment income is deductible [ITA 8(1)(i); IT-352R2, par. 10].

- The capital cost of Class 10.1 cars is limited to $30,000 plus tax [ITA 13(7)(g)]. The HST rate is 13% since the car was purchased in Ontario. The limit is $30,000 x 1.13 = $33,900.

- The following items were excluded:
  - Mental health benefit for son is not a taxable benefit.
  - Reimbursement for moving expenses are not taxable but employee must reduce actual moving cost when claiming moving deduction under other deductions in the aggregating formula in ITA 3.
  - Costs to acquire clothing are not a permitted deduction under 8(1)(f) as they are a personal item.
Carla has the option of deducting travel and car expenses under ITA 8(1)(h) & (h.1) which have no limit. If she does this she is denied any deduction under ITA 8(1)(f). In this case, Carla is better claiming the deduction under ITA 8(1)(f).

2. Ram will have to include in employment income an imputed interest benefit equal to the difference between the CRA prescribed interest rate on the loan and the 2% interest paid (assuming the interest is paid by 30 days after the end of the year) [ITA 80.4(1)]. The imputed interest benefit is deemed to be interest paid by Ram [ITA 80.5]. Thus, the employment benefit as well as the 2% interest actually paid can be deducted as an expense when calculating property income [ITA 20(1)(c)].
CASE

Markowski

[ITA: 5(1); 6(1)(a), (e), (k); 6(2), (4), (9); 80.4(1), (4); 8(1)(h), (h.1); 8(4); 67.1]

John Markowski is a senior mechanic in the logging industry. Because of the specialized nature of his work, he is highly paid. His current employer pays him a basic salary with no special benefits.

Recently, Markowski received an offer of employment from a corporation in the same line of business. The salary offered is lower than what he currently receives but a number of benefits are included in the remuneration package.

Markowski is confused by the offer. He does not like the idea of a reduced salary but realizes that the benefits have some value. He also realizes that what is really important is the level of disposable income that he has for himself and his family.

Markowski has provided you with the pertinent information (see Exhibits 1 and 2) and has asked you to help him make a decision.

Required:

1. Determine what Markowski’s net income from employment for tax purposes will be if he remains with his current employer (Exhibit 1).

2. Determine what Markowski’s net income from employment for tax purposes will be if he accepts the offer from the competitor (Exhibit 2).

3. Assuming that Markowski pays tax at a rate of 40%, determine the amount by which his personal disposable income will increase (or decrease) if he accepts the new offer.
Exhibit 1: Information regarding current employment and certain other expenditures

1. Markowski’s gross salary next year will be $70,000. From this, the employer will deduct the required income tax, Canada Pension Plan contributions of $2,217, and Employment Insurance premiums of $787.

2. It is part of Markowski’s ordinary duties to work on equipment at locations other than the main repair depot. On average, he is called out of town two or three days each month. On such trips, he must always stay overnight in a hotel. His contract of employment requires that he pay his own automobile expenses. The company reimburses him for his hotel costs (lodging but not meals). No reimbursement is made for the vehicle.

3. Markowski leases his own car at $500 per month. He incurred the following additional travel costs in the current year:

<table>
<thead>
<tr>
<th>Expense</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Insurance</td>
<td>$800</td>
</tr>
<tr>
<td>Repairs and maintenance</td>
<td>600</td>
</tr>
<tr>
<td>Gasoline</td>
<td>2,200</td>
</tr>
<tr>
<td>Meals (out of town)</td>
<td>200</td>
</tr>
</tbody>
</table>

During the year, Markowski drove a total of 22,000 kilometres, of which 4,000 were for his employer. Markowski anticipates that travel costs in the future will be about the same as they were this year.

4. Markowski is required to purchase and maintain his own small tools. Every year, he spends approximately $500 on new tools and to replace lost or stolen tools. He also purchases his own work coveralls and pays for their cleaning, which amounts to another $300 per year.

5. Markowski will take possession of his new home in three months, and he is currently shopping for a mortgage. He expects to obtain a $90,000 mortgage with interest at 8% for a term of five years.

6. Markowski maintains the following insurance policies:

<table>
<thead>
<tr>
<th>Insurance Policy</th>
<th>Premium cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Term life insurance of $300,000</td>
<td>$1,200</td>
</tr>
<tr>
<td>Private medical insurance</td>
<td>600</td>
</tr>
<tr>
<td>House fire insurance</td>
<td>1,000</td>
</tr>
</tbody>
</table>

7. Markowski is a golfer and belongs to a private club. His annual membership dues are $1,200.
Exhibit 2: Information regarding offer of employment with competitor

1. The proposed salary is $60,000 per year. From that amount, the employer will deduct the required income tax, Canada Pension Plan contributions of $2,217, and Employment Insurance premiums of $787.

2. The employer will lease an automobile identical to the one currently used by Markowski. However, the employer’s lease cost will be only $450 per month because of a fleet discount. In addition, the employer will pay the annual insurance cost of $800, the repair and maintenance costs, which are estimated to be $600 annually, and the gasoline costs of $2,200. Markowski will be entitled to operate the car for personal use. The number of business kilometres and personal kilometres driven will be the same as they are now. The employer will pay for all out-of-town meals when an overnight stay is required. The cost of meals is expected to be $200 per year.

3. The employer maintains a good supply of small tools, and mechanics are not required to purchase or use their own. In addition, the employer maintains a complete wardrobe of work coveralls, and so Markowski will not have to purchase or launder his own.

4. As a senior mechanic, Markowski will be entitled to a low-interest loan (3%) from the employer of up to five years’ duration. Such loans can be renewed at the end of term. The maximum loan amount is $10,000. Assume the prescribed interest rate set by the CRA is currently 7%.

5. The employer maintains a group term life insurance program and a private medical insurance program. At no cost to Markowski, the employer will provide $300,000 of group term life insurance as well as medical coverage equal to what he currently has. The premium costs to the employer will be as follows:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Life insurance</td>
<td>$900</td>
</tr>
<tr>
<td>Medical insurance</td>
<td>500</td>
</tr>
</tbody>
</table>

These amounts are lower than Markowski’s current costs because group discounts are available to the employer.

6. The employer has agreed to pay Markowski’s annual golf club dues of $1,200. As Markowski does not entertain and deal with customers, the employer derives no benefit from Markowski’s membership in the club.
**Solution to Case - Markowski**

**Part (1) Employment income - Current employer:**

- **Salary [ITA 5(1)]** $70,000
- **Deduct:**
  - **Auto travel costs [ITA 8(1)(h.1)]**
    - **Lease** $6,000
    - **Insurance** 800
    - **Repairs** 600
    - **Gasoline** 2,200
    - **Employment portion** $4,000/22,000 x $9,600 (1,745)
    - **Meals out of town** (50% x $200) [ITA 8(1)(h), 8(4), 67.1] (100)
  - **Total Deduction** $9,600

  **Note:** There is no deduction for the tradesperson’s tools as the cost of the tools was not in excess of $1,000 in the year [ITA 8(1)(s)]. Clothing costs are not deductible under ITA 8(1)(i) because they are not consumed.

**Part (2) Employment income - New offer:**

- **Salary [ITA 5(1)]** $60,000
- **Auto standby charge** ([[$450 x 12] x 2/3] [ITA 6(1)(e), 6(2)] 3,600
- **Auto operating benefit** 18,000 km x 24¢ [ITA 6(1)(k)] 4,320
- **Low interest loan** [ITA 6(9), 80.4(1)]
  - **Prescribed rate** (7% x $10,000) $700
  - **Less actual interest** (3% x $10,000) (300)
  - **Life insurance** [ITA 6(1)(a), 6(4)] 900
  - **Club dues** [ITA 6(1)(a), IT-470R] 1,200
  - **Total** $70,420

  **Note:** If the low interest loan is used to assist with the purchase of the home, ITA 80.4(4) will limit the prescribed rate used to calculate the taxable benefit to 7%, the rate in effect when the loan was made to Markowski.
**Part (3) Increase (decrease) in disposable income:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reduction in gross salary</td>
<td>$(10,000)</td>
</tr>
<tr>
<td>Increase in tax cost</td>
<td></td>
</tr>
<tr>
<td>$(68,155 - $70,420 = 2,265) x 40%</td>
<td>(906)</td>
</tr>
<tr>
<td>Cash savings from benefits:</td>
<td></td>
</tr>
<tr>
<td>Lease on auto ($500 x 12)</td>
<td>6,000</td>
</tr>
<tr>
<td>Operating costs</td>
<td></td>
</tr>
<tr>
<td>insurance</td>
<td>$ 800</td>
</tr>
<tr>
<td>repairs</td>
<td>600</td>
</tr>
<tr>
<td>gas</td>
<td>2,200</td>
</tr>
<tr>
<td>Travel (meals)</td>
<td>200</td>
</tr>
<tr>
<td>Small tools</td>
<td>500</td>
</tr>
<tr>
<td>Wardrobe costs (coveralls)</td>
<td>300</td>
</tr>
<tr>
<td>Mortgage interest ($10,000 x [8% - 3%])</td>
<td>500</td>
</tr>
<tr>
<td>Life insurance</td>
<td>1,200</td>
</tr>
<tr>
<td>Medical insurance</td>
<td>600</td>
</tr>
<tr>
<td>Club dues</td>
<td>1,200</td>
</tr>
<tr>
<td>Increase in disposable income</td>
<td>$ 3,194</td>
</tr>
</tbody>
</table>

**hzzled**
CASE

Sapasko Industries Ltd.

Sapasko Industries Ltd. is a Canadian-controlled private corporation that manufactures a small line of plastic containers. The company has been in existence for only nine years but has grown rapidly. Last year, sales reached $8,000,000, and a record high profit of $750,000 was achieved.

The company now employs 41 staff in addition to the president, who is the sole shareholder. The current annual payroll, exclusive of the income of the shareholder/president, is $1,730,000 and consists of salaries, bonuses, and compulsory benefits, such as Canada Pension Plan and Employment Insurance contributions. The company is concerned about its increasing payroll costs, especially since recent wage increases in their industry have averaged 10%. The company’s year-end is approaching, and Sapasco must soon decide on salary adjustments for its existing staff.

Not long ago, Sapasco was approached by an insurance company, which suggested that it start up an employee benefit plan, which would include a deferred profit-sharing plan and three basic insurance plans. The insurance company indicated that if the insurance plans were accepted as a group, it could reduce the annual premiums by 20% of the normal retail rate. Also, it could invest the deferred profit-sharing plan funds to yield an average return 1% higher than that earned by individuals who invest separately in RRSPs.

The president of Sapasco has asked Carol Asaki, the personnel manager, to review the insurance company’s proposal. The president tells her, “I have always felt that excessive benefit programs create more administrative headaches than they are worth. But I’m willing to look at them further in view of the large wage settlements we may be facing. Let me know the value of the proposal to us as well as to the employees.”

To prepare her report to the president, Asaki gathers together certain information, which is summarized in Exhibit I. In addition, she pulls the personnel file on one of the company’s employees. The information in this file is summarized in Exhibit II.

Required:

On behalf of Asaki, prepare a draft report for the president.
EXHIBIT I
SAPASCO INDUSTRIES LTD.
PAYROLL SUMMARY

<table>
<thead>
<tr>
<th># of employees</th>
<th>Salary range</th>
<th>Payroll</th>
</tr>
</thead>
<tbody>
<tr>
<td>2</td>
<td>$100,000 and over</td>
<td>$240,000</td>
</tr>
<tr>
<td>4</td>
<td>$60,000 – $100,000</td>
<td>320,000</td>
</tr>
<tr>
<td>9</td>
<td>$40,000 – $60,000</td>
<td>450,000</td>
</tr>
<tr>
<td>14</td>
<td>$25,000 – $40,000</td>
<td>460,000</td>
</tr>
<tr>
<td>12</td>
<td>$18,000 – $25,000</td>
<td>260,000</td>
</tr>
<tr>
<td>41</td>
<td></td>
<td>$1,730,000</td>
</tr>
</tbody>
</table>

Tax rates
Sapasco Industries Ltd. 25%

Employees (by income range):
- $0 – $41,000: 26%
- $41,000 – $83,000: 34%
- $83,000 – $129,000: 40%
- $129,000 and over: 45%

Proposed benefit plan

**DPSP:** Contributions will range from $0 to $3,500 and should average $2,000 annually per employee. Currently, DPSP funds can be invested to yield 12% annually.

Insurance plans

<table>
<thead>
<tr>
<th></th>
<th>Average premium per employee</th>
</tr>
</thead>
<tbody>
<tr>
<td>Group term life insurance</td>
<td></td>
</tr>
<tr>
<td>Basic ($25,000 coverage)</td>
<td>$100</td>
</tr>
<tr>
<td>Additional ($75,000 coverage)</td>
<td>$400</td>
</tr>
<tr>
<td>Group health and dental plan</td>
<td>$500</td>
</tr>
<tr>
<td>Group accident and sickness plan (disability)</td>
<td>$600</td>
</tr>
</tbody>
</table>

EXHIBIT II
SAPASCO INDUSTRIES LTD.
Summary of Personnel File
Jason Steiman

Age: 33
Family status: Married, three children
Current salary: $50,000
Amounts withheld from salary:
- Canada Pension Plan
- Employment Insurance
- Monthly contributions made directly to employee’s bank for the purchase of his private RRSP ($200 per month).
SOLUTION to CASE - Sapasko Industries Ltd.

The proposed benefit plan includes both a deferred profit sharing plan and several types of group insurance plans. The general benefits of these two plans are reviewed separately as the tax implications of each are different.

Before reviewing the plans, it is useful to establish the potential cost to Sapasko of a wage settlement under the existing structure. As all remuneration is currently paid in the form of direct salaries, a wage settlement of 10% (current industry trend) would have the following annual cost:

<table>
<thead>
<tr>
<th>Current salaries $1,730,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Increased salary costs (10%) $173,000</td>
</tr>
<tr>
<td>Less tax savings @ 25% (43,250)</td>
</tr>
<tr>
<td>After-tax cost $129,750</td>
</tr>
</tbody>
</table>

The value of this increase would be different for various groups of employees within the company as personal tax rates vary depending upon their current levels of income. The after-tax increase in disposable income for employees in the 45% tax bracket is 5.5%, for employees in the 40% tax bracket 6%, for employees in the 34% tax bracket 6.6%, and 7.4% for employees in the 26% tax bracket. By providing other forms of compensation that have a preferential tax treatment to the employees, these same after-tax increases may be achieved but at a lower cost to Sapasko.

Group Insurance Plans

A complete package of insurance programs would cost Sapasko $1,500 per employee as follows:

- Life insurance $400
- Health insurance $500
- Disability $600
- $1,500

Because these plans can be obtained for a cost that is 20% lower than what an employee would have to pay on their own, the value of the plan to each employee is $1,875 ($1,500/.80).

The tax treatment of the above benefits to the employees is as follows:

- The life insurance premium ($400) is taxable.
- All other premiums are not taxable to the employee.

Notice that the above tax treatment leaves a significant portion of benefit tax free because the difference between the fair market value of the benefit and the employer's cost is also not taxable. Therefore, the total non-taxable portion of the $1,875 benefit value is $1,475 as follows:

<table>
<thead>
<tr>
<th>Health and disability premiums ($500 + $600) $1,100</th>
</tr>
</thead>
<tbody>
<tr>
<td>Value of benefits in excess of cost ($1,875 - $1,500) 375</td>
</tr>
<tr>
<td>$1,475</td>
</tr>
</tbody>
</table>

Therefore, each employee is taxable on only $400 of the $1,875 benefit value.
Using Jason Steiman as a sample employee, the overall value of the benefit plan can be quantified. Steiman is married and has three children. Therefore, it is likely that he requires and probably already has life, private health, and income protection insurance. Currently, he would have to pay these premiums from after-tax income and at a cost that is higher than Sapasko's cost under the group plan.

Steiman's current salary is $50,000 and therefore his marginal tax rate is 34%. The after-tax value of receiving the group insurance benefit plan would be as follows:

\[
\begin{align*}
\text{Value of benefits} & \quad \$1,875 \\
\text{Less tax:} & \\
\$400 @ 34\% & \quad (136) \\
\text{After-tax value} & \quad \$1,739
\end{align*}
\]

An after-tax benefit of $1,739 is equivalent to receiving a fully taxable salary of $2,635.

\[
x - .34x = 1,739 \\
x = \frac{1,739}{.66} = 2,635
\]

Therefore, from Steiman's perspective, a direct salary increase of $2,635 is equivalent to the proposed benefit package. However, from Sapasko's perspective, the cost of a salary increase is considerably different from the cost of providing the benefit package.

\[
\begin{align*}
\text{Pre-tax cost of salary} & \quad \$2,635 \\
\text{Pre-tax cost of benefit package} & \quad (1,500) \\
\text{After-tax amount} & \quad \$1,135
\end{align*}
\]

If, as part of this year's wage settlement, Sapasko offered the benefit program to each of its 41 employees in lieu of its pre-tax salary equivalent, total savings of $46,535 would occur ($1,135 x 41 = $46,535). Therefore, the potential wage increase of $173,000 could be reduced to approximately $126,465 ($173,000 - $46,535) and still provide employees with a pre-tax salary equivalent increase of 10%.

In other words, Sapasko can provide a wage increase equivalent to industry standard of 10% through a combination of salary plus the benefit program at a pre-tax cost to Sapasko of only 7.3% ($126,465/$1,730,000). The costs associated with a 10% increase under the existing structure (salaries only) and the proposed structure are compared below:

| Pre-tax Salary Cost to Pre-tax Salary Equivalent for Employees |
|---------------------------------------------------------------|---------------------------------------------------------------|
| Salaries only:                                               |                                                               |
| Pre-tax amount                                               | $173,000                                                      |
| After-tax amount                                             | 129,750                                                       |
| Salaries and benefits:                                       |                                                               |
| Pre-tax amount                                               | 126,465                                                       |
| After-tax amount                                             | 94,849                                                        |
| After-tax cash saving                                        | $34,901                                                       |
|                                                               | nil                                                           |

The above analysis assumes that all employees are in a 34% tax bracket (similar to Steiman). This, of course, is not the case. However the above provides a reasonable estimate of the benefits that
could be achieved by Sapasko.

From the employees' perspective, the after-tax wage increase from the benefit program simply meets the industry standard. The advantage from the tax treatment of the benefits has effectively been retained by Sapasko as a cost reduction. Sapasko could consider sharing the cost reduction with the employees. For example, in Steiman's case, Sapasko could provide him with an increase as follows:

<table>
<thead>
<tr>
<th></th>
<th>Cost to Sapasko</th>
<th>Value to Steiman</th>
</tr>
</thead>
<tbody>
<tr>
<td>Benefit package</td>
<td>$1,500</td>
<td>$1,875</td>
</tr>
<tr>
<td>Salary increase (arbitrary)</td>
<td>2,000</td>
<td>2,000</td>
</tr>
<tr>
<td>Tax - saving for Sapasko (25%)</td>
<td>(875)</td>
<td></td>
</tr>
<tr>
<td>- Steiman - benefit (34% of $400)</td>
<td>(136)</td>
<td></td>
</tr>
<tr>
<td>- salary</td>
<td>(680)</td>
<td></td>
</tr>
<tr>
<td></td>
<td><strong>3,500</strong></td>
<td><strong>3,875</strong></td>
</tr>
</tbody>
</table>

This provides Steiman with a pre-tax salary equivalent increase of $4,635 (x - .34x = $3,059) or a pre-tax wage increase of 9.3% ($4,635/$50,000) which is just below the industry average of 10%. At the same time, Sapasko's cost on a pre-tax basis is only 7% ($3,500/$50,000) which is substantially lower than the 10% industry standard.

Note: Regarding the disability insurance, the above discussion deals with the benefit relating to the premium cost and not to any potential insurance claims for wage loss replacements. If a claim is made on the policy, the periodic amounts received by the employee would be a taxable benefit [ITA 6(1)(f)]. In contrast, where the employee pays all of the premium, any potential claims would not be taxable. Therefore, a trade-off occurs between the value of the tax-free premium payments and the potential receipt of taxable claims. Claims from health plans and life insurance plans are not taxable under any circumstances.

**Deferred Profit Sharing Plan**

The advantage of a DPSP is that the compensation value is not included in the employee's income until it is removed from the plan. In addition, investment returns on the funds are also not taxable until removed from the plan.

However, the tax rules governing registered funds impose an overall limit to the amount of tax deferred contributions that can be made on behalf of an individual to all types of plans (RPP, RRSP and DPSP) whether or not the contribution is made by the individual or their employer. Therefore, if Sapasko initiates a DPSP, any contribution made by them will reduce the amount that the employees can contribute to their own RRSP. Therefore, the plan itself creates no tax advantages for Sapasko employees.

However, an advantage can be gained by the preferential investment rates that are offered to Sapasko. In this case, Sapasko can obtain a higher investment return of 1% per annum compared to the return that could be obtained if an employee invested their own funds in an RRSP. The advantages of this can be expressed in terms of Jason Steiman's position.

Steiman currently invests $2,400 annually in an RRSP, which is less than his annual limit. Probably he does not contribute more because of his personal living requirements. Therefore, if Sapasko offers a compensation increase by way of a DPSP rather than a cash salary increase, Steiman will contribute less to his RRSP in order to supplement increased living costs. In terms of the amount,
the DPSP provides no advantage. For example, assume the DPSP for Steiman is equal to his RRSP contribution of $2,400. The following comparison can be made:

As a salary:
- Cash received $2,400
- Less tax @ 34% (816)
- Increase in after-tax cash $1,584
- Increase in RRSP $2,400

As a DPSP:
- Salary received $0
- Reduction in RRSP contribution 2,400
- Less previous tax savings @ 34% (816)
- Increase in after-tax cash $1,584
- Increase in DPSP $2,400

Therefore, both alternatives give Steiman increased personal funds of $1,584 while still maintaining his tax deferred contributions of $2,400.

However, by using the DPSP, the annual contribution will earn 12% (based on current rates) compared to 11% (1% lower) in an RRSP. The value of this benefit depends on the length of time that the funds remain in the plan. The following assumptions are made:

- Steiman will work to age 65. As he is 33 years old, this leaves 32 years remaining for contributions.
- At age 65, the full value of the plan will be paid out in a lump sum resulting in a tax cost.
- Steiman’s tax rate remains constant at 34%.

The after-tax value of $2,400 invested annually for 32 years at the two rates of interest are as follows:

<table>
<thead>
<tr>
<th>Rate</th>
<th>Investment</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>12%</td>
<td>$2,400</td>
<td>$819,430</td>
</tr>
<tr>
<td>11%</td>
<td>$2,400</td>
<td>658,870</td>
</tr>
</tbody>
</table>

Pre-tax advantage 160,560
Tax @ 34% (54,590)

After-tax advantage $105,970

This advantage can be translated into a pre-tax salary equivalent. Keep in mind that Steiman does not contribute his annual limit to an RRSP. His current limit is 9,000 (18% x $50,000). Therefore, an additional salary could be paid into an RRSP, eliminating the tax on the salary. To compensate for the advantage achieved from a DPSP above Steiman would have to receive an additional annual salary of $585 and invest the full amount in his own RRSP at the lower rate of 11% calculated as follows:

<table>
<thead>
<tr>
<th>Investment</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>$585</td>
<td>$160,560</td>
</tr>
<tr>
<td>Less tax on wind-up (34%)</td>
<td>(54,590)</td>
</tr>
</tbody>
</table>

$105,970
Therefore, the 1% investment return advantage has a pre-tax salary equivalent of $585 per year for Steiman. It is important to recognize that the advantage for other employees may be different. For example, certain employees may already be contributing their annual limit to an RRSP and therefore an additional salary would be fully taxable and only the after-tax proceeds could be invested (which would also be taxable annually).

Consider an employee who already earns $150,000 in salary, has a marginal tax rate of 45%, is 40 years of age and anticipates working to age 65. If the employee already contributes the maximum to an RRSP, a $2,400 DPSP contribution would reduce the amount of his or her RRSP contribution and, similar to Steiman, would gain the advantage of a 1% investment return increase. The value of this and its pre-tax salary equivalent is calculated below.

\[
\begin{align*}
$2,400 & \text{ for 25 years @ 12\%} & \quad & 358,401 \\
$2,400 & \text{ for 25 years @ 11\%} & \quad & 304,797 \\
\text{Less tax on assumed payment (45\%)} & \quad & (24,122) \\
\text{After-tax advantage} & \quad & 29,482
\end{align*}
\]

As the employee's deferred plan limit has been used, he or she would have to invest an additional after-tax salary at 6.05% (11\% - tax @ 45\%) annually for 25 years to make up the $29,482 value. The pre-tax salary equivalent is calculated as follows:

\[
\begin{align*}
$502 & \text{ for 25 years @ 6.05\%} = 29,482 \\
\text{Pre-tax salary increase required:} \\
x - .45x & = 502 \\
X & = 913
\end{align*}
\]

Therefore, for this particular employee, a $2,400 DPSP contribution is equivalent to a total salary increase of $3,313.

The above indicates that Sapasko would be wise to initiate the benefit plans as they can achieve the required 10% wage increase for a cost of less than 10% to the company.
CHAPTER 5

INCOME FROM BUSINESS

Review Questions

1. In order to earn business income, a taxpayer must be involved in an undertaking that constitutes a business. For tax purposes, briefly define “business.”

2. Explain the term “adventure or concern in the nature of trade,” and provide an example of such an activity.

3. Can an item of property (such as land) that has the potential to provide a long-term benefit to its owner create business income or a business loss when it is sold? Explain.

4. To what extent, if any, does the tax treatment of property that is classified as inventory, rather than as capital property, affect a taxpayer’s financial risk in acquiring such property?

5. A taxpayer’s income from business for tax purposes is defined simply as “the profit there from.” Explain what is meant by this.

6. What impact do the accounting concepts of revenue recognition, accrual, and matching have on the determination of business income for tax purposes?

7. To what extent, if any, does the definition of business income for tax purposes deviate from the general definition of profit? (Note: this relates to the answer to question 5.)

8. Explain why the following expenditures are not deductible in arriving at business income for tax purposes, even though they may be consistent with the general definition of profit.

   (a) Small donations to a large number of charitable organizations.

   (b) A fee paid to a real estate consultant for finding an appropriate building for storing the inventory of a wholesale business.

   (c) A reserve for the anticipated cost of product guarantees relating to products sold in the current year.

   (d) The cost of entertaining business clients at the wedding of the daughter of the owner of the business.

   (e) Fees paid to an architect to draw a set of plans for the expansion of a company’s head office building.

   (f) Office rent of $40,000 annually, when the building is valued at $100,000 and is owned by the spouse of the corporation’s primary shareholder.

9. Explain why a business, in determining net income from business for tax purposes, can deduct a reserve for potentially uncollectible accounts receivable but cannot deduct a reserve for anticipated sales returns.

10. What is the significance of sections 18 and 20 of the Income Tax Act?
11. A business maintains a policy of providing memberships for senior employees at social clubs and clubs with sporting facilities. In some circumstances, such memberships are provided mainly to improve the business contacts of the employers; in others, they are provided solely as compensation. Explain the tax treatment of this kind of expense. In your answer, refer to the general rules for determining income from business.

12. What is the tax treatment when an item of inventory is sold in a particular year but the customer is required to pay for the item in equal annual instalments over four years?

13. At the end of its taxation year, a business has two unsold items of inventory. Item A has a cost of $10,000 and a market value of $15,000. Item B has a cost of $7,000 and a market value of $4,000. For tax purposes, what valuation methods can be used to determine ending inventory? Determine these amounts based on the information provided.

14. One often hears the comment “A business keeps two sets of records—one for the bank and one for tax purposes.” While this comment has sinister connotations, to what extent is it not sinister? Explain how the failure to maintain separate records for tax purposes may reduce a company’s rate of return on business activities.

15. Briefly compare and contrast the general treatment for tax purposes of employment income and business income.
Solutions to Review Questions

R5-1. The term business is generally defined as a profession, calling, trade, manufacture, or undertaking of any kind whatever and includes an adventure or concern in the nature of trade [ITA 248(1)]. Therefore, activities such as manufacturing, mining, exploration, construction, logging, farming, fishing, selling of property as a retailer or wholesaler, transportation, and selling services are obvious business activities. The size of the activity is not relevant in determining whether or not a business activity exists. Therefore, a person providing hockey lessons to one person for a fee is conducting a business activity in the same way that the operation of a large hockey school is a business.

R5-2. An adventure or concern in the nature of trade occurs when a taxpayer acquires property for the purpose of reselling it at a profit, even though that activity is not part of the person's normal business activities. For example, an individual, in an isolated transaction, may acquire a piece of land in the hope of trading it at a profit. This isolated transaction is similar to the normal activity of a real estate development and trading business. Consequently, it is an adventure or concern in the nature of trade and is included as a business activity.

R5-3. Yes. A gain or loss on the sale of property can result in business income (loss) or a capital gain (loss). Property acquired and used for the purpose of providing the owner with a long-term benefit is capital property and its disposition results in a capital gain or loss. However, property, even though it has the ability to provide a long-term benefit, will be treated as inventory and the sale will generate business income (loss) if it was acquired for the purpose of reselling it at a profit. Therefore, it is the property's intended use and actual use which determine its tax treatment and not its ability to be used in a certain manner.

R5-4. The amount of risk a person is willing to accept on a particular investment is influenced, in part, by the potential returns which may be achieved as well as the extent of loss exposure. Therefore, the tax treatment of potential gains and losses is relevant.

On the upside, property that is inventory is fully taxable as business income, whereas property that is capital property is taxable on only one-half of the gain. Therefore, a different classification of the same type of property purchased will result in different after-tax returns even though the pre-tax returns are identical.

On the downside, property classified as inventory results in a business loss which is fully deductible against all other sources of income. Therefore, assuming the taxpayer has other sources of income and has a tax rate of 45%, a $100,000 business loss will reduce taxes on other income by $45,000 leaving a maximum loss exposure of only $55,000. In comparison, if the property is classified as capital property, a $100,000 loss can reduce income by only $50,000 (1/2 of $100,000) reducing taxes by $22,500 (45% of $50,000) leaving a net loss exposure of $77,500. In addition, the capital loss can only be offset against capital gains, which reduces the likelihood of recovering all or a portion of the $22,500 potential tax saving.

An investor may be prepared to take a greater risk if the potential loss is $55,000 from inventory property compared to a loss of $100,000 on capital property (if the loss can't be offset) considering that the investment is the same amount.

R5-5. The term "profit" is not defined in the ITA. It is, therefore, up to the courts to develop guiding principles to assist in determining profit for tax purposes. For many years the courts have given significant consideration to GAAP when dealing with conflicts between taxpayers and CRA. The Supreme Court of Canada reaffirmed that GAAP is not law but rather a significant interpretive aid to help establish an accurate profit. However, it remains that profit from
business is normally first determined using GAAP. The actual profit for tax purposes then becomes a question of law, where income per financial statements (GAAP) is modified according to the ITA, established case law (“rules of law”) and established business principles. The intent is to provide an accurate picture of revenues and expenses incurred to earn those revenues.

In general terms, profit is a net concept reflecting the revenues earned minus expenses of the entity. Reference to business income, therefore, means the net amount and not the gross income [ITA 9(1)].

R5-6. The accounting concepts of accrual, revenue recognition, and matching affect the time period (taxation year) in which revenues and expenses are recognized for tax purposes.

The accrual concept requires that expenses are recognized when they are incurred and not necessarily when they are paid. Therefore, an expense incurred in year one but not paid until year two will normally be deducted for tax purposes in year one. Similarly, the concept of revenue recognition requires that revenue be recognized when the earning process is substantially complete (usually when title to property is transferred or a service is rendered) and not necessarily when payment is received.

The matching concept may further alter the timing of an expense deduction by delaying its recognition until the year in which it contributes to earning revenue. For example, the purchase of inventory may occur in year one but is not sold until year two. Therefore, the deduction of the inventory cost to arrive at business income is delayed until year two.

Consequently, each of the concepts affects the timing of recognition for determining income and, therefore, affects the timing of the related tax liability.

R5-7. Although business income for tax purposes is the profit in accordance with well accepted business principles using the interpretive aid of generally accepted accounting principles, a number of general limitations are specifically imposed which may alter that determination. In particular, six general limitations are imposed on the deduction of expenses:

- An expense incurred is only deductible if it was incurred for the purpose of gaining, producing or maintaining income from business [ITA 18(1)(a)].
- No deduction is permitted if the expenditure is for, or on account of capital, depreciation, obsolescence or depletion except as specifically permitted [ITA 18(1)(b)].
- An expense is denied as a deduction if it was incurred to earn income that is not taxable [ITA 18(1)(c)].
- No deduction is permitted for a reserve except as specifically permitted [ITA 18(1)(e)].
- Expenses on account of personal or living expenses are denied [ITA 18(1)(h)].
- No expense is deductible unless it is reasonable under the circumstances [ITA 67].

R5-8. Although each item listed may be a reduction of income to arrive at profit in accordance with accounting principles, they are restricted for tax purposes by one of the six general limitations described in the answer to question 7.

a) **Donations** - They are not for the purpose of earning income [ITA 18(1)(a)] as the small contributions to charities will not enhance or maintain the company's ability to earn income. It is a gift.
b) **Finders fee** - The finders fee is on account of capital because it is part of the cost of acquiring the building which is a capital asset [ITA 18(1)(b)]. It will be permitted to be deducted over time as part of the capital cost allowance system which replaces accounting amortization.

c) **Product guarantee reserve** - Although consistent with the accounting concept of conservatism it is not deductible for tax purposes as the general limitations do not permit the deductions of reserves [ITA 18(1)(e)]. While there are exceptions, this type of reserve is not one of them.

d) **Entertainment** - Although reasonable entertainment expenses are deductible, the cost of entertaining guests who are business clients at a wedding of the daughter of the owner may be restricted because they are personal or living expenses [ITA 18(1)(h)].

e) **Architects fees** - The fees are not deductible because they are a capital expenditure as part of the cost of the building expansion [ITA 18(1)(b)]. It may be deducted over a period of time as part of the capital cost allowance system.

f) **Rent** - The rent payment of $40,000 appears to be unreasonable as it represents a return of 40% to the owner of the building who is related to the owner of the corporation paying the rent. A reasonable portion would be permitted as a deduction. The remainder is denied [ITA 67].

R5-9. One of the general limitations for arriving at income from business prohibits the deduction of reserves except as specifically permitted [ITA 18(1)(e)]. No exception is provided for the cost of anticipated sales returns. Therefore, they are not deductible. Actual warranty costs can be deducted as they occur in accordance with the general rules. In comparison, a reserve for doubtful accounts receivable is, by exception, permitted to be deducted provided that it is reasonable and the creation of the debt was included in income [ITA 20(1)(l)]. Accounts receivable from the sale of goods or services is included as part of sales revenue when originated. Therefore, a reserve for uncollectible accounts receivable is permitted.

R5-10. Although income from business is the profit as determined under ITA 9(1) (see question 5) modified by six general expense limitations, a number of exceptions are permitted. Both section 18 and 20 are significant because they are the source that identifies many of the items that are excepted from the general rules.

Section 18 lists a number of items that are not deductible even though the general rules would otherwise permit their deduction. Conversely, section 20 lists a number of items that can be deducted even though the general rules would prohibit them.

R5-11. In accordance with the general rules the payment of club dues for employees would be deductible. Their deduction is acceptable for the determination of profit in accordance with generally accepted accounting principles, if they appear reasonable, are not on the account of capital and are not a reserve. In addition they are incurred for the purpose of earning income either by improving business contacts or as a form of compensation to employees who work to generate income.

However, by exception, section 18 of the Income Tax Act specifically prohibits the deduction of club dues for any reason notwithstanding the general rules [ITA 18(1)(l)].

R5-12. Under generally accepted accounting principles the revenue and the related cost of inventory sold is recognized in the year in which the product is sold even though extended payment terms exist.
However, by exception, paragraph 20(1)(n) permits the deferred portion of the profit to be deducted as a reserve where the property sold is inventory and (except for inventory that is land) all or part of the payment is not due for at least two years from the date of sale. The profit referred to is the gross profit (i.e., selling price minus the cost of the product sold) and the reserve is calculated as:

\[
\text{reserve} = \frac{\text{gross profit}}{\text{gross selling price}} \times \text{amount due after the end of the year}
\]

Therefore, a portion of the profit is recognized in proportion to the deferred payments with the additional constraint that all profit must be recognized by the end of year four. The reserve can be claimed for a maximum of three years [ITA 20(8)]. The reserve cannot be claimed where the purchaser of the property is a corporation controlled by the taxpayer or is a partnership of which the taxpayer is the majority interest partner [ITA 20(8)].

A reserve is permitted for inventory that is land as long as an amount is due after the end of the taxation year in which the property was sold [ITA 20(8)].

R5-13. The ending inventory can be valued using two basic alternatives 10(1):

1. All at market [Reg 1801]:
   
   \[
   \begin{array}{c|c}
   \text{A} & \$15,000 \\ \text{B} & 4,000 \\ \hline
   & \$19,000
   \end{array}
   \]

2. Lower of cost or market:
   
   \[
   \begin{array}{c|c|c}
   \text{A} & \$10,000 & \text{(cost)} \\ \text{B} & 4,000 & \text{(market)} \\ \hline
   & \$14,000
   \end{array}
   \]

Because the deduction for cost of goods sold is determined as opening inventory plus purchases minus closing inventory, each of the above alternative values will reduce the cost of goods sold (and, therefore, increase profits for tax purposes) by different amounts. Inventory valued at market will increase profits by $19,000. Inventory valued at the lower of cost or market will increase profits by only $14,000. The chosen method must be consistent from year to year except where a change is approved by CRA [ITA 10(2.1)].

R5-14. Because income for tax purposes may be different from profit determined in accordance with generally accepted accounting principles, it is essential that a taxpayer maintain records for normal accounting purposes as well as for tax purposes. For example, inventory can be valued by two alternative methods, one of which deviates from normal accounting principles. Another example is landscaping costs which are capital items for accounting purposes but are deductible for tax purposes when paid [ITA 20(1)(aa)]. The number of variations is significant and a business must have an information system which highlights this information. The amount of tax payable obviously affects the amount of cash flow which in turn has an impact on the future return on investment.

The timing of certain deductions is discretionary and in some cases it may be advantageous to deduct the expense later than sooner. For example if next year’s tax rate is expected to be significantly higher than the current year, it may be advisable not to claim the current year’s reserve for doubtful accounts. A reserve for doubtful accounts can, by choice, be excluded this year but claimed next year when the tax rate is higher. Without both accounting records...
and tax records, the value of such choices and their impact on the amount and timing of cash flow may not be evident.

R5-15. Based on the general rules for determining employment income and business income the two can be compared as follows:

a) Employment income (income minus deductions) is determined on a cash basis. Income is recognized when received (not necessarily when earned) and permitted expenses are deducted when paid. Business income, on the other hand, uses the accrual method requiring income to be recognized when earned and expenses deducted when incurred.

b) The determination of employment income permits no deductions except those specifically allowed, whereas, the calculation of business income permits the deduction of all expenses incurred to earn income subject to certain exceptions.

c) Employees can earn a specified number of non-taxable and tax deferred benefits. The determination of business income has no specific list of non-taxable income.
Key Concept Questions

QUESTION ONE

Which one of the following transactions is most likely to be treated as business income for tax purposes? Which one will likely be treated as a capital gain? *Income tax reference: ITA 9(1); IT-218R.*

1. In Year 1, Bill purchased a parcel of land for $100,000 with the intention of building a rental property. In Year 5, Bill sold the rental property for $500,000.

2. In Year 1, Martha purchased a parcel of land for $100,000 with the intention of holding it until the land increased in value and could be sold at a gain. In Year 5, Martha sold the property for $500,000.

QUESTION TWO

Sharp Ltd. incurred the following expenses in the current year:

- $25,000 in legal and accounting fees with respect to the issue of a new class of preferred shares.
- $8,000 for landscaping around the office building.
- $1,200 in interest paid to the CRA for late income tax instalments.
- $2,700 in interest on funds borrowed to finance the purchase of new office equipment.
- $40,000 in scientific research and experimental development expenditures.
- $80,000 in stock-based compensation expense.

Comment on the deductibility for tax purposes of each of the expenses. *Income tax reference: ITA 7(3), 18, 20(1), 37(1), (2).*

QUESTION THREE

Gary carries on an accounting business as a sole proprietor. The business is an HST registrant. In the current year he incurred the following expenses, among others:

- $12,312—Lease payment for his car (12 months). Eighty percent of the kilometres driven were for business purposes.
- $1,000—Donation to a registered charity.
- $5,000—Entertaining clients (meals and theatre tickets).
- $2,400—Golf club annual dues. Many of Gary’s clients are members of the golf club.

Comment on the deductibility of these four expenses (and the HST implications). *Income tax reference: ITA 18(1), 67.1, 67.3.*

QUESTION FOUR

In the current year SPL Ltd. paid tax-free automobile allowances of 50¢ per kilometre to two of its employees. Employee #1 drove 15,000 km and Employee #2 drove 6,000 km in carrying out their duties of employment.

Comment on the deductibility of the car allowance for SPL Ltd. *Income tax reference: ITA 18(1)(r).*
Solutions to Key Concept Questions

KC 5-1

[ITA: 9(1) – Capital vs. Income]

The intended use of the property on acquisition is the principal factor in deciding its tax treatment on a subsequent sale.

In Bill’s case, the land was acquired for the purpose of providing Bill with a long-term enduring benefit by generating rental income. The sale of the rental property will most likely be treated as a capital gain in which case only one-half of the gain will be taxable.

In Martha’s case, the land was acquired for the purpose of reselling it at a profit. The profit on the sale of the land, like any inventory item, will be treated as business income. 100% of the profit will be taxable.

KC 5-2

[ITA: 18, 20(1), 37(1), (2) – Deductions]

The $25,000 legal and accounting fee incurred with respect to the issue of a new class of shares is a cost of issuing shares and as such is deductible over 5 years [ITA 20(1)(e)]. Therefore, $5,000 is deductible in the current year and in each of the following 4 years.

The $8,000 expense for landscaping is deductible in the current year, provided that the $8,000 was paid in the current year [ITA 20(1)(aa)].

The $1,200 of interest paid to the CRA is not deductible [ITA 18(1)(t)].

The $2,700 of interest paid to finance the purchase of office equipment is fully deductible in the year incurred [ITA 20(1)(c)]. Interest can, at the taxpayer’s option, be deducted on a cash basis when paid, rather than by the accrual method. Alternatively, the interest expense can be added to the cost of the equipment and deducted over time in the form of CCA [ITA 21].

Scientific research and experimental development (SR&ED) carried on in Canada is given preferential tax treatment. The expenditures, both current & capital in nature (except for buildings), are deductible in full in the year incurred [ITA 37(1)(a)&(b)]. Alternatively, the deduction, or any portion of it, can be saved and deducted in any future year [ITA 37(2)]. In addition, the SR&ED expenditures may also generate an investment tax credit, which reduces tax payable [ITA 127(5)]. Investment tax credits claimed in the year reduce the SR&ED expenditure pool in the following year or are included in income, if there is no balance in the SR&ED pool [ITA 12(1)(t), 37(1)(e)].

Stock-based compensation expense is not deductible. The Income Tax Act denies an employer a deduction in connection with the sale or issue of shares to an employee [ITA 7(3)(b)].
Automobile lease payments for tax purposes are limited to $800 plus tax per month [ITA 67.3]. Since Gary’s accounting practice is an HST registrant, he recovers the HST he pays and, thus, HST cannot be included as a cost. Thus, the car lease payments for the year are limited to $800 x 12 months = $9,600. Gary uses the car 80% for business purposes - $9,600 x 80% = $7,680. Gary’s deductible amount is $7,680.

Donations to registered charities are not for the purpose of earning income. They are gifts. Therefore, no deduction is available [ITA 18(1)(a)]. Donations involve a transfer of money which is not a supply and, therefore, is outside the scheme of HST. No HST input tax credit is available [ETA 123(1)].

Fifty per cent of entertainment expenses are deductible [ITA 67.1]. Therefore, Gary can deduct $2,500. Although an HST input tax credit is initially allowed on the full amount expended for food and entertainment, there will be a recapture of 50% of the total input tax credit in respect of these expenses [ETA 236].

Membership dues in any club, the main purposes of which is to provide dining, recreational or sporting facilities for its members, are not deductible [ITA 18(1)(l)]. Therefore, the golf club dues are not deductible. HST input tax credits are not allowed in respect of these non-deductible membership fees [ETA 170(1)(a)].

**KC 5-4**

[ITA: 18(1)(r) – Car allowances]

Since the car allowances are tax-free to the employees, SPL Ltd. is subject to a deduction limit of $0.52 (2011) for the first 5,000 business kilometres travelled by each employee and $0.46 (2011) for the remainder [ITA 18(1)(r)].

<table>
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<th>Allowance paid</th>
<th>Employee #1</th>
<th>Employee #2</th>
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<tr>
<td>15,000 km x $0.50</td>
<td>$7,500</td>
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</tr>
<tr>
<td>6,000 km x $0.50</td>
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<td>$3,000</td>
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</table>

Maximum deductible:

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<th>Employee #1</th>
<th>Employee #2</th>
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<tbody>
<tr>
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<td>$2,600</td>
<td>$2,600</td>
</tr>
<tr>
<td>10,000 km x $0.46</td>
<td>4,600</td>
<td></td>
</tr>
<tr>
<td>1,000 km x $0.46</td>
<td></td>
<td>460</td>
</tr>
</tbody>
</table>

$7,200         $3,060

Non-deductible portion:

<p>| | |</p>
<table>
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<th></th>
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</thead>
<tbody>
<tr>
<td>Employee #1 ($7,500 - $7,200)</td>
<td>$300</td>
</tr>
<tr>
<td>Employee #2</td>
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</tr>
<tr>
<td>Total</td>
<td>$300</td>
</tr>
</tbody>
</table>
Problems

PROBLEM ONE

[Issue: Capital vs. Income]

X, Y, and Z each purchased an identical piece of land at a cost of $4,000.

- X constructed a restaurant on her land and operated it profitably for several years.
- Y did nothing with her land. It simply remained unused for several years.
- Z rented out his land for a number of uses—car parking, summer carnivals, and so on.

Reasonable returns were achieved.

Four years later, X, Y, and Z each sold their land for $12,000. X sold the land as part of the sale of the restaurant business. Y subdivided the land into three separate parcels and sold each for $4,000. Z had no intention of selling the land but received an offer that he felt he could not refuse.

Required:

Is the gain on sale of the land ($12,000 – $4,000 = $8,000) income from business for X, Y, and Z? Explain.
Solution to P 5-1

X - It is apparent that X purchased the land and used it to derive a long-term benefit. The land was used to permit the construction of a building to house a restaurant which generated revenue. The land is, therefore, capital property and when sold results in a capital gain of $8,000 ($4,000 taxable).

Y - It appears that Y acquired the land for the purpose of trading it at a profit and not to provide a long-term benefit. This is evidenced by the fact that the land was not used and was subdivided into saleable lots. The land may be considered inventory and the gain of $8,000 fully taxable as business income.

Z - Z's intention is not as clear. It may be considered as capital property because Z derived a long-term benefit from various rental returns. Also no attempt was made to sell the property; it was sold after an unsolicited offer which was too good to refuse. On the other hand, it could be argued that Z made no long-term commitments to derive benefits but instead leased the land for short term and varying uses. This may indicate that the intention was to trade the land at a profit and avoided long-term leases in an attempt to keep the land free for sale. Therefore, whether this gain is business income or capital gain is not clear based on the information available.
PROBLEM TWO

[Issue: Capital vs. Income on sale of a licence]

Carl Fenson of Winnipeg owned three taxicabs that operated for 24 hours a day (two shifts of 12 hours). Fenson worked one shift himself and hired drivers for the other shifts. At the time, in addition to the normal taxi licence, a special licence was required to deliver passengers to Winnipeg International Airport. This special licence was referred to as a “one way” licence because it could be used to deliver passengers to the airport but not to pick up customers there. The licences were issued for 10-year renewable terms.

In 20X1, Fenson purchased three additional airport licences for $10,000 each, even though he did not have vehicles for their use. He immediately resold two of the licences for $18,000 each to a relative. Shortly thereafter, he purchased a mini-van, assigned the third new licence to that vehicle, and rented the van with the licence to a third party.

In 20X3, Transport Canada converted all one-way licences to two-way licences. In response to an unsolicited offer, Fenson cancelled the van lease and sold the third licence for $45,000.

Required:

What type of income did Fenson earn from the licence sales? Explain.
Solution to P 5-2

The issue is whether the sale of the licenses creates capital gains or business income.

- Sale of two licenses to relatives:

  This appears to be an adventure or concern in the nature of trade because he acquired the licenses for $10,000 each and immediately resold them for $18,000 each. Also Fenson did not have any vehicles which could use the licenses when acquired.

- Sale of third license:

  There are two possible arguments for the third license.

  1) The license together with a vehicle was rented to a third party indicating its purpose of acquisition was to achieve a long-term benefit from rental returns. In addition, it was only sold when a fortuitous change in the law made the license more valuable and an unsolicited offer was received. Based on the above, the sale could be construed as a capital gain.

  2) To the contrary, it may be argued that Fenson’s original intention in acquiring the license was established by the treatment of the first two licenses which were sold at a quick profit. Therefore, the primary intention of all three licenses was to trade them at a profit. The history of the past transactions may be relevant. The renting of the third license may have been a temporary measure until the license could be sold. Therefore, the gain on the third license may be considered to be business income.
PROBLEM THREE

[Issue: Capital vs. Income; ITA: 20(1)(n); 20(8)]

Demo Ltd., a Canadian-controlled private corporation, sold two parcels of land during its 20X0 taxation year. Details of each transaction are as follows:

1. A one-hectare site in Winnipeg was sold for $200,000. The full price was received in cash. The land had been purchased five years before for $160,000. Demo had intended to construct a warehouse on the land for the purpose of storing inventory for its 12 retail stores. Subsequently, it was decided that the warehouse should be located in Saskatoon; for this reason, the Winnipeg site was sold.

2. A two-hectare site in Calgary was sold for $600,000. The land had been purchased two years previously for $320,000, with the intention that it would be sold after property values increased. Demo received a $90,000 down payment in 20X0. The full balance of the purchase price is due and payable in 20X4.

Required:

1. Determine the minimum increase to the 20X0 income for tax purposes of Demo Ltd. As a result of the two property sales (ignore interest considerations on any unpaid balance).

2. In what year will the entire taxable gain, if any, be recognized for the Calgary property?
Solution to P 5-3

1. The sale of the Winnipeg land is considered to be a capital gain because it was purchased with the intention providing a long term benefit to the company by creating additional warehouse space. It was sold only after the plans changed and the warehouse location was moved to another city.

The sale of the Calgary land is a business transaction resulting in business income because the land was purchased for resale at a profit after the anticipated value increase. Because the property is land inventory and the proceeds are deferred beyond the year of sale, a reserve for deferred proceeds can be claimed at the discretion of the taxpayer [ITA 20(1)(n)].

Calgary land - Business income:
Selling price $600,000
Cost (320,000)
   Business income 280,000
Less reserve [ITA 20(1)(n)]
   510,000 /600,000 x 280,000 = (238,000)
   Business income 42,000

Winnipeg land - capital gain:
Proceeds of disposition $200,000
Cost (160,000)
   Capital gain $ 40,000
   Taxable capital gain - ½(40,000) 20,000
   Increase to net income $62,000

2. The entire profit on the Calgary land will be recognized by the end of 20X3 as the reserve for inventory sales extends for 36 months beyond the date of sale [ITA 20(8)].
PROBLEM FOUR

[ITA: 18(1)(e); 20(1)(l), (p); 50(1)]

P.Q. Enterprises operates a wholesale business. Most of its sales are made on credit. Accounts receivable, therefore, make up a large portion of the company’s balance sheet. At year end, the accounts receivable totalled $450,000. Of this amount, management estimates that $25,000 might not be collectible because no payments on account have been made for over 90 days.

In addition, the company loaned $15,000 to a former friend of the owner, charging 13% interest. This loan is also considered to be doubtful, as the friend refuses to acknowledge the existence of the debt.

Required:

1. What amount, if any, can be deducted from income in this particular year?

2. Assume that in the next year the doubtful accounts of $25,000 are re-analyzed, with the following results:

   - Still doubtful: $15,000
   - Considered good: $4,000
   - Legally bankrupt: $6,000

   What is the tax impact in this second year?
Solution to P 5-4

1. P.Q. Enterprises can deduct $25,000 as a reserve in the particular year [ITA 20(1)(l)]. This amount relates to the accounts receivable. As a general rule no reserves are permitted as a deduction [ITA 18(1)(e)]. However, the exceptions in section 20 permit a reserve deduction for doubtful accounts of a reasonable amount provided that the doubtful debts were previously included in income. As the accounts receivable were created from taxable sales revenue the debts are considered to have been previously included in income. Reserves based on an arbitrary percentage of total accounts receivable are not considered reasonable and are, therefore, not deductible. For a reserve for doubtful debts to be considered reasonable in amount, it is necessary to identify the debts that are doubtful of collection and estimate the percentage of the doubtful debts that will probably not be collected. The CRA accepts a reserve calculated, as a percentage of the total doubtful debts or a series of percentages relating to an age-analysis of those debts, based on the taxpayer’s past collection history [IT-442R]. In the case of P.Q. Enterprises, management has identified specific accounts where amounts may not be collected based on no payments being received in 90 days. Therefore, the reserve is considered to be a reasonable amount.

The doubtful loan is, however, not the same. The loan did not create income when it originated. Such a loan may still be permitted for a reserve from business income if part of the company’s business includes the lending of money. This does not appear to be the case in this situation. The loan itself is capital property because it was acquired to provide a long-term benefit - i.e., from interest returns. The ability to claim a loss for tax purposes will be determined by the rules developed in Chapter 8 (Capital Gains and Losses). A capital loss from a loan can be recognized in the year in which it is determined to be uncollectable [ITA 50(1)]. Therefore, the loan loss of $15,000 can be recognized as a capital loss this year but can only be used to the extent that the company has capital gains.

If the company had accrued interest on the loan (property income), the amount due but uncollectable would qualify for a bad debt deduction because the amount due was previously included in income [ITA 20(1)(p)].

2. In accordance with section 12, any reserve claimed in a year must be included in income the following year. At that time a re-evaluation of the status of uncorrectable accounts can be made and a new reserve claimed. Any debts that are actually bad but no longer doubtful can be deducted as a bad debt separate from the reserve [ITA 20(1)(p)]. Therefore, the results of the second year are as follows:

Income – last year’s reserve [ITA 12(1)(d)] $25,000
Deduct:
   New reserve [ITA 20(1)(l)] (15,000)
   Actual bad debt [ITA 20(1)(p)] (6,000)

Increase to income $ 4,000

Effectively the error from the first year ($4,000) is reversed and corrected in the following year.
PROBLEM FIVE

[ITA: 18(1)(b), (e), (l); 20(1)(c), (e), (dd); 67.1]

The controller of Mead Pipes Ltd. is completing the preparation of the corporation’s 20X1 tax return but is uncertain about the tax treatment of the following eight expense items:

1. Finder's fee to obtain a mortgage on the company's buildings $6,000
2. Property taxes on the company's new fishing lodge, which is used by employees 1,200
3. Interest for late payment of municipal property taxes for the warehouse 600
4. Brokers’ fees for the purchase of publicly traded shares 1,400
5. Permanent landscaping of land around the head office buildings 4,800
6. Cost of investigating a site for a proposed warehouse, when the site was rejected 2,000
7. Hockey tickets to entertain customers 1,800
8. Reserve for the possible costs for guarantees of products sold in the year 8,000

Required:

Determine the amount by which the preceding items will reduce the net income for tax purposes of Mead Pipes Ltd. for 20X1. When an item has been totally excluded from your calculation, provide a brief reason why.
**Solution to P 5-5**

The items will reduce net income for tax purposes by:

**Finder's fee:**
This is on account of capital but it is specifically deductible at 1/5 per year as a cost of borrowing [ITA 20(1)(e)].

$1,200

**Interest on late property taxes:**
Interest is specifically allowed on items used to earn income [ITA 20(1)(c)]. The property taxes are deductible and so is the interest.

$600

**Permanent landscaping:**
Although this is a capital item, it is specifically allowed as a deduction in the year paid [ITA 20(1)(aa)].

$4,800

**Investigation of site:**
This also is a capital item but is allowed as a deduction in the year paid [ITA 20(1)(dd)].

$2,000

**Hockey tickets:**
Deductible as a promotion expense but is limited to 50% of $1,800 [ITA 67.1]

$900

$9,500

The following items were excluded:

- Property taxes on fishing lodge - specifically denied as a deduction [ITA 18(1)(l)].
- Broker's fee - is a capital item and thus, not deductible [ITA 18(1)(b)]. It is added to the cost of the shares.
- Reserve for product guarantees - Denied by the general rule that reserves are not permitted [ITA 18(1)(e)]. No exception is provided for this specific type of reserve.
PROBLEM SIX

[ITA: 18(1)(b), (e), (l), (n); 19(1); 20(1)(a), (e), (cc)]

Central Products Ltd. is in the process of completing its 20X0 financial statements and tax return. A junior accountant has given you a list of items that he does not know how to treat for tax purposes. The list includes the following eight items:

1. Purchase price of a patent giving the company exclusive rights to manufacture a product $120,000
2. Cost of annual dues to a golf club for three senior salespeople to entertain existing and potential customers 8,000
3. The union contract expired four months before the year end and gaining is still in process. A 3% wage increase is expected, and the company has recorded a reserve to cover the four-month period 60,000
4. Legal fees paid for making a representation to a provincial government against a proposal to introduce a payroll tax 15,000
5. Donations paid to a registered charity 10,000
6. Advertising in a foreign trade newspaper that was distributed to Canadian customers 4,000
7. Travel costs (airfare and lodging) for a senior executive to visit a Foreign supplier to inspect and sign a purchase agreement for a new manufacturing machine. The machine was delivered and used in 20X0 3,000
8. Legal, accounting, and printing costs to prepare a prospectus offering common shares for sale to the public 32,000

Required:

Describe how each of the above items will be treated for tax purposes for the 20X0 taxation year.
Solution to P 5-6

1. Patent - capital item and is denied a full deduction by the general rules [ITA 18(1)(b)]. It qualifies for a deduction over time by capital cost allowance [ITA 20(1)(a)] (see Chapter 6) - class 44 - 25% x $120,000 x 1/2.

2. Club dues - for the purpose of earning income but is denied a deduction [ITA 18(1)(l)].

3. Wage reserve - denied a deduction under the general rule that disallows reserves [ITA 18(1)(e)].

4. Legal fees for representation - capital item but is specifically allowed as a deduction in the year paid [ITA 20(1)(cc)].

5. Donations – not an expense to earn income. They are gifts. Therefore, not deductible in the computation of business income [ITA 18(1)(a)].

6. Foreign advertising - is for the purpose of earning income but, because it is directed to a Canadian market, the deduction is denied [ITA 19(1)].

7. Travel cost - capital item because it is part of the cost of acquiring equipment. The full amount is denied a deduction under the general rules [ITA 18(1)(b)]. The amount qualifies for capital cost allowance as part of the manufacturing equipment cost (see Chapter 6) - class 29, 50% x $3,000 x 1/2.

8. Prospectus costs - are actually capital items (costs of arranging financing) but can be deducted over five years at the rate of 1/5 per year (1/5 x $32,000 = $6,400) [ITA 20(1)(e)].
PROBLEM SEVEN

[ITA: 9(1); 18(1)(b), (e), (h), (l); 20(1)(a), (e), 20(10); 34; 37(1); 67.1; 67.2]

Simone Cherniak has just completed the second year of operating her veterinary clinic. You have been retained by Cherniak for tax assistance and advice. At a recent meeting, you gathered information on her practice, which is presented below.

For the year ended December 31, 20X2, the clinic showed a profit of $123,700, as follows:

- Professional service: $321,000
- Gross profit from surgical instrument sales: 28,000
- Administration and other expenses: 228,300
- Interest income: 3,000

Net income: $123,700

Included in the above is depreciation/amortization expense of $23,000 on fixed assets and amortization of development costs of $4,400. Additional information is outlined below.

1. On February 28, 20X2, Cherniak purchased a competitor’s business and merged it with her own. The following assets were acquired:

   - Truck: $18,000
   - Equipment: 50,000

2. During the year, Cherniak designed and patented a new surgical instrument. On July 1, 20X2, a legal fee of $4,000 was paid for the patent (life of 20 years) registration; this amount is included in administration expenses. In October, $16,000 was spent on consultants to research metal alloys, and this cost is being amortized as development costs in the financial statement.

3. Professional services revenue includes the value of unbilled services compiled from a work-in-progress file. At December 31, 20X2, unbilled services amounted to $27,000, compared with $18,000 at the same time last year. In 20X1, Cherniak had made an election under section 34 of the Income Tax Act to exclude work in progress from income.

4. Some of the items included under administrative and other expenses are as follows:

   - Group life insurance for office staff: $1,100
   - Christmas gifts to staff (under $200 each): 1,400
   - Dues to golf club (for employee): 1,200
   - Meals and drinks for clients: 400
   - Books (15-volume set on veterinary medicine): 3,000
   - Interest on car loan (six months): 2,100
   - Finder’s fee for a loan to finance equipment: 1,000

5. The income statement includes a cost of $3,150 for attending three conventions during the year. Convention #1 ($750) was in July 20X2. Conventions #2 ($1,350) and #3 ($1,050) were both in December 20X2. Each convention includes a cost of $100 for meals. For each of the December conventions, the airfare of $200 was included in accounts payable at the end of the year.
6. Vehicle costs include operating costs of $2,400 for the automobile (including $400 for car parking). The automobile was driven 24,000 km. Of this, 12,000 km was for customer travel, 2,000 km was for travel between her home and the clinic, and 10,000 km was for personal travel.

7. Cherniak expects that a number of the new manufactured surgical instruments will be returned for modification, which she will do at no extra cost to the customer. The income statement includes a $2,000 deduction based on her estimate of the returns. As of December 31, 20X2, $800 of costs were incurred for returned items.

8. Cherniak moved from rented premises to new rented premises on February 28, 20X2, with 20 months remaining on the old lease. The landlord accepted a payment of $8,000 in exchange for cancelling the lease. The accounting records have amortized this cost over the remainder of the lease term and accordingly have deducted $4,000 ($8,000 - 10 m/20 m) as rent expense.

9. Capital cost allowance (CCA) for tax purposes has been correctly calculated as $15,000.

Required:

Determine Cherniak’s income from business for tax purposes for the 20X2 taxation year. Identify any other sources of income that are taxable in the year.
Solution to P 5-7

Income from business – 20X2:
Income per financial statements [ITA 9(1)] $ 123,700
Interest income - is property income (3,000)
Depreciation [ITA 18(1)(b)] 23,000
Amortization of development costs [ITA 18(1)(b)] 4,400
Patent cost (capital item) [ITA 18(1)(b)]
- qualifies for capital cost allowance 4,000
Research and development - actual [ITA 37(1)] (16,000)
Work in progress exclusion ($27,000 - $18,000) [ITA 34] (9,000)
Club dues [ITA 18(1)(l)] 1,200
Meals ($400 x 50%) [ITA 67.1] 200
Book set (capital item) [ITA 18(1)(b)]
- qualifies for capital cost allowance 3,000
Car loan interest ($2,100 – ($300 x 6 months)) [S 67.2] 300
Finder’s fee on loan ($1,000 x 4/5) [ITA 20(1)(e)] 800
Convention expenses (limited to 2 conventions)
(Expenses must be paid) [ITA 20(10)]
Exclude convention #1 (the lowest cost) 750
Meals for #2 and #3 (50% x ($100 + $100)) [ITA 67.1] 100
Airfare not paid in 20X2 ($200 x 2) 400
Personal portion of auto [ITA 18(1)(h)]
($2,400 - $400 parking = $2,000 x 12,000/24,000) 1,000
Reserve for return sales less actual returns
($2,000 - $800) [ITA 18(1)(e)] 1,200
Lease cost - full cost allowed
($8,000 - $4,000 already deducted) (4,000)
Capital cost allowance [ITA 20(1)(a)] (15,000)

Income from business $117,050

The only other source of income is property income - interest of $3,000.

Note: The purchase of the truck, equipment, patent, and books are all capital costs and qualify for capital cost allowance.
PROBLEM EIGHT

[ITA: 3; 9(1); 10(2); 18(1)(b), (e), (h), (l), (t); 18(9); 20(1)(a), (e), (e.2), (q), (cc); 78(4); 147.1(8), (10; 147.2(1), (2)]

The financial information shown in the table at the top of the next page was presented for Massive Enterprises Ltd. for the year ending May 31, 20X1.

### Statement of Income

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$1,700,000</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>$830,000</td>
</tr>
<tr>
<td>Gross profits</td>
<td>$870,000</td>
</tr>
<tr>
<td>Expenses:</td>
<td></td>
</tr>
<tr>
<td>Salaries and wages</td>
<td>$235,000</td>
</tr>
<tr>
<td>Management bonuses</td>
<td>50,000</td>
</tr>
<tr>
<td>Employee benefits</td>
<td>30,000</td>
</tr>
<tr>
<td>Interest expenses</td>
<td>9,000</td>
</tr>
<tr>
<td>Insurance</td>
<td>7,000</td>
</tr>
<tr>
<td>Appraisal costs</td>
<td>8,000</td>
</tr>
<tr>
<td>Legal and accounting</td>
<td>12,000</td>
</tr>
<tr>
<td>Repairs and maintenance</td>
<td>22,000</td>
</tr>
<tr>
<td>Travel</td>
<td>8,000</td>
</tr>
<tr>
<td>Advertising and promotion</td>
<td>10,000</td>
</tr>
<tr>
<td>Bad debts</td>
<td>36,000</td>
</tr>
<tr>
<td>Provision for sales returns</td>
<td>17,000</td>
</tr>
<tr>
<td>Depreciation/amortization</td>
<td>16,000</td>
</tr>
<tr>
<td>Donations</td>
<td>4,000</td>
</tr>
<tr>
<td>Loss on sale of marketable securities</td>
<td>6,000</td>
</tr>
<tr>
<td>Other:</td>
<td></td>
</tr>
<tr>
<td>Interest on government bonds</td>
<td>$10,000</td>
</tr>
<tr>
<td>Net gains on sales of land</td>
<td>40,000</td>
</tr>
<tr>
<td>Net income</td>
<td>$450,000</td>
</tr>
</tbody>
</table>

### Additional Information:

* All relates to the statement of income.

1. **Cost of sales:**

   - Opening inventory (at cost) $280,000
   - Purchases 970,000
   - Closing inventory (at lower of cost or market) 420,000
   - Cost of sales $830,000

   The closing inventory at the end of the previous year was valued at the lower of cost or market, which amounted to $270,000.
2. The salaries and wages of $235,000 included salaries of $95,000 to the president, $80,000 to the president’s spouse (who worked as a full-time manager), and $15,000 to a full-time housekeeper, who looked after the children so that the president and the president’s spouse could work full-time in the business.

3. Management bonuses:

   Bonuses awarded and paid during the current year $10,000
   Bonuses awarded at the end of the current year, to be paid (with interest) at the end of the following fiscal year 30,000
   Bonuses awarded at the end of the current year and paid on June 30, 20X1 10,000
   $50,000

4. Employee benefits:

   Canada Pension Plan and Employment Insurance $ 5,000
   Lump sum past service contribution to the company pension plan for one particular employee 10,000
   Contributions to the company’s pension plan for several employees (maximum contribution for each employee was $3,000) 9,000
   Annual club dues to three golf clubs for senior managers 6,000
   $30,000

5. Interest expense included interest of $8,000 on a bank loan that was used to purchase new equipment during the previous year. In addition, $1,000 of interest arising from deficient income tax instalments was paid to the CRA.

6. Insurance expenses:

   Public liability insurance for the current year $2,000
   Three-year fire and theft insurance premium beginning the first day of the current taxation year 3,000
   Life insurance on the president of the company (required as collateral for a bank loan) 2,000
   $7,000

7. Appraisal costs:

   To determine the replacement cost of business assets to establish the current year’s fire and theft insurance requirements $ 5,500
   To value the assets of the business in order to establish the company’s share value so that the shareholder could use the shares as collateral for a personal bank loan 2,500
   $ 8,000
8. Legal and accounting expenses:

Legal fees:
- To collect an account receivable: $400
- Cost of amending the Articles of Incorporation: $1,000
- Costs of issuing a new class of preference shares and debentures: $3,000

Accounting:
- Tax consultations for a submission to a federal government task force on sales tax reform: $2,000
- Annual audit fees: $5,600

Total: $12,000

9. Repair and maintenance costs:
- Office cleaning, snow removal, lawn care: $2,000
- Cost of landscaping grounds: $11,000
- Repainting several offices: $4,000
- Engine replacement for one of the delivery trucks: $5,000

Total: $22,000

10. Travel costs (incurred for sales personnel):
- Airfares: $5,000
- Meals and beverages while travelling: $3,000

Total: $8,000

11. Advertising and promotion costs:
- Catalogues: $6,000
- Meals and beverages for employees entertaining Customers: $3,000
- Promotional pens: $1,000

Total: $10,000

12. Bad debts expense of $36,000 represented an increase in the reserve for doubtful accounts receivable arising from the sale of merchandise.

13. As a result of past experience, the company began a new policy of providing a reserve of 1% of sales for expected future returns of defective merchandise sold. Although the year’s provision was $17,000, only $12,000 of merchandise was returned.

14. The depreciation/amortization expense of $16,000 was based on the estimated useful life of depreciable property owned (equipment and vehicles). Capital cost allowance and amortization of eligible capital expenditures for tax purposes have been correctly calculated as $19,000 in total.

15. The loss on sale of securities resulted from the sale of shares in public corporations. These were acquired several years earlier using excess funds not needed for the business.
16. The net gain on the sale of land of $40,000 consisted of the following:

• *Property 1*, which was acquired three years earlier at a cost of $100,000 as a potential site for a new head office building. However, new leased space became available, thus eliminating the need for a new building. Because of this, the land has been sold at the market price of $160,000.

• *Property 2*, which was purchased four years earlier with excess corporate funds after it was learned that a new shopping centre was being planned for the area. The company believed that the new shopping centre would enhance property values and purchased the land at a cost of $90,000 in the hope that it could be sold at a substantial profit. But the shopping centre proposal was cancelled and the land was sold in the current year for $70,000.

**Required:**

1. For the year ended May 31, 20X1, determine the company's net income from business for tax purposes.

2. Also, determine the company's overall net income for tax purposes in accordance with the aggregating formula.
Solution to P 5-8

The question requires the determination of net income from business. Therefore, other items such as property income and capital gains, if any, are excluded even though they may be taxable as part of the corporation's total net income from all sources:

Income per financial statements 20X1 [ITA 9(1)] $450,000

1) Although inventory can be valued by different methods the opening inventory of a new year must be consistent with the closing inventory of the previous year ($280,000 - $270,000) [ITA 10(2)].

2) Salary to housekeeper is a personal living expense even though it permitted the spouse to work full-time in the business. [ITA 18(1)(h)]

3) Compensation bonuses can be deducted on the accrual basis only if they are paid within 180 days of the taxation year. Therefore, a bonus of $30,000 payable after one year is not deductible until next year [ITA 78(4)].

4) Registered Pension plan contributions made by the employer during the year and within 120 days after the end of the year are deductible [ITA 20(1)(q); 147.2(1)]. If the RPP is a defined benefit plan, all contributions are deductible if they are determined by an actuary to be necessary to fund the plan [147.2(2)]. In the case of a defined contribution plan, the total of the employer and employee contributions, combined, for a year for a member of the plan, cannot exceed 18% of the employee’s compensation for the year, limited to limited to $22,970 (2011) [147.1(1), (8)]. Contributions to fund past service benefits are also allowed [ITA 147.1(10)].

In this case, the RPP contributions of $19,000 ($10,000 + $9,000) appear to be deductible in the current year.

5) Dues to golf clubs are not deductible, by exception, even though they are part of the compensation package [ITA 18(1)(l)].

6) Interest on deficient tax instalments is not deductible [ITA 18(1)(t)]

7) Three year fire insurance must follow accounting principles and matched to income over three years ($2,000 is deductible in next two years) [ITA18(9)].

Life insurance is not for employee compensation and its potential income is not taxable. Therefore, it is normally not deductible. However, because it is required for the bank loan, it is a cost incurred to borrow money. Normally, these types of costs, by exception to the general rule, can be deducted over five years at 1/5 per year. However, because the insurance is a recurring annual amount it is fully deductible [ITA 20(1)(e.2)].

8) Appraisal cost for corporate share valuation is on account of capital. Also, it was incurred for the personal benefit of the shareholder and not to earn income [ITA 18(1)(b)&(h)]
9) Cost of amending articles of incorporation is a capital item and qualifies as eligible capital property for gradual write-off [ITA 18(1)(b)].

Cost of issuing new class of shares normally is not deductible because it is a capital item. However, by exception, it can be deducted over five years at 1/5 per year. Therefore, 4/5 of $3,000 is not deductible this year [ITA 20(1)(e)].

Cost of sales tax reform submission is specifically permitted as a deduction as a cost of representation [ITA 20(1)(cc)].

10) Engine replacement for truck is a capital item because it extends the normal useful life of the asset [ITA 18(1)(b)]. It qualifies for capital cost allowance on trucks [ITA 20(1)(a)].

11) Meals and beverages are restricted to 50% of the actual cost. Therefore, increase income by 50% of $3,000 [ITA 67.1].

12) Meal and beverage costs for employees entertaining customers are limited to 50% of actual cost (50% of $3,000) [ITA 67.1].

13) Reserve for sales returns of 1% of sales is not deductible due to general reserve limitation [ITA 18(1)(e)]. However, the actual cost of returns is deductible for the year.

14) All depreciation is disallowed by the general limitation [18(1)(b)]

But related capital cost allowance is permitted [ITA 20(1)(a)]

15) Loss on sale of securities is a capital loss and is not part of net income from business [ITA 18(1)(b)]. However, 1/2 of $6,000 is relevant for computation of net taxable capital gains [ITA 38]

16) Net gains on sales of land (book gain)
The gain of $60,000 on head office site is a capital gain and not part of business income [ITA 18(1)(b)]. Property 2 was purchased to trade at a profit. The loss of $20,000 is, therefore, a business loss and remains fully deductible (see below).

17) Interest income on government bond is property income and should be excluded from business income.

18) Donations are not for the purpose of earning income [ITA 18(1)(a)].

Net income from business  
$489,900

Business loss – sale of property 2  
$(20,000)
Overall net income for tax purposes of the corporation is as follows:

<table>
<thead>
<tr>
<th>3 (a)</th>
<th>Net income from business</th>
<th>$489,900</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Property income (interest)</td>
<td>10,000</td>
</tr>
<tr>
<td>3 (b)</td>
<td>taxable capital gains (land) (1/2 of $60,000)</td>
<td>$30,000</td>
</tr>
<tr>
<td></td>
<td>less allowable capital loss (securities) (1/2 of $6,000)</td>
<td>(3,000)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>27,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td>526,900</td>
</tr>
<tr>
<td>3 (c)</td>
<td>Other deductions</td>
<td>0</td>
</tr>
<tr>
<td>3 (d)</td>
<td>Losses – Business</td>
<td>(20,000)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>526,900</td>
</tr>
<tr>
<td></td>
<td>Net income for tax purposes</td>
<td>$506,900</td>
</tr>
</tbody>
</table>
PROBLEM NINE

[ITA: 11(1); 34.1(1), (2), (3); 249.1(1), (4)]

Shirley Jensen terminated her employment on May 31, 20X0, after earning taxable employment income of $20,000. On June 1, 20X0, she opened a proprietorship retail store. She has been informed that the taxation year for the business should be the calendar year. However, she is aware that an election can be made that permits her to use a non-calendar fiscal year. She has indicated that for administrative reasons, the desirable fiscal year end is May 31 of each year. Before she makes a decision, Jensen wants to know the tax implications of choosing one method over the other.

Her profits from the retail store for the next few years are estimated to be as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>December 31</th>
<th>May 31</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X0—seven months</td>
<td>$50,000</td>
<td>–0–</td>
</tr>
<tr>
<td>20X1</td>
<td>85,000</td>
<td>85,000</td>
</tr>
<tr>
<td>20X2</td>
<td>90,000</td>
<td>90,000</td>
</tr>
</tbody>
</table>

Income tax rates for each year are assumed to be 26% on the first $41,000 of income, 34% on the next $42,000, 40% on the next $46,000, and 45% on income over $129,000. Jensen will have no other sources of income in each of the years, except the employment income of $20,000 in 20X0.

**Required:**

With the information provided, outline the tax consequences to Jensen for each alternative method of determining business income for each of the three taxation years. Which method will you recommend?
Solution to P 5-9

Individuals are required to use a calendar year-end for business income if they do not make the ITA 249.1(4) election [ITA 249.1(1)]. An election is available under ITA 249.1(4) to retain an off-calendar year-end, but where this election is made an additional income inclusion applies each year under ITA 34.1.

Calendar year

If Jensen uses the calendar year as her fiscal period, income tax will be payable in each of the years as follows:

20X0
Taxable income is $70,000 ($20,000 employment income + $50,000 business income). Income tax is $20,520 ([$41,000 x 26%] + [$29,000 x 34%]).

20X1
Taxable income is $85,000 resulting in income tax of $25,740 ([$41,000 x 26%] + [$42,000 x 34%] + [$2,000 x 40%]).

20X2
Taxable income is $90,000 resulting in income tax of $27,740 ([$41,000 x 26%] + [$42,000 x 34%] + [$7,000 x 40%]).

Election to use a non-calendar year end

If Jensen makes the election under ITA 249.1(4) to use a non-calendar year end, i.e., the May 31 fiscal year, income tax will be payable in each of the years as follows:

20X0
The first fiscal year begins on June 1, 20X0 and ends on May 31, 20X1. Therefore, no business income is included in the 20X0 taxation year. Taxable income is the employment income of $20,000 resulting in tax of $5,200 ($20,000 x 26%).

20X1
The alternative method requires the inclusion of the business income for the year ended May 31, 20X1 plus an estimate of the business income from June 1, 20X1 to December 31, 20X1. The income for tax purposes is $134,583 and the resulting tax is $45,852 calculated as follows:

Year ended May 31, 20X1(being seven months in 20X0 and five months in 20X1) $ 85,000
Add estimate of income from June 1, 20X1 to December 31, 20X1 - $85,000 x 7/12 [ITA 34.1(1)] 49,583
Income for tax purposes $134,583
Income tax - ($41,000 x 26%) + ($42,000 x 34%) + ($46,000 x 40%) + ($5,583 x 45%) $45,852
20X2
The calculation is similar to 20X1 except that the profit adjustment for the period from June 1, 20X1 to December 31, 20X1 ($49,583) can be deducted from the May 31, 20X2 fiscal profit. Income for tax purposes is $92,917 resulting in income tax of $28,907 as follows:

Year ended May 31, 20X2      $90,000
Deduct portion included in 20X1 above  [ITA 34.1(3)] (49,583) 40,417
Add estimate of income from June 1, 20X2 to December 31, 20X2 - $90,000 x 7/12 [ITA 34.1(1)] 52,500
Income for tax purposes $92,917
Income tax - ($41,000 x 26%) + ($42,000 x 34%) + ($9,917 x 40%) $28,907

Alternative election
If the May 31 fiscal period is chosen, a second alternative election is available. This permits Jensen to include an estimate of the 20X0 business income (from June 1, 20X0 to December 31, 20X0) in the 20X0 taxation year [ITA 34.1(2)]. This is $49,583 (the May 31, 20X1 profit of $85,000 x 7/12). Her income and tax for each of the years is summarized below:

<table>
<thead>
<tr>
<th></th>
<th>20X0</th>
<th>20X1</th>
<th>20X2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salary</td>
<td>$20,000</td>
<td>$85,000</td>
<td>$90,000</td>
</tr>
<tr>
<td>Business income to May 31</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Add 20X0 special adjustment (above) [ITA 34.1(2)]</td>
<td>49,583</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Add estimate of profit - June 1 to December 31 [ITA 34.1(1)]</td>
<td>49,583</td>
<td>52,500</td>
<td></td>
</tr>
<tr>
<td>Deduct portion included in previous year [ITA 34.1(3)]</td>
<td>0 (49,583)</td>
<td>(49,583)</td>
<td></td>
</tr>
<tr>
<td>Income tax</td>
<td>$20,378</td>
<td>$25,740</td>
<td>$28,907</td>
</tr>
</tbody>
</table>

Income tax for each of the three options is summarized below:

<table>
<thead>
<tr>
<th></th>
<th>December 31</th>
<th>May 31 Alternative 1</th>
<th>May 31 Alternative 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X0</td>
<td>$20,520</td>
<td>$5,200</td>
<td>$20,378</td>
</tr>
<tr>
<td>20X1</td>
<td>25,740</td>
<td>45,852</td>
<td>25,740</td>
</tr>
<tr>
<td>20X2</td>
<td>27,740</td>
<td>28,907</td>
<td>28,907</td>
</tr>
<tr>
<td></td>
<td>$74,000</td>
<td>$79,959</td>
<td>$75,025</td>
</tr>
</tbody>
</table>
Using the calendar year has the lowest tax over the three years and relates directly to the actual incomes earned. This is because the alternative methods cause greater amounts of income to be realized sooner when profits are rising annually. If profits were constant, the total taxes for the three years for each method would be the same with variation occurring only in timing.

Jensen should not overlook the benefit of achieving a low amount of tax in 20X0. Under alternative method one, a tax deferral of $15,320 ($20,520 - $5,200) results. This temporary additional cash flow may be very important in the first year of a new business to help fund unforeseen costs of developing the new business. It is important to remember that this is only a short term cash flow benefit because the 20X1 tax will take back the full deferral.

If the administrative problems overcome by using the May 31 year end are significant to Jensen, one of the alternative methods can be recommended. Notice that the alternative method two results is almost identical to the calendar year result. Therefore, in this case, the choice is really between alternative methods one & two. The insurance of having approximately $15,178 ($20,378 - $5,200) of extra cash flow for the business start-up under alternative method one must be weighed against its overall higher tax of $4,934 ($79,959 - $75,025). Keep in mind that if profits become constant in future years the tax for all three methods will be the same.
PROBLEM TEN

[ITA: 3; 6(1)(c); 8(1)(b); 12(1)(c); 31; 38(a), (b), (c); 60(0); 63]

Sharon Cloutier is semi-retired and sits on the board of directors of several Canadian public corporations. A summary of her 20X0 financial activity is presented below.

Interest on long-term bonds $20,000
Gain on sale of farmland (Cloutier acquired the farmland three years ago with the intention of subdividing it into building lots for resale but sold it in 20X0 after losing a rezoning application.) 13,000
Director’s fees from public corporations 22,000
Gain on sale of public corporations shares 16,000
Legal fees paid to collect a bonus on a former employment contract 2,000
Legal fees paid to dispute an income tax reassessment 1,500
Loss on sale of shares of a Canadian-controlled private corporation that qualifies as a small business corporation 8,000
Loss on sale of public corporation shares 20,000
Share of the operating loss from a partnership that operates a small grain farm with hired help 18,000
Qualified moving expenses 1,000

Required:

Determine Cloutier’s income for tax purposes in accordance with section 3 of the Income Tax Act.
Solution to P 5-10

Income for tax purposes:

ITA 3(a) Employment income:
- Directors fees [ITA 6(1)(c)] $22,000
- Less legal fee - bonus [ITA 8(1)(b)] (2,000)

Property income:
- Interest [ITA 12(1)(c)] 20,000

Business income:
- Land sale 13,000

ITA 3(b) Taxable capital gain:
- Public shares - ½(16,000) $8,000
- Allowable capital loss:
  - Public shares - ½(20,000) (10,000)

ITA 3(c) Other deductions:
- Moving expenses [ITA 63] (1,000)
- Legal fees - reassessment [ITA 60(o)] (1,500)

ITA 3(d) Losses:
- ABIL - ½ x $8,000 (4,000)
- Farm loss * [ITA 31] - lesser of:
  - $2,500 + 1/2(18,000 - 2,500) = 10,250
  - $18,000 (actual loss)
  - $8,750 (limit) (8,750)

Income for tax purposes $37,750

* Chief source of income is not farming, nor a combination of farming and some other source. Therefore, farm loss is restricted.
PROBLEM ELEVEN

[ITA: 6(1)(a), (e), (k); 6(2); 7(1), (1.1), (8); 13(7)(e); 18(1)(l); 20(1)(c), (q), (y); 56(1); 67.2; 67.3; 80.4(1); 110(1)(d), (d.1); IT-470R]

At a recent executive meeting of H Co., the president complained, “Our compensation program is unimaginative because we pay our employees by salary or commission only. Surely there are other forms of compensation which would make our company more attractive to employees.”

Required:

As the personnel manager of H Co., prepare a list of compensation alternatives. For each, briefly describe the tax consequences to both the employee and the employer.
Solution to P 5-11

1. **Deferred Profit Sharing Plan:**

   **Employee** - The employer's contribution to the DPSP is not a taxable benefit [ITA 6(1)(a)]. In addition, investment income within the plan is not taxable when earned. However, the employee is taxable on any amount paid out of the plan to the employee [ITA 56(1), 147].

   **Employer** - Provided that contributions are made for employees who are not specified shareholders of the employer corporation, the amounts contributed are deductible from the employer's business income but subject to a limited amount per employee [ITA 20(1)(y)]. The limit is the lesser of [ITA 147(5.1)]:

   - one-half of the money purchase limit for the year (2011 - $22,970) $11,485, and
   - 18% of the employee's compensation for the year.

   The employer has until 120 days after the end of the employer's fiscal year to contribute the amount [ITA 147(8)].

2. **Registered Pension Plan:**

   **Employee** - Employer's contributions to the plan are not a taxable benefit to the designated employee [ITA 6(1)(a)]. Investment income within the plan on invested contributions is not taxable. Any amounts paid out of an RPP to the employee are taxable when received [ITA 56(1)(a)].

   **Employer** - Contributions for current service are, subject to a per employee limit, deductible in arriving at business income [ITA 20(1)(q)]. The limit is the lesser of [ITA 147.1(8)]:

   - the money purchase limit for the year (2011 - $22,970), and
   - 18% of the employee's compensation for the year.

   The employer has until 120 days after the end of the employer's fiscal year to contribute the amount [ITA 147.2].

3. **Private Health Insurance Contributions:**

   **Employee** - Not a taxable benefit to the employee [ITA 6(1)(a)].

   **Employer** - As compensation the full amount is deductible.

4. **Group Sickness or Accident (Disability) Insurance:**

   Same as private health insurance.

5. **Supplementary Unemployment Benefit Insurance:**

   Same as 4) and 5) above.
6. **Company Automobile:**

*Employee* - If the employer pays for auto operating costs relating to personal use, the employee is taxable on an arbitrary amount of 24¢ for each personal kilometre driven [ITA 6(1)(k)]. In addition, an arbitrary benefit (standby charge) based on availability of the auto for personal use is imposed for the value of the car itself. If the car is owned by the employer the benefit is 2% of the cost of the car each month available. If the car is leased the benefit is 2/3 of the lease cost. If the kilometres driven for business use exceeds 50% of the total kilometers, the standby charged is adjusted by multiplying the amount by the personal kilometers and dividing it by 1,667 km per month (20,004 km per year) [ITA 6(1)(e), 6(2)].

*Employer* - The employer can deduct the costs relating to the automobile. Operating expenses and lease payments are deducted when incurred, whereas, the cost of an owned auto is subject to capital cost allowance. Certain restrictions to these costs apply. Only $30,000 (plus tax) of the auto's cost is available for capital cost allowance [ITA 13(7)(g)]. Lease payments are restricted to a maximum of $800 (plus tax) per month [ITA 67.3], and interest on a loan to acquire the car is limited to $300 per 30-day period [ITA 67.2].

7. **Non-interest or Low-interest Loans:**

*Employee* - The employee is taxable on a benefit determined as the amount by which the prescribed rate of interest (adjusted regularly by CRA) exceeds the amount of interest actually paid by the employee within 30 days after the end of the year [ITA 80.4(1)].

*Employer* - The loan itself is not deductible because it is a capital item and will be repaid. If the employer borrows money (and incurs interest) and loans it to the employee for no interest or a reduced rate of interest it may be argued that all or a portion of the employer’s cost is not deductible because it wasn't incurred to earn income (i.e., from interest returns). However, it can also be argued that the interest cost for employee loans is deductible because it is part of the compensation package and, therefore, is for the purpose of earning income [ITA 20(1)(c)].

8. **Employee Stock Option Plans:**

*Employee* - The employee will receive a taxable employment benefit equal to the difference between the market value of the shares purchased and the preferential option price [ITA 7(1) & (1.1)].

Where the employer is a public corporation, the benefit occurs when the shares are purchased. If the employer is a public corporation, and the option price is the same or higher than the market value of the shares at the date the option was granted, one half of the benefit amount can be deducted from net income in arriving at taxable income [ITA 110(1)(d)].

If the employer is a Canadian-controlled private corporation, the benefit will be recognized only when the shares are sold. In addition a deduction equal to 1/2 the employment benefit may be deducted in arriving at taxable income if one of the two conditions is met:

- the option price is not less than the share value at the grant date [ITA 110(1)(d)], or
- the shares are not sold within two years of being acquired [ITA 110(1)(d.1)].

*Employer* - There is no tax effect to the employer. Stock-based compensation is not deductible for tax purposes [ITA 7(3)(b)]. The employer receives cash from the issue of treasury shares which is not taxable income.
9. **Club Dues:**

   *Employee* – Normally, not taxable to the employee provided that, the employee being a member of the club is primarily for the employer’s benefit [IT-470R].

   *Employer* - The cost of all club dues (social and recreational) are not deductible [ITA 18(1)(l)].

The above list is limited to the nine most common items.
PROBLEM TWELVE

[ITA: 20(1)(l), (n); 37(1) – Shifting income between years]

Carlson Electronics Ltd. is a Canadian-controlled private corporation that wholesales electronics equipment. The company also manufactures a small switching device and has begun a research program to improve the product.

The controller has just completed the first draft of the financial statements for the year ended December 31, 20X1. A profit of $100,000 is indicated. The company has recently secured some new major customers, and next year’s profits are expected to be $570,000. The current year’s income statement and next year’s projected income statement are as in the table below.

As a Canadian-controlled private corporation, the company pays tax at an assumed rate of 15% on its first $500,000 of annual active business income and at 25% on income in excess of $500,000.

At a meeting with the company president, the controller provides the following additional information:

- As a result of improved administration and a revised credit policy, the amount of uncollectible receivables has declined. In fact, the 20X1 administrative expenses include a reserve for doubtful accounts of only $21,000; the previous year’s reserve was $70,000.

<table>
<thead>
<tr>
<th>20X1 actual</th>
<th>20X2 projected</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$1,280,000</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>810,000</td>
</tr>
<tr>
<td>Gross profit</td>
<td>470,000</td>
</tr>
<tr>
<td>Other expenses:</td>
<td></td>
</tr>
<tr>
<td>Selling</td>
<td>146,000</td>
</tr>
<tr>
<td>Administrative</td>
<td>170,000</td>
</tr>
<tr>
<td>Research and development</td>
<td>62,000</td>
</tr>
<tr>
<td></td>
<td>78,000</td>
</tr>
<tr>
<td>Other income:</td>
<td></td>
</tr>
<tr>
<td>Gain on sale of land</td>
<td>8,000</td>
</tr>
<tr>
<td>Net income</td>
<td>$100,000</td>
</tr>
</tbody>
</table>

- The research and development expense of $62,000 in 20X1 includes direct costs (wages and materials) for designing and testing an improved switching device. Of these costs, 90% qualify as scientific research and experimental development costs for income tax purposes.

- In 20X1, the corporation sold a parcel of land for $216,000. The land, which is next to a proposed real estate development, was acquired the previous year for $200,000. Carlson had hoped to turn a quick profit by holding the land until a public announcement about the project was made. The selling price of $216,000 consisted of cash of $108,000, with the remaining amount of $108,000 payable (with interest) in 20X2. In accordance with the income tax provisions, the gain of $16,000 is being recognized as income over two years ($8,000 per year), and this is reflected in the financial statements.
Whenever possible, the company takes advantage of purchase discounts offered by its suppliers. Most suppliers offer a purchase discount of 2% of the merchandise cost if payment is made within 10 days; otherwise, the full purchase price is payable at the end of 30 days, with substantial interest charged thereafter. Owing to the anticipated sales volume increase for 20X2, the company’s purchases will be heavy during the early part of the new year. Carlson has a line of credit at the local bank and usually pays interest at 8% on its loans. Currently, it has used up all of its approved line of credit.

**Required:**

1. Based on the financial statements provided, what amount of tax will the company be required to pay in 20X1 and in 20X2?

2. What actions can be taken to reduce the amount of tax payable over the two-year period? Calculate the tax savings, if any, which can be achieved by these actions.

3. Should the company take the actions suggested in question 2? Why, or why not?
Solution to P 5-12

1. Tax liability based on financial statements:

   Tax on 1st $500,000:
   - 20X1 $100,000 @ 15% $15,000
   - 20X2 $500,000 @ 15% $75,000
   Tax on income over $500,000:
   - 20X1 $0
   - 20X2 $70,000 @ 25% $17,500
   Tax liability $15,000 $92,500

2. Because the two assumed tax rates (15% and 25%) are applied on an annual basis, Carlson is forced to pay tax at the high rate (25%) on $70,000 of income in 20X2. This occurs because the income was not earned evenly over the two year period. In 20X1 Carlson earned $100,000 of income which is $400,000 short of the low rate limit of $500,000. However, in 20X2 the company exceeded the low-rate limit by $70,000 ($570,000 - $500,000). As a result part of the low rate limit in 20X1 was unused. If Carlson can increase the 20X1 income and reduce the 20X2 income by an equivalent amount, a greater amount will be taxed at 15% and a lesser amount will be taxed at 25%.

   The shift of income recognition can be achieved by not claiming available discretionary deductions in 20X1 and delaying them until 20X2 as follows:

   a) The $21,000 reserve for doubtful accounts does not have to be claimed [ITA 20(1)(l)]. This will increase the 20X1 income. It also means that it will not be necessary to add the amount back into 20X2 income as is normally required. So 20X2 income is reduced.

   b) The land gain is business income because it was acquired for the purpose of reselling it at a gain. The company is entitled to claim a reserve in proportion to the deferred proceeds of sale [ITA 20(1)(n)]. The reserve is discretionary and does not have to be deducted. If it is not deducted, 20X1 income will increase by $8,000.

   c) Qualified Scientific Research and Experimental Development costs can be deducted in the year incurred or delayed to any future year [ITA 37(1)]. Therefore, $55,800 (90% of $62,000) of the 20X1 expenses can be deducted in 20X2 instead of 20X1.
The revised incomes and related tax costs would be:

<table>
<thead>
<tr>
<th></th>
<th>20X1</th>
<th>20X2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Previous profit</td>
<td>$100,000</td>
<td>$570,000</td>
</tr>
<tr>
<td>Adjustments:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Reserve for bad debts</td>
<td>21,000</td>
<td>(21,000)</td>
</tr>
<tr>
<td>Land reserve</td>
<td>41,000</td>
<td>(41,000)</td>
</tr>
<tr>
<td>Scientific research</td>
<td>8,000</td>
<td>(8,000)</td>
</tr>
<tr>
<td>Revised profit</td>
<td>$170,000</td>
<td>$500,000</td>
</tr>
<tr>
<td>Revised tax</td>
<td></td>
<td></td>
</tr>
<tr>
<td>20X1 ($170,000 @ 15%)</td>
<td>$25,500</td>
<td></td>
</tr>
<tr>
<td>20X2 ($500,000 @ 15%)</td>
<td></td>
<td>$75,000</td>
</tr>
<tr>
<td>Tax Saving:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Previous tax</td>
<td>$15,000</td>
<td>$92,500</td>
</tr>
<tr>
<td>Revised tax</td>
<td>25,500</td>
<td>75,000</td>
</tr>
<tr>
<td>Tax reduction (increase)</td>
<td>($10,500)</td>
<td>$17,500</td>
</tr>
</tbody>
</table>

3. Although tax is reduced by $7,000 over two years it consists of a tax increase in 20X1 of $10,500 and a tax reduction of $17,500 in 20X2. Therefore, the tax saving is achieved with the consequence of a lower cash flow for one year.

The reduced cash flow in 20X1 reduces the company's ability to claim the purchase discounts for payment within 10 days instead of 30 days (i.e., 20 days in advance). Because there are 18 twenty day periods in the year, the company's cost of this will be 36% of the reduced cash flow (18 periods @ 2% = 36%) or $4,884 (36% of $13,568). This loss is tax deductible and, as it occurs in 20X2, the tax savings will be $1,221 (25% of $4,884) resulting in an after-tax cost of $3,663 ($4,884-$1,221).

In this particular case the benefit of the lower overall tax far exceeds the cost of $3,663. In addition, the tax saving is permanent creating a permanently higher cash position which can be used to increase the use of purchase discounts (providing a pre-tax return of 36%) annually thereafter.

While the decision is in this case is obvious because of the large tax savings, it may not be as obvious in other situations. In such situations, a present value analysis of the alternate cash flows should be made to make the actual decision.
CHAPTER 6
THE ACQUISITION, USE, AND DISPOSAL OF DEPRECIABLE PROPERTY

Review Questions

1. Under the income tax system, neither capital expenditures nor amortization/depreciation can be deducted when income for tax purposes is being calculated. The same system imposes an arbitrary and uniform method of cost allocation based on the type of asset used. Explain the reason for this significant departure from generally accepted accounting principles in arriving at income for tax purposes.

2. The cost allocation system divides capital assets into two general categories. Identify these categories, and briefly state, in general terms, what types of assets are included in each category.

3. Can an individual who earns employment income claim a deduction for CCA in arriving at income from employment? If the answer is yes, are any restrictions imposed?

4. A business acquires land for a customer parking lot and incurs the following costs:

<table>
<thead>
<tr>
<th>Description</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>$50,000</td>
</tr>
<tr>
<td>Legal fees to complete purchase agreement</td>
<td>2,000</td>
</tr>
<tr>
<td>Legal fees in connection with obtaining a mortgage loan for the land</td>
<td>1,000</td>
</tr>
<tr>
<td>Small building for attendant</td>
<td>10,000</td>
</tr>
<tr>
<td>Exterior landscaping</td>
<td>2,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$65,000</strong></td>
</tr>
</tbody>
</table>

Briefly explain the tax treatment of these costs.

5. A business can obtain the right to use property through ownership or leasing. Briefly compare the tax treatment of purchasing land and building with that of leasing land and building. Refer to both the amount and timing of the related deductions for tax purposes.

6. What is the meaning and significance of the term “capital cost” of an asset?

7. Explain why the deduction of capital cost allowance is a “discretionary” deduction.

8. Depreciable properties are divided into a number of different classes, and a specific allocation rate (CCA rate) is assigned to each class. Explain why this system is fair to some taxpayers, unfair to others, and more than fair to others.

9. Briefly explain what is meant by the “pool concept” in the CCA system.

10. “In all cases, the acquisition of a new asset in a particular class will result in the reduction of the normal maximum rate of CCA by one-half in the year of purchase.” Is this statement true? Explain.
11. To what extent, if any, does the pooling concept inherent in the CCA system affect the tax treatment of any gains and losses that occur on the disposition of depreciable property? In general terms, explain when a gain or loss will occur.

12. Describe the possible ramifications of purchasing new depreciable property on the last day of the current taxation year as opposed to the first day of the next taxation year (that is, one day later).

13. What is a leasehold improvement, and how does its tax treatment vary from the normal CCA treatment?

14. Taxpayer A leases a building for 15 years. Taxpayer B secures the right to lease a building for 15 years by signing a three-year lease with two renewable option periods—one for 2 additional years and a second for 10 years. Both A and B incur leasehold improvement costs at the beginning of the lease. Explain the tax treatment of the leasehold improvements to both A and B. Which taxpayer has signed the better lease? Explain.

15. If the sale of an asset results in income from a recapture of CCA, is it necessary to acquire another asset in the same year in order to avoid the recapture? Explain.

16. Explain the tax consequences, if any, when an individual proprietor of a new business transfers personal-use office furniture for use in the business.

17. Describe two alternative tax treatments that may apply when a business purchases a franchise.

18. How does the treatment given eligible capital property differ from that given depreciable property?

19. Explain why a businessperson might view the cost of a $100,000 building as being significantly higher than the cost of a $100,000 delivery truck. Make a cost comparison, assuming the taxpayer is subject to a 45% tax rate and can invest funds to generate an after-tax cash return of 9%. (Assume the building was used by the seller before March 19, 2007).
Solutions to Review Questions

R6-1. The determination of amortization for accounting purposes is extremely subjective, requiring an estimate of an asset's useful life, annual usage, and salvage value. Consequently, assets of a similar type are subject to a wide range of amortization rates and methods even though they may be used for similar purposes in similar type businesses.

The arbitrary capital cost allowance system overcomes the consequence of subjectivity associated with amortization methods and eliminates the need for an excessive amount of assessment review by CRA. In addition, it treats all assets within a general category in the same manner providing equal treatment to each taxpayer. In some respects the system is unfair because it gives no consideration to the way in which different businesses use similar assets and, therefore, the CCA system may not conform to economic reality.

R6-2. The two categories are Depreciable Capital Property and Eligible Capital Property. (The Income Tax Act uses the term depreciable property even though accounting uses the term "amortization").

Depreciable property includes primarily tangible assets such as equipment, vehicles and buildings although it can also include certain intangible assets with a defined limited legal life.

Eligible Capital Property consists of intangible assets that have no specified legal life such as goodwill, customer lists, licences, incorporation costs and so on.

R6-3. Yes, individuals who are employed may claim capital cost allowance in certain circumstances. Employees earning employment income can only claim capital cost allowance in arriving at their travel costs associated with their employment duties. CCA can be claimed only on automobiles, aircraft (and musical instruments). Employment income cannot be reduced by CCA on any other type of asset even if it is used in the performance of employment duties [ITA 8(1)(j) & (p)].

R6-4. Although total cost of acquiring and preparing the land for use is $65,000, the several component parts are treated differently.

Land ($50,000) is a capital asset because it has a long-term and enduring benefit and is not deductible as an expense. In addition, it does not qualify as depreciable property and no capital cost allowance is available.

Legal fees ($2,000) to complete the purchase agreement are capital in nature, associated with the cost of the land. The fees are not deductible but are merely added to the land cost [ITA 18(1)(b)].

Legal fees ($1,000) in connection with obtaining mortgage financing are also a capital item. However, by exception, the expense qualifies as a cost incurred to issue debt and is permitted to be deducted over five years at 1/5 per year [ITA 20(1)(e)].

The small building ($10,000) is a property separate from the land. It is a capital expenditure and not deductible. However the building qualifies as Class 1 property and is subject to CCA at 4%, declining balance. If the building is placed in a separate Class 1, the CCA rate will increase by 2% to 6%.

Exterior landscaping ($2,000) is a capital item and not normally deductible. However, by exception, ITA 20(1)(aa) permits the full amount to be deducted when paid.
R6-5. If the property is purchased the cost of the land cannot be deducted for tax purposes. The building cost can be deducted as capital cost allowance at 4% or 6% annually (except year one – ½ year rule applies) declining balance.

In comparison, if the property is leased a deduction for tax purposes is available for the land as well as the building. The full amount of rent for the land and building is deductible in the year in which it is incurred.

R6-6. The term capital cost refers to the total cost amount associated with the acquisition of a depreciable property. It is significant because it is the base to which the CCA rate is applied. The capital cost includes the original purchase price or construction cost plus all costs incurred to bring the asset to a state of working order.

R6-7. The rate of capital cost allowance permitted annually signifies the maximum amount that is available but does not require that all or any portion must be claimed in any one year. Therefore, within the constraint of the maximum annual limit, the timing of the deduction of capital cost allowance is at the discretion of the taxpayer. Failure to claim all or a portion of the maximum in a particular year does not result in any penalty as the undepreciated capital cost of the Class simply remains at a higher amount which increases the deduction available in the future [Reg. 1100(1)].

R6-8. When assets are designated to a particular Class the rate of CCA associated with the Class may be indicative of some general average use for those types of properties. To the extent that a particular asset conforms to the average use the tax treatment is equitable. However, if a taxpayer owning the same type of asset uses the asset significantly more than another taxpayer thereby reducing the asset’s useful life, the same rate of CCA must be used which is inequitable. Conversely, an asset could be used less than the average use resulting in an increase to its useful life, but the CCA rate permits a faster write-off making the tax treatment more than equitable.

R6-9. The pool concept means that all assets of the same Class (e.g., Class 8 or Class 10) are lumped together as a single total for the entire Class. Therefore, each asset loses its individual identity and CCA is not claimed or determined separately for each asset within the class.

R6-10. The statement is not true. Although it is true that there is a 1/2 rule for new acquisitions it does not always apply.

First of all, the one-half rule does not apply to all classes of property. For example, it does not apply to Class 14, certain assets of Class 12, Class 52 (computers acquired January 28, 2009 – January 31, 2011) and to eligible capital property [Reg. 1100(2)].

Secondly, even where the one-half rule applies, it only applies to the extent that there are net additions for the year. If, for example, there are additions in the year but there are also disposals, the one-half rule applies only on the amount by which the additions exceed the disposals. Therefore, the one-half rule does not apply every time there is an addition.

Finally, the half-year rule does not apply to property acquired from a person not dealing at arms length if it was owned by the transferor at least 364 days before the end of the acquirer’s taxation year in which the property was acquired [Reg. 1100(2.2)].
R6-11. Because all assets of a class are pooled in a single total, it is not possible to establish if the price from the sale of an individual asset is less than or greater than the undepreciated capital cost of that specific asset. The pool concept recognizes that some assets in the pool will be sold at less than their depreciated value and some will be sold at a greater amount. By reducing the pool by the selling price of the asset, any gain or loss simply affects the pool's total and its impact is, therefore, averaged over the life of the pool. Gains or losses on depreciable property are only recognized as follows:

a) a loss will occur when there is a balance in the pool at the year end but no assets are left in the pool. The loss is referred to as a terminal loss [ITA 20(16)].

b) income will occur when, at the end of any year, the pool balance is negative whether assets are left in the pool or not. This income is referred to as recaptured depreciation [ITA 13(1)].

c) if, at any time, the selling price of an asset exceeds its original cost a capital gain is recognized [ITA 40(1)].

R6-12. The timing of a purchase may affect the recognition of both terminal losses and recaptured depreciation [ITA 13(1), 20(16)].

Where a terminal loss is about to occur because there is a balance in the pool but no assets remain, the acquisition of an asset on the last day of the year, regardless of its cost, will eliminate the recognition of the terminal loss leaving the balance to be deducted by normal CCA. If the purchase was delayed until the first of the new year, the full terminal loss would be recognized for tax purposes.

The reverse may be true where a recapture is imminent. A purchase of a new asset before the year end will reduce the amount of the recapture. Delaying the purchase for one day, to the next taxation year, forces the recognition of the recapture and starts a new pool in the next year.

R6-13. A leasehold improvement is the cost incurred by the tenant of a leased building to improve the premises to their specific needs. Because the improvement is to the landlord's property, it will belong to the landlord at the end of the lease. Nevertheless, leasehold improvements are eligible for CCA under Class 13 [Reg.1100(1)(b), Sch III].

Class 13 varies from the normal CCA rules in that the rate of write-off is based on a straight line approach (over the term of the lease plus one option period) as opposed to the declining balance method [Sch III].

R6-14. Taxpayer A has signed a single lease for 15 years with no options to renew. The cost of leasehold improvements are written off at the lesser of 1/5 (arbitrary) or 1/15 (number of years in lease). Therefore the cost is amortized over 15 years.
Taxpayer B has the right to use the property for 15 years (lease plus options) but the cost of the improvements can be written off at the lesser of:

a) \( \frac{1}{5} \) per year

or

b) \( \frac{\text{Cost}}{3+2} = \frac{1}{5} \) per year

\((\text{lease term} + \text{one option period})\)

Therefore the cost of leasehold improvements for B can be deducted over five years.

It is difficult to determine which taxpayer has signed the better lease. Taxpayer B has the advantage of writing-off the cost of improvements over five years, thereby enhancing after-tax cash flow significantly in the early years of the lease. However, the cost of this advantage is that B may have to renegotiate the rental payments whenever the renewal options are exercised. In comparison, A has a lower after-tax cash flow in the early years because the cost of improvements are written-off over 15 years, but the rent payments are guaranteed for 15 years and will not increase.

R6-15. Normally, to avoid or reduce a recapture of capital cost allowance in a year in which it is about to occur requires the purchase of another asset before the year end. However, in the case of property that is real estate (Class 1) a recapture in the current year can be avoided or reduced if a replacement property is acquired within one year or 12 months after the end of the taxation year in which the original property was sold. This extension is permitted only where the real estate is used in a business (not as an investment earning rents) and the replacement property is used for similar purposes [ITA 13(4), 44(1)&(5)].

R6-16. The transfer of the property to the business is a change of use from personal to business and therefore results in a deemed disposition at fair market value for tax purposes [ITA 45(1)]. The business is deemed to have acquired the furniture at fair market value and that value qualifies as an addition to Class 8 which is eligible for capital cost allowance at the rate of 20%. This result assumes that the furniture's fair market value is less than its original cost [ITA 13(7)(b)].

If the value of the property is greater than the original cost (resulting in a capital gain to the taxpayer) the amount eligible for CCA is reduced by 1/2 of the capital gain, i.e., the non-taxable portion of the gain [ITA 13(7)(b)].

R6-17. A franchise may qualify as a Class 14 asset if it has a limited legal life. As such the full cost is normally deducted on a straight line basis over the legal life of the franchise [Reg. 1100(1)(c)]. A faster write-off rate can apply if it conforms to the asset's economic value, e.g., where legal agreements and other relevant factors indicate that such is reasonable. Alternatively, if the franchise has an unlimited life it is not Class 14 but rather is eligible capital property (ECP) and only three-quarters of its cost can be deducted at 7% per year declining balance [Reg. 1100(1)(c)].
R6-18. Eligible capital property is treated differently from most depreciable properties as follows:

a) Only 75% of the cost is available for allocation compared to 100% for depreciable property [ITA 14(5) definition of cumulative eligible capital].

b) The one-half rule does not apply in the first year.

c) 75% of the selling price of any eligible capital property is credited to the cumulative eligible capital pool even if it is greater than the original amount added [ITA 14(5) definition of cumulative eligible capital].

For depreciable property the pool is credited only to the extent of the original cost of the asset [ITA 13(21) definition of undepreciated capital cost].

Therefore, a gain on sale of eligible capital property is business income, whereas a portion of the gain on depreciable property may be a capital gain.

If the negative balance in the cumulative eligible capital account exceeds the amount of previous deductions from the account, that excess is taxable as business income to the extent of 2/3 of the amount. This puts that portion of income on an equal footing to capital gains (2/3 x 3/4 = ½ inclusion) but remains classified as business income [ITA 14(1)].

R6-19. The real cost of a property is equal to its cash cost minus the tax savings that will be achieved from any related tax deductions. In addition, the timing of the related tax savings is important because increased cash flow can be reinvested. A building may be regarded as having a greater cost than equipment because the cost of the building, in this case, must be deducted at a rate of 4% annually, whereas, the cost of the equipment is deducted at 20% annually. Therefore, the equipment produces greater tax savings in the early years.

By determining the present value of the tax savings from capital cost allowance the after-tax cost of a purchase can be determined. The building and equipment are compared below using the formula –

\[
\frac{C \times T \times R}{R + I}
\]

<table>
<thead>
<tr>
<th>Cash Price</th>
<th>$100,000</th>
<th>$100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Present value of tax savings:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Building:</td>
<td>$100,000 x .45 x .04</td>
<td>(13,846 )</td>
</tr>
<tr>
<td></td>
<td>.04 + .09</td>
<td></td>
</tr>
<tr>
<td>Equipment:</td>
<td>$100,000 x .45 x .20</td>
<td>(31,034)</td>
</tr>
<tr>
<td></td>
<td>.20 + .09</td>
<td></td>
</tr>
<tr>
<td>Net Cost</td>
<td>$ 86,154</td>
<td>$ 68,966</td>
</tr>
</tbody>
</table>

The above calculations ignore the potential resale value of the properties when they are no longer needed. Obviously, the resale value of the building would be quite different from
that of the equipment, and this factor should be considered when comparing costs.

Also, the above formula does not consider the effect of the one-half rule on the first year CCA. The effect is normally insignificant.
Key Concept Questions

QUESTION ONE

In the current year, Eddie Enterprises purchased new office equipment costing $40,000. The vendor gave Eddie Enterprises $3,500 for the old office equipment which had been purchased three years ago for $6,000. At the beginning of the current year, the class 8 UCC balance was $10,000.

Calculate the maximum CCA deduction for class 8 for the current year. Income tax reference: ITA 13(21), 20(1)(a); Reg. 1100(1), (2).

QUESTION TWO

In the current year, Decrease Ltd. purchased class 8 equipment costing $20,000. Later in the year, Decrease Ltd. sold other class 8 equipment for $30,000. The equipment sold originally cost $108,000. At the beginning of the current year, the class 8 UCC balance was $42,000.

Calculate the maximum CCA deduction for Class 8 for the current year. Income tax reference: ITA 13(21), 20(1)(a); Reg. 1100(1), (2).

QUESTION THREE

At the end of last year, the UCC balance for class 12 was $1,300. During the current year, a class 12 item with an original cost of $8,000 was disposed for $2,000. There were no other class 12 transactions in the current year.

Calculate the effect of the disposal on business income for the current year. Income tax reference: ITA 13(21).

QUESTION FOUR

A few years ago, Fast Ltd. purchased a new photocopier for $48,000 and elected to put the photocopier in a separate class 8. At the end of last year, the UCC balance for the separate class 8 was $33,000. During the current year, the photocopier was sold for $25,000.

Calculate the effect of the disposal on business income for the current year. Income tax reference: ITA 20(16).

QUESTION FIVE

On May 1, 20X6, Kayla purchased a Frosty Frozen Foods franchise and commenced carrying on business immediately as a sole proprietor. She paid $60,000 for the franchise. The franchise agreement has a 10-year term. The frozen foods business was so successful that Kayla quickly needed more space. On November 1, 20X6, Kayla purchased a small building for $200,000 (land $100,000 + building $100,000) and moved her business into it immediately. Assume the building was constructed after March 18, 2007.

Calculate the maximum CCA deduction for these assets for 20X6 and 20X7. Income tax reference: ITA 20(1)(a); Reg. 1100(1)(a.2), (c), 1100(2), (3); 1101(5b.1).
QUESTION SIX

On October 1, 20X1, Neo Enterprises signed a lease for new office space. The contract gives Neo Enterprises the use of the space for four years with the option of renewing the lease for two additional three-year periods. In November, 20X1 Neo Enterprises spent $84,000 renovating the office space. In February, 20X2 an additional $30,000 was spent on leasehold improvements. Neo Enterprises has a December 31 year end.

Calculate the maximum class 13 CCA for years 20X1, 20X2 and 20X3. Assume the class 13 UCC balance at the end of year 20X0 is $0. Income tax reference: ITA: 20(1)(a); Reg.1100(1)(b).

QUESTION SEVEN

X Ltd. is a GST registrant. At the end of last year, the class 10.1 UCC balance was $24,500. In the current year, X Ltd. disposed of the class 10.1 car for $28,000. The car had originally cost $33,000 plus GST and PST at 7%. At the same time, X Ltd. purchased a new car costing $38,000 plus GST and PST at 7%.

Determine the income tax implications for X Ltd. for the current year. How would your answer change if X Ltd. was an HST registrant? Income tax reference: ITA: 13 (7)(g); 20(1)(a),20(16.1); Reg. 1101(1af), 1100(2.5), 7307.

QUESTION EIGHT

Noluck Enterprises has a December 31 year end. On March 20, 20X6 the company’s warehouse was destroyed by fire. The original cost of the warehouse was $120,000. At the time of the fire, the warehouse was valued at $300,000 and was insured. Class 1 had a UCC balance of $95,000 at December 31, 20X5. Noluck was forced to lease a warehouse until a new one could be acquired. On November 30, 20X8, Noluck purchased a new warehouse costing $325,000. Assume the new warehouse was constructed after May 18, 2007.

Calculate the minimum recapture of CCA on the disposal of the warehouse. Income tax reference: ITA 13(1), (4).

QUESTION NINE

In Year 1, Takeover Corp. purchased another business. The purchase price included $100,000 for goodwill. In Year 3, the acquired business was sold. The sale price included $140,000 for the goodwill.

Calculate the amount to be included in Takeover Corp.’s business income in Year 3. Assume the CEC balance at the beginning of Year 1 is $0. Income tax reference: ITA: 14(1), (5), 20(1)(b).
QUESTION TEN

In the current year, Tom sold a building which he owned personally to a corporation wholly owned by him and his wife. The corporation paid Tom $400,000 for the building. Tom purchased the building some years ago for $250,000. The UCC of the building at the beginning of the current year was $200,000. Tom does not deal at arm's length with the corporation.

Determine the tax consequences for Tom and the corporation. *Income tax reference: ITA 13(7)(e); Reg 1100(2.2).*

QUESTION ELEVEN

Karen sold equipment to her wholly owned corporation for its fair market value, $40,000. Karen initially purchased the equipment for $100,000 and at the beginning of the current year the UCC of the equipment was $65,000. The equipment was the last asset remaining in the Class. Karen does not deal at arm’s length with the corporation.

Determine the tax consequences for Karen and the corporation. *Income tax reference: ITA 13(7)(e)(iii), (21.2); Reg. 1100(2.2).*

QUESTION TWELVE

Kristin owns a rental property. She purchased the land for $200,000 and built the building at a time when construction costs were high. Her total cost for the building is $400,000. In the current year she sold the rental property for $450,000 (land $300,000; building $150,000). At the beginning of the year the UCC of the building was $320,000.

Determine the amount to be included in Kristin’s income with respect to the sale of the rental property. *Income tax reference: ITA 13 (21.1).*
### Solutions to Key Concept Questions

#### KC 6-1

[ITA: 13(21), 20(1)(a); Reg. 1100(1),(2) - Additions to the pool exceed Disposals]

**Class 8**

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>UCC balance, beginnin</td>
<td>$10,000</td>
</tr>
<tr>
<td>of year</td>
<td></td>
</tr>
<tr>
<td>Purchases</td>
<td>$40,000</td>
</tr>
<tr>
<td>Disposals</td>
<td>(3,500)</td>
</tr>
<tr>
<td>CCA: $10,000 x 20%</td>
<td>(2,000)</td>
</tr>
<tr>
<td>$36,500 x 20% x ½</td>
<td>(3,650)</td>
</tr>
<tr>
<td>UCC balance, end of</td>
<td>$40,850</td>
</tr>
<tr>
<td>year</td>
<td></td>
</tr>
</tbody>
</table>

#### KC 6-2

[ITA: 13(21), 20(1)(a); Reg. 1100(1),(2) – Disposals exceed Additions]

**Class 8**

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>UCC balance, beginnin</td>
<td>$42,000</td>
</tr>
<tr>
<td>of year</td>
<td></td>
</tr>
<tr>
<td>Purchases</td>
<td>$20,000</td>
</tr>
<tr>
<td>Disposals</td>
<td>(30,000)</td>
</tr>
<tr>
<td>CCA: $32,000 x 20%</td>
<td>(6,400)</td>
</tr>
<tr>
<td>UCC balance, end of</td>
<td>$25,600</td>
</tr>
<tr>
<td>year</td>
<td></td>
</tr>
</tbody>
</table>

#### KC 6-3

[ITA: 13(1) – Recapture]

**Class 12**

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>UCC balance, beginnin</td>
<td>$1,300</td>
</tr>
<tr>
<td>of year</td>
<td></td>
</tr>
<tr>
<td>Purchases</td>
<td>$ 0</td>
</tr>
<tr>
<td>Disposals</td>
<td>(2,000)</td>
</tr>
<tr>
<td>Recapture of CCA</td>
<td>700</td>
</tr>
<tr>
<td>UCC balance, end of</td>
<td>$ 0</td>
</tr>
<tr>
<td>year</td>
<td></td>
</tr>
</tbody>
</table>
KC 6-4

[ITA: 20(16) – Terminal loss]

Class 8

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>UCC balance, beginning of year</td>
<td>$33,000</td>
</tr>
<tr>
<td>Purchases</td>
<td>$0</td>
</tr>
<tr>
<td>Disposals</td>
<td>(25,000)</td>
</tr>
<tr>
<td>Terminal loss</td>
<td>(8,000)</td>
</tr>
<tr>
<td>UCC balance, end of year</td>
<td>$0</td>
</tr>
</tbody>
</table>

A terminal loss can be claimed since there are no assets left in the class.

KC 6-5

[Reg. 1100(1)(a.2), (c); 1100(2) 1/2 year rule; Reg. 1100(3) - Short taxation year; Reg 1101(5b.1) – separate class election]

Class 1:

(20X6) Capital cost of building $100,000
CCA: $100,000 x 6% x ½ x 245/365 days = (2,014)
UCC 97,986

(20X7) CCA: 97,986 x 6% = (5,879)
UCC $ 92,107

Class 14:

(20X6) CCA: $60,000 x 245 (# of days owned in 20X6) = $4,025
3,652 (# of days in life of the franchise)

(20X7) CCA: $60,000 x 365 (# of days owned in 20X7) = $6,000
3,652 (# of days in life of the franchise)

[Note – the number of days in the life of the franchise includes 2 additional days for the two leap years that would occur in the 10 years].

The building is an addition to Class 1. Since the non-residential building was constructed after March 18, 2007, it has a 6% CCA rate based on the declining-balance [Reg. 1000(1)(a.2)] provided Kayla elects to place the building in a separate Class 1 [Reg 1101(5b.1)]. The solution assumes she did so. The election is made by attaching a letter to the tax return for the year in which the building is acquired.

The franchise, having a limited legal life (10 years) is an addition to Class 14, a straight-line class. CCA on Class 14 is calculated by multiplying the cost by the number of days the franchise is owned in the year divided by the total number of days in its legal life [Reg. 1100(1)(c)].
For Class 1, the amount of CCA that can be claimed in the year the asset is acquired is restricted to one-half the normal rate [Reg. 1100(2)]. This rule does not apply to Class 14.

Kayla, being an individual, has a calendar year-end for her business [ITA 249]. Therefore, the first taxation year is a short taxation year consisting of 245 days (May 1 to December 31). CCA for Class 1 must be prorated by the number of days in the taxation year divided by 365 [Reg. 1100(3)]. Prorating for a short taxation year does not apply to Class 14.

**KC 6-6**

[ITA: 20(1)(a); Reg. 1100(1)(b) – Class 13 CCA]

**Class 13:**

<table>
<thead>
<tr>
<th>Year</th>
<th>UCC balance, beginning of year</th>
<th>Purchases</th>
<th>Disposals</th>
<th>CCA (1/2 x $12,000)</th>
<th>UCC balance, end of year</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X1</td>
<td>$0</td>
<td>$84,000</td>
<td>0</td>
<td>$6,000</td>
<td>$78,000</td>
</tr>
<tr>
<td>20X2</td>
<td>$78,000</td>
<td>$30,000</td>
<td>0</td>
<td>$14,500</td>
<td>$93,500</td>
</tr>
<tr>
<td>20X3</td>
<td>$93,500</td>
<td>0</td>
<td>0</td>
<td>$17,000</td>
<td>$76,500</td>
</tr>
</tbody>
</table>

*Leasehold improvements:*

<table>
<thead>
<tr>
<th>Year</th>
<th>Capital Cost</th>
<th>Lease Term</th>
<th>Option Term</th>
<th>CCA Limit</th>
<th>CCA Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X1</td>
<td>$84,000</td>
<td>4</td>
<td>3</td>
<td>1/5 x $84,000</td>
<td>$16,800</td>
</tr>
<tr>
<td>20X2</td>
<td>$30,000</td>
<td>3</td>
<td>3</td>
<td>1/5 x $30,000</td>
<td>$6,000</td>
</tr>
</tbody>
</table>

The Class 13 half-year rule in Reg. 1100(1)(b) applies. Therefore, in 20X1, the CCA is reduced from $12,000 to $6,000, and in 20X2, the CCA of $5,000 is reduced to $2,500.
KC 6-7

[ITA: 13 (7)(g); 20(1)(a), 20(16.1); Reg. 1101(1af), 1100(2.5), 7307 – Luxury Automobiles]

X Ltd. will be able to deduct CCA of $3,675 on the old car and $4,860 on the new car in the current year.

Class 10.1 has a number of special rules.

- CCA can be claimed on only $30,000 plus tax, even though the car cost more ($38,000 + tax) [ITA 13(7)(g); Reg. 7307]. Since X Ltd. is a GST registrant, GST is not a cost since it will be recovered [ITA 248(16); 13(7.4)]. Therefore, the capital cost addition to Class 10.1 is $32,100 ($30,000 plus PST @7%).

- Each car is placed in its own class, and CCA is calculated on each car separately [Reg. 1101(1af)].

- When a vehicle is sold, neither a recapture of CCA nor a terminal loss is permitted [ITA 13(2), 20(16.1)].

- CCA in the first year is limited to 15% (1/2 x 30%) [Reg. 1100(2)]. Also CCA of 15% is allowed in the year of sale [Reg. 1100(2.5)].

<table>
<thead>
<tr>
<th>Class 10.1</th>
<th>Class 10.1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Car sold</td>
<td>Car purchased</td>
</tr>
<tr>
<td>UCC</td>
<td>UCC</td>
</tr>
<tr>
<td>Opening balance</td>
<td>$24,500</td>
</tr>
<tr>
<td>Purchases</td>
<td>32,100</td>
</tr>
<tr>
<td>CCA:</td>
<td></td>
</tr>
<tr>
<td>$24,500 x 30% x ½</td>
<td>(3,675)</td>
</tr>
<tr>
<td>$32,100 x 30% x ½</td>
<td>(4,815)</td>
</tr>
<tr>
<td>Closing balance</td>
<td>$0</td>
</tr>
</tbody>
</table>

If X Ltd. was an HST registrant, the HST would not be included in the cost since it would be recoverable. Therefore, the capital cost addition to Class 10.1 would be $30,000. CCA on the new car for the current year would be $4,500 ($30,000 x 15%).

KC 6-8

[ITA: 13(1), (4); Involuntary disposition]

Class 1:

<table>
<thead>
<tr>
<th>20X6:</th>
<th>UCC balance, beginning of year</th>
<th>$95,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchases</td>
<td>$0</td>
<td></td>
</tr>
<tr>
<td>Disposals (limited to original cost)</td>
<td>(120,000)</td>
<td>(120,000)</td>
</tr>
<tr>
<td>(25,000)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Recapture of CCA</td>
<td>25,000</td>
<td></td>
</tr>
<tr>
<td>UCC balance, end of year</td>
<td>$0</td>
<td></td>
</tr>
</tbody>
</table>
When the disposition is involuntary and recapture occurs, the taxpayer is permitted to defer recognition of the recapture if property with a similar use is acquired within 2 years or 24 months after the taxation year in which the forced disposition occurs [ITA 13(4)].

The new warehouse was acquired on November 30, 20X8 which is within the 2-year time limit. Noluck should attach a letter to its 20X8 tax return indicating that an election under ITA 13(4) is being made to defer the 20X6 recapture. The letter should include an amended calculation of the 20X6 recapture as follows:

20X6 Amended:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>UCC balance, beginning of year</td>
<td>$95,000</td>
</tr>
<tr>
<td>Purchases</td>
<td>0</td>
</tr>
<tr>
<td>Disposals (limited to original cost)</td>
<td>$(120,000)</td>
</tr>
<tr>
<td>Reduced by the lesser of:</td>
<td></td>
</tr>
<tr>
<td>Normal recapture $25,000</td>
<td></td>
</tr>
<tr>
<td>Cost of new warehouse $325,000</td>
<td>$25,000</td>
</tr>
<tr>
<td>Recapture of CCA</td>
<td>$ 0</td>
</tr>
</tbody>
</table>

If the disposition of the warehouse was voluntary, the new warehouse would have to be acquired by December 31, 20X7, being 1 year after the end of the 20X6 taxation year, in order to defer the recapture.

If the new warehouse is placed in a separate CCA Class it will qualify for an additional allowance of 2% bringing the CCA rate to 6%. The 6% rate applies for buildings that were not used by anyone prior to March 19, 2007, where more than 90% of the floor space of the building is used at the end of the year for a non-residential use [Reg 1100(1)(a.2)].

KC 6-9

[ITA: 14(1), (5); 20(1)(b) - CEC]

**Cumulative eligible capital account:**

<table>
<thead>
<tr>
<th>Year 1:</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening balance</td>
<td>$ 0</td>
<td></td>
</tr>
<tr>
<td>Purchase of goodwill ($100,000 x ¾)</td>
<td>75,000</td>
<td></td>
</tr>
<tr>
<td>Deduction ($75,000 x 7 %)</td>
<td>(5,250)</td>
<td></td>
</tr>
<tr>
<td>Year 2:</td>
<td>Deduction ($69,750 x 7%)</td>
<td>(4,883)</td>
</tr>
<tr>
<td>Year 3:</td>
<td>Sale of goodwill ($140,000 x ¾)</td>
<td>(105,000)</td>
</tr>
<tr>
<td>Negative balance</td>
<td>$(40,133)</td>
<td></td>
</tr>
</tbody>
</table>

Business income:

- Recapture of CEC previously deducted ($5,250 + $4,883) $10,133
- Taxable portion of excess ($40,133 - $10,133) x 2/3 or ($140,000 - $100,000) x 1/2 $20,000

Business income $30,133
KC 6-10

[ITA 13(7)(e); Reg 1100(2.2) – Depreciable property acquired from related person]

**Tom:** Tom has a taxable capital gain of $75,000 \((1/2 \times \text{proceeds} \$400,000 - \text{ACB} \$250,000)\) and recapture of $50,000 \((\text{UCC} \$200,000 - \text{cost} \$250,000)\).

**Corporation:** Where a depreciable asset is acquired from a non-arm’s length person, ITA 3(7)(e) prevents an increase in the depreciable base of property where the transferor benefits from the half-taxation of capital gains. If the cost of the depreciable property to the transferee would otherwise exceed the capital cost to the transferor, the capital cost to the transferee is limited to the sum of the capital cost to the transferor and the transferor’s taxable capital gain. In other words, the capital cost for the corporation is reduced by the non-taxable portion of the capital gain.

The corporation’s cost of the building is $400,000 but the capital cost for tax purposes is deemed to be only $325,000 [ITA 13(7)(e)]. This is calculated as being equal to Tom’s capital cost ($250,000) plus Tom’s taxable capital gain ($75,000). The corporation can claim CCA on only $325,000. For capital gains purposes, the corporation’s cost remains the actual price of $400,000.

The corporation will not be subject to the half year rule when calculating CCA on the building since it was owned continuously by a related person (Tom) for at least 364 days before the end of the corporation’s taxation year [Reg 1100(2.2)].

KC 6-11

[ITA: 13(7)(e)(iii), (21.2) – Terminal loss denied on transfer to affiliated person]

**Karen:** Without ITA 13(21.2) Karen would have a terminal loss of $25,000 \((\text{UCC} \$65,000 - \text{proceeds} \$40,000)\). ITA 13(21.2) deems a terminal loss that occurs on the sale of depreciable property to an affiliated person to be nil. The amount of the denied terminal loss ($25,000) remains with Karen who can continue to claim CCA on the amount. She can recognize the terminal loss ($25,000 less CCA claimed) when the equipment is no longer owned by an affiliated person. An affiliated person means an individual and spouse and any corporation controlled by either of them [ITA 251.1(1)]. Two corporations are affiliated if they are controlled by affiliated persons.

**Corporation:** The corporation’s cost and capital cost for the equipment is $100,000 since the depreciable asset has been acquired from a related person, the capital cost to the corporation cannot be less than Karen’s capital cost [ITA 13(7)(e)(iii)]. The UCC is $40,000, the price paid. The excess of the capital cost ($100,000) over the UCC ($40,000) is deemed to be CCA claimed by the corporation and, thus, subject to recapture. The corporation will not be subject to the half year rule when calculating CCA on the equipment if it was owned continuously by a related person (Karen) for at least 364 days before the end of the corporation’s taxation year [Reg 1100(2.2)].
KC 6-12

[ITA: 13(21.1) – Disposition of a building]

Without S.13(21.1), the sale of the land and building would result in a capital gain on the land of $100,000, one-half of which is taxable, and a terminal loss of $170,000 (UCC $320,000 – proceeds $150,000) on the building. The net effect of this would be to reduce Kristin’s income by $120,000 (taxable capital gain $50,000 – terminal loss $170,000).

Where land and building are sold together, any terminal loss on the building is reduced to the extent of any capital gain on the land [S.13(21.1)]. This is achieved by increasing the proceeds for the building by the lesser of the terminal loss on the building and the capital gain on the land. In this case the proceeds for the building are increased by $100,000 to $250,000 and the proceeds for the land are reduced by $100,000 to $200,000. This reduces the taxable capital gain on the land to Nil (proceeds $200,000 – ACB $200,000) and reduces the terminal loss to $70,000 (UCC $320,000 - Proceeds $250,000).
Problems

PROBLEM ONE

[ITA: 14(5); 20(1)(a), (b); Reg. 1100(1), (2) - Sch II]

State the class number for each of the following 13 items, and briefly describe the method and rate of cost allocation:

1. Furniture and fixtures
2. Tools (each costing less than $500)
3. Printing press used by a publisher of paperback books (purchased after March 18, 2007 and before 2012)
4. Paving of a parking lot
5. Concession licence for a 10-year time period
6. Franchise for an unlimited life
7. Computer application software
8. Computer hardware (purchased after January 27, 2009 and before February 2011)
9. Customer list
10. Glasses and cutlery used in the operation of a restaurant
11. Sprinkler system in a building
12. Television commercial used to promote company products
13. Cost of reorganizing a corporation’s share capital

Solution to P 6-1

1. Class 8 - 20% declining balance
2. Class 12 - 100% declining balance (No ½ year rule adjustment)
3. Class 29 - Manufacturing equipment, 50% straight-line. (1/2 year rule applies).
4. Class 17 - 8% declining balance
5. Class 14 - 10% straight line, or any reasonable basis that reflects economic value
6. Cumulative Eligible Capital - 3/4 of cost at 7% declining balance
7. Class 12 - 100% declining balance (1/2 year rule applies)
8. Class 52 - 100% declining balance (No ½ year rule adjustment).
9. Cumulative Eligible Capital - 3/4 of cost at 7% declining balance
10. Class 12 - 100% declining balance (No ½ year rule adjustment)
11. Class 1 - 4% declining balance (assuming the sprinkler system is added to a building in the 4% pool)
12. Class 12 - 100% declining balance (1/2 year rule applies)
13. Cumulative Eligible Capital - 3/4 of cost at 7% declining balance
PROBLEM TWO

[ITA: 13(1), (21); 20(1)(a); 20(16); 40(1); Reg. 1100(1)(a)]

A wholesale business with a December 31 year end purchased new equipment on November 25, 20X0, for $10,000. Before 20X0, the business owned no other equipment.

Required:

1. What are the tax consequences if in 20X2 the business sells the equipment for (a) $3,000? (b) $8,000? (c) $12,000?

2. How would your answer to (a) and (b) change if on December 31, 20X2, the business acquired new equipment costing $1,000? Would it be advisable to delay the purchase by one day (that is, until January 1, 20X3)?
Solution to P 6-2

1. The equipment qualifies as a Class 8 asset with a capital cost allowance rate of 20%. The undepreciated capital cost of the Class at the end of 20X1 (the year before the sale) is as follows: [Reg. 1100(1)(a)(viii)]

<table>
<thead>
<tr>
<th>Year</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X0</td>
<td>Purchase</td>
<td>$10,000</td>
</tr>
<tr>
<td></td>
<td>CCA (20%)</td>
<td>$(1,000)</td>
</tr>
<tr>
<td>20X1</td>
<td></td>
<td>$9,000</td>
</tr>
<tr>
<td></td>
<td>CCA (20%)</td>
<td>$(1,800)</td>
</tr>
<tr>
<td></td>
<td>Undepreciated capital cost</td>
<td>$7,200</td>
</tr>
</tbody>
</table>

In 20X2 the following occurs:

a) Sale for $3,000:
   - UCC: $7,200
   - Proceeds: $4,200
   - Terminal loss (deduction) [ITA 20(16)]: $(4,200)
   - Recapture [ITA 13(1)]: $0

b) Sale for $8,000:
   - UCC: $7,200
   - Proceeds: $(8,000)
   - Recapture [ITA 13(1)]: $800
   - Plus: Recapture [ITA 13(1)]: $0

 c) Sale for $12,000:
   - UCC: $7,200
   - Proceeds (limited to original cost): $(10,000)
   - Recapture [ITA 13(1)]: $2,800
   - Plus: Proceeds of sale: $12,000
   - Original cost: $10,000
   - Capital gain: $2,000
   - Taxable (1/2): $1,000
2. If $1,000 of new equipment was purchased on the last day of the fiscal year in a) and b) above the answer would be changed as follows:

a) UCC $7,200
   
   Purchase 1,000
   Sale (3,000)
   
   CCA 20% of $5,200 (1,040)
   $4,160

The purchase eliminates the terminal loss of $4,200 because there is an asset left in the pool. It would be advantageous to delay the purchase for one day to the first day of the next taxation year as this would permit the full terminal loss of $4,200 in 20X2 leaving the $1,000 purchase in 20X3 for normal CCA. Cash flow from tax savings would be enhanced.

b) UCC $7,200
   
   Purchase 1,000
   Sale (8,000)
   
   CCA 20% of $200 (40)
   $160

The purchase of $1,000 completely eliminates $800 of recapture and therefore enhances the current year's cash flow. Effectively, because of the impending recapture, $840 of the $1,000 purchase price is deducted in 20X2 ($800 + $40). If the $1,000 was delayed to the beginning of next year the full $800 recapture would occur in 20X2 Therefore the delay is not advantageous.
PROBLEM THREE

[ITA: 13(1),(4), (21); 14(5); 20(1)(a), (b); 40(1); 44(1), (5); Reg. 1100(1); Sch. II]

Maple Enterprises Ltd. has always claimed maximum CCA. The following information relates to the corporation’s capital transactions:

1. The undepreciated capital cost of certain CCA classes at the end of the previous taxation year was as follows:

   Class 1  $200,000 (one building in class)
   Class 8  190,000

2. In 20X1 (the current year), the company expanded into the manufacturing business by purchasing the following assets:

   Equipment (manufacturing)  $30,000
   Product licence for an indefinite period  10,000

3. The building was sold in 20X1 for $260,000 (original cost—$230,000).

4. During 20X1, the company purchased office furniture for $14,000.

Required:

1. Calculate the net increase or decrease in the corporation’s net income for tax purposes for the 20X1 taxation year.

2. Given that the 20X1 taxation year has passed, can any action be taken in the 20X2 taxation year to reduce the net income for tax purposes of year 20X1? Explain.
Solution to P 6-3

1. Depreciable property:

<table>
<thead>
<tr>
<th>Class</th>
<th>1</th>
<th>8</th>
<th>29</th>
</tr>
</thead>
<tbody>
<tr>
<td>UCC beginning of year</td>
<td>$200,000</td>
<td>$190,000</td>
<td>$0</td>
</tr>
<tr>
<td>Purchases</td>
<td>14,000</td>
<td>30,000</td>
<td></td>
</tr>
<tr>
<td>Sale (up to original cost)</td>
<td>(230,000)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Recapture</td>
<td>30,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>CCA:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>$190,000(20%) + $14,000(20%)(1/2)</td>
<td>(39,400)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>$30,000(50%)(1/2) (note 1)</td>
<td>(7,500)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>$0</td>
<td>$164,600</td>
<td>$25,500</td>
<td></td>
</tr>
</tbody>
</table>

Cumulative Eligible capital:
- Beginning balance: $0
- Addition (3/4) of $10,000: 7,500
- 20X1 deduction 7% of $7,500: (525)
- $6,975

Capital Gain (Building)
- Proceeds: $260,000
- Cost: 230,000
- Capital gain: $30,000
- Taxable (1/2) of $30,000: $15,000

Effect on 20X1 income:
- Business income
  - Recapture: $30,000
  - Less: CCA (39,400 + 7,500): (46,900)
  - CEC write-off: (525)
  - Decrease: (17,425)
  - Taxable Capital Gain: 15,000
  - Net decrease: $2,425

Note 1
Manufacturing and processing equipment – assumed purchased between March 19, 2007 and December 31, 2013. Otherwise, Class 43.

2. Yes. The company could acquire a replacement building in 20X2 provided it is used for similar purposes in conducting a business activity. The replacement in 20X2 would permit the 20X1 recapture to be reduced to zero and reduce the cost of the replacement building [ITA 13(4)].

A similar deferral is available for the capital gain on the building [ITA 44(1)]. If the cost of the new building equals or exceeds the proceeds for the sold building ($260,000) the entire gain can be deferred. This is discussed in Chapter Eight.

The above replacement property rules apply where the replacement property is acquired within one year of 12 months after the end of the taxation year of the sale and applies only to real estate used in a business and eligible capital property [ITA 44(1),(5), 13(4),(4.1), 14(6),(7)].
PROBLEM FOUR

[ITA: 9, 13(2), (7)(g), 20(1)(a), 20(16.1); 67.2; Reg. 1100(1)(a)(xi); 1101(1af), (2), (2.5), (3); 7307(1); Class 10.1]

Wai Yeung is a self-employed insurance saleswoman. She started her business on July 1, 20X1, and ended her first taxation year on December 31, 20X1. On July 1, 20X1, she purchased a car for $32,000 plus HST. The car is financed with a bank loan.

From July 1, 20X1, to December 31, 20X1, interest costs amounted to $1,960. Yeung incurred the following additional expenses relating to her automobile:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Repairs and maintenance</td>
<td>$300</td>
</tr>
<tr>
<td>Insurance</td>
<td>1,100</td>
</tr>
<tr>
<td>Gasoline</td>
<td>1,700</td>
</tr>
<tr>
<td>Parking while on business</td>
<td>420</td>
</tr>
</tbody>
</table>

During the period, Yeung drove 15,000 kilometres, of which 12,000 were for business.

Required:

1. Determine the maximum amount that Yeung can deduct from her business income for tax purposes in 20X1.

2. Calculate the maximum CCA that Yeung can deduct in 20X2 and 20X3, assuming that business kilometres driven and total kilometres driven both remain constant and that Yeung's car is sold in 20X3 for $21,000 and replaced with a new car costing $34,000 plus HST.

3. Would your answers to 1 and 2 above change if Yeung were employed as an insurance saleswoman, rather than self-employed? Explain.
Solution to P 6-4

Part 1

The maximum deductions are:

Parking $420
Automobile costs (see calculation below) $6,002
$6,422

Automobile costs:

Operating:
- Repairs and maintenance $300
- Insurance 1,100
- Gasoline 1,700
3,100

Interest (limited to $300/month) [ITA 67.2]:
- Actual $1,960
- Limit ($300 x [184 days/30 days]) $1,840
1,840

Capital cost allowance:
The car is a Class 10.1 asset and the cost for CCA purposes is limited to
$30,000 + tax [ITA 13(7)(g), Reg.7307(1)]
$30,000 x 1.13 x 30% x 1/2 x 184 days/365 days* = 2,563

Allowable - $7,208 x 12,000 km/15,000 km = $6,002

* prorated for the business short year end, July 1 to Dec 31 [Reg. 1100(3)]. The HST rate is assumed to be 13%. The HST is included in the cost of the car for CCA purposes. Since her business involves selling insurance, the business would not be a HST registrant because insurance is a HST exempt supply.
### Part 2

<table>
<thead>
<tr>
<th>Description</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X1 capital cost ($30,000 x 1.13) [ITA 13(7)(g)]</td>
<td>$33,900</td>
</tr>
<tr>
<td>CCA 20X1 (above)</td>
<td>(2,563)</td>
</tr>
<tr>
<td>Undepreciated capital cost</td>
<td>31,337</td>
</tr>
<tr>
<td>CCA 20X2 @ 30%</td>
<td>(9,401)</td>
</tr>
<tr>
<td>Undepreciated capital cost</td>
<td>21,936</td>
</tr>
<tr>
<td>CCA 20X3 - Disposed auto – $21,936 x 30% x ½ [Reg. 1100(2.5)]</td>
<td>(3,290)</td>
</tr>
<tr>
<td>Nil</td>
<td></td>
</tr>
</tbody>
</table>

**New Class 10.1**

<table>
<thead>
<tr>
<th>Description</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>New auto – capital cost ($30,000 x 1.13)</td>
<td>$33,900</td>
</tr>
<tr>
<td>CCA 20X3 - $33,900 x 30% x ½</td>
<td>(5,085)</td>
</tr>
<tr>
<td>Undepreciated capital cost</td>
<td>$28,815</td>
</tr>
</tbody>
</table>

Business portion: 20X2 - $9,401 x 12000km/15000km                             | $7,521         |
20X3 – ($3,290 + $5,085) x 12,000/15,000km                                  | $6,700         |

Each luxury automobile is put into a separate Class 10.1 [Reg. 1101(1af)].
Recapture and Terminal losses do not apply to Class 10.1 [ITA 13(2), 20(16.1)]

### Part 3

If Yeung was an employed salesperson (employee), the CCA calculation in the first year would not be pro-rated for the short year end as her taxation year for employment income is the entire calendar year. Therefore, CCA in 20X1 would be $5,085 ($33,900 x 30% x 1/2 x 12000km/15000km). This would affect the CCA claim in 20X2 and 20X3 since CCA is calculated on the undepreciated capital cost balance.
PROBLEM FIVE

[ITA: 14(1); 20(1)(a), (b); 40(1); Reg. 1100(1), (2)]

Photo Tonight, a film-developing and camera-repair franchise, began business on January 1, 20X1. In the process of beginning operations, it incurred the following capital expenditures:

- Developing equipment: $80,000
- Furniture and fixtures: $30,000
- Small tools (under $500): $15,000
- Franchise (expires in 20 years): $75,000
- Incorporation costs: $5,000
- Pickup truck: $12,000
- Leasehold improvements (10-year lease): $30,000

The business was immediately successful and generated substantial profits for the years ended December 31, 20X1 and 20X2.

In 20X2, the truck was traded in for a larger unit costing $20,000. A value of $7,000 was assigned to the old truck when it was traded in.

In 20X3, the owner was forced to leave the business due to illness. As a result, the assets were valued and sold on December 31, 20X3, for the following values:

- Developing equipment: $60,000
- Furniture and fixtures: $15,000
- Small tools: $10,000
- Franchise: $85,000
- Incorporation costs: $0
- Pickup truck: $15,000
- Leasehold improvements: $15,000
- Goodwill: $50,000

Total: $250,000

**Required:**

Determine the effect of all these transactions on net income for tax purposes for the 20X1, 20X2, and 20X3 taxation years. Assume that the assets purchased in 20X1 were purchased prior to March 19, 2007.
### Solution to P 6-5

<table>
<thead>
<tr>
<th>Rate</th>
<th>30%</th>
<th>20%</th>
<th>100%</th>
<th>20 yrs.</th>
<th>30%</th>
<th>10 yrs.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Class</td>
<td>43*</td>
<td>8</td>
<td>12</td>
<td>14</td>
<td>10</td>
<td>13</td>
</tr>
</tbody>
</table>

#### 20X1

<table>
<thead>
<tr>
<th>Items</th>
<th>30%</th>
<th>20%</th>
<th>100%</th>
<th>20 yrs.</th>
<th>30%</th>
<th>10 yrs.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchases</td>
<td>$80,000</td>
<td>30,000</td>
<td>15,000</td>
<td>75,000</td>
<td>12,000</td>
<td>30,000</td>
</tr>
<tr>
<td>CCA</td>
<td>(12,000)</td>
<td>(3,000)</td>
<td>(15,000)</td>
<td>(3,750)</td>
<td>(1,800)</td>
<td>(1,500)</td>
</tr>
<tr>
<td></td>
<td>68,000</td>
<td>27,000</td>
<td>0</td>
<td>71,250</td>
<td>10,200</td>
<td>28,500</td>
</tr>
</tbody>
</table>

#### 20X2

<table>
<thead>
<tr>
<th>Items</th>
<th>30%</th>
<th>20%</th>
<th>100%</th>
<th>20 yrs.</th>
<th>30%</th>
<th>10 yrs.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>68,000</td>
<td>27,000</td>
<td>0</td>
<td>71,250</td>
<td>23,200</td>
<td>28,500</td>
</tr>
<tr>
<td>CCA</td>
<td>(20,400)</td>
<td>(5,400)</td>
<td>-</td>
<td>(3,750)</td>
<td>(5,010)</td>
<td>(3,000)</td>
</tr>
<tr>
<td></td>
<td>47,600</td>
<td>21,600</td>
<td>0</td>
<td>67,500</td>
<td>18,190</td>
<td>25,500</td>
</tr>
</tbody>
</table>

#### 20X3

<table>
<thead>
<tr>
<th>Items</th>
<th>30%</th>
<th>20%</th>
<th>100%</th>
<th>20 yrs.</th>
<th>30%</th>
<th>10 yrs.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>(60,000)</td>
<td>(15,000)</td>
<td>(10,000)</td>
<td>(75,000)</td>
<td>(15,000)</td>
<td>(15,000)</td>
</tr>
<tr>
<td>CCA</td>
<td>(12,400)</td>
<td>6,600</td>
<td>(10,000)</td>
<td>(7,500)</td>
<td>3,190</td>
<td>10,500</td>
</tr>
<tr>
<td>Recapture</td>
<td>12,400</td>
<td>10,000</td>
<td>7,500</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Terminal Loss</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

**Class 43:** The development equipment is assumed to have been acquired before March 19, 2007. Manufacturing and processing equipment acquired between March 19, 2007 and December 31, 2011 has a CCA rate of 50% straight-line – Class 29.

**Class 12 & Class 14:** \(\frac{1}{2}\) rule does not apply to small tools in Class 12 and all items in Class 14.

**Class 10:** CCA for 20X2 is calculated as follows –
- \(10,200 \times 30\% = \$3,060\)
- \(13,000 \times (20,000 - 7,000) \times 30\% \times \frac{1}{2} = \$1,950\)
- **Total:** \$5,010

**Class 13:** Class 13 CCA is $3,000 per year (1/2 in the first year).
- Lesser of 1) \(\frac{1}{5} \times 30,000 = \$6,000\), and
- 2) \(30,000 / 10 = \$3,000\)
- **Total:** $3,750

**Class 14:** $75,000 x 365/(20 x 365) = $3,750
Cumulative Eligible Capital:

<table>
<thead>
<tr>
<th>Year</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X1</td>
<td>Incorporation costs ¾ of $5,000</td>
<td>$3,750</td>
</tr>
<tr>
<td>20X1</td>
<td>Write-off 7%</td>
<td>(262)</td>
</tr>
<tr>
<td>20X2</td>
<td>Write-off 7%</td>
<td>(244)</td>
</tr>
<tr>
<td>20X3</td>
<td>Sale 3/4 of $50,000 (goodwill)</td>
<td>(37,500)</td>
</tr>
</tbody>
</table>

Negative balance: (34,256)

Recapture of previous deductions ($262 + $244): $506
Excess – 2/3 x ($34,256 – 506) OR ($50,000 - $5,000) x 1/2: 22,500
Business income (taxable) [ITA 14(1)]: $23,006

Capital Gain on sale of Franchise:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sale of Franchise - proceeds</td>
<td>$85,000</td>
</tr>
<tr>
<td>Cost</td>
<td>(75,000)</td>
</tr>
<tr>
<td>Capital Gain</td>
<td>$10,000</td>
</tr>
<tr>
<td>Taxable (1/2)</td>
<td>$5,000</td>
</tr>
</tbody>
</table>
PROBLEM SIX

[ITA: 20(1)(a); 40; 45(1)]

Harley Krane purchased a side-by-side duplex in 20X0 for $120,000 (land $20,000, building $100,000). The units were designed and previously used for residential use but Krane used them for his business.

Both units were used to conduct his law practice; one unit housed a small group of paralegals in his employ, who processed most of the real estate transactions for his clients.

In 20X2, Krane stopped practising real estate law in order to concentrate on family law and terminated the staff positions of all paralegals. Krane then occupied the freed-up duplex unit as his personal residence, which meant he no longer had to commute.

At the end of 20X1, the duplex building had an undepreciated capital cost of $94,000. Recently, a duplex of similar size across the street was sold for $150,000.

Required:

How will Krane’s net income for tax purposes for 20X2 be affected by the above activity?
Solution to P 6-6

The two units of the duplex are included together in Class 1 for capital cost allowance purposes. The change in use, for one unit from business use to personal use, results in a deemed disposition at fair market value for tax purposes [ITA 45(1)].

Using the recent sale of a similar duplex as a guide, the fair market value of Krane's property can be established at $150,000. This value is for the entire duplex and includes the land and the building. Therefore the total value must be apportioned based on the original allocation.

<table>
<thead>
<tr>
<th>Value of each unit:</th>
<th>1/2 of $150,000</th>
<th>$75,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>(land and building)</td>
<td>$75,000</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Value of land and building:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Land ($20,000/$120,000 x $75,000)</td>
<td>$12,500</td>
</tr>
<tr>
<td>Building ($100,000/$120,000 x $75,000)</td>
<td>$62,500</td>
</tr>
</tbody>
</table>

Deemed sale of Building:

<table>
<thead>
<tr>
<th>UCC of Class 1</th>
<th>$94,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proceeds from one unit (to a maximum of cost - each unit cost 1/2 of $100,000 = $50,000)</td>
<td>(50,000)</td>
</tr>
<tr>
<td>20X2 CCA - 4% x $44,000</td>
<td>(1,760)</td>
</tr>
<tr>
<td>$42,240</td>
<td></td>
</tr>
</tbody>
</table>

Capital Gain:

<table>
<thead>
<tr>
<th>Proceeds</th>
<th>$62,500</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost</td>
<td>(50,000)</td>
</tr>
<tr>
<td>Capital Gain</td>
<td>$12,500</td>
</tr>
<tr>
<td>Taxable (1/2)</td>
<td>$6,250</td>
</tr>
</tbody>
</table>

Deemed sale of land:

<table>
<thead>
<tr>
<th>Proceeds</th>
<th>$12,500</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost (1/2 of $20,000)</td>
<td>(10,000)</td>
</tr>
<tr>
<td>Capital Gain</td>
<td>$2,500</td>
</tr>
<tr>
<td>Taxable (1/2)</td>
<td>$1,250</td>
</tr>
</tbody>
</table>

Therefore Krane will incur taxable capital gains of $7,500 ($6,250 + $1,250) and can deduct $1,760 of CCA against the business income of the law practice.

Note that a CCA rate of 6% was NOT used for the building. The 6% CCA rate applies to buildings that were not used by anyone prior to March 19, 2007, where more than 90% of the floor space of the building is used at the end of the year for a non-residential use [Reg 1100(1)(a.2)].
PROBLEM SEVEN

[ITA: 9(1); 14(5); 18(1)(b); 20(1)(a), (b); Reg. 1100(1)(a), (b); 1100(2)(a)(iv); Sch III; Class 13 & 14]

Window Shine Ltd. was incorporated on July 1, 20X1, and purchased an existing business on the same date. The purchase included the following assets:

- **Delivery trucks** $40,000
- **Goodwill** 12,000
- **Franchise** 10,000

Immediately after incorporation, the company moved into leased premises, having signed a lease for three years with an option to renew for an additional three. Rental payments of $2,000 per month began in July 20X1. The premises required alterations, and in July 20X1, the company incurred costs of $15,000 for these.

The franchise that was purchased for $10,000 has a remaining legal life of five years. At the end of the five-year period, the franchise may be renewed at a nominal cost only if the franchiser is satisfied with the performance of the franchisee.

The company’s fiscal year end is June 30, 20X2. A brief financial statement is presented for the first year of operations.

**Revenue** $120,000

**Expenses:**

- **Wages** $26,000
- **Office** 4,000
- **Building improvements** 15,000
- **Rent** 24,000
- **Delivery expense** 3,000
- **Amortization/depreciation (truck)** 6,000
- **Amortization of goodwill** 2,000
- **Amortization of franchise** 2,000
- **Other** 12,000 94,000

**Net income for the year** $ 26,000

**Required:**

Determine the corporation’s net income from business for tax purposes for the 20X2 taxation year.
Solution to P 6-7

Accounting income per financial statement [ITA 9(1)] $26,000
Add:
   Building improvements [ITA 18(1)(b)] 15,000
   Amortization ($6,000 + $2,000 + $2,000) [ITA 18(1)(b)] 10,000
   
   51,000
Deduct:
   Capital cost allowance (note 1) [ITA 20(1)(a)] (9,250)
   Write-off of cumulative eligible Capital (note 2) [ITA 20(1)(b)] (630)

   Net income for tax purposes $41,120

Note 1
Capital Cost Allowance:
   Class 10 (Delivery truck *)
     20X2 CCA $40,000 x 30% x ½ $ 6,000
   Class 14 (Franchise)
     20X2 CCA $10,000 x 365 days /(5x365) (no ½ rule) ** 2,000
   Class 13 (leasehold improvements)
     20X2 CCA - lesser of: (1) 1/5 x $15,000 = $3,000 or,
     (2) $15,000 = $2,500.
     (3 + 3)
     CCA - $2,500 x ½ [Reg. 1100(1)(b)] 1,250

   $ 9,250

* The capital cost is not limited to $30,000 plus tax because delivery trucks are not luxury automobiles [ITA 248(1) automobile defined].
** [Reg. 1100(2)(a)(iv)]

Note 2
Cumulative Eligible Capital: [ITA 14(5)]
   Goodwill - 3/4 of $12,000 $9,000
   20X2 write-off 7% x $9,000 (no 1/2 rule) [ITA 20(1)(b)] (630)

   $8,370
PROBLEM EIGHT

[ITA:  3; 9(1); 13(7)(g); 18(1)(b), (e), (h); 20(1)(a), (aa); 39(1)(c); Reg. 1100(1)(a), (b); Sch III; Class 13]

In late 20X0, Conrad Petry retired from his job of 30 years and began receiving a pension of $4,000 per month. Unable to cope with full retirement, he purchased a small retail business on January 1, 20X1. At that time, he moved into rented premises under a seven-year lease that included an option to renew for another three years. He immediately spent $12,000 to improve the premises. The business incurred a small loss in 20X1, but 20X2 was profitable. Information relating to the 20X2 business activity is provided below.

In addition, in 20X2, Petry disposed of an investment that he had owned for several years: shares of a small business corporation. He sold the shares, which originally had cost $20,000, for $12,000.

Additional information concerning retail business (20X2)

1. The financial statements indicate a profit of $9,500 for the year ended December 20X2.
2. During the year, Petry withdrew $1,000 each month from the business for personal use. However, in order to reflect the proper economic costs of the business, he insisted that the accountant deduct a fair salary for his own efforts in the business. Accordingly, salary expense was increased by $38,000, and Petry's equity was credited with an equal amount.
3. The profit includes a deduction for amortization/depreciation of $3,500.
4. On February 28, 20X2, additional improvements costing $18,000 were made to the leased premises. This amount appears on the balance sheet as a fixed asset.
5. On June 30, 20X2, Petry purchased the land beside the leased premises. This land is to provide extra parking space for customers but can also be used to build a company-owned store building when the current lease expires. The costs relating to the land totalled $58,200, determined as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land price</td>
<td>$40,000</td>
</tr>
<tr>
<td>Cost of paving parking area</td>
<td>12,000</td>
</tr>
<tr>
<td>Permanent landscaping costs paid</td>
<td>4,000</td>
</tr>
<tr>
<td>Legal fees to prepare purchase agreement</td>
<td>1,000</td>
</tr>
<tr>
<td>Legal and registration fees for first mortgage financing of the land</td>
<td>1,200</td>
</tr>
<tr>
<td></td>
<td><strong>$58,200</strong></td>
</tr>
</tbody>
</table>

The land and the paving of the parking lot are recorded as fixed assets. The other costs have been deducted as 20X2 expenses.
6. In January 20X2, Petry purchased an automobile for $34,000 plus HST. All of the operating expenses (gas, oil, repairs, insurance, and so on) of $4,300 were paid by the business and included in travel costs. No amortization/depreciation was deducted. The car was used for the following purposes:

<table>
<thead>
<tr>
<th>Purpose</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Travel to and from work</td>
<td>20%</td>
</tr>
<tr>
<td>Travel to Vancouver to see suppliers</td>
<td>25%</td>
</tr>
<tr>
<td>Personal travel</td>
<td>55%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>100%</strong></td>
</tr>
</tbody>
</table>

7. Sales revenue has been reduced by $10,000 for a reserve for anticipated post-Christmas returns.

**Required:**

Determine Petry’s net income from business and his overall net income for tax purposes for the 20X2 taxation year.
Solution to P 6-8

Business income:
Income per financial statements [ITA 9(1)] $ 9,500
Imputed salary 38,000
Amortization [ITA 18(1)(b)] 3,500
CCA on leasehold improvements (Class 13)
  Original – 1/10 ($12,000) $1,200
  New – 1/9 ($18,000) = $2,000 (1/2) 1,000 (2,200)
CCA on paving parking area (Class 17) $12,000 x 8% x ½  (480)
Legal fees for land purchase (capital item) [ITA 18(1)(b)] 1,000
Legal fees for obtaining mortgage (1/5 is deductible as a cost of obtaining financing) add back - 4/5 x $1,200 [ITA 20(1)(e)] 960
Auto operating costs
  Personal portion is 75% (to and from work 20% + personal 55%)
  $4,300 x 75% [ITA 18(1)(h)] 3,225
CCA on auto (Class 10.1) Capital Cost is limited to $30,000 + tax
  CCA - $30,000 x 30% x 1/2 = $4,500 * [ITA 13(7)(g)]
  Business portion - $4,500 x 25% (1,125 )
Reserve for potential sales returns [ITA 18(1)(e)] 10,000

$62,380

* Assuming that the retail business is a HST registrant, the HST has not been added to the cost of the automobile.

Total income:
ITA 3(a) Business income $ 62,380
  Other income - pension ($4,000 x 12) 48,000
  110,380
ITA 3(d) Allowable business investment loss
  Sale of shares – 1/2 ($12,000 - $20,000) (4,000)
  $106,380
PROBLEM NINE

[ITA: 9(1); 13(1); 18(1)(a), (b); 20(1)(a), (b); 40(1); 78(4); Reg. 1100(1), (2), (3); 1101(5p)]

KC Restaurants Ltd., a Canadian-controlled private corporation, was incorporated on July 1, 20X0, and began operations immediately. By December 31, 20X0 (the corporation’s first year end), three new restaurants had been opened, two of which were franchises.

During the first few months of operations, the following expenditures were made by KCR:

- Legal fees for the cost of incorporation: $4,000
- Cooking equipment, including food processors, ovens, and hot plates: $320,000
- Franchise #1: $40,000
- Franchise #2: $80,000
- Cutlery, plates, glasses, and cups: $115,000
- Computer programs for restaurant accounting: $3,000
- Building (constructed after March 18, 2007): $222,000

Franchise #1 was purchased on October 1, 20X0, and will expire after 120 months. Franchise #2, which was acquired on July 1, 20X0, has no expiry date and will continue indefinitely, provided that the terms of the franchise agreement are met. Other equipment, such as tables and chairs, was leased.

For the taxation year ending December 31, 20X0, KCR claimed a deduction for the maximum available CCA and cumulative eligible capital account. For tax purposes, after these deductions were made, the company lost $40,000 in 20X0.

The company became profitable in 20X1. A summary of the income statement prepared for accounting purposes for the year ended December 31, 20X1, with additional information, is provided below.

20X1 financial statement (summarized) and other information

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$1,845,000</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>$1,011,000</td>
</tr>
<tr>
<td>Gross profit</td>
<td>834,000</td>
</tr>
<tr>
<td>Occupancy costs</td>
<td>$72,000</td>
</tr>
<tr>
<td>Salaries and wages</td>
<td>275,000</td>
</tr>
<tr>
<td>General overhead</td>
<td>301,000</td>
</tr>
<tr>
<td>Advertising and other</td>
<td>96,000</td>
</tr>
<tr>
<td>Gain on sale of goodwill</td>
<td>60,000</td>
</tr>
<tr>
<td>Net losses on sale of fixed assets</td>
<td>(22,000)</td>
</tr>
<tr>
<td>Net income</td>
<td>$128,000</td>
</tr>
</tbody>
</table>
The following additional information relates to the previous 20X1 financial statements:

1. On December 1, 20X1, KCR sold the non-franchised restaurant. The sale price included these proceeds:

<table>
<thead>
<tr>
<th>Proceeds</th>
<th>Original cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Goodwill $60,000</td>
<td>$0</td>
</tr>
<tr>
<td>Land 15,000</td>
<td>12,000</td>
</tr>
<tr>
<td>Building 230,000</td>
<td>220,000</td>
</tr>
<tr>
<td>Cooking equipment 40,000</td>
<td>72,000</td>
</tr>
<tr>
<td>Cutlery, plates, glasses 26,000</td>
<td>37,000</td>
</tr>
</tbody>
</table>

2. Included in advertising expenses is $2,000 of donations made to a registered charity.

3. Salaries include an accrued bonus of $12,000 awarded on December 31, 20X1, to a manager. The bonus will be paid in three equal instalments of $4,000 on April 30, 20X2, August 31, 20X2, and December 31, 20X2.

4. Expenses include accounting amortization/depreciation of $102,000.

**Required:**

1. Calculate the undepreciated capital cost for tax purposes for each class of depreciable property at the end of the 20X0 taxation year after CCA claims for that year. (Assume assets purchased in 20X0 were purchased after March 18, 2007.)

2. Calculate the balance in the cumulative eligible capital account at the end of the 20X0 taxation year after the deduction for that year.

3. For the taxation year ended December 31, 20X1, calculate KCR’s net income for tax purposes. Begin your answer with net income per the financial statement, and add or subtract adjustments.
Solution to P 6-9

Part (1) CCA 20X0

The company has a short year end and the CCA must be reduced accordingly [Reg. 1100(3)].

**CLASS 29**

<table>
<thead>
<tr>
<th>Cost</th>
<th>CCA</th>
<th>UCC</th>
</tr>
</thead>
<tbody>
<tr>
<td>$320,000</td>
<td>$320,000 x 25% x 184/365 =</td>
<td>(40,329)</td>
</tr>
</tbody>
</table>

**CLASS 14**

- Franchise #1 $40,000
- CCA: 92 days/3652 days (or 120 months) x $40,000 = (1,008) $38,992

The 1/2 year and short taxation year rules are not applicable to Class 14 [Reg. 1100(2) & (3)].

**CLASS 12**

- Cutlery $115,000
- Other software for computer 3,000
- CCA: Cutlery $115,000 x 100% x 184/365 = $(57,973)
- Software $3,000 x 100% x ½ x 184/365 = (756) $59,271

The 1/2 rule applies to the software but not the cutlery [Reg. 1100(2)].

**CLASS 1**

- Building $220,000
- CCA $220,000 x 6% x 1/2 x 184/365 = (3,327) $216,673

An additional allowance of 2% (increasing the rate to 6%) is available for new buildings acquired after March 18, 2007 where more than 90% of the floor space is used at the end of the year for a non-residential use [Reg 1100(1)(a.2)]. To receive the additional allowance the building must be placed in a separate CCA class [Reg 1101(5b.1)]. The building does not qualify for the 10% CCA rate since it is unlikely that greater than 90% of the floor space of the restaurant is used for processing of food.

Part (2) Cumulative eligible capital - 20X0

- Legal fees for incorporation - $4,000 x 3/4 = $3,000
- Franchise #2 - $80,000 x 3/4 = 60,000
- 20X0 deduction - 7% x $63,000 x 184/365 = (2,223) $60,777

CECA is prorated for a short taxation year [ITA 20(1)(b)].
Part (3) Net income for 20X1

Income per financial statement [ITA 9(1)] $128,000

Add:
- Amortization [ITA 18(1)(b)] 102,000
- Unpaid remuneration - two bonus payments are paid later than 179 days after the year end. ($4,000 + $4,000) [ITA 78(4)] 8,000
- Recapture of CCA (note 1) [ITA 13(1)] 3,327
- Taxable capital gains (note 1) [ITA 40(1)] 6,500
- Donations [ITA 18(1)(a)] 2,000
- Net losses on sale of fixed assets [ITA 18(1)(b)] 22,000

Net income for tax purposes $271,827

Deduct:
- Gain on sale of goodwill (60,000)
- CCA (note 2) [ITA 20(1)(a)] (197,271)
- Deduction of CEC (note 3) [ITA 20(1)(b)] (1,104)

Net income for tax purposes $13,452

Note 1:
Class 1 -
- UCC opening $216,673
- Proceeds (limit to cost) (220,000)
- Recapture $(3,327)

Taxable capital gains:
- Building ($230,000 - $220,000) x 1/2 $5,000
- Land ($15,000 - $12,000) x 1/2 1,500

$6,500

Note 2:
Capital cost allowance:
Class 29 -
- UCC beginning of the year $279,671
- Disposal (40,000)
- CCA lesser of (1) $239,671
  (2) 50% x $320,000 $160,000
  + ($239,671 > 75% x $320,000) 0

$79,671

Class 14 - $40,000 x 365/3652 (4,000)

Class 12 -
- UCC $59,271
- Disposal (26,000)
- CCA 100%
  (33,271) (33,271)

$0

$197,271

Note 3:
CECA:
- Cumulative eligible capital - opening $60,777
- Sale of goodwill 3/4 x $60,000 (45,000)
- 20X1 deduction – 7% x $15,777 (1,104)

$14,673

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Solutions Manual Chapter Six
PROBLEM TEN

ITA: 9(1); 13(1); 18(1)(b), (n); 14(5); 20(1)(a), (b)

Samson Enterprises Ltd. achieved a profit in 20X1 of $120,000. The income statement is summarized below.

Sales $1,300,000
Cost of sales 780,000
Gross profit 520,000
Administrative and selling expenses 451,000
69,000
Other income (expenses) 51,000
Net income before tax $ 120,000

Certain details of the summarized income statement are provided below.

1. Administrative and selling expenses include the following:

(a) Donations to registered charities $ 3,000
(b) Amortization/depreciation of tangible assets 12,000

Note 1: At the end of the previous year, the undepreciated capital cost of certain asset classes was as follows:

Class 1 $80,000
Class 8 32,000
Class 10 50,000

Note 2: During the current year, the company sold its land and building for $150,000 (land $40,000, building $110,000) and moved into leased premises. The original cost of the property was $130,000 (land $30,000, building $100,000). The building had an accounting book value of $70,000 at the time of sale.

Note 3: The company owns several pieces of equipment. During the year, one unit that originally cost $10,000 and had a book value of $6,000 was sold for $8,000.

(c) Legal fees:

• Settling a dispute relating to the purchase of defective merchandise for sale 4,000
• Reorganizing the corporation’s share capital 8,000

(d) Amortization 9,000

Note: The current year’s amortization expense applies to a number of intangible assets.

• During the previous year (20X0), the company took over a competitor and purchased goodwill for $40,000 and a franchise (unlimited life) for $10,000.
• During the current year, the franchise was sold for $8,000 when its book value for accounting purposes was $9,000. In addition, the company purchased an existing patent
from a competitor for $20,000. The patent with a remaining legal life of 10 years was purchased on the first day of the current year.

2. Other income (expenses) includes the following:
   - Gain on sale of land: $10,000
   - Gain on sale of building: $40,000
   - Gain on sale of equipment: $2,000
   - Loss on sale of franchise: $(1,000)

   **Total:** $51,000

Required:

Determine the net income for tax purposes of Samson Enterprises for the 20X1 taxation year.
Solution to P 6-10

Analysis of Cumulative Eligible Capital:

The opening balance was not provided. It must be determined from its inception in the previous year (20X0).

20X0
Purchased Goodwill (3/4) of $40,000 $30,000
Purchased franchise (3/4) of $10,000 7,500
Assumed write-off in 20X0 (7%) (2,625)
Balance at end of 20X0 34,875

20X1
Addition - legal fees for share reorganization (3/4) of $8,000 6,000
Reduction - franchise sale (3/4 of $8,000) (6,000)
20X1 write-off - 7% of $34,875 (2,441)
$32,434

Analysis of Depreciable Property:

<table>
<thead>
<tr>
<th>Class:</th>
<th>1(4%)</th>
<th>8(20%)</th>
<th>10(30%)</th>
<th>44(25%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening balance</td>
<td>$ 80,000</td>
<td>$32,000</td>
<td>$50,000</td>
<td>$ 0</td>
</tr>
<tr>
<td>Additions (patent)</td>
<td>$20,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Disposals</td>
<td>(100,000) (8,000) 0 0</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(20,000) 24,000 50,000 20,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>20X2 CCA</td>
<td>(4,800) (15,000) (2,500)*</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>20X2 Recapture</td>
<td>20,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>0</td>
<td>$19,200</td>
<td>$35,000</td>
<td>$17,500</td>
<td></td>
</tr>
</tbody>
</table>

* Note: $20,000 x 1/2 x 25% = $2,500. The taxpayer can elect to treat the patent as Class 14 with CCA on a straight line basis (10 years), (or some other reasonable amount based on economic value) without applying the one-half rule.

Sale of Land and Building (Capital Portion):

<table>
<thead>
<tr>
<th></th>
<th>Land</th>
<th>Building</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proceeds</td>
<td>$40,000</td>
<td>$110,000</td>
<td>$150,000</td>
</tr>
<tr>
<td>Cost</td>
<td>(30,000)</td>
<td>(100,000)</td>
<td>(130,000)</td>
</tr>
<tr>
<td>Capital Gain</td>
<td>$10,000</td>
<td>$ 10,000</td>
<td>$ 20,000</td>
</tr>
<tr>
<td>Taxable ½ of $20,000</td>
<td></td>
<td></td>
<td>$10,000</td>
</tr>
</tbody>
</table>
Net income for tax purposes:

a) Income from business:
   Income per financial statement [ITA 9(1)] $120,000
   Add: Donations [ITA 18(1)(a)] 3,000
   Legal fees - reorganization of share capital [ITA 18(1)(b)] 8,000
   Amortization (tangible assets) [ITA 18(1)(b)] 12,000
   Amortization (other) [ITA 18(1)(b)] 9,000
   Accounting loss on sale of franchise [ITA 18(1)(b)] 1,000
   Recapture of capital cost allowance [ITA 13(1)] 20,000
   
   173,000

   Deduct:
   Capital cost allowance: (4,800 + 15,000 + 2,500) [ITA 20(1)(a)] (22,300)
   Eligible capital property write-off [ITA 20(1)(b)] (2,441)
   Accounting gain on sale of:
      - land (10,000)
      - building (40,000)
      - equipment (2,000)
   
   Net income from business 96,259

b) Taxable capital gains

   10,000

   Net income for tax purposes $106,259
PROBLEM ELEVEN

[ITA: 12(1)(x); 13(7.4)]

East Side Products Ltd. (ESP) recently expanded its business by acquiring the operations of a competitor. As a result of the expansion, additional office space was needed. On the first day of the current fiscal year, ESP rented additional premises under a five-year lease agreement with two three-year renewal options. As an inducement to sign the lease, the landlord paid ESP $20,000 to cover part of the cost of improving the offices. Before occupying the premises, ESP spent $38,000 for necessary renovations.

Profits from business operations for the current year are expected to be $175,000. Because of the expansion, future years’ profits are expected to exceed $550,000 annually. For several years, ESP had invested its excess cash from annual profits in secure bonds. The proceeds from all of these bonds were used to acquire the competitor’s business. For the next several years, the company will again invest excess cash in secure bonds; it expects to earn an average yield of 9%.

ESP is a Canadian-controlled private corporation. The first $500,000 of annual business profits are subject to a 15% tax rate. Annual business profits over $500,000 are taxed at 25%.

**Required:**

Describe the alternative tax treatments for the inducement payment. Which treatment should ESP use? Show a detailed calculation that compares the tax cost of each alternative.
Solution to P 6-11

ESP can choose to treat the inducement payment of $20,000 in one of two ways:

1. The full amount can be included in income from business for the current year [ITA 12(1)(x)] or
2. The amount can be deducted from the cost of the leasehold improvements [ITA 13(7.4)].

If it is included in income, the current year's profit will increase by $20,000 to $195,000. The tax cost will be $3,000 ($20,000 @ 15%).

The cost of leasehold improvements qualify for CCA under Class 13 and the annual CCA is equal to the cost ($38,000) divided by the number of years in the lease plus one option period (5+3 = 8). If the $20,000 inducement is applied to reduce the improvement costs, it causes the CCA to be lower in each of the years a deduction is permitted. If it is assumed that the lease will be terminated after eight years, CCA will be reduced by the following:

<table>
<thead>
<tr>
<th>Year</th>
<th>CCA Reduction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current year</td>
<td>$20,000/(5+3) = $2,500 x 1/2 $1,250</td>
</tr>
<tr>
<td>Year 2</td>
<td>2,500</td>
</tr>
<tr>
<td>Year 3</td>
<td>2,500</td>
</tr>
<tr>
<td>Year 4</td>
<td>2,500</td>
</tr>
<tr>
<td>Year 5</td>
<td>2,500</td>
</tr>
<tr>
<td>Year 6</td>
<td>2,500</td>
</tr>
<tr>
<td>Year 7</td>
<td>2,500</td>
</tr>
<tr>
<td>Year 8 - Terminal year - unamortized balance</td>
<td>3,750</td>
</tr>
<tr>
<td>Total</td>
<td>$20,000</td>
</tr>
</tbody>
</table>

These reductions cause higher incomes in the current year and in the subsequent seven years. The income in the current year is taxed at a rate of 15%. However, the higher income in the subsequent years will be subject to a tax rate of 25% because the income in those years will exceed the low rate threshold.

It is necessary to compare the two options on a present value basis. An appropriate discount rate would be 9% being the expected rate of return on excess funds invested. However, these returns are subject to a 25% tax rate and this reduces the discount rate to 6.75% (9% - tax @ 25%).
The following comparison can be made:

<table>
<thead>
<tr>
<th></th>
<th>Absolute Cost</th>
<th>Present Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>1) Include in current year's income - tax cost is $20,000 @ 15%</td>
<td>$3,000</td>
<td>$3,000</td>
</tr>
<tr>
<td>2) Reduce cost of improvements:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current year - $1,250 @ 15%</td>
<td>$188</td>
<td>$188</td>
</tr>
<tr>
<td>Next six years: $2,500 @ 25% = $625 x 6 years</td>
<td>3,750</td>
<td>2,981*</td>
</tr>
<tr>
<td>Last year (terminal year) $3,750 @ 25%</td>
<td>938</td>
<td>582**</td>
</tr>
<tr>
<td></td>
<td>$4,876</td>
<td>$3,751</td>
</tr>
</tbody>
</table>

* Present value of an annuity for the next six years after the current year.
** Present value of $1 received at the end of year seven (7 years after the current year).

Based on the above, ESP should include the inducement payment in the current year's income as it results in a cost reduction of $751 ($3,751 - $3,000).
CASES

Patterson Traders Inc.

[ITA: 20(1)(a), (b); Reg. 1100(1)]

Patterson Traders Inc. has developed substantial cash reserves after several successive years of profitable operations. The company intends to use those reserves to diversify and has targeted two businesses for possible acquisition. Both target businesses are corporations.

Patterson has stated that it wants to acquire only the individual assets of any business it acquires, rather than the shares of the corporation that owns the assets. In addition, Patterson has a strong cash position and so has no desire to incur debt.

Information relating to the two target businesses is as follows:

<table>
<thead>
<tr>
<th>Assets</th>
<th>1</th>
<th>2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>$50,000</td>
<td>$40,000</td>
</tr>
<tr>
<td>Building</td>
<td>300,000</td>
<td>310,000</td>
</tr>
<tr>
<td>Equipment (manufacturing)</td>
<td>500,000</td>
<td>200,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>-0-</td>
<td>450,000</td>
</tr>
<tr>
<td>Licence</td>
<td>150,000</td>
<td>-0-</td>
</tr>
<tr>
<td></td>
<td><strong>$1,000,000</strong></td>
<td><strong>$1,000,000</strong></td>
</tr>
</tbody>
</table>

Both target companies are manufacturers, though their products are different. Both are expected to generate annual profits of $400,000 before amortization/depreciation and income taxes.

One of the products of business 1 is manufactured under licence. The licence agreement extends for 15 years and stipulates payment of a royalty based on sales volume. The licensee has an option to renew the licence at the end of the 15-year period subject to a renegotiation of the royalty percentage.

Currently, the cash reserves are invested in secure bonds, which earn interest at 12% annually. These cash reserves are not sufficient to acquire both businesses, and so Patterson will acquire only one of them. The company intends to use the profits of the acquired business to again build up a cash reserve, which will be invested in secure bonds. The corporate tax rate is 25%.

Required:

Advise Patterson Traders whether it should purchase business 1 or business 2.
Solution to Case – Patterson Traders Inc.

The primary objective of this case is to emphasize the tax impact on future cash flows that result from varying asset mixes. Even though the initial capital outlay and the anticipated pre-tax cash profits for each business are identical, the future after-tax cash flows are dramatically different due to the nature of the assets within each business and their related tax treatment.

As a second objective, the student is required to put the tax factor into perspective by focusing on certain non-tax issues of a more subjective nature.

One method of analysis is to determine which business will provide the highest rate of return by examining future after-tax cash flows. An accurate analysis is difficult because the case lacks certain information. For example, there is no indication of the useful life of the equipment and possible replacement costs. In addition, the time frame and certainty of potential profits is unknown. To complete the analysis the following assumptions are made, each of which can be challenged and substituted with other assumptions:

- The time frame of expected profits is limited to 15 years which ties in with the life of the manufacturing licence of business 1.
- Equipment is expected to provide service over the 15 year life assumed above.
- Each business presents an equivalent risk and the company is prepared to take such a risk provided that the return on investment is at least 15% after-tax.

Based on the above assumptions the relevant cash flows are compared on a net-present value basis using a discount factor of 15%.

<table>
<thead>
<tr>
<th>Business</th>
<th>Business 2</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Cash Outflow:</strong></td>
<td></td>
</tr>
<tr>
<td>Purchase Price</td>
<td>$1,000,000</td>
</tr>
<tr>
<td><strong>Cash Inflows:</strong></td>
<td></td>
</tr>
<tr>
<td>1. Future profit before amortization and tax</td>
<td></td>
</tr>
<tr>
<td>Profits</td>
<td>$400,000</td>
</tr>
<tr>
<td>Less annual tax 25%</td>
<td>(100,000)</td>
</tr>
<tr>
<td>Present value of</td>
<td></td>
</tr>
<tr>
<td>$300,000 for 15 years @ 15%</td>
<td>$1,755,000</td>
</tr>
<tr>
<td>2. Present value of tax savings from capital cost allowance</td>
<td></td>
</tr>
<tr>
<td>Licence (Note 1)</td>
<td>14,625</td>
</tr>
<tr>
<td>Building (Note 2)</td>
<td>15,789</td>
</tr>
<tr>
<td>Equipment (Note 3)</td>
<td>96,154</td>
</tr>
<tr>
<td>Goodwill (Note 4)</td>
<td>-</td>
</tr>
<tr>
<td>Present value</td>
<td>$1,881,568</td>
</tr>
<tr>
<td><strong>Excess of inflows</strong></td>
<td>$881,568</td>
</tr>
</tbody>
</table>
(Note 1) Licence: Class 14, CCA straight line of $10,000 per year \((150,000/15)\) [Reg 1100(1)(c)]. Tax saving - $2,500 (25%) annually discounted at 15% = $14,625

The formula for calculating the present value of reductions in tax payable due to capital cost allowance (ignoring the \(\frac{1}{2}\) year rule) is as follows:

\[
\text{Marginal Rate of Investment} \times \frac{\text{Rate of Income tax}}{\text{Capital Cost Allowance}} = \frac{(\text{Rate of Capital Cost Allowance} + \text{Rate of Return})}{\text{(Rate of Capital Cost Allowance + Rate of Return)}}
\]

<table>
<thead>
<tr>
<th>Business #1</th>
<th>Business #2</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Note 2) Building</td>
<td>(Note 2) Building</td>
</tr>
<tr>
<td>(300,000 \times .25 \times .04)</td>
<td>(310,000 \times .25 \times .04)</td>
</tr>
<tr>
<td>(.04 + .15)</td>
<td>(.04 + .15)</td>
</tr>
<tr>
<td>$15,789</td>
<td>$16,316</td>
</tr>
<tr>
<td>(Note 3) Equipment</td>
<td>(Note 3) Equipment</td>
</tr>
<tr>
<td>(500,000 \times .25 \times .50)</td>
<td>(200,000 \times .25 \times .50)</td>
</tr>
<tr>
<td>(.50 + .15)</td>
<td>(.50 + .15)</td>
</tr>
<tr>
<td>$96,154</td>
<td>$38,462</td>
</tr>
<tr>
<td>(Note 4) Goodwill</td>
<td>(Note 4) Goodwill</td>
</tr>
<tr>
<td>N/A</td>
<td>(337,500 \times .25 \times .07)</td>
</tr>
<tr>
<td></td>
<td>(.07 + .15)</td>
</tr>
<tr>
<td></td>
<td>$26,847</td>
</tr>
</tbody>
</table>

*the above calculations ignore the \(1/2\) rule for year 1.

Building – A CCA rate of 4% has been used for the building. The additional allowance of 6% (increasing the rate to 10%) is not available since the building was used prior to March 19, 2007 (assumed).

Equipment – Manufacturing and processing equipment acquired between March 19, 2007 and December 31, 2013 qualifies for a 50% straight-line CCA rate (Class 29).

The above analysis indicates that both businesses will yield a return in excess of 15%. However, Business #1 yields a greater return on investment than Business #2. This difference is attributed to the faster write-off of the assets of Business #1, which has substantially more equipment than Business #2.

It is important to recognize that the above calculations have not considered the potential liquidation value of the businesses after 15 years. This factor should be considered in acquisition decisions (see Chapter 18 case - Bayly Corporation).

Notwithstanding that Business #1 provides a greater rate of return under the assumptions made, the student should recognize that a number of other issues may be relevant. For example:
1. The risk associated with each business may vary because the products produced are not similar.

2. Business 1 is subject to a limited licence on one of its products which creates uncertainty about the future profits.

3. Business 1 appears to be highly capital intensive with equipment compared to Business 2. There is no indication when Business 1 might have to replace the equipment, and technological advances may be forthcoming which would render their production process less efficient than competitors.

The above factors and others may overshadow the tax benefits that appear to make Business 1 more attractive.
CASE TWO

Platt Enterprises Ltd.

Platt Enterprises started a wholesale business two years ago and has made a profit from the beginning. To date, the company has been storing merchandise inventory in a public warehouse, but the business has grown to a point where this policy is now cumbersome.

The company expects to enjoy unusually rapid growth for the next five years until it achieves a steady market share. Platt is seeking to acquire warehouse space for its exclusive use that will carry it through the growth period. After five years, it intends to obtain a more permanent space designed and built for its own specific needs.

A suitable site has been found that will meet Platt’s needs for the next five years. The owner of the property has given Platt two options. Under the first of these, Platt would purchase the land and building for $200,000 ($50,000 for land, $150,000 for the building). Under the second, Platt would lease the land and building for five years at an annual rent equal to 11% of the property’s current value ($200,000). The lease would be a net lease requiring Platt to pay for all operating costs associated with the property, including property taxes, insurance, utilities, and maintenance.

The company is having difficulty choosing between the two options. The rental rate of 11% of the property’s value does not seem excessive, considering that the company can borrow funds at 10% (it currently has no major debt). In fact, there are sufficient cash resources to purchase the property with cash. The purchase option also appears attractive, even though the land and building will have to be sold at the end of five years. In particular, the company is aware that recent studies of the local real estate market predict that warehouse properties will increase in value at the rate of 5% annually for the next eight years.

Platt realizes that the same issue will have to be examined again in five years. A local real estate developer who is planning a long-term industrial real estate development is aware of Platt’s five-year plan. The developer has indicated that it is prepared to design and construct a building for Platt that will be ready by the end of the five-year period. The developer has also indicated that a group of investors wants to own the proposed property and lease it to Platt under a long-term lease arrangement. Of course, Platt could also choose to own the future property. Platt Enterprises is subject to a 25% tax rate.

Required:

1. Prepare an analysis, and advise Platt Enterprises as to which option is most advantageous. You may assume that the future property needed after five years will be obtained through the lease arrangement suggested by the developer.

2. To what extent, if any, would your decision be affected if it were assumed that the future property needed after five years will be purchased by Platt, rather than leased?
Solution to Case Two – Platt Enterprises Ltd.

1. This case emphasizes the impact on cash flows resulting from the tax treatment of properties acquired for use under a lease arrangement or purchase. It also highlights the issue that real estate consists of more than one type of property - land and building.

Under both options the company has the use of the property for five years but for tax purposes the amount and the timing of deductions vary.

If the land and building is leased the annual rent payments are fully deductible. In comparison, if the property is owned, only the cost of the building is deductible in the form of capital cost allowance. Therefore the lease permits a deduction for the use of land but a purchase does not. Although owning the property prohibits a deduction for land it nevertheless provides the ability to obtain a growth in value as real estate values change. These variables are analyzed below. The relevant cash flows are discounted at 10% (see subsequent discussion) and the rate was chosen on an arbitrary basis.

**Leasing**

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual rent cost (11% of $200,000)</td>
<td>$22,000</td>
</tr>
<tr>
<td>Tax saving (25% of $22,000)</td>
<td>(5,500)</td>
</tr>
<tr>
<td>Annual after-tax cost</td>
<td>$16,500</td>
</tr>
<tr>
<td>Present value of $16,500 annually for 5 years discounted at 10% equals</td>
<td>$62,535</td>
</tr>
</tbody>
</table>

**Owning**

Cash flows from owning the property consist of the following:
- Cost of land and building ($200,000)
- Tax savings from deduction of capital cost allowances on the building.
- Proceeds from the sale of property.
- Tax cost on gains resulting from the property sale.

Based on the estimated growth in real estate values (5% annually) the property will be worth $255,256 at the end of five years ($200,000 x 5% x 5 years (compounded)).

As the property is sold in year five and no replacement occurs, capital cost allowance occurs for the first four years only.

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of Building</td>
<td>$150,000</td>
</tr>
<tr>
<td>CCA (year 1) 150,000 (4%)(1/2)</td>
<td>(3,000)</td>
</tr>
<tr>
<td></td>
<td>147,000</td>
</tr>
<tr>
<td>CCA (year 2) 4%</td>
<td>(5,880)</td>
</tr>
<tr>
<td></td>
<td>141,120</td>
</tr>
<tr>
<td>CCA (year 3) 4%</td>
<td>(5,645)</td>
</tr>
<tr>
<td></td>
<td>135,475</td>
</tr>
<tr>
<td>CCA (year 4) 4%</td>
<td>(5,419)</td>
</tr>
<tr>
<td>Undepreciated capital cost</td>
<td>130,056</td>
</tr>
<tr>
<td>Sale in year five (credit pool with cost)</td>
<td>(150,000)</td>
</tr>
<tr>
<td></td>
<td>(19,944)</td>
</tr>
<tr>
<td>Recapture</td>
<td>19,944</td>
</tr>
<tr>
<td></td>
<td>$ 0</td>
</tr>
</tbody>
</table>
Capital Gain on Sale:
Proceeds $255,256
Cost of (land and building) (200,000)
Taxable (1/2) $ 55,256

\$

The relevant cash flows and net present values are as follows:

<table>
<thead>
<tr>
<th>Actual</th>
<th>NPV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash out: Purchase of property ($200,000)</td>
<td>($200,000)</td>
</tr>
<tr>
<td>Cash in:</td>
<td></td>
</tr>
<tr>
<td>Year 1 25% of $3,000</td>
<td>750</td>
</tr>
<tr>
<td>Year 2 25% of $5,880</td>
<td>1,470</td>
</tr>
<tr>
<td>Year 3 25% of $5,645</td>
<td>1,411</td>
</tr>
<tr>
<td>Year 4 25% of $5,419</td>
<td>1,355</td>
</tr>
<tr>
<td>Sale of property $255,256</td>
<td></td>
</tr>
<tr>
<td>Less Tax</td>
<td></td>
</tr>
<tr>
<td>Recapture (25% of $19,944) (4,986)</td>
<td></td>
</tr>
<tr>
<td>Capital gain (25% of $27,628) (6,907)</td>
<td>243,363</td>
</tr>
<tr>
<td>Net present value (cost)</td>
<td>$(45,233)</td>
</tr>
</tbody>
</table>

Based on a discount rate of 10% there is an advantage of $17,302 to owning (leasing - $62,535; owning $45,233).

It is important to recognize that the choice of the discount rate is significant in this case because the nature of the cash flows under each option is considerably different. Leasing result in annual outflows only, whereas owning results in a large initial outflow followed by future inflows with a large inflow at the end of five years. For example, the comparative net present value costs of leasing vs. owning using different discount rates are summarized below:

<table>
<thead>
<tr>
<th>Discount Rate</th>
<th>NPV Leasing</th>
<th>NPV Owning</th>
<th>Choice</th>
</tr>
</thead>
<tbody>
<tr>
<td>6%</td>
<td>69,465</td>
<td>13,210</td>
<td>Own</td>
</tr>
<tr>
<td>10%</td>
<td>62,535</td>
<td>45,233</td>
<td>Own</td>
</tr>
<tr>
<td>14%</td>
<td>56,595</td>
<td>69,915</td>
<td>Lease</td>
</tr>
</tbody>
</table>

Arguments can be made to justify alternative rates.

For example, if excess cash flow from choosing one method over another was simply used to invest in secure bank certificates earning 10% (and not for business expansion) an after-tax discount rate of 7.5% could be used (10% - 25% tax = 7.5%) which would favor owning in this case.

On the other hand, if the cash differential can be used for business expansion and earn an after-tax return of 14% then this rate can be used, reversing the result in favor of leasing.
2. If the future property required after five years is purchased rather than leased, the comparative analysis in part 1 above would change under the ownership option. If the current building is purchased and sold after five years, the recapture of capital cost allowance and the capital gain can be deferred. The acquisition of replacement property would permit the recapture as well as the capital gain on the land and building to be deferred (discussed in Chapter 8). The newly constructed building would qualify for 6% CCA.
CHAPTER 7

INCOME FROM PROPERTY

Review Questions

1. Although the *Income Tax Act* specifically refers to property income as a separate type of income, it does not provide a specific definition of the term. Identify the source from which the definition of property income is derived, briefly explain the term's meaning, and provide examples of income from property.

2. Distinguish between income from property and the gains or losses that may occur from the sale of property.

3. Interest income earned on loans by a financial institution may, for tax purposes, be classified in a different way from interest income earned on loans by taxpayers who are investing their savings. Explain why.

4. Briefly explain how income from property is determined for tax purposes.

5. Compare and contrast the taxation year of an individual with that of a corporation with respect to the determination of business income and property income.

6. “An individual can deduct for tax purposes the interest expense incurred on the mortgage loan attached to his or her personal residence.” Is this statement true? Explain.

7. A taxpayer has sold property (land) for $200,000 that was originally purchased for $70,000. The property was sold to an arm’s-length party (not related). The terms of sale involve a cash payment of $100,000 on closing, with the balance to be paid at $20,000 per year for five years, with no interest charged on the unpaid balance. For tax purposes, what types of income may result for the vendor from this transaction?

8. An individual invests in a bank term deposit on July 1, 20X0. When does the individual recognize the interest income for tax purposes if the investment has a term of three years, with interest compounded annually but paid only at the end of the three-year term? Would your answer be different if the taxpayer were a corporation? Explain.

9. Can a taxpayer deduct a reserve for unpaid interest on a loan if the interest appears not to be collectible? Explain. How does the treatment of unpaid interest compare with the treatment of the loan principal when its repayment is in doubt?

10. Briefly explain why an individual who receives dividends from a Canadian corporation must include 125% or 138% (141% in 2011) of the dividend received in income for tax purposes, while a corporation receiving the same dividend includes only the actual amount of the dividend.

11. “If a loss occurs from the renting of real estate (that is, if annual expenses exceed rental income), the loss is not recognized in determining a taxpayer’s overall net income for tax purposes.” Is this statement true? Explain.
12. A building that costs $200,000 and is rental property will always create a terminal loss or a recapture of capital cost allowance when it is sold. The same result may not occur if the building is used directly in a business activity. Explain this.

13. An investor in real estate may achieve a higher rate of return by acquiring a small portion (part ownership) of several properties, rather than a lesser number of whole properties. Explain this.

14. Why is the purchase of rental real estate often referred to as a “tax-sheltered” investment?

15. Often, an enterprise conducting an active business will separate its business operations from its appreciating assets (such as real estate) by establishing a separate corporation for each. How may this type of structure impair future expansion activities?
Solutions to Review Questions

R7-1. The definition of property income is derived from common law precedents. From this source income from property can be defined as the return on invested capital where little or no time, labour or attention is expended by the investor in producing the return. Property income includes the interest earned on bonds and loans, dividends earned on shares of corporations and rents earned from real estate [ITA 9(1)].

R7-2. Income from property refers to the regular returns derived from ownership of the property (such as dividends from shares). The gain or loss which results from the actual sale of the property is classified either as a capital gain (loss) or business income (loss) depending on the purpose for acquiring the property [ITA 38, 39(1)].

R7-3. Interest income earned by a financial institution such as a bank or trust company is normally classified as business income because substantial cost and effort is expended to earn the interest -- the loaning of money is a part of the entity’s business. A taxpayer who earns interest from investing their savings earns property income because little effort is required to generate and maintain the returns.

R7-4. Income from property is determined using the same rules as income from business. It is the profit determined in accordance with well accepted business principles with the aid of normal accounting principles. Similar to business income, the determination of profit is modified by several general limitations and can apply the same exceptions to those limitations [ITA 9(1)].

R7-5. The taxation year of a corporation is the fiscal period chosen to account for its affairs. Therefore both business income and property income are determined annually for the corporation’s fiscal year.

In contrast, property income earned by an individual cannot use a fiscal period and must be accounted for on a calendar year basis. For individuals carrying on business a calendar year end is required, however, an election to use an alternative method is available [ITA 34.1].

R7-6. Yes, the statement can be true. Interest expense on a loan is deductible in arriving at property income provided that the funds obtained from the loan are used to acquire an investment which in turn can generate taxable income [ITA 20(1)(c)]. Therefore, if an individual borrows money by mortgaging a home and uses the funds to acquire an income generating investment (and does not use the funds to buy the home) the interest is deductible.

R7-7. Because the property is sold to an arm’s length buyer with substantial deferred payments without interest, it may be construed that the selling price of the property was increased in exchange for the elimination of interest. In such circumstance, a portion of the price may be considered to be property income from interest and taxed accordingly.

The gain on the sale of the land (less the imputed interest) may be a capital gain if the land was originally acquired by the vendor to provide a long-term benefit and was not purchased for resale at a profit. As the capital gain is only 1/2 taxable, the reduced capital gain and enhanced interest income results in a greater taxable amount. On the other hand, the gain on sale of the land may be business income, in which case treating it as property income (interest) or business income would result in the same taxable amount.
R7-8. The individual must recognize the interest earned to each anniversary day (annual accrual method) from the issue date of the investment. Therefore, no income would be recognized in 20X0. But income from July 1, 20X0 to June 30, 20X1 would be included in the 20X1 taxation year [ITA 12(4), (11)]. Income earned from July 1, 20X1 to June 30, 20X2 would be included in the 20X2 taxation year. And income earned from July 1, 20X2 to June 30, 20X3 would be included in the 20X3 taxation year.

If the taxpayer is a corporation it must use the accrual method at all times. Income from July 1, 20X0 to December 31, 20X0 (assuming December 31 is the corporation's year end) would be recognized in the 20X0 taxation year [ITA 12(3)].

R7-9. Using the same rules for determining income from business it can be ascertained that a deduction for a reserve for uncollectible interest on a loan can be made. Although the general limitations prohibit the deduction of reserves, a specific exception is made for uncollectible amounts which have previously been included in income. Provided that the uncollected interest has been previously recognized as income, a reserve is permitted [ITA 20(1)(l) & (p)].

However, a reserve is not permitted for the uncollectible principal of the loan because it did not create income when it was established. If, however, it was part of the taxpayer's normal course of business to lend money, a reserve for the principal is permitted. [ITA 20(1)(l) & (p)].

R7-10. Dividends received from a corporation represent corporate earnings that have already been taxed in the corporation. In order to diminish or eliminate the incidence of double taxation, a different mechanism exists for shareholders who are individuals and who are corporations. Individuals are taxable on the receipt of dividends, but that tax is reduced by a dividend tax credit which theoretically is equal to corporate taxes paid (27.5% or 20%). Therefore, an individual includes 141% (2011) of the eligible dividend received and 125% of the non-eligible dividend received in income, which is supposed to represent the pre-tax income of the corporation that has been distributed. For example, corporate income of $125 less corporate tax of 20% ($25) leaves $100 available for a dividend distribution. The individual, on receipt of a $100 non-eligible dividend includes $125 in income, calculates personal tax, and then reduces that tax by the dividend tax credit which is equal to $25 [ITA 82(1)(a), (b), 121].

If, however, the shareholder is a corporation, double tax is avoided by removing the dividend from taxable income altogether. As there is no dividend tax credit there is no need for the gross-up. A corporation simply includes the actual dividend in net income and removes the full amount when calculating taxable income [ITA 112(1)].

R7-11. The statement is not true. A loss from real estate rentals can be used to offset other types of income. However, a rental loss cannot be created or increased by a capital cost allowance (CCA) deduction [Reg. 1100(11)]. Therefore, where expenses before CCA exceed the revenues an actual loss is recognized but the loss cannot be increased further by CCA.

R7-12. Each building that is classified as a rental property to its owners and costs more than $50,000 must be included in a separate capital cost allowance class to which no additions can be made [Reg. 1101(1ac)]. Therefore, the sale of one building combined with the purchase of another is not pooled, and the sale will result in a recapture or terminal loss unless the selling price is equal to the property's undepreciated capital cost.

All buildings owned and used directly by the owner in a business are pooled together in a single class. Therefore, the sale of one building in a pool of several buildings, or the sale of a building combined with the replacement of another, may not result in a recapture or terminal
loss. [Note that it is possible to place buildings meeting certain requirements into a separate Class 1.]

R7-13. If an investor purchases a fewer number of larger real estate properties (each costing over $50,000), the opportunity to dispose of a lower quality property in order to acquire a better quality property is diminished, because the cash available on the sale of the first property may be reduced by tax on the recapture of capital cost allowance. However, if a larger number of lower cost properties (each costing less than $50,000) are acquired, the sale of one to acquire a better quality property may defer the tax on recapture due to the fact that the properties are pooled in a single capital cost allowance class. Therefore more cash is available for replacement.

Of course, one must also consider the marketability of properties that are partly owned compared to properties that are wholly owned.

R7-14. Real estate is often referred to as a tax-sheltered investment because it permits the deduction of capital cost allowance even when it is not an actual expense and bears no relationship to economic reality. Capital cost allowance is an arbitrary allocation of a building cost which does not take into account the estimated salvage value of the property. In many cases, the sale of a building, results in substantial recapture of capital cost allowance indicating that the previous deductions of capital cost allowance were too high. Therefore, annual rental income is subject to annual reduced tax in exchange for the payment of tax at a later time (recapture). In effect, a portion of the annual rental income is sheltered from tax until the property is sold and this enhances annual cash flows.

R7-15. By separating the appreciating property from the business corporation the property becomes classified as rental property. Therefore, the normal transaction of selling a smaller building to replace it with a larger building as part of an expansion program will result in diminished cash flows from recapture of capital cost allowance, impairing the expansion capability (each rental property over $50,000 falls into a separate class).

On the other hand, this diminished cash flow could be avoided if the building were held directly in the business corporation as a business asset because the sale and replacement activities are pooled in the same class.

The replacement property rules allow a taxpayer who incurs a capital gains and/or recapture on the disposition of a former business property to elect to defer the capital gain and/or recapture to the extent that the taxpayer reinvests the proceeds in a replacement property within one year or 12 months after the end of the taxation year in which the disposal takes place [ITA 13(4); 44(1)]. The taxpayer can take advantage of these rules even if the property is held separate from the business as long as the person who owns the property is related to the entity which uses the property to carry on business. Former business property is defined in ITA 248(1) as a capital property used by the taxpayer or a related person for the purposes of earning income from a business. These rules are discussed in Chapters 6 and 8.
Key Concept Questions

QUESTION ONE

Determine the amount of interest to be included in income in Years 1, 2, and 3 for each of the following situations. *Income tax reference: ITA 12(1)(c), 12(3), (4), (11).*

- Percel Ltd. has a December 31 year end. In Year 1, Percel purchased a $10,000 bond on its issue date of November 1. The bond pays interest at 6% compounded annually. Percel will receive interest when the bond matures on October 31, Year 3.

- Debra purchased a $10,000 bond on its issue date, November 1, Year 1. The bond pays interest at 6%, compounded annually. Debra will receive the interest when the bond matures on October 31, Year 3.

QUESTION TWO

Anne received the following dividend income during the current year:

- $1,000 of eligible dividends from taxable Canadian corporations
- $1,000 of non-eligible dividends from taxable Canadian corporations
- $1,000 of foreign dividends. The foreign country withheld $150 in foreign tax and Anne received the net amount of $850.

Determine the amount of dividend income to be included in Anne’s property income for the current year. *Income tax reference: ITA 12(1)(j), (k), 82(1).*

QUESTION THREE

A Ltd. received the following dividend income during the current year:

- $1,000 of eligible dividends from a taxable Canadian corporation
- $1,000 of non-eligible dividends from a taxable Canadian corporation

Determine the amount of dividend income to be included in A’s property income for the current year. *Income tax reference: ITA 12(1)(j), 112(1).*
QUESTION FOUR

At the end of the current year, Fred owned two rental properties. Rental property #1 cost $125,000 (land $50,000; building $75,000) and at the close of last year had a UCC of $64,000. Rental property #2 was acquired in the current year for $210,000 (land $80,000; building $130,000). Revenue and expenses for the rental properties during the year were as follows:

<table>
<thead>
<tr>
<th></th>
<th>Property #1</th>
<th>Property #2</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>$13,200</td>
<td>$4,500</td>
<td>$17,700</td>
</tr>
<tr>
<td>Expenses:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mortgage interest</td>
<td>(0)</td>
<td>(3,000)</td>
<td>(3,000)</td>
</tr>
<tr>
<td>Repairs &amp; maintenance</td>
<td>(5,000)</td>
<td>(0)</td>
<td>(5,000)</td>
</tr>
<tr>
<td>Property tax</td>
<td>(3,100)</td>
<td>(1,000)</td>
<td>(4,100)</td>
</tr>
<tr>
<td>Insurance</td>
<td>(500)</td>
<td>(200)</td>
<td>(700)</td>
</tr>
<tr>
<td>Income</td>
<td>$ 4,600</td>
<td>$ 300</td>
<td>$ 4,900</td>
</tr>
</tbody>
</table>

Determine the maximum CCA deduction for the rental properties for the current year. Income tax reference: Reg. 1100(11), 1101(1ac).
Solutions to Key Concept Questions

KC 7-1

[ITA: 12(1)(c), 12(3), (4), (11) - Interest income]

In both cases $1,236 of interest will be earned and received on the maturity of the bond on October 31, Year 3.

Nov 1, Year 1 to Oct 31, Year 2 - $10,000 x 6% = $600
Nov 1, Year 2 to Oct 31, Year 3 - $10,600 x 6% = 636

$1,236

Timing of income recognition for tax purposes:

Perce Ltd.

Corporations must include interest income as it is earned on a daily basis [ITA 12(3)].

Year 1: Nov 1 to Dec 31 - $10,000 x 6% x 61/365 = $100
Year 2: Jan 1 to Oct 31 - $10,000 x 6% x 304/365 = 500
Nov 1 to Dec 31 - $10,600 x 6% x 61/365 = 106

Year 3: Jan 1 to Oct 31 - $10,600 x 6% x 304/365 = 530

$1,236

Debra

Individuals must include interest income on an annual accrual basis referred to as an anniversary day accrual [ITA 12(4)]. Interest earned to the anniversary day must be included. The first anniversary day in this case is October 31, Year 2 [ITA 12(11)]. The second anniversary day is October 31, Year 3, the maturity date in this case.

Year 1: No interest income is included as there is no anniversary day $0
Year 2: Interest earned Nov 1, Year 1 to Oct 31, Year 2 is included 600
Year 3: Interest earned Nov 1, Year 2 to Oct 31, Year 3 is included 636

$1,236

KC 7-2

[ITA: 12(1)(j), (k), 82(1) - Dividend income (Individual)]

Anne will include $3,660 of dividend income in her property income for the current year.

Eligible dividends from Canadian corporations – grossed up ($1,000 x 141%) = $1,410
Other dividends from Canadian corporations – grossed up ($1,000 x 125%) = 1,250
Dividends from foreign corporation 1,000

$3,660
### KC 7-3

[ITA: 12(1)(j), 112(1) - Dividend income (Corporation)]

A Ltd. will include $2,000 of dividend income in property income for the current year. The corporation includes the amount received [ITA 12(1)(j)]. In computing its **taxable income** the corporation will deduct the $2,000 of dividends received from taxable Canadian corporations [ITA 112(1)].

### KC 7-4

[Reg. 1100(11), 1101(1ac) - Rental income]

Two special rules apply to rental properties with respect to CCA:

- Each rental building costing $50,000 or more must be held in a separate CCA class. They cannot be pooled [Reg. 1101(1ac)].
- CCA can be deducted only to the extent that it does not create or increase a net loss from all rental properties combined [Reg. 1100(11)].

<table>
<thead>
<tr>
<th>Class 1</th>
<th>Class 1</th>
</tr>
</thead>
<tbody>
<tr>
<td>#1</td>
<td>#2</td>
</tr>
<tr>
<td>UCC, beginning of year</td>
<td>$64,000</td>
</tr>
<tr>
<td>Purchases</td>
<td></td>
</tr>
<tr>
<td>Maximum CCA available:</td>
<td>$5,160</td>
</tr>
<tr>
<td>$64,000 x 4%</td>
<td>$2,560</td>
</tr>
<tr>
<td>$130,000 x 4% x ½</td>
<td>$2,600</td>
</tr>
</tbody>
</table>

Since these are residential buildings the CCA rate is 4%. Although a maximum of $5,160 CCA is available, the maximum CCA that can be claimed is limited to $4,900, being the net rental income before CCA for the two properties, combined. The $4,900 of CCA can be claimed partly from property #1 and partly from property #2, in any proportion up to the maximum available for each class.

- Net rental income before CCA: $4,900
- CCA: $(4,900)
- Net rental income for tax purposes: $0
PROBLEM ONE

[ITA: 12(1)(c); 12(3), (4), (11)]

On April 1, 20X0, a corporation with a December 31 taxation year purchased a three-year investment certificate for $20,000. The certificate pays interest only at the end of the three-year term but is compounded annually at the rate of 10%. Currently, the corporation's marginal tax rate is 28%. However, in 20X1, the marginal tax rate will increase to 25%.

An individual makes the identical investment on April 1, 20X0. The individual’s marginal tax rate in 20X0 is also 28% and is expected to rise to 25% in 20X1.

Required:

Calculate and compare the tax on the interest income for the three-year period for the individual and the corporation.
Solution to P 7-1

The actual interest income earned on the investment certificate is:

<table>
<thead>
<tr>
<th>Year</th>
<th>Interest Rate</th>
<th>Principal</th>
<th>Interest Earned</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>10%</td>
<td>$20,000</td>
<td>$2,000</td>
</tr>
<tr>
<td>Year 2</td>
<td>10%</td>
<td>$22,000</td>
<td>2,200</td>
</tr>
<tr>
<td>Year 3</td>
<td>10%</td>
<td>$24,200</td>
<td>2,420</td>
</tr>
</tbody>
</table>

$6,620

The Individual:

The individual can use the cash method or the receivable method, subject to the overriding anniversary day accrual rules. The receivable method would normally recognize the interest when it is due and payable at the end of the three year term. Similarly the cash method (if paid on time) would require recognition at the end of three years. However, both the receivable and cash method are constrained by the anniversary day accrual method which requires that interest on an investment must be recognized at least every year from the date of issue [ITA 12(4), 12(1)(c), 12(11)].

The actual payment of interest occurs at the same time under each alternative however, the amount and timing of tax payments are different.

Tax payments under the anniversary day accrual method:

<table>
<thead>
<tr>
<th>Income</th>
<th>Tax Rate</th>
<th>Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>20X1</td>
<td>2,000</td>
<td>25%</td>
</tr>
<tr>
<td>20X2</td>
<td>2,200</td>
<td>25%</td>
</tr>
<tr>
<td>20X3</td>
<td>2,420</td>
<td>25%</td>
</tr>
<tr>
<td>TOTAL TAX</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The Corporation:

The corporation must use the standard accrual method to recognize interest income [ITA 12(3)].

Tax payments under the accrual method:

<table>
<thead>
<tr>
<th>Income</th>
<th>Tax Rate</th>
<th>Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X0</td>
<td>275/365 x $2,000 = $1,507</td>
<td>28%</td>
</tr>
<tr>
<td>20X1</td>
<td>90/365 x $2,000 = $493</td>
<td>275/365 x $2,200 = 1,658</td>
</tr>
<tr>
<td>20X2</td>
<td>90/365 x $2,200 = $542</td>
<td>275/365 x $2,420 = 1,823</td>
</tr>
<tr>
<td>20X3</td>
<td>90/365 x $2,420 = $597</td>
<td>25%</td>
</tr>
<tr>
<td>TOTAL TAX</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
The timing and amounts of tax payments are compared below:

<table>
<thead>
<tr>
<th></th>
<th>Corporation</th>
<th>Individual</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X0</td>
<td>$ 422</td>
<td>$ 0</td>
</tr>
<tr>
<td>20X1</td>
<td>538</td>
<td>500</td>
</tr>
<tr>
<td>20X2</td>
<td>591</td>
<td>550</td>
</tr>
<tr>
<td>20X3</td>
<td>149</td>
<td>605</td>
</tr>
<tr>
<td></td>
<td><strong>$1,700</strong></td>
<td><strong>$1,655</strong></td>
</tr>
</tbody>
</table>
PROBLEM TWO

[ITA: 5(1); 8(1)(m); 12(1)(c), (j), (k), (l); 12(4), (11); 13(1), (21); 20(1)(a), (c), (e), (e.1), (bb); 74.1(2); 82(1)(a), (b); Reg 1101(1ac)]

Ken Potman is the sole shareholder in Brickbase Enterprises Ltd., a Regina-based construction company. In addition, Potman is a 25% partner in a retail kitchenware store, although he does not actively participate in its management. The following information relates to Potman’s financial affairs for the year 20X1:

1. Brickbase was organized three years ago. For its year ending May 31, 20X1, the company earned a profit of $88,000. Potman originally contributed $200,000 to the corporation, using $50,000 of his own savings and funding the balance with a loan. In return, the corporation issued Potman $1,000 worth of common shares and $199,000 of preferred shares. In 20X1, the company declared a dividend of $12,000 on the preferred shares. All of Brickbase’s income is subject to the small business deduction.

2. During the year, Potman sold a warehouse property for $180,000 (land $15,000, building $165,000). The building was used by Brickbase to store construction equipment, and the company paid Potman a fair rental for use of the property. The property was originally purchased at a cost of $140,000 (land $10,000, building $130,000).

At the end of 20X0 the building had an undepreciated capital cost of $110,000. Simultaneously with the sale, Potman purchased a larger warehouse property (constructed after March 18, 2007), which was also rented to Brickbase. The new property cost $400,000 (land $50,000, building $350,000). During the year, the company paid Potman net rents of $30,000 for both properties. The new property was financed with the proceeds from the sale of the old building as well as mortgage financing.

3. The retail store partnership earned $40,000 for its year ending December 31, 20X1. The profit consisted of a $32,000 profit from operations and $8,000 of interest income earned on excess undistributed cash deposits.

4. Potman’s other cash receipts and disbursements for 20X1 are shown in the table below.

5. On July 1 of the previous year, Potman purchased a four-year guaranteed investment certificate for $30,000 that bears interest at 10%. The interest compounds annually but is not payable until the end of the four-year term. Potman did not include any amount of interest in his previous year’s income.

6. During the year, one of the Canadian public corporations of which Potman is a shareholder issued him 100 additional shares as a stock dividend. The shares had a stated value of $40 per share. Potman placed the shares in his safety deposit box along with his other securities.
Receipts:

- Salary from Brickbase: $62,000
- Dividends from Canadian public corporations: 6,000
- Dividends from foreign public corporations (net of 10% foreign withholding tax): 9,000
- Winnings from provincial lottery: 2,000
- Interest on a loan to his daughter: 1,000

Disbursements:

- Contribution to Brickbase employee pension plan: 3,000
- Investment counsel fees: 1,000
- Legal fees for registering mortgage on new warehouse: 5,000
- Life insurance premium on policy required as collateral for the bank loan used to purchase Brickbase shares: 1,000
- Interest on warehouse building mortgage: 21,000
- Interest paid on house mortgage (The house mortgage is $100,000, of which $70,000 was used to acquire the house. The balance was used to purchase public corporation shares.): 10,000
- Interest on bank loan (re: Brickbase shares): 15,000
- Donations to local charity: 4,000
- Safety deposit box fees: 100

Required:

Determine separately, for the year 20X1, Potman’s income for tax purposes from employment, business, and property.
Solution to P 7-2

Property income:

<table>
<thead>
<tr>
<th>Interest</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Share of interest earned by partnership</td>
<td>$2,000</td>
</tr>
<tr>
<td>(25% of $8,000) [ITA 12(1)(l)]</td>
<td></td>
</tr>
<tr>
<td>Interest from daughter [ITA 12(1)(c), 74.1(2)]</td>
<td>1,000</td>
</tr>
<tr>
<td>Investment certificate (note 1)</td>
<td>3,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Dividends [ITA 12(j), (k), 82(1)]</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stock dividend ($40 x 100 = $4,000 x 141% (2011))</td>
<td>$5,640</td>
</tr>
<tr>
<td>Brickbase Enterprises ($12,000 x 125%)</td>
<td>15,000</td>
</tr>
<tr>
<td>Canadian public corporations ($6,000 x 141% (2011))</td>
<td>8,460</td>
</tr>
<tr>
<td>Foreign dividends ($9,000 + tax of $1,000)</td>
<td>10,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Less:</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest on bank loan [ITA 20(1)(c)]</td>
<td>15,000</td>
</tr>
<tr>
<td>Interest on house mortgage [ITA 20(1)(c)]</td>
<td>(3,000)</td>
</tr>
<tr>
<td>Life insurance – collateral on Brickbase shares fully deductible [ITA 20(1)(e.2)]</td>
<td>(1,000)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Rental</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rental Income</td>
<td>$30,000</td>
</tr>
<tr>
<td>Recapture on sale of warehouse ($130,000 - $110,000) Note 2</td>
<td>20,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Deduct:</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest on mortgage</td>
<td>21,000</td>
</tr>
<tr>
<td>CCA ($350,000 x .06 x 1/2) *</td>
<td>10,500</td>
</tr>
<tr>
<td>Legal fees to register mortgage (cost of arranging financing 1/5 of $5,000) [ITA 20(1)(e)]</td>
<td>(1,000)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Deduct</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Safety deposit box</td>
<td>(100)</td>
</tr>
<tr>
<td>Investment counsel fees [ITA 20(1)(bb)]</td>
<td>(1,000)</td>
</tr>
</tbody>
</table>

**NET INCOME FROM PROPERTY**          **$42,500**

* Non-residential buildings built after March 18, 2007 qualify for an additional allowance of 2% increasing the CCA rate to 6%. To receive the additional allowance the taxpayer must elect to place the building in a separate Class 1.

**Note 1**

Investment certificate - No interest is paid until the end of four years. The annual accrual method requires that interest be recognized on each one year anniversary date. In this case one year of interest must be recognized by June 30, 20X1 -10% of $30,000 = $3,000 [ITA 12(4)].
Note 2
Sale of Building and CCA - The warehouse building although used by Brickbase Enterprises to conduct its business is, nevertheless, a rental property to Potman who rents it to the corporation. The building falls into a separate CCA class [Reg. 1101(1ac)] and therefore results in a recapture on sale even though another building was acquired in the same year.

Old building:

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>UCC</td>
<td>$110,000</td>
</tr>
<tr>
<td>Sale ($165,000 - credit pool</td>
<td>($130,000)</td>
</tr>
<tr>
<td>With original cost of $130,000</td>
<td>(130,000)</td>
</tr>
<tr>
<td>Recapture [ITA 13(1)]</td>
<td>$(20,000)</td>
</tr>
</tbody>
</table>

New building:

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Addition [ITA 13(21)]</td>
<td>$350,000</td>
</tr>
<tr>
<td>CCA 20X1 ($350,000 x .06 x ½)</td>
<td>(10,500)</td>
</tr>
<tr>
<td>UCC</td>
<td>$339,500</td>
</tr>
</tbody>
</table>

In addition, the sale of the property will result in capital gains on the land and building to the extent the selling price exceeds the cost. These gains are not part of property income.

The replacement property rules allow a taxpayer who incurs a capital gains and/or recapture on the disposition of a former business property to elect to defer the capital gain and/or recapture to the extent that the taxpayer reinvests the proceeds in a replacement property within one year or 12 months after the end of the taxation year in which the disposal takes place [ITA 13(4); 44(1)]. The taxpayer can take advantage of these rules even if the property is held separate from the business as long as the person who owns the property is related to the entity which uses the property to carry on business. Former business property is defined in S.248(1) as a capital property used by the taxpayer or a related person for the purposes of earning income from a business.

In this case, the credit to the UCC for the disposal of the old building would be reduced by the lesser of the recapture ($20,000) and the cost of the new building ($350,000). Thus, $110,000 - $110,000 = Nil recapture. The capital cost of the new building is reduced by the $20,000 of deferred recapture.

These rules are discussed in Chapters 6 and 8.

Employment income:

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salary [ITA 5(1)]</td>
<td>$62,000</td>
</tr>
<tr>
<td>Less: Contribution to pension plan [ITA 8(1)(m)]</td>
<td>(3,000)</td>
</tr>
<tr>
<td>Net employment income</td>
<td>$59,000</td>
</tr>
</tbody>
</table>

Business income:

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Share of partnership profits [ITA 12(1)(l)]</td>
<td></td>
</tr>
<tr>
<td>Total profits</td>
<td>$40,000</td>
</tr>
<tr>
<td>Business income</td>
<td>32,000</td>
</tr>
</tbody>
</table>

Potman's share -- 25% of $32,000 = $8,000
PROBLEM THREE

[ITA: 13(1); 20(1)(a); 45(1); Reg. 1100(11); 1101(1ac)]

Anne Osinski acquired a townhouse unit in 20X0 for $120,000 (land $10,000, building $110,000). She bought the unit in order to rent it. By the end of 20X2, the undepreciated capital cost of the building was $103,500. In August 20X3, Osinski decided to live in the unit herself. At that time, similar townhouses were selling for $136,000 (land $12,000, building $124,000). Prior to August, her 20X3 net rental income before capital cost allowance was $1,000.

In September 20X3, Osinski purchased, for rental purposes, a residential condominium unit for $145,000 (land $15,000, building $130,000). Between September and the end of the taxation year, the condo earned net rentals of $900 before capital cost allowance.

Required:

Determine the change to Osinski’s 20X3 net income for tax purposes as a result of the above activity.
Solution to P 7-3

The change in use of the townhouse from investment to personal use, results in a deemed disposition at fair market value [ITA 45(1)].

Her net income for tax purposes is:

Rental income:

- Rents – townhouse $1,000
- Rents – condo 900
- Recapture of CCA on deemed disposition of the townhouse ($110,000 - $103,500) [ITA 13(1)] 6,500

Rental income before CCA 8,400

- Less CCA on condo (Class 1) $130,000 x 4% x 1/2 (2,600)

Net rental income 5,800

Capital gains:

- Building ($124,000 - $110,000) ½ $7,000
- Land ($12,000 - $10,000) ½ 1,000 8,000

Net Income $13,800

Note:
The new condo falls into a separate CCA class because its cost is greater than $50,000 [Reg. 1101(1ac)]. It does not qualify for the additional 2% CCA since it is a residential building. Also, note that the recapture is considered to be rental income and its inclusion increases the rental income to a level that permits the CCA to be claimed [Reg. 1100(11)].
PROBLEM FOUR

[ITA: 13(1); 20(1)(a); Reg. 1100(11); 1101(1ac)]

After receiving an inheritance, Sandra Yaworski decided to invest her newly acquired funds in real estate. In 20X1, she purchased the following properties:

<table>
<thead>
<tr>
<th>Property</th>
<th>Land</th>
<th>Building</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$10,000</td>
<td>$40,000</td>
<td>$50,000</td>
</tr>
<tr>
<td>2</td>
<td>12,000</td>
<td>45,000</td>
<td>57,000</td>
</tr>
<tr>
<td>3</td>
<td>20,000</td>
<td>80,000</td>
<td>100,000</td>
</tr>
<tr>
<td>4</td>
<td>30,000</td>
<td>100,000</td>
<td>130,000</td>
</tr>
</tbody>
</table>

Each of the properties is a residential condominium unit, and each unit is part of a separate condominium high-rise project. Not all of the units were fully rented during the year of acquisition, and Yaworski determined that her net rental position (before capital cost allowance) for each of the properties was as follows for 20X1:

<table>
<thead>
<tr>
<th>Property</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rent revenue</td>
<td>$4,000</td>
<td>$5,000</td>
<td>$7,000</td>
<td>$12,000</td>
<td>$28,000</td>
</tr>
<tr>
<td>Expenses*</td>
<td>(6,000)</td>
<td>(3,000)</td>
<td>(6,000)</td>
<td>(9,000)</td>
<td>(24,000)</td>
</tr>
<tr>
<td>Income (loss)</td>
<td>($2,000)</td>
<td>$2,000</td>
<td>$1,000</td>
<td>$3,000</td>
<td>$4,000</td>
</tr>
</tbody>
</table>

* Property taxes, insurance, interest, maintenance.

In 20X2, one of Yaworski’s close relatives ran into financial difficulty, and she was forced to sell two of the properties in order to provide financial assistance. She sold property 1 for $52,000 (land $12,000, building $40,000) and property 3 for $110,000 (land $24,000, building $86,000). In 20X2, the four properties (including the two sold properties to the date of sale) earned net rental income of $7,000.

**Required:**

Determine Yaworski’s net income from property from the rental properties for 20X1 and 20X2.
Solution to P 7-4

For capital cost allowance purposes buildings 1 and 2 are pooled together because their cost is less than $50,000. Buildings #3 and #4 fall into separate pools [Reg. 1101(1ac)].

The maximum available capital cost allowance in 20X1 is as follows:

<table>
<thead>
<tr>
<th>Class 1</th>
<th>Pool</th>
<th>A</th>
<th>B</th>
<th>C</th>
</tr>
</thead>
<tbody>
<tr>
<td>Building 1</td>
<td>$40,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>45,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>$80,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4</td>
<td></td>
<td></td>
<td></td>
<td>$100,000</td>
</tr>
<tr>
<td></td>
<td>$85,000</td>
<td>$80,000</td>
<td>$100,000</td>
<td></td>
</tr>
</tbody>
</table>

CCA available - 4% x ½

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>C</th>
</tr>
</thead>
<tbody>
<tr>
<td>$1,700</td>
<td>$1,600</td>
<td>$2,000</td>
<td></td>
</tr>
<tr>
<td>TOTAL</td>
<td>$5,300</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The 20X1 rental income for tax purposes is as follows:

Net rentals before CCA from all four properties ($28,000 - $24,000) $4,000
Less capital cost allowance
Available -- $5,300
Maximum permitted [Reg. 1100(11)] (4,000)
Net rental income $ 0

Note that these buildings do not qualify for the additional 2% allowance for buildings acquired after March 18, 2007 since they are residential buildings.

The limited capital cost allowance of $4,000 must be allocated among the pools, subject to the maximum available to each pool. The taxpayer must choose the allocation. Without the benefit of hindsight (i.e., knowing when and which properties may be sold) it is difficult to plan the best strategy. One possible option is to claim the maximum CCA from a pool which holds several assets (e.g., Pool A) because a sale of one property would not likely create a recapture whereas single asset pools always create recapture.

Using this principle, CCA is applied first to Pool A, then to Pool B and finally to Pool C until the limit of $4,000 is reached.
This results in the following effect on the CCA pools in 20X1 and 20X2:

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>C</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X1</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Opening UCC</td>
<td>$85,000</td>
<td>$80,000</td>
<td>$100,000</td>
<td></td>
</tr>
<tr>
<td>20X1 CCA</td>
<td>(1,700)</td>
<td>(1,600)</td>
<td>(700)</td>
<td>$(4,000)</td>
</tr>
<tr>
<td>UCC</td>
<td>83,300</td>
<td>78,400</td>
<td>99,300</td>
<td></td>
</tr>
<tr>
<td>20X2</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sales</td>
<td>(40,000)</td>
<td>(80,000)</td>
<td>-</td>
<td>$43,300</td>
</tr>
<tr>
<td></td>
<td>$43,300</td>
<td>(1,600)</td>
<td>99,300</td>
<td></td>
</tr>
<tr>
<td>Recapture</td>
<td>1,600</td>
<td></td>
<td></td>
<td>$1,600</td>
</tr>
<tr>
<td>CCA 4%</td>
<td>(1,732)</td>
<td>(3,972)</td>
<td>$5,704</td>
<td></td>
</tr>
<tr>
<td></td>
<td>$41,568</td>
<td>$0</td>
<td>$95,328</td>
<td></td>
</tr>
</tbody>
</table>

20X2 net rental:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Net rentals before CCA</td>
<td>$7,000</td>
</tr>
<tr>
<td>Recapture of capital cost allowance</td>
<td>1,600</td>
</tr>
<tr>
<td><strong>INCOME BEFORE CCA</strong></td>
<td>$8,600</td>
</tr>
<tr>
<td>20X2 CCA</td>
<td>(5,704)</td>
</tr>
<tr>
<td><strong>NET RENTAL INCOME</strong></td>
<td>$2,896</td>
</tr>
</tbody>
</table>

The allocation of capital cost allowance to the three pools was not totally satisfactory. No recapture occurred in Pool A. However, Pool B which holds property #3 resulted in full recapture. Notice that Pool B claimed full CCA in 20X1 whereas Pool C was reduced to $700 (from the maximum available of $2,000). Much of the recapture could have been avoided if Pool C claimed full CCA in 20X1 and Pool B was reduced. Unfortunately, information was not available to make that decision. The decision-maker could have considered reducing both pools by a similar amount rather than forcing the limitation on only one pool. This would have spread the risk from not knowing which property might be sold first.
PROBLEM FIVE

[ITA: 20(1)(c)]

Toshiaki Minamiyama is a successful business executive. Over the years, he has allocated a portion of his large salary to the building of an investment portfolio. He currently has a net worth of $800,000 (exclusive of retirement plans), as follows:

Personal assets:
- Automobiles $ 30,000
- Sailboat 29,000
- House 220,000

Investment assets:
- Corporate and government bonds (average interest return—10%) 200,000
- Common shares of public corporations 306,000
- Rental real estate 360,000

Total Investment assets = 1,145,000

Liabilities:
- First mortgage on house (interest at 9%) $(150,000)
- Term financing on sailboat (12%) $(15,000)
- First mortgage on rental real estate (10%) $(180,000)

Net worth $ 800,000

Minamiyama seldom trades his investments, as his strategy is to hold various types of investments for a long time in order to delay any tax that may occur on their disposition. (He is in the 45% tax bracket.) In fact, he chose not to dispose of any investments when he needed money to purchase his house and sailboat.

Required:

From a tax planning perspective, what would you recommend he do in order to enhance his wealth accumulation? If possible, quantify how he would benefit from your recommendations, assuming a five-year time period.
Solution to P 7-5

Minamiyama has a substantial amount of investment income and is subject to high marginal tax rates. In addition, he has outstanding debt, from which a large portion of the interest is not deductible because the loans were made to acquire personal property and are not for the purpose of earning income.

If, for example, the bond investment which earns taxable interest income is compared to the personal debt which incurs non-deductible interest the following analysis can be made:

| Investment in Bonds | $200,000 |
| Less interest bearing debt | |
| House mortgage | $(150,000) |
| Sailboat debt | (15,000) | 165,000 |
| Net equity | $35,000 |

The net equity results in the following annual cash flow:

| Interest income ($200,000 @ 10%) | $20,000 |
| Less tax @ 45% | (9,000) |
| Net cash inflow | 11,000 |
| Interest expense (not deductible) | |
| House $150,000 @ 9% | $(13,500) |
| Boat $15,000 @ 12% | (1,800) | (15,300) |
| NET CASH COST | $(4,300) |

Therefore equity of $35,000 actually results in an annual after-tax cash loss of $4,300.

If $165,000 of bonds were liquidated (leaving bonds of 35,000) and used to pay off the personal debt, the annual after-tax cash flow would be a positive amount of $1,925 as follows:

| Interest income $35,000 @ 10% | $3,500 |
| less tax @ 45% | (1,575) |
| Interest expense | 0 |
| NET CASH INFLOW | $1,925 |

Annual cash flow, after-tax, would increase by $6,225 (i.e., from a loss of $4,300 to a gain of $1,925 = $6,225). If this annual income is reinvested in corporate bonds yielding 10% (5.5% after-tax; 10% - 45% tax = 5.5%) the series of annual payments would compound to $36,653 after five years ($6,225 for 5y @ 5.5%).
In addition, a further wealth enhancement could be achieved if, shortly after the house mortgage was paid off, a new mortgage of $165,000 was taken out at the same rate of 9% but used to purchase new bonds yielding 10%. Because the mortgage funds are now used to generate income, the interest would be deductible and a further annual cash gain of $908 could be achieved as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>New bond interest income:</td>
<td>$16,500</td>
</tr>
<tr>
<td>10% of $165,000</td>
<td></td>
</tr>
<tr>
<td>Less deductible interest expense</td>
<td></td>
</tr>
<tr>
<td>9% of $165,000</td>
<td>(14,850)</td>
</tr>
<tr>
<td>Less tax @ 45%</td>
<td>(742)</td>
</tr>
<tr>
<td><strong>NET CASH GAIN</strong></td>
<td><strong>$ 908</strong></td>
</tr>
</tbody>
</table>

After five years the $908 annual cash flow would accumulate to an additional $5,436, resulting in a total wealth enhancement of $42,089 ($36,653 + $5,436).
PROBLEM SIX

[ITA: 13(1); 20(1)(a); Reg. 1101(1ac)]

Quantro Enterprises Ltd. and Baizley Holdings Ltd. (BHL) are both 100% owned by Harold Baizley. Both companies are Canadian-controlled private corporations. Quantro operates a wholesale business and pays rent to BHL for the use of a warehouse property.

BHL owns only one asset—the warehouse building and related land that is rented by Quantro for $36,000 per year. The property was originally owned by Quantro but was sold to BHL several years ago as a means to reduce the risk exposure of this appreciating asset.

On December 31, 20X1 (the year end of both companies), BHL sold the warehouse property to a third party for $370,000 (land $40,000, building $330,000). The property originally cost $320,000 (land $25,000, building $295,000). The undepreciated capital cost of the building at December 31, 20X0, was $254,000.

One month before selling the warehouse property, BHL purchased a newly constructed warehouse property for $480,000 (land $50,000, building $430,000).

Required:

Determine BHL’s net income for tax purposes for 20X1.
Solution to P 7-6

The warehouse is considered to be a rental property. Therefore, the new property acquired must be placed in a separate Class 1, since it cost more than $50,000 [ITA 1101(lac)].

Income:
Rent $36,000
Recapture of CCA ($295,000 - $254,000) 41,000
77,000
Less CCA on new warehouse
$430,000 x 6% x ½ * (12,900)
(12,900)
64,100
Taxable capital gains:
Building ($330,000 - $295,000) ½ $17,500
Land ($40,000 - $25,000) ½ 7,500 25,000
$89,100

* Non-residential buildings acquired after March 18, 2007 and placed in a separate class have a CCA rate of 6% (other than buildings that were used by any person or partnership prior to March 19, 2007).

Former business property is defined in ITA 248(1) as a capital property used by the taxpayer or a related person for the purposes of earning income from a business. Since the warehouse owned by BHL is used by Quantro (a related person) in its wholesale business, it qualifies as a former business property. Thus, BHL can elect under ITA 44(1) and ITA 13(4) to defer recognition of the capital gain and recapture on the sale of the old warehouse.
PROBLEM SEVEN

[ITA: 9(1); 12(1)(c), (j), (k), (l), 18(1)(a), (b); 20(1)(a), (e), (n), (aa); Reg. 1100(11)]

Sally Corbet is the sole shareholder of Corbet Holdings Ltd. (CHL), a Canadian-controlled private corporation. The corporation holds investments in shares, bonds, and real estate. You have been retained to complete CHL’s tax return for the year ended December 31, 20X2, and provide certain other tax advice.

It is now February 15, 20X3, and you have gathered the information outlined below.

1. The draft income statement for the year ended December 31, 20X2, is as follows:

   Income
   Interest on bonds and certificates $ 78,000
   Dividend income 32,000
   Net loss from real estate rentals (19,000)
   Gain on sale of land (Pelican Lake) 170,000
   Share of profits of Pantry Products Ltd. 120,000
   **381,000**

   Expenses
   Legal fees for general corporate affairs $ 1,000
   Director’s fees 21,000
   Donations—charitable 8,000 (30,000)
   **381,000**

2. CHL owns a 40% interest in Delroy (a partnership), which has a June 30, 20X2, year end. The partnership’s profit for the year was $200,000, which consisted of dividends from taxable Canadian corporations of $80,000 and royalties from mineral rights of $120,000. On December 31, 20X2, CHL received $100,000 as its share of a partnership cash distribution. The partnership’s results are not reflected in the above income statement.

3. On September 30, 20X2, CHL purchased a $100,000 guaranteed investment certificate bearing 9% interest. The company intends to record the interest of $9,000 on September 30, 20X3, its one-year anniversary date.

4. The dividend income of $34,000 consists of the following:

   Canadian Public corporations $16,000
   Turner Inc.—an American corporation—net of a 10% U.S. withholding tax 18,000

   Not included in the above is a dividend received from Pantry Products Ltd. of $25,000. CHL owns 50% of its voting shares and records the investment using the equity method of accounting. Pantry earned business income of $240,000 in the current year.

5. During the year, CHL received 100 shares of Mustang Ltd. (a public corporation) as a stock dividend. Mustang increased its paid-up capital by $30 for each stock dividend share issued. CHL did not record the receipt of the stock dividend.
6. In January 20X2, CHL purchased three hectares of land at Pelican Lake for $130,000. The land was then rezoned and subdivided into six building lots. The entire subdivision was immediately sold to a building contractor for $300,000. The payment terms called for no cash down, but payments of $50,000 are required as the contractor completes construction on each lot. By December 31, 20X2, one payment of $50,000 had been received.

7. In 20X1, CHL had purchased two rental properties as follows:

<table>
<thead>
<tr>
<th></th>
<th>Land</th>
<th>Building</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fourplex</td>
<td>$50,000</td>
<td>$150,000</td>
<td>$200,000</td>
</tr>
<tr>
<td>Townhouse 1</td>
<td>20,000</td>
<td>40,000</td>
<td>60,000</td>
</tr>
<tr>
<td></td>
<td>$70,000</td>
<td>$190,000</td>
<td>$260,000</td>
</tr>
</tbody>
</table>

Maximum capital cost allowance was claimed in 20X1.

In 20X2, townhouse 1 was sold for $75,000 (land $25,000, building $50,000).

On December 1, 20X2, CHL purchased townhouse 2 for $50,000 (land $11,000, building $39,000). Also, in 20X2, CHL constructed a sixplex rental unit for $437,000, as follows:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>$ 80,000</td>
</tr>
<tr>
<td>Permanent landscaping</td>
<td>8,000</td>
</tr>
<tr>
<td>Labour and materials</td>
<td>300,000</td>
</tr>
<tr>
<td>Air-conditioning and heating equipment</td>
<td>49,000</td>
</tr>
<tr>
<td></td>
<td>$437,000</td>
</tr>
</tbody>
</table>

All of the properties resulted in a net rental loss of $19,000 (as shown on the financial statement). The following items are included in the net loss calculation:

<table>
<thead>
<tr>
<th>Cost</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of surveying land (new sixplex)</td>
<td>$ 2,400</td>
</tr>
<tr>
<td>Amortization/depreciation</td>
<td>28,000</td>
</tr>
<tr>
<td>Legal fees for mortgage (new sixplex)</td>
<td>2,000</td>
</tr>
<tr>
<td>Advertising for new tenants</td>
<td>4,000</td>
</tr>
</tbody>
</table>

Required:

Determine CHL’s net income for tax purposes for the 20X2 taxation year. Also, prepare a breakdown of the net income for tax purposes showing the net income from property and any other sources of income. Assume all rental properties are residential properties.
Solution to P 7-7

Net income for tax purposes (20X2):
Net income per financial statements [ITA 9(1)] $351,000
Donations [ITA 18(1)(a)] 8,000
Gain on sale of land (Pelican Lake) [ITA 18(1)(b)] (170,000)
Sale of subdivided land is business income:
  Gain (300,000 - 130,000) $170,000
  Reserve 250,000/300,000 x 170,000 [ITA 20(1)(n)] (141,667) 28,333
Share of profits of Pantry Products Ltd.
  - separate corporation (120,000)
Dividend from Pantry [ITA 12(1)(jj)] 25,000
Share of partnership profit [ITA 12(1)(l)]
  (80,000 x 40%) - dividend income 32,000
  (120,000 x 40%) - royalty income 48,000
Interest on GIC (9,000 x 3/12) [ITA 12(1)(c)] 2,250
Additional dividend on US shares [ITA 12(1)(k)]
  - foreign tax withheld 2,000
Stock dividend (100 @ $30) [ITA 248(1)] 3,000
Rental loss (see note below) 19,000
Taxable capital gain on Townhouse #1:
  land and building (75,000 – 60,000)/2 7,500
Net income for tax purposes $236,083

Note (rental properties):
  Rental loss reported $(19,000)
  Landscaping included in capital costs [ITA 20(1)(aa)] (8,000)
  Cost of surveying land (add to land cost) [ITA 18(1)(b)] 2,400
  Amortization [ITA 18(1)(b)] 28,000
  Cost of financing mortgage (legal) [ITA 20(1)(e)]
    (1/5 deductible annually) 4/5 x 2,000 1,600
Income before CCA 5,000
CCA limited to net rental income [Reg.1100(11)] (5,000)

Rental income $0

CCA Schedule:

<table>
<thead>
<tr>
<th>Class</th>
<th>20X1</th>
<th>20X1 CCA 4%</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$150,000</td>
<td>$40,000</td>
</tr>
<tr>
<td>1</td>
<td>(3,000)</td>
<td>(800)</td>
</tr>
<tr>
<td></td>
<td>147,000</td>
<td>39,200</td>
</tr>
</tbody>
</table>

Purchase Townhouse #2 39,000
Constructed sixplex *349,000
Sale: townhouse #1
  147,000 38,200 *349,000
Maximum CCA (4%)*
  (5,880) (1,528) (6,980)

* Cost includes labour and materials of $300,000 plus the cost of air conditioning and heating equipment. CCA is - $349,000 x 4% x 1/2 = $6,980. Residential properties are not eligible for the 6% CCA rate.
Note that where costs of surveying land are incurred as part of the investigation of a site to determine whether the land is physically suited for the planned building and the building is intended for use in a business carried on by the taxpayer, the surveying costs are deductible in the year paid [ITA 20(1)(dd); IT-350R].

**Breakdown of net income for tax purposes:**

The net income for tax purposes includes property income, business income and taxable capital gains. General administrative expenses of $1,000 for legal and $21,000 for directors’ fees should be apportioned between the business income and the property income proportionately.

The property income *before* the administrative expenses is as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net income for tax purposes</td>
<td>$236,083</td>
</tr>
<tr>
<td>Add - administrative expenses</td>
<td></td>
</tr>
<tr>
<td>($1,000 + $21,000)</td>
<td>22,000</td>
</tr>
<tr>
<td>Deduct:</td>
<td></td>
</tr>
<tr>
<td>Business income - land sale</td>
<td>(28,333)</td>
</tr>
<tr>
<td>Taxable capital gain</td>
<td>(7,500)</td>
</tr>
<tr>
<td>Property income</td>
<td>$222,250</td>
</tr>
</tbody>
</table>

The breakdown of net income for tax purposes is:

**Business income:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land sale</td>
<td>$28,333</td>
</tr>
<tr>
<td>less administrative expense</td>
<td></td>
</tr>
<tr>
<td>(22,000 x 28,333 / (28,333 + 222,250))</td>
<td>(2,488)</td>
</tr>
</tbody>
</table>

**Property income:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Above</td>
<td>$222,250</td>
</tr>
<tr>
<td>Less administrative expense</td>
<td></td>
</tr>
<tr>
<td>(22,000 x 222,250 / (28,333 + 222,250))</td>
<td>(19,512)</td>
</tr>
</tbody>
</table>

**Taxable capital gain**

<table>
<thead>
<tr>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>7,500</td>
</tr>
</tbody>
</table>

$236,083
PROBLEM EIGHT

[ITA: 3; 5(1); 6(1)(b), (f); 8(1)(h.1), (j); 12(1)(c), (l), 12(4); 13(7)(g); 20(1)(a), (bb); 60(i); 82(1); Reg. 1100(2.5); 1100(11); 1101(1af); 7307]

Carol Wong is the president and major shareholder of CW Ltd., a Canadian-controlled private corporation that operates a construction business in Regina, Saskatchewan. CW earns only business income which is all subject to the small business deduction.

In 20X7, she had a number of financial transactions. She has asked you to help her prepare her 20X7 tax return and provide advice on other tax matters. The following additional financial information is provided:

1. Wong’s 20X7 gross salary was $90,000, from which CW Ltd. deducted the following amounts:

   - Income tax $30,000
   - CPP and EI premiums $3,004
   - Private health insurance premiums $600
   - Group sickness and accident insurance premiums $400

   In addition to her salary, CW Ltd. paid $2,000 to a deferred profit-sharing plan, $600 of private health insurance premiums, and $400 of group sickness and accident insurance premiums on Wong’s behalf.

2. Wong is required to use her own automobile for company business. For this, CW Ltd. pays her an annual allowance of $3,600. In 20X7, Wong incurred automobile operating costs of $5,200. Also, in 20X7, she purchased a new automobile for $34,000 plus HST, and received $18,000 as a trade on her old car. At the end of the previous year, the old car had an undepreciated capital cost allowance balance of $15,000 (class 10.1). Of the 20,000 kilometres driven in 20X7, 12,000 were for employment purposes.

3. For three months in 20X7, Wong was sick and could not attend work. She received $9,000 from the company’s group sickness and accident insurance plan. Since the plan’s inception, Wong had paid premiums totalling $2,000.

4. During 20X7, Wong purchased a warehouse property and leased it to CW Ltd. to store construction equipment. The property cost $250,000 (land 30,000, building 220,000). The building was constructed after March 18, 2007. The price for the land includes $2,000 of permanent landscaping completed just after acquisition. The 20X7 rental income is summarized below.

   Rent received $20,000
   Expenses:
     Insurance 1,200
     Property taxes 4,000
     Interest 10,000
   Repairs:
     General maintenance 800
     Storage shed addition 3,000 (19,000)
   Income $1,000
5. Wong is a 30% partner in a computer software business but is not active in its management. The partnership financial statement shows a profit of $40,000 for the year ended December 31, 20X7. The profit consists of $32,000 from software sales and $8,000 from interest earned.

6. On July 1, 20X6, Wong purchased a three-year guaranteed investment certificate for $20,000 with interest at 10%. The interest compounds annually but is not payable until July 1, 20X9.

7. Wong received (made) the following additional receipts (disbursements) in 20X7:

**Receipts:**
- Dividends (Eligible) from Canadian public corporations $2,000
- Dividends (Non-eligible) from CW Ltd. 3,000
- Dividends from foreign corporations (net of 10% foreign tax) 900
- Winnings from a provincial lottery 12,000

**Disbursements:**
- Contribution to RRSP (within allowable limits) 10,000
- Dental expenses for children 3,500
- Donation to a charity 2,000
- Safety deposit box 100
- Life insurance premium used as collateral for personal bank loan 800
- Investment counsel fees 1,000

**Required:**

Determine Wong’s minimum net income for tax purposes in accordance with the aggregating formula of section 3 of the *Income Tax Act*. 
Solution to P 7-8

Net income for tax purposes:

Employment income:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salary [ITA 5(1)]</td>
<td>$ 90,000</td>
</tr>
<tr>
<td>Group sickness benefit ($9,000 - $2,000) [ITA 6(1)(f)]</td>
<td>7,000</td>
</tr>
<tr>
<td>Automobile allowance (unreasonably low) [ITA 6(1)(b)]</td>
<td>3,600</td>
</tr>
<tr>
<td>Operating costs</td>
<td>$ 5,200</td>
</tr>
<tr>
<td>CCA Class 10.1 old car ($15,000 x 30% x 1/2)</td>
<td>2,250</td>
</tr>
<tr>
<td>[ITA 8(1)(j), Reg 1100(2.5)]</td>
<td></td>
</tr>
<tr>
<td>CCA Class 10.1 new car ($30,000 x 1.13 x 30% x ½)</td>
<td>5,085</td>
</tr>
<tr>
<td>[ITA 8(1)(j), 13(7)(g), Reg. 1101(1af)]</td>
<td></td>
</tr>
<tr>
<td>12,000/20,000 km x $12,535</td>
<td>(7,521)</td>
</tr>
<tr>
<td></td>
<td>93,079</td>
</tr>
</tbody>
</table>

Business income:

Partnership (30% x $32,000) [ITA 2(1)(l)] 9,600

Property income:

Partnership (30% x $8,000) [ITA 12(1)(l)] 2,400

Rental property:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income reported</td>
<td>$1,000</td>
</tr>
<tr>
<td>Storage shed (to building CCA)</td>
<td>3,000</td>
</tr>
<tr>
<td>Landscaping (from land cost)</td>
<td>(2,000)</td>
</tr>
<tr>
<td>CCA class 1 - ($220,000 + $3,000) x 6% x ½ = 6,690 - limit to rental income</td>
<td>(2,000)</td>
</tr>
<tr>
<td>Interest – GIC (10% x 20,000) [ITA 12(4)]</td>
<td>2,000</td>
</tr>
<tr>
<td>Dividends: [ITA 12(1)(j), (k), 82(1)]</td>
<td></td>
</tr>
<tr>
<td>Public (2,000 x 141% (2011))</td>
<td>2,820</td>
</tr>
<tr>
<td>CW Ltd. (3,000 x 125%)</td>
<td>3,750</td>
</tr>
<tr>
<td>Foreign ($900 + $100)</td>
<td>1,000</td>
</tr>
<tr>
<td></td>
<td>7,570</td>
</tr>
<tr>
<td></td>
<td>11,970</td>
</tr>
</tbody>
</table>

Property deductions:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Safety deposit box (assumed used to hold investments)</td>
<td>(100)</td>
</tr>
<tr>
<td>Investment counsel fees [ITA 20(1)(bb)]</td>
<td>(1,000)</td>
</tr>
<tr>
<td></td>
<td>10,870</td>
</tr>
<tr>
<td>Other deductions: RRSP [ITA 60(i)]</td>
<td>(10,000)</td>
</tr>
<tr>
<td></td>
<td>113,549</td>
</tr>
</tbody>
</table>

Net income for tax purposes

$103,549
PROBLEM NINE

[ITA: 9(1); 12(1)(d); 13(1); 20(1)(a), (l), (m); 39(1)(b); Reg. 1100(11), 1101(1ac)]

CB Ltd. is a Canadian-controlled private corporation owning a portfolio of investments including stocks, bonds, and rental properties. The financial statements for the year ended June 30, 20X1, show a profit of $104,300, summarized as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bond interest</td>
<td>$ 50,000</td>
</tr>
<tr>
<td>Taxable dividends from Canadian</td>
<td></td>
</tr>
<tr>
<td>corporations</td>
<td>$20,000</td>
</tr>
<tr>
<td>Gain on sale of assets</td>
<td>$40,000</td>
</tr>
<tr>
<td>Rental loss</td>
<td>$(5,700)</td>
</tr>
<tr>
<td><strong>Income before income taxes</strong></td>
<td><strong>$104,300</strong></td>
</tr>
</tbody>
</table>

Additional financial information is outlined below.

1. The previous year’s corporation tax return includes the following tax account balances:

   **Undepreciated capital cost:**
   - Class 1—building A $125,000
   - Class 1—building B 35,000
   - Class 1—building C 46,000

2. Taxable Canadian dividends totalling $20,000 include $8,000 from public corporations and $12,000 from X Ltd., a Canadian-controlled private corporation. CB Ltd. Owns 30% of X Ltd.’s common shares.

3. The rental properties were purchased prior to March 18, 2007. The details are as follows:

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>C</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land cost</td>
<td>$20,000</td>
<td>$35,000</td>
<td>$21,000</td>
</tr>
<tr>
<td>Building cost</td>
<td>130,000</td>
<td>40,000</td>
<td>49,000</td>
</tr>
<tr>
<td></td>
<td><strong>$150,000</strong></td>
<td><strong>$75,000</strong></td>
<td><strong>$70,000</strong></td>
</tr>
</tbody>
</table>

On February 28, 20X1, property A was sold for $170,000 (land 30,000, building 40,000) and property B was sold for $77,000 (land 40,000, building 37,000). The combined rentals resulted in a loss of $5,700 after deducting amortization/depreciation of $3,000 for the year ended June 30, 20X1. The rental revenue includes a $1,000 rental deposit applying to the last two months’ rent on a lease expiring December 31, 20X2.

For the year ended June 30, 20X0, CB Ltd. deducted a reserve for unpaid rents of $2,000. In January 20X1, $1,000 of the unpaid rents was received and credited to the reserve account. No reserve has been claimed at June 30, 20X1; however, $1,200 of the current year’s rent remains unpaid.

**Required:**

Determine CB’s minimum net income for tax purposes for the 20X1 taxation year.
Solution to P 7-9

Net income per financial statement (20X1) [ITA 9(1)] $104,300
Gain on sale of assets [ITA 18(1)(b)] (40,000)
Taxable capital gains: [ITA 38]
  Property A - ½(170,000 – 150,000) land and building 10,000
  Property B - ½ (40,000 - 35,000) land only 2,500
Capital loss on depreciable property (building) is denied [ITA 39(1)(b)] 0
Rental loss (included in financial statement income) 5,700
Rental income (loss) (see note 1) (1,100)

Net income for tax purposes $ 82,500

Note 1:

First determine maximum CCA that is available. Then determine rental income before CCA to establish CCA limit.

Rental Property A is in a separate Class 1 pool since the capital cost is $50,000 or more [Reg. 1100(11)].

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>UCC beginning of year</td>
<td>$125,000</td>
</tr>
<tr>
<td>Sale of property (credit to pool limited to capital cost)</td>
<td>(130,000)</td>
</tr>
<tr>
<td>Recapture [ITA 13(1)]</td>
<td>$ (5,000)</td>
</tr>
</tbody>
</table>

Rental Property B & C are pooled - Class 1

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>UCC beginning of year (35,000 + 46,000)</td>
<td>$ 81,000</td>
</tr>
<tr>
<td>Sale of property B</td>
<td>(37,000)</td>
</tr>
<tr>
<td>Available CCA - 4% x 44,000</td>
<td>$ 1,760</td>
</tr>
</tbody>
</table>

Maximum CCA cannot exceed rental income [Reg. 1100(11)] calculated as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rental Income:</td>
<td>$ (5,700)</td>
</tr>
<tr>
<td>Loss for the year</td>
<td>5,000</td>
</tr>
<tr>
<td>Recapture of CCA</td>
<td>3,000</td>
</tr>
<tr>
<td>Amortization [ITA 18(1)(b)]</td>
<td>1,000</td>
</tr>
<tr>
<td>20X0 bad debt reserve ($2,000 - $1,000) [ITA 12(1)(d)]</td>
<td>(1,200)</td>
</tr>
<tr>
<td>20X1 bad debt reserve [ITA 20(1)(l)]</td>
<td>(1,000)</td>
</tr>
<tr>
<td>Rental deposit [ITA 20(1)(m)]</td>
<td>1,100</td>
</tr>
<tr>
<td>Rental income before CCA</td>
<td>(1,100)</td>
</tr>
<tr>
<td>CCA - limit</td>
<td>0</td>
</tr>
<tr>
<td>Net rental income</td>
<td>$ 0</td>
</tr>
</tbody>
</table>
CASE

Helen Chapman

[ITA: 13(1); 20(1)(a), (c), (e), (aa); 38; 39; 40(1); Reg. 1100(11)]

Helen Chapman is 56 years old and intends to retire in four years. Most of her investment funds are tied up in her employer’s pension plan and in her personal registered retirement savings plan. In addition, she has managed to accumulate a personal investment fund of $100,000, which currently is invested in government treasury bills earning interest at 9%.

Immediately before retirement, Chapman intends to use her personal investments and her pension plans to acquire a life annuity that will provide her with a guaranteed monthly income. She is looking for an investment for the $100,000 currently invested in treasury bills that will maximize the value of the annuity. Her investment counsellor has proposed two secure investment options, as follows:

• **Option 1** is a corporate bond yielding annual interest of 13%. The counsellor has advised that Chapman could fund a purchase of $200,000 of the bonds with $100,000 of cash (from the treasury bills) and $100,000 of borrowed funds. Because her house is debt-free, her bank has offered to provide her with a term loan secured by a mortgage on the house. The loan interest rate would be 10%, and no principal payments would be required until the end of the term of the loan.

• **Option 2** is a real estate investment. A small, single-tenant commercial building is currently under construction and will be completed in six weeks. A prospective tenant has already agreed to a 12-year lease. The lease calls for rent payments of $40,000 annually for four years, at which time the annual rent will increase by 12% and then remain fixed for the remaining eight years of the lease. The tenant will be responsible for all costs associated with the property, including property taxes and insurance.
Solution to Case - Helen Chapman

In comparing the two investments, it is assumed that Helen can reinvest the after-tax annual returns in treasury bills similar to her current investment, and earn 9% annually (or 5% after tax; 9% - 45% tax = 5% rounded).

Option 1 - Corporate Bond

Annual cash flow:
- Interest income ($200,000 x 13%) $26,000
- Interest expense on loan ($100,000 x 10%) [ITA 20(1)(c)] (10,000)
  Less tax @ 45% (7,200)

Value of investment after four years:
- Sale of bonds $200,000
- Less bond loan (100,000)
  Net interest return for four years ($8,800)
    Reinvested and compounded at 5% 37,929
    Total available for annuity $137,929

Option 2 - Real Estate

Before determining the cumulative position of this option, a number of separate items must be examined:

A. Resale Value of Property: The value of the property to the owner is based upon the net rentals which can be achieved. Assuming that the property will be sold to an investor after four years who will also hold the property to earn rental income, the value of the property should increase in proportion to the increase in net rentals. After four years the net rentals increase by 12%. Therefore, it is assumed that the property value will increase from $398,000 to $445,760 (land cost $40,000 + landscaping $8,000 = $48,000 x 1.12 = $53,760; building cost $350,000 x 1.12 = $392,000).

B. Deductions for Tax Purposes:
   In addition to the annual interest expense the following amounts are deductible in particular years:
   - Landscaping of $8,000 is fully deductible in year 1 [ITA 20(1)(aa)].
   - Legal fees of $2,000 to register the mortgage is a cost of borrowing money and can be deducted at 1/5 per year [ITA 20(1)(e)]. However, because the term is for four years the remaining balance is deductible in year 4.

<table>
<thead>
<tr>
<th>Year</th>
<th>1/5 ($2,000)</th>
<th>Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>400</td>
<td></td>
</tr>
<tr>
<td>Year 2</td>
<td>400</td>
<td>800</td>
</tr>
<tr>
<td>Year 3</td>
<td>400</td>
<td></td>
</tr>
<tr>
<td>Year 4</td>
<td>Balance</td>
<td>$2,000</td>
</tr>
</tbody>
</table>
Capital cost allowance is limited to the net rental income in any year as follows [ITA 20(1)(a), Reg. 1100(11)]:

<table>
<thead>
<tr>
<th>Year</th>
<th>Rent income</th>
<th>Interest expense</th>
<th>Landscaping</th>
<th>Legal cost</th>
<th>CCA</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$40,000</td>
<td>(27,000)</td>
<td>(8,000)</td>
<td>(400)</td>
<td>$4,600</td>
</tr>
<tr>
<td>2</td>
<td>$40,000</td>
<td>(27,000)</td>
<td>(8,000)</td>
<td>(400)</td>
<td>$12,600</td>
</tr>
<tr>
<td>3</td>
<td>$40,000</td>
<td>(27,000)</td>
<td>(8,000)</td>
<td>(400)</td>
<td>$12,600</td>
</tr>
<tr>
<td>4</td>
<td>$40,000</td>
<td>(27,000)</td>
<td>(8,000)</td>
<td>(800)</td>
<td>$12,200</td>
</tr>
</tbody>
</table>

CCA
- Year 1: 6% (1/2) to maximum of $4,600 = $345,400
- Year 2: 6% to maximum of $12,600 = $332,800
- Year 3: 6% to maximum of $12,600 = $332,800
- Sold in year 4: $320,200

C. Gain on sale of property

Recapture of CCA [ITA 13(1)]
- UCC: $320,200
- Proceeds limited to cost: (350,000)
- $29,800

Capital Gain [ITA 39, 40(1)]
- Proceeds: $53,760
- Building: $392,000
- Total: $445,760
- Cost: (40,000)
- (350,000)
- (390,000)
- Building: $13,760
- $42,000
- Total: $55,760
- Taxable 1/2 of $55,760 [ITA 38] = $27,880

D. Taxable Incomes and taxes payable in cash year

<table>
<thead>
<tr>
<th></th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net rents</td>
<td>$4,600</td>
<td>$12,600</td>
<td>$12,600</td>
<td>$12,200</td>
</tr>
<tr>
<td>Recapture</td>
<td></td>
<td></td>
<td></td>
<td>29,800</td>
</tr>
<tr>
<td>Taxable capital gains</td>
<td></td>
<td></td>
<td></td>
<td>27,880</td>
</tr>
<tr>
<td>CCA</td>
<td>(4,600)</td>
<td>(12,600)</td>
<td>(12,600)</td>
<td></td>
</tr>
<tr>
<td>Taxable Income</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$69,880</td>
</tr>
<tr>
<td>Tax @ 45%</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$31,446</td>
</tr>
</tbody>
</table>

E. Cash flows excluding sale of property

<table>
<thead>
<tr>
<th>Year</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net rents ($40,000 - $27,000)</td>
<td>$13,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net rents</td>
<td>13,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net rents</td>
<td>13,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net rents</td>
<td>13,000</td>
<td></td>
<td></td>
<td>$52,000</td>
</tr>
</tbody>
</table>
F. Value after four years

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sale of property</td>
<td>$445,760</td>
</tr>
<tr>
<td>Less mortgage</td>
<td>(300,000)</td>
</tr>
<tr>
<td></td>
<td>$145,760</td>
</tr>
<tr>
<td>Net annual rents of $13,000</td>
<td>56,031</td>
</tr>
<tr>
<td>reinvested at 5% after-tax</td>
<td></td>
</tr>
<tr>
<td></td>
<td>$201,791</td>
</tr>
<tr>
<td>Less tax in year four</td>
<td>(31,446)</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>Total available for annuity</td>
<td>$170,345</td>
</tr>
</tbody>
</table>

The real estate investment provides a total of $170,435 after four years compared to $137,929 from the bond investment.

Students may also include points in the discussion such as:

- the inclusion of a real estate commission on the sale.
- a different assumption about the value of real estate after four years.
- the fact that real estate may not be easy to liquidate when desired.
CHAPTER 8

GAINS AND LOSSES ON THE DISPOSITION OF CAPITAL PROPERTY—CAPITAL GAINS

Review Questions

1. A capital gain or capital loss is the gain or loss realized from the disposition of capital property. What is meant by the term “capital property,” and how is it different from other types of property?

2. Is it necessary for property to provide a long-term benefit to its owners in order for the gain or loss on sale to be considered a capital gain or capital loss?

3. When it is unclear whether a gain or loss on a sale of property is of a capital nature, what factors are considered when judging the transaction?

4. An investor acquired a residential high-rise apartment as an investment. The property has now been owned for 11 years and annually has provided reasonable net rental income. This net rental income has been reinvested in other types of properties as well as in improvements to the apartment building. The owner is considering either selling the property to another investor or dividing the property into separate condominium units that will be marketed to existing tenants and to the public. Explain how a gain on sale will be treated for tax purposes under each alternative.

5. Distinguish among financial property, personal-use property, and listed personal property. Which of these three categories is (are) subject to capital gains treatment?

6. Distinguish between a capital gain and a taxable capital gain and between a capital loss and an allowable capital loss.

7. Explain why the tax treatment of capital gains is often described as preferential, while the treatment of capital losses is often considered unfair.

8. “A capital gain or loss can be recognized for tax purposes only when capital property is sold.” Is this statement true? Explain.

9. A corporation acquires a licence that permits it to manufacture a patented product for 10 years in exchange for the payment of a royalty. Describe the tax treatment that will occur if the taxpayer sells the licence for more than its cost or less than its cost to another party before the 10-year term expires. Would the tax treatment be the same if the licence had an unlimited life?

10. What advantage can a taxpayer achieve by incurring a capital gain on property and permitting the purchaser to pay for the property over a number of years?

11. Because of the tax treatment, an investment in shares of a small business corporation may present less risk than an investment in shares of a public corporation. Explain why.
12. What difference does it make when the sole shareholder of a corporation provides $10,000 of additional capital to the corporation as a loan (shareholder’s loan), rather than in return for additional share capital?

13. “The sale of a warehouse building used by a taxpayer to operate a business can result in a capital gain but not a capital loss.” Is this statement true? Explain.

14. Explain how the tax treatment of personal-use property deviates from the normal tax treatment of capital property.

15. When an investor buys some shares of a corporation at one price and later buys more shares of the same corporation at another price, how does the investor determine the cost for tax purposes when some, but not all, of the shares are eventually sold?

16. When an investor acquires a commodity or a contract to purchase a commodity in the future, what type of property does that investor own? Can a gain or loss on the sale of commodities or futures contracts result in a capital gain or loss?

17. An investment in capital property that appreciates in value at 10% per year is more valuable than an investment in capital property that provides an annual return, such as interest, of 10%. Explain why.
Solutions to Review Questions

R8-1. Property acquired for the purpose of providing the owner with a long-term or enduring benefit is classified as capital property. For tax purposes, it can be distinguished from two other types of property: inventory and eligible capital property. Property acquired for the purpose of reselling it at a profit is inventory, and any gain or loss realized is business income (loss). Certain types of capital properties that are acquired for the purpose of providing a long-term benefit are, however, classified as eligible capital property and do not receive normal capital gains treatment for tax purposes. As discussed in Chapter 6, eligible capital property includes property of an intangible nature that does not have a defined legal life (goodwill, franchises and licences with an unlimited life, customer lists, incorporation costs, and so on). Gains or losses from eligible capital property are considered to be business income (loss) [ITA 54 definition of capital property].

R8-2. It is not necessary for property to actually provide a long-term benefit to its owner, but rather the intended purpose of acquisition must be to provide such a benefit. Whether or not property actually achieves its intended purpose is governed by future events which may or may not be controllable by the owner.

R8-3. A taxpayer's intended purpose in acquiring a property is not always clear, and yet it is necessary for the tax authorities to assess such transactions. The following factors are considered when judging intended purpose:

- period of ownership.
- nature of the transaction, including the point of purchase, use of the property during the ownership period, and the reasons for and the method of the disposition.
- number and frequency of transactions.
- relation of the transaction to the taxpayer's business.

By examining all of the above factors together, a course of conduct may be apparent which supports the intended purpose.

R8-4. Sale of entire property to an investor - based on the limited information, it would appear that the selling price in excess of the original cost would be a capital gain. The property was held for a long period of time and generated regular annual benefits. As there is no indication of a history of buying and selling such properties, the intended purpose of acquisition as a capital property appears to be supported.

Sale of property by separate condominium units - The selling process under this alternative requires significant effort by the vendor and therefore becomes a factor in assessing the original intention. Three possible results may occur. Because the method of sale is similar to that used by developers, it provides evidence that the property was acquired for the purpose of resale and any gain is business income. Another possibility is that the owner changed intention at some point. For example, once it was decided to dispose of the property, a condo sale was initiated to enhance the proceeds. Because the use of the property changed, it would be appropriate to expect a capital gain up to the value before the condo conversion, and business income on the additional profit. However, neither of these may be appropriate if, for example, a number of tenants requested a condo conversion after they become aware the property was for sale. Such circumstances may nullify the influence of the conversion allowing full capital gain treatment.
R8-5. Personal-use property is capital property owned by a taxpayer and used primarily for personal use and enjoyment (car, house, boat) [ITA 54 definition personal-use property]. Listed personal property is specific capital property identified as jewellery, rare folios, manuscripts or books, prints, paintings and similar works of art, stamps and coins [ITA 54 definition listed personal property]. Financial property is capital property that provides a benefit from financial returns. All three categories of capital property are subject to capital gains treatment.

R8-6. A capital gain is the amount by which the proceeds of disposition from capital property exceed the adjusted cost base and the costs of disposition [ITA 40(1)(a)(i)]. A capital loss is the amount by which the adjusted cost base plus the costs of disposition exceeds the proceeds of disposition [ITA 40(1)(b)]. A taxable capital gain and allowable capital loss is one-half of the capital gain or capital loss determined above [ITA 38(a) & (b)].

R8-7. The tax treatment of capital gains is considered to be preferential to other types of income because only one-half of the gain is taxable. The treatment of capital losses may be considered to be unfair because they can only be applied to reduce taxable income to the extent of capital gains earned from the sale of capital properties [ITA 3(b)], whereas other types of losses can be applied against any source of income.

R8-8. The statement is not true. A capital gain or loss is recognized when a disposition of the property occurs. While in most cases a disposition is caused by a sale, there are a number of situations where a deemed disposition occurs for tax purposes even though a sale or exchange has not taken place. A deemed disposition at fair market value occurs when:

- property is transferred by way of a gift [ITA 69(1)(b)(ii)].
- the use of property changes from personal use to business or investment use or vice versa [ITA 45(1)].
- when a taxpayer ceases to be a resident of Canada [ITA 128.1].
- a taxpayer dies [ITA 70(5-10)].

In addition, loans receivable are deemed to be disposed of when the debt is considered to be uncollectible [ITA 50(1)(a)]. Similarly, a deemed disposition of shares occurs when the corporation is legally bankrupt or when the business has ceased and the corporation is insolvent (and an election is made under subsection 50(1) [ITA 50(1)(b)].

R8-9. The licence is capital property that also qualifies as depreciable property under class 14 (due to its limited legal life). If the property is sold for a price in excess of the original cost, one-half of the excess is a taxable capital gain [ITA 38(a)]. In addition, to the extent that capital cost allowance has been claimed on the original cost, a recapture of capital cost allowance will occur which is considered to be business income [ITA 13(1)]. If the license is sold at less than the original cost, a capital loss will NOT occur [ITA 39(1)(b)(i)]. Instead either a recapture of capital allowance or a terminal loss may occur depending on whether the selling price is greater than or less than the undepreciated capital cost of the class 14 depreciable property [ITA 13(1); 20(16)]. A capital loss cannot occur on depreciable property [ITA 39(1)(b)(i)].

If the license was for an unlimited life, the tax treatment would not be the same because the license would be classified as eligible capital property. In that case, three-quarters of the selling price is credited to the cumulative eligible capital account (see Chapter 6) and may result in business income if and when this account becomes negative [ITA 14(5)]. To the extent a negative balance exceeds the recapture of previous amounts deducted, then 2/3’s of that excess is taxable [ITA 14(1)].
The above presumes that the license was not acquired for the purpose of selling it at a profit. If this was the case, the licence would be inventory and treated accordingly.

R8-10. With delayed payment of proceeds, the taxpayer can use the capital gain reserve provisions which delay the recognition of a portion of the taxable capital gain within defined limits. This has two possible advantages.

- The taxpayer can earn interest (from the purchaser) on amounts that would otherwise have been paid out as tax in the year of sale. Therefore, returns on the investment of the proceeds are enhanced.
- By spreading out the recognition of income over several years, the rate of tax may be lower in some or all of those future years [ITA 40(1)(a)(iii), 40(2)(a)].

R8-11. If an investment in shares of a small business corporation results in a loss, that loss would qualify as an allowable business investment loss (1/2 of the capital loss) [ITA 38(c) & 39(1)(c)]. The loss can be offset against any other source of income provided that the taxpayer has other sources of income (e.g., from business employment property or other sources) [ITA 3 (d)] and will result in an immediate reduction of taxes otherwise payable.

On the other hand, a loss from the sale of shares of a public corporation can only be offset against other capital gains, which restricts the use of the loss [ITA 3(b)]. Therefore, it is more difficult to obtain a tax reduction from the loss on public corporation shares. Hence, such investments, all else being equal, present greater risk.

R8-12. In both circumstances the owner provides the same amount of capital to the corporation. However, the ultimate tax treatment to the owner may be different for each method. If the corporation has financial difficulty and the owner’s capital is in jeopardy, the loan method results in a better tax treatment. A capital loss on the loan is deemed to occur when the debt is considered to be uncollectible, whereas a loss on the share capital will occur only when the shares are sold or the corporation becomes legally bankrupt or has ceased operations and is insolvent [ITA 50(1)]. Therefore, capitalization by debt provides an opportunity for a faster recognition of a loss for tax purposes. If the owner can use such a loss sooner rather than later, the ultimate loss measured in cash flow terms may be diminished; or the tax savings achieved earlier can be advanced to the corporation to reduce its financial problems and reduce the risk of a business failure.

R8-13. Yes, the statement is true. The building is depreciable capital property which can result in a capital gain if the selling price is greater than the cost. However, as depreciable property, no capital loss can occur [ITA 39(1)(b)(i)]. Proceeds below the original cost affect only the capital cost allowance class which the building is part of. See the solution to question 9 above.

R8-14. The tax treatment of personal-use property deviates from the normal treatment of capital property because any loss incurred on personal-use property is deemed to be zero [ITA 40(2)(g)(iii)]. Therefore, gains on personal use property are taxable but losses from such property cannot be used even to reduce capital gains from other personal use properties.

R8-15. The acquisition of shares of the same class of a corporation is considered to be identical properties for tax purposes. The adjusted cost base of each identical property acquired (in this case, each share) is the weighted average cost of all the identical properties up to the point of the sale of some or all of those properties [ITA 47(1)].
R8-16. The acquisition of commodities can only provide a benefit to the owner as a result of their resale. Therefore, such properties are always acquired for the purpose of reselling at a profit. The property is inventory and any gain or loss is either business income or a business loss. However, by administrative policy, a taxpayer may elect to treat commodity transactions as capital property resulting in capital gains or capital losses provided that method is used consistently. This option is not available to taxpayers who are associated with the commodity business or who take commodity positions as part of their normal business or trade.

R8-17. An investment in capital property providing an annual growth rate of 10% will be taxed only when the property is sold, and only one-half of the gain is taxable. The investment, therefore, compounds annually at the pre-tax rate of 10% and is taxed only when realized. An investment in capital property that earns 10% annual interest is taxable annually as it is earned, and the full amount is taxable. Therefore, an investment return of 10% can only compound at its after-tax rate. For example, if the investor is subject to a 40% tax rate, the 10% return will compound when reinvested at 6% annually compared to 10% under the capital gain option. Therefore, over time, holding appreciating property provides an increased rate of return because of the timing and the amount of the tax cost (1/2 is taxable).
Key Concept Questions

QUESTION ONE

Colin sold capital property in 20X1 for $600,000 and incurred $24,000 in selling costs. The property had an adjusted cost base of $176,000. Colin received $150,000 at the time of the sale and a note for the balance. The note is to be repaid over nine years in equal instalments of $50,000, commencing in 20X2.

Determine the minimum taxable capital gain to be reported by Colin in 20X1, 20X2, and 20X3. 
*Income tax reference: ITA 40(1)(iii).*

QUESTION TWO

Which of the following corporations are Small business corporations (SBC) as defined in ITA 248 of the Income Tax Act?

a) A Ltd. is a public corporation with 95% of the fair market value of its assets used in an active business carried on primarily in Canada.

b) B Ltd. is a Canadian-controlled private corporation with 60% of the fair market value of its assets used in an active business carried on in Canada. The remaining 40% is an investment in long-term bonds.

c) C Ltd. is a Canadian-controlled private corporation with 80% of the fair market value of its assets used primarily in an active business carried on in Canada. The remaining 20% is term deposits.

d) D Ltd. is a Canadian-controlled private corporation that owns one asset. The asset is a warehouse that is used by a related corporation in carrying on its active business in Canada.

QUESTION THREE

In 20X1 Ross loaned $10,000 to a small business corporation. The loan bears interest at 6% per annum and is due on demand. Ross did not receive his interest in 20X3 although he reported it on his 20X3 tax return. By December 31, 20X4, it was established that the loan was bad and that Ross would not be receiving the $10,000 principal and the interest for 20X3 nor 20X4.

Determine the 20X4 tax consequences for Ross. 
*Income tax reference: ITA 20(1)(p), 39(1)(c), 50(1).*
QUESTION FOUR

Determine the loss to be reported for tax purposes for each of the following dispositions. *Income tax reference: ITA 20(16), 39(1)(b)(i), 40(2)(g), 40(3.3), (3.4), 53(1)(f), 54.*

a) Anita sold a class 10 depreciable asset for $10,000. The asset cost $25,000 when it was purchased. The UCC of class 10 is $16,000.

b) Bill sold his home for $180,000. The home cost $210,000 when it was purchased.

c) Cathy transferred shares of X Ltd. worth $18,000 to her RRSP. She paid $25,000 for the shares when she purchased them a few years ago.

c) Dan sold 100 shares of N Ltd. for $10,000 on December 15th, 20X7. The ACB of the 100 shares was $17,000. On January 5, 20X8, the value of N Ltd. declined further and Dan repurchased 40 shares of N Ltd. for $3,200.

e) On June 30, 20X0, Old Inc. sold its investment in shares of Blue Ltd. (1% of Blue’s outstanding shares) to New Inc. for $30,000. The shares had been acquired 4 years previous for $40,000. Carla is the controlling shareholder of both Old Inc. and New Inc. In February, 20X1, New Inc. sold the shares of Blue Ltd. for $46,000. The taxation year end for New Inc. and Old Inc. is December 31.

QUESTION FIVE

In the current year, Valerie disposed of the following personal items:

<table>
<thead>
<tr>
<th>Item</th>
<th>Proceeds</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Car</td>
<td>$1,500</td>
<td>$6,000</td>
</tr>
<tr>
<td>Jewellery</td>
<td>200</td>
<td>1,200</td>
</tr>
<tr>
<td>Oil painting</td>
<td>2,000</td>
<td>800</td>
</tr>
<tr>
<td>Antique table</td>
<td>1,800</td>
<td>900</td>
</tr>
</tbody>
</table>

Valerie has an unclaimed capital loss on listed personal property of $3,000 that was incurred five years ago.

Determine Valerie’s net taxable capital gains to be reported for the current year. *Income tax reference: ITA 3(b), 40(2)(g)(iii), 41(1), (2), 46(1), 54.*

QUESTION SIX

Mr. Market traded in shares of Blue Inc. during the current year. His transactions were as follows:

<table>
<thead>
<tr>
<th>Date</th>
<th>No. of shares</th>
<th>Cost per share</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 15</td>
<td>200</td>
<td>$45</td>
<td>$9,000</td>
</tr>
<tr>
<td>March 7</td>
<td>300</td>
<td>$22</td>
<td>$6,600</td>
</tr>
<tr>
<td>November 21</td>
<td>(100)</td>
<td>$45</td>
<td>$4,500</td>
</tr>
</tbody>
</table>

Determine the ACB of the shares sold. Mr. Market did not own any shares of Blue Inc. before January 15. *Income tax reference: ITA 47(1).*
QUESTION SEVEN

Early last year, Hazel purchased 100 units of Sky mutual fund for $12 per unit. She received a T3 from the fund for last year showing the following distributions from the fund, all of which were reinvested in her account resulting in the purchase of three additional units:

- Actual amount of eligible dividends $30.00
- Taxable amount of eligible dividends $41.40
- Capital gains $10.00
- Interest $ 8.00

On January 4th of the current year, Hazel sold 50 of her mutual fund units for $900.

Determine the taxable capital gain to be reported by Hazel in the current year. *Income tax reference: ITA 47(1).*

QUESTION EIGHT

Jane acquired a house in 20X1 for $300,000. In 20X3 she acquired a cottage for $150,000. She lived in the house in the winter and in the cottage in the summer. In 20X5 she sold both properties. She received $400,000 for the house and $250,000 for the cottage.

Determine the minimum taxable capital gain to be reported by Jane on the sale of the two properties. *Income tax reference: ITA 40(2)(b).*

QUESTION NINE

Richard is employed by a Canadian oil company. In Year 3, he was transferred from Toronto to Calgary. He rented his home to a tenant while he was in Calgary (Year 3 to Year 9). In the middle of Year 9 he moved back into his home in Toronto. In Year 12 he sold his Toronto home. The value of the home at relevant dates was as follows:

- Year 1 (purchase price) $250,000
- Year 3 commenced renting the home $320,000
- Year 9 moved back into the home $450,000
- Year 12 sold the home $490,000

Determine the minimum taxable capital gain(s) to be recognized by Richard — (a) without a subsection 45(2) election, and (b) with a subsection 45(2) election. *Income tax reference: ITA 40(2)(b), 41(1), 45(2), 54, 54.1.*
QUESTION TEN

On March 20th of the current year, Stephen sold his common shares of Salt Ltd., an eligible small business corporation, for $800,000. His shares had an ACB of $100,000. On October 1st of the current year, Stephen purchased newly issued common shares of Pepper Ltd., also an eligible small business corporation. He paid $400,000 for the shares of Pepper Ltd. *Income tax reference: ITA 44.1.*

a) Determine the maximum amount of capital gain on the sale of the Salt Ltd. shares that can be deferred.

b) What will be the ACB of the Pepper Ltd. shares, assuming Stephen elects to defer the maximum capital gain possible, on the Salt Ltd. shares?

QUESTION ELEVEN

On March 20, 20X7, Growth Ltd. moved its head office into its newly acquired building in Toronto. The new building cost $800,000 (land $300,000; building $500,000). The former office building, in downtown Toronto, was sold in January, 20X6 for $650,000 (land $200,000; building $450,000). Growth Ltd. operated from leased space in the meantime. The former office building cost $400,000 (land $150,000; building $250,000). Class 1 had an UCC balance of $220,000 at the end of 20X5. Growth Ltd. has a December 31 year end.

Describe the tax consequences of the move, including the capital cost and UCC for the new building, assuming Growth Ltd. wishes to minimize taxes. *Income tax reference: ITA 13(4); 44(1), (5).*

QUESTION TWELVE

In the current year, James earned the following income:

- Employment income $80,000
- Property income 2,000
- Gains:
  - Shares of Corporation X $12,000
  - Personal-use property 7,000
  - Listed personal property 1,600 20,600
- Losses:
  - Shares of Corporation Y (15,000)
  - Shares of small business corporation (4,000)
  - Listed personal property (300) (19,300) $83,300

Determine net income in accordance with the aggregating formula in Section 3 of the ITA.
Solutions to Key Concept Questions

KC 8-1

[ITA: 40(1)(iii) – Capital gains reserve]

The minimum taxable capital gain to be reported is $50,000 in 20X1, $30,000 in 20X2 and $40,000 in 20X3.

\[
\begin{array}{ll}
\text{(20X1)} & \text{Proceeds} \quad \$600,000 \\
& \text{ACB} \quad (176,000) \\
& \text{Selling costs} \quad (24,000) \\
& \text{Gain} \quad 400,000 \\
& \text{Capital gains reserve – lesser of:} \\
& \quad \text{\$450,000/600,000 x \$400,000 = \$300,000} \\
& \quad \text{4/5 x \$400,000 = \$320,000} \\
& \text{Capital gain} \quad \$100,000 \\
& \text{Taxable capital gain} \quad \$ 50,000 \\
\end{array}
\]

\[
\begin{array}{ll}
\text{(20X2)} & \text{Gain (20X1 reserve)} \quad \$300,000 \\
& \text{Capital gains reserve – lesser of:} \\
& \quad \text{\$400,000/600,000 x \$400,000 = \$266,667} \\
& \quad \text{3/5 x \$400,000 = \$240,000} \\
& \text{Capital gain} \quad \$ 60,000 \\
& \text{Taxable capital gain} \quad \$ 30,000 \\
\end{array}
\]

\[
\begin{array}{ll}
\text{(20X3)} & \text{Gain (20X2 reserve)} \quad \$240,000 \\
& \text{Capital gains reserve – lesser of:} \\
& \quad \text{\$350,000/600,000 x \$400,000 = \$233,333} \\
& \quad \text{2/5 x \$400,000 = \$160,000} \\
& \text{Capital gain} \quad \$ 80,000 \\
& \text{Taxable capital gain} \quad \$ 40,000 \\
\end{array}
\]

KC 8-2

[ITA: 248(1) definition of Small Business Corporation]

A small business corporation (SBC) is defined in ITA 248(1) as a Canadian-controlled private corporation (CCPC) with all or substantially all (90% or more) of the fair market value of its assets attributable to one of the following:

- Used principally in an active business carried on primarily in Canada by the particular corporation or by a corporation related to it,
- Shares or debt of one or more connected SBCs (greater than 10% ownership), or
- A combination of the two.
a) A Ltd. cannot be a SBC because it is not a CCPC.

b) B Ltd. cannot be a SBC because less than 90% of the fair market value of its assets is qualifying assets.

c) Whether C Ltd. is a SBC depends on whether the term deposits are a short term investment of excess cash that will be needed in the business cycle and therefore an asset used in the active business. If it is, then C Ltd. is a SBC. If the term deposits are excess cash that will not be needed in the business, then C Ltd. is not a SBC because less than 90% of the fair market value of its assets is qualifying assets.

d) D Ltd. is a SBC. It is a CCPC with all of the fair market value of its assets being assets used in an active business carried on in Canada by a related corporation.

KC 8-3

[ITA: 20(1)(p); 39(1)(c); 50(1) – ABIL]

The interest income included in Ross’s 20X3 income has become a bad debt in 20X4. Therefore, in 20X4 Ross can claim a bad debt deduction [ITA 20(1)(p)] in computing his property income for the year.

The $10,000 loan has become a bad debt in 20X4. Ross can make an election under ITA 50(1) to be deemed to dispose of the loan at the end of 20X4 for proceeds of Nil and to have reacquired it on the first day of 20X5 for a cost of Nil. If Ross makes the election, he will have an allowable business investment loss (ABIL) of $5,000 in 20X4. The ABIL is deductible against all sources of income.

Loan to small business corporation (SBC):

<table>
<thead>
<tr>
<th>Proceeds</th>
<th>$0</th>
</tr>
</thead>
<tbody>
<tr>
<td>ACB</td>
<td>$(10,000)</td>
</tr>
<tr>
<td>Business investment loss</td>
<td>$(10,000)</td>
</tr>
<tr>
<td>Allowable business investment loss</td>
<td>$(5,000)</td>
</tr>
</tbody>
</table>

This solution assumes Ross has never claimed a capital gains deduction. See chapter 10.

KC 8-4

[ITA: 20(16), 39(1)(b)(i), 40(2)(g), 40(3.3),(3.4), 53(1)(f), 54 – Capital losses denied]

a) There is a terminal loss of $6,000 on the disposal of the Class 10 asset [ITA 20(16)]. Capital losses are not allowed on depreciable assets [ITA 39(1)(b)(i)]. The selling price of $10,000 is $15,000 less than the cost of $25,000; this loss is fully recognized for tax purposes as follows:

CCA claimed in previous year $ 9,000
Terminal loss 6,000
$15,000

b) The home is a personal-use property (PUP) as defined in ITA 54. Therefore, the loss is denied for tax purposes [ITA 40(2)(g)(iii)].
c) The $7,000 loss on the shares transferred to the RRSP is denied for tax purposes. If the shares had been transferred to a TFSA, the loss would be denied as well [ITA 40(2)(g)(iv)].

d) Dan has an allowable capital loss (ACL) of $2,100 in 20X7.

<table>
<thead>
<tr>
<th>Proceeds</th>
<th>$10,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>ACB</td>
<td>(17,000)</td>
</tr>
<tr>
<td>Loss</td>
<td>(7,000)</td>
</tr>
<tr>
<td>Superficial loss – 40/100 x $7,000</td>
<td>2,800</td>
</tr>
<tr>
<td>Capital loss</td>
<td><em>(4,200)</em></td>
</tr>
<tr>
<td>Allowable capital loss</td>
<td><em>(2,100)</em></td>
</tr>
</tbody>
</table>

The loss on 40 of the shares ($2,800) is a superficial loss because Dan acquired identical shares within the 30-day period following the sale [ITA 54]. The superficial loss is denied and is added to the ACB of the 40 shares reacquired [ITA 53(1)(f)]. Therefore, the ACB of the 40 shares acquired is $6,000 (cost $3,200 + superficial loss $2,800).

e) Old Inc. has an allowable capital loss (ACL) of $5,000 but not until 20X1.

<table>
<thead>
<tr>
<th>20X0 Sale:</th>
<th>Proceeds</th>
<th>$30,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>ACB</td>
<td>(40,000)</td>
<td></td>
</tr>
<tr>
<td>Loss</td>
<td>(10,000)</td>
<td></td>
</tr>
<tr>
<td>Denied Loss</td>
<td>10,000</td>
<td></td>
</tr>
<tr>
<td>Capital loss</td>
<td>0</td>
<td></td>
</tr>
</tbody>
</table>

Old Inc. is denied the capital loss in 20X0 since the loss was incurred on the sale of a capital property to an affiliated person [ITA 40(3.3)]. Old Inc. and New Inc. are affiliated persons, since they are both controlled by Carla [ITA 251.1 (1)(c)]. The denied loss is retained by Old Inc. and cannot be recognized until such time as the affiliated person sells the asset (and it remains sold for 30 days) or the asset is deemed sold under the deemed disposition rules (i.e., on death) [ITA 40(3.4)].

The capital loss can be recognized by Old Inc. in 20X1 when New Inc. sells the shares of Blue Ltd. The allowable capital loss is $5,000.

New Ltd. will have a capital gain of $16,000 on the sale (Proceeds $46,000 – ACB $30,000).

**KC 8-5**

[ITA: 3(b), 40(2)(g)(iii), 41(1), (2), 46(1), 54 Definitions LPP & PUP]

<table>
<thead>
<tr>
<th></th>
<th>LPP</th>
<th>PUP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Car ($1,500 - $6,000)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Jewellery ($1,000 - $1,200)</td>
<td></td>
<td>(200)</td>
</tr>
<tr>
<td>Oil painting ($2,000 - $1,000)</td>
<td>1,000</td>
<td></td>
</tr>
<tr>
<td>Antique table ($1,800 - $1,000)</td>
<td>800</td>
<td>800</td>
</tr>
</tbody>
</table>

LPP loss carried forward | (800) |
Net gain – LPP | $ Nil |
Taxable net gain – LPP | $ Nil |
ITA 3(b): Taxable capital gains – other than LPP ($800 x ½) = $400
Taxable net gain – LPP 0
Net taxable capital gains for the year $400

Note 1: PUP losses are denied [ITA 40(2)(g)(iii)].
Note 2: Where the cost or the proceeds of PUP or LPP is less than $1,000, the amount is bumped to $1,000 [ITA 46(1)].
Note 3: LPP losses can be carried back 3 years and forward 7 and deducted in computing net LPP gains for the year [ITA 41(2)].

**KC 8-6**

[ITA: 47(1) – Identical properties]

<table>
<thead>
<tr>
<th>Blue Inc shares:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Proceeds</td>
<td>$4,500</td>
</tr>
<tr>
<td>ACB</td>
<td>(3,120)</td>
</tr>
<tr>
<td>Capital gain</td>
<td>$1,380</td>
</tr>
<tr>
<td>Taxable capital gain</td>
<td>$690</td>
</tr>
</tbody>
</table>

The adjusted cost base of each identical property acquired is the weighted average cost of all the identical properties acquired up to the point of sale [ITA 47(1)]. When Mr. Market sold the 100 shares, he owned 500 shares with a total cost of $15,600 or $31.20 per share. Thus, the ACB of the 100 shares sold is $3,120 ($31.20 x 100 shares).

**KC 8-7**

[ITA: 47(1) – Identical properties - Mutual funds]

<table>
<thead>
<tr>
<th>Proceeds $900</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>ACB $12.12 x 50 units</td>
<td>(606)</td>
</tr>
<tr>
<td>Capital gain</td>
<td>$294</td>
</tr>
<tr>
<td>Taxable capital gain</td>
<td>$147</td>
</tr>
</tbody>
</table>

The ACB of the mutual fund units is the weighted average cost of all the identical units acquired up to the point of sale [ITA 47(1)].

\[
100 \text{ units} \times $12 = 1,200 \\
\frac{3 \text{ units} \times 48}{103} = 1,248 \\
\]

ACB per unit $12.12 ($1,248/103 units)

* distribution reinvested $48 (actual amount of dividends $30 + capital gains $10 + interest $8)
The minimum taxable capital gain is $10,000. Since the gain per year owned on the cottage is higher than on the house, designation years should be allocated to the cottage to completely exempt the gain before allocating any years to the house.

<table>
<thead>
<tr>
<th></th>
<th>House</th>
<th>Cottage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proceeds</td>
<td>$400,000</td>
<td>$250,000</td>
</tr>
<tr>
<td>ACB</td>
<td>(300,000)</td>
<td>(150,000)</td>
</tr>
<tr>
<td>Gain</td>
<td>100,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Principal residence exemption</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(1+3)/5 x 100,000</td>
<td>(80,000)</td>
<td></td>
</tr>
<tr>
<td>(1+2)/3 x 100,000</td>
<td>(100,000)</td>
<td></td>
</tr>
<tr>
<td>Capital gain</td>
<td>$ 20,000</td>
<td>Nil</td>
</tr>
<tr>
<td>Taxable capital gain</td>
<td>$ 10,000</td>
<td>$ Nil</td>
</tr>
<tr>
<td>Gain per year</td>
<td>$20,000</td>
<td>$33,333</td>
</tr>
</tbody>
</table>

Years designated:
- Cottage - 20X4 and 20X5
- House - 20X1, 20X2 and 20X3

If the cottage is designated for two years, with the 1+ rule, the gain on the cottage is exempt. This leaves three years to be allocated to the house.

**KC 8-9**

[ITA: 40(2)(b), 41(1), 45(2), 54, 54.1 – Principal residence exemption and change in use]

**Part (a) No subsection 45(2) election**

In year 3 when Richard begins earning rental income, he changes the use of the property from personal use to income earning. When this occurs Richard is deemed to dispose of the home for its fair market value and to immediately reacquire it at a cost equal to that fair market value. The same occurs in year 9 when Richard changes the use of the property back to personal use [ITA 45(1)].

<table>
<thead>
<tr>
<th></th>
<th>Year 3</th>
<th>Year 9</th>
<th>Year 12</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proceeds</td>
<td>$320,000</td>
<td>$450,000</td>
<td>$490,000</td>
</tr>
<tr>
<td>ACB</td>
<td>(250,000)</td>
<td>(320,000)</td>
<td>(450,000)</td>
</tr>
<tr>
<td>Gain</td>
<td>70,000</td>
<td>130,000</td>
<td>40,000</td>
</tr>
<tr>
<td>Principal residence exemption</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(1+2)/3 x $70,000</td>
<td>(70,000)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Years designated – 1 &amp; 2</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Not a principal residence</td>
<td></td>
<td>(0)</td>
<td></td>
</tr>
<tr>
<td>(1+3)/4 x $40,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Years designated – 9 to 11</td>
<td></td>
<td>(40,000)</td>
<td></td>
</tr>
<tr>
<td>Capital gain</td>
<td>$ 0</td>
<td>$130,000</td>
<td>$ 0</td>
</tr>
<tr>
<td>Taxable capital gain</td>
<td>$ 0</td>
<td>$ 65,000</td>
<td>$ 0</td>
</tr>
</tbody>
</table>
Part (b) Subsection 45(2) election

If Richard elects under subsection 45(2) not to recognize the change in use in Year 3 then the property remains a personal-use property for tax purposes even though he is earning rental income from it. When he moves back into the home in Year 9, there is no change in use since the property has remained a personal-use property.

The definition of principal residence includes a property that the taxpayer does not ordinarily inhabit but that has a subsection 45(2) election on it. Such a property can be designated as a principal residence for a maximum of 4 years [ITA 54]. However, where the taxpayer is not living in the home due to an employment transfer, the 4 years is extended indefinitely, provided that the employee moves back into the home within 1 year after ceasing to be employed by that employer [ITA 54.1].

Richard can designate the Toronto home as his principal residence for years 1, 2, 3, 9, 10, 11 and 12 because he ordinarily inhabited the Toronto home at some time during those years. He can designate the Toronto home for years 4, 5, 6, 7 and 8, if the property has a subsection 45(2) election on it during those years, because he is not living in the home due to an employment transfer and he moves back into the home within the time requirement.

| Year 12 | Proceeds | $490,000 |
|        | ACB      | (250,000) |
|        | Gain     | 240,000   |
| Principal residence exemption - (1+11)/12 x $240,000 | (240,000) |
| Years designated – 1 to 11 | Capital gain | $0 |
| Taxable capital gain | $0 |

Thus, in this case, Richard is better to make the subsection 45(2) election.

KC 8-10

[ITA: 44.1 – Eligible small business deferral]

Section 44.1 provides a deferral of the gain on disposal of an investment in a small business when an investment in another small business is made. To qualify the share must be newly issued common shares and must be owned by the individual for at least 185 days. Once the individual sells the shares, a new investment must be made in another eligible small business within a specified time frame. The new shares must be acquired within 120 days after the end of the year in which the old shares are sold.

Part (a):
The sale of the Salt Ltd. shares results in capital gain of $700,000 ($800,000 - $100,000). Since 50% of the proceeds from the sale of the Salt Ltd. shares ($400,000/$800,000 = 50%) are reinvested in Pepper Ltd., an eligible small business corporation, 50% of the capital gain on the Salt Ltd. shares can be deferred. Thus, Stephen can defer $350,000 of the capital gain.

Part (b):
The deferred portion of the capital gain ($350,000) reduces the ACB of the new investment in Pepper Ltd. shares from $400,000 to $50,000 ($400,000 - $350,000).
In 20X6, Growth Ltd.'s income for tax purposes increased by $155,000 because of the disposal of the Toronto office building (recapture $30,000 + taxable capital gains $125,000).

Class 1:

<table>
<thead>
<tr>
<th></th>
<th>Land</th>
<th>Building</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proceeds</td>
<td>$200,000</td>
<td>$450,000</td>
</tr>
<tr>
<td>ACB</td>
<td>(150,000)</td>
<td>(250,000)</td>
</tr>
<tr>
<td>Capital gain</td>
<td>$50,000</td>
<td>$200,000</td>
</tr>
<tr>
<td>Taxable capital gain</td>
<td>$25,000</td>
<td>$100,000</td>
</tr>
</tbody>
</table>

When the disposition is voluntary and recapture occurs, the taxpayer is permitted to defer recognition of the recapture if a replacement property with a similar business use is acquired within 12 months after the taxation year in which the disposition occurs [ITA 13(4)]. Similarly, the capital gain can be deferred, provided the same criteria are met [ITA 44(1)].

The new office building was acquired by March 20, 20X7 which is within the 12 month time limit. Growth Ltd. should attach a letter to its 20X7 tax return indicating that elections under ITA 13(4) & ITA 44(1) are being made to defer the 20X6 recapture and taxable capital gains. The letter should include amended calculations for 20X6 as follows:

20X6 Amended:

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>UCC balance, beginning of year</td>
<td>$220,000</td>
<td></td>
</tr>
<tr>
<td>Purchases</td>
<td>$0</td>
<td></td>
</tr>
<tr>
<td>Disposals (limited to original cost)</td>
<td>$(250,000)</td>
<td>$(250,000)</td>
</tr>
<tr>
<td>Reduced by the lesser of:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Normal recapture $30,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Cost of new building $500,000</td>
<td>30,000</td>
<td>(220,000)</td>
</tr>
<tr>
<td>Recapture of CCA</td>
<td></td>
<td>$0</td>
</tr>
</tbody>
</table>
Capital gains – lesser of

- normal capital gain $50,000 $200,000
- proceeds for the former asset in excess of amount spent for the replacement asset
  - land ($200,000 - $300,000) 0
  - building ($450,000 - $500,000) 0

Capital gain $0 $0

Since all of the proceeds for both the land and the building were reinvested in the replacement property, the entire capital gain is deferred. If Growth Ltd had downsized (spent less for the new property than the proceeds received for the former property), a capital gain equal to the proceeds not invested would have been recognized.

The tax value of the new premises is reduced by the income deferred on the former premises. The ACB for the replacement property will be reduced by the deferred capital gain [ITA 44(1)(f)]. The ACB and UCC for the replacement property acquired are as follows:

<table>
<thead>
<tr>
<th></th>
<th>Land</th>
<th>Building</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost</td>
<td>$300,000</td>
<td>$500,000</td>
</tr>
<tr>
<td>Less capital gain deferred [ITA 44(1)(f)]</td>
<td>(50,000)</td>
<td>(200,000)</td>
</tr>
<tr>
<td>ACB of replacement property</td>
<td>$250,000</td>
<td>300,000</td>
</tr>
<tr>
<td>Recapture deferred [ITA 13(4)(d)]</td>
<td>(30,000)</td>
<td></td>
</tr>
<tr>
<td>UCC of replacement building</td>
<td>$270,000</td>
<td></td>
</tr>
</tbody>
</table>

KC 8-12

[ITA: 3 – Aggregating formula]

3(a) Employment income $80,000
    Property income 2,000

3(b) Taxable capital gains:
    Shares of Corp X ($12,000 x ½) 6,000
    Personal-use property ($7,000 x ½) 3,500 $9,500
    Taxable net gain – LPP ($1,600 - $300) x ½ 650
    10,150
    Allowable capital losses ($15,000 x ½) (7,500) 2,650
    84,650

3(c) Other deductions 0

3(d) ABIL on SBC shares ($4,000 x ½) (2,000)

Net income for tax purposes $82,650
Problems

PROBLEM ONE

[ITA: 12(4); 20(1)(n); 20(8); 40(1)(a); 40(1.1); ITAR 26(3)]

Jennifer Farmer farmed for 36 years. She has recently sold her farm assets. Her primary crop was asparagus, and 20 of Jennifer’s 25 hectares of land were devoted to growing this vegetable.

The land had cost her $10,000 in 1967. She has sold it for an all-inclusive price of $175,000 that includes an unharvested asparagus crop that is 70% mature. Asparagus is a perennial plant consisting of a strong root stock which, when planted, remains in the soil for many years and requires little annual maintenance. Every year, the root stock provides two or three asparagus crops, which are harvested at little cost and sold directly to a food wholesaler.

The sale agreement for $175,000 included a cash down payment of $35,000 and a first mortgage of $140,000 held by Farmer. The mortgage is to be paid in seven annual instalments of $20,000. Interest of 12% will be charged on the unpaid balance. Farmer has sought your advice concerning the tax implications of the sale.

Required:

1) Describe to Farmer how the preceding transaction will be treated for tax purposes.

2) What additional information will you require to determine the actual amount of income for tax purposes created by the transaction?
1. The total sale price of $175,000 includes three separate properties:

   **Land** - is capital property because it was acquired to provide a long-term benefit from farming. Any gain will be a capital gain. The gain is determined as the selling price in excess of the land's adjusted cost base. Because the land was acquired before 1972, the adjusted cost base is its value at December 31, 1971 [Median rule ITAR 26(3)].

   **Root Stock** - is capital property because it provides a long-term benefit in the form of regular asparagus crops. The gain on the root stock is a capital gain.

   **70% mature crop** - is grown regularly for resale purposes and is, therefore, classified as inventory. Any gain on sale will result in business income.

   Because a portion of the proceeds on the land and root stock are deferred over seven years, a capital gain reserve can be claimed annually, provided that the full gain is recognized over 5 years and at least 20% of the gain is recognized each year on a cumulative basis (a 10 year reserve limit would apply if the farm property was sold to a child) [ITA 40(1)(a)(iii), 40(1.1)]. The annual interest (12%) on the deferred proceeds is property income and is recognized on the annual accrual method at each annual anniversary date [ITA 12(4)].

   To the extent that a portion of the deferred proceeds relates to the sale of the inventory and is deferred beyond two years, a reserve can be claimed against the business income provided that the full income from the inventory sale is recognized within four years (Maximum 3-year reserve) (see Chapter 5) [ITA 20(1)(n), 20(8)].

2. Additional information required:

   (a) The value of the land at December 31, 1971 in order to establish the adjusted cost base. A similar value may also be needed for the root stocks if they have been in use since prior to 1972 [ITAR 26(3)].

   (b) A reasonable breakdown of the $175,000 sale price between the land, root stock and asparagus inventory.
PROBLEM TWO

[Capital vs. Income]

Murray George is a professional musician and composer. For 15 years, he has made a good living from this profession. He derives his income from concert appearances (for substantial fees) and from royalties on original musical compositions.

As of 20X0, George has been internationally famous in the classical music field. In 20X1, the Canadian National Music Library agreed to purchase a number of documents from him. These documents included:

(a) 26 of George’s original manuscripts, written in his own hand;
(b) a box containing 15 of his youthful works, including first drafts and final versions; and,
(c) a copy of George’s personal diary, to be exhibited to the public only after his death.

For these items, he received $50,000, to be paid in the amount of $30,000 in 20X1 and $20,000 in 20X2. Over the years, the compositions (other than his youthful works) had generated income from royalties, which George had declared as professional income for tax purposes.

The Canadian National Music Library is not a commercial enterprise. It is a registered charitable foundation. Before filing his 20X1 tax return, George obtained the CRA’s advice on how the receipt of $50,000 should be handled. Their response was that the $50,000 clearly represents business revenue and should be added to his professional earnings in 20X1.

Required:

State whether you agree or disagree with the CRA’s advice, and provide reasons for and against your position.
**Solution to P 8-2**

CRA’s position that the entire $50,000 is business income from professional activities can be supported on the basis that he makes his living from both writing and performing music. Therefore, all revenues associated with his creative works and his fame form part of his overall income earning process. It can be argued that a manuscript, once written, is a valuable inventory item which can earn income from royalties or, alternatively, from the sale of the entire manuscript. It is more difficult to support this view for the box of youthful works and for the personal diary, although it is not uncommon for an entertainer, once famous, to exploit that position to increase revenues.

Alternatively, it can be argued that each of the items sold is a capital property resulting in a capital gain. As such, only one-half of the amount is taxable and the gain can be recognized over two years in proportion to the receipt of the proceeds [ITA 40(1)(a)(iii)]. This position can be supported as follows:

- George has no apparent history of writing music for the purpose of selling the manuscripts. Normally, the manuscripts are retained for the purpose of earning royalties. Therefore, their acquisition, through creative work, was for the purpose of providing a long-term benefit in the form of royalties.

- George’s diary and box of youthful works do not generate any royalty revenue. They are personal items which can be classified, for tax purposes, as personal-use property because they were acquired (created) for personal use and enjoyment, before a music career was established.

- The nature of the purchaser is also important. The buyer is not a commercial enterprise but rather a public library trying to preserve his major works. This adds credibility to the position that the sales are once-in-a-lifetime activities of a capital nature and not an adventure in the nature of trade.

- It is unclear whether the acquisition of the original manuscripts will entitle the library to the future royalties on those manuscripts. Probably that is not the case as the library simply wants the handwritten copies for preservation. This property was not created for the purpose of resale and its value increase was fortuitous rather than part of a scheme of profit-making from the sale of the handwritten copies.

It is the authors’ opinion that the income is a capital gain and not business income. However there is obvious support for the contrary.
PROBLEM THREE

[Capital vs. Income]

R.M. Inc. (RMI) manufactures earth-moving and excavation equipment. RMI is owned and managed by Ross Meister. It is now February 15, 20X2. Meister has asked you to help the company deal with a tax problem. The CRA is questioning the capital gains treatment of a 20X1 sale of land by RMI; it believes that the full amount of the gain should have been included in income.

Meister wants to know what arguments the CRA will likely present and how RMI can counter them. Also, he wants to know what the tax consequences will be if the CRA succeeds in making an adjustment. Details of the land transaction are offered below.

RMI purchased 50 hectares of vacant land in an industrial park on December 2, 20X0, for $1.35 million. The purchase was financed, in part, by a five-year first mortgage of $500,000 with interest at 12%. At first, Meister intended to move RMI from its current location to the new location just north of Toronto. He knew that even if he decided later not to move from his current premises, he had purchased the land at a bargain price and would be able to make a profit if he sold it.

On April 1, 20X1, RMI accepted an offer of $3.68 million for 40 hectares of the vacant land. RMI took back a $685,000 first mortgage, repayable at $30,000 per year, with the balance due in 20X6. In RMI’s 20X1 corporate tax return, the land disposition was recorded as a capital gain. The remaining 10 hectares of land were retained by RMI.

Meister decided to build RMI’s new warehouse on the 10-hectare site. RMI will retain its current location as a garage for storing and servicing construction equipment. RMI is subject to a 25% tax rate on all of its income.

Required:

Prepare a brief report that answers Meister’s questions.
Solution to P 8-3

In order to establish if the transaction is business income or capital gain the following factors must be considered:

- nature of asset (land).
- *primary* and *secondary* intention of acquisition.
- length of time land held.
- number and frequency of transactions.
- extent and terms of borrowing.
- nature of company's business.

*Arguments in favour of capital gains treatment:*

- The land was purchased with the intent to construct a facility for the company's own use.
- The land area zoning is consistent with the intended facility (zoned industrial park).
- The offer to purchase was unsolicited; therefore there was no active intent to sell.
- The company is not in the real estate business.
- The borrowing for acquisition was for a long term indicating that the intended use was long term and of a capital nature.
- The company has no prior history of buying and selling land.

*Arguments in favour of business income treatment:*

- There was no attempt to earn income from or to develop the vacant land.
- The land was purchased with the secondary intent to sell for a profit if the plant was not built.
- The amount of land purchased exceeded that required for the plant.
- The quick flip of the property indicates an adventure in the nature of trade.

It is the authors’ opinion that the secondary intention factor combined with the purchase of substantially more land than was required indicate that the transaction results in business income. However, there are persuasive arguments for the opposing view.

If the transaction is treated as *business income*, the company will incur additional taxes of $325,000 as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proceeds on sale of 40 hectares</td>
<td>$3,680,000</td>
</tr>
<tr>
<td>Cost of land sold:</td>
<td></td>
</tr>
<tr>
<td>40/50 hectares x $1,350,000</td>
<td>$1,080,000</td>
</tr>
<tr>
<td>Income on sale of land</td>
<td>$2,600,000</td>
</tr>
<tr>
<td>Less taxable gain reported on the 20X1 tax return</td>
<td>$1,300,000</td>
</tr>
<tr>
<td>Untaxed portion</td>
<td>$1,300,000</td>
</tr>
<tr>
<td>Additional tax payable - $1,300,000 x 25%</td>
<td>$325,000</td>
</tr>
</tbody>
</table>
While the above determines the amount of additional tax payable, it does not address the timing of the tax. As a capital gain, a reserve can be claimed for deferred proceeds [ITA 40(1)(a)(iii)]. As business income a reserve can also be claimed [ITA (20(1)(n) & 20(8)]. However the tax treatment under these reserves is different.

**Capital gain:**

If the transaction is a capital gain, the 20X1 income for tax purposes would be:

- Gain on land (above) $2,600,000
- Deduct 20X1 reserve - lesser of:
  - a) $685,000/$3,680,000 x $2,600,000 = $483,967
  - b) 4/5 x $2,600,000 = $2,080,000
- Taxable in 20X1 (1/2) $1,058,016

Using the capital gain reserve, the entire gain must be recognized within five taxation years even if there is still an unpaid balance [ITA 40(1)(a)(iii)].

**Business income:**

If the transaction is business income the 20X1 income for tax purposes would be:

- Gain on land (above) $2,600,000
- Less reserve:
  - $685,000/$3,680,000 x $2,600,000 = (483,967)
- Taxable in 20X1 $2,116,033

However, as business income, the entire gain must be recognized within four years compared to five if it was a capital gain [ITA 20(1)(n), 20(8)].
PROBLEM FOUR

[ITA: ITA 40(2)(g); 53(1)(f); 54; 69(1); 82(1)(b); 248(1); focus - adjusted cost base of identical properties; the treatment of stock dividends; superficial losses; and, deemed dispositions]

In 20X0, Kiranjit Dhillon acquired 1,000 shares of Pluton Ltd. (a Canadian public corporation) at a cost of $21,000 plus a brokerage commission of $600. During 20X0, she received cash dividends of $1,200. In 20X1, Pluton failed to pay the cash dividend owing to a cashflow shortage; instead, it issued a stock dividend, whereby Dhillon received an additional 100 shares. At the time of the stock dividend, the share value was $18 per share.

On December 15, 20X1, with the company's financial position continuing to decline, Dhillon sold all of her shares of Pluton for $15,000. She felt relieved when the share values declined further over the next two weeks. She incurred brokerage fees of $300 on the sale.

Early in the new year, Pluton apparently solved its financial crisis by selling an unprofitable subsidiary. Dhillon’s broker recommended that she again invest in Pluton’s shares. On January 11, 20X2, she purchased 1,000 shares at a cost of $12,000 plus brokerage fees of $200.

In June 20X2, she gifted all of her shares in Pluton to her son, who was about to attend university. At that time, the shares were valued at $20,000.

Required:

Calculate the amount by which Dhillon’s net income for tax purposes will be affected by the above transactions for the years 20X1 and 20X2.
Solution to P 8-4

Stock dividend:

Deemed to be a taxable dividend received [ITA 248(1)]

\[
100 \text{ shares} \times \$18 = 1,800 \times 1.44 \text{ [ITA 82(1)(b)]} = \$2,592
\]

Sale of Pluton shares in 20X1:

Proceeds of disposition (1,100 shares) [ITA 54] $15,000
Less: adjusted cost base (see below) (23,400)
   cost of disposition (300)
Less amount considered to be a superficial loss [ITA 54] and therefore denied [ITA 40(2)(g)]
   1,000 \times 8,700/1,100 = 7,909
Capital loss $(791)
Allowable capital loss (1/2) $(396)

The superficial loss occurs on the 1,000 shares of Pluton because, after selling 1,100 shares on December 15, 20X1, Dhillon repurchased 1,000 of the same shares within 30 days [ITA 54].

Gift of shares in 20X2:

Deemed proceeds of disposition (1,000 shares) [ITA 69(1)] $20,000
Adjusted cost base (see below) (20,109)
Capital loss $(109)
Allowable capital loss (1/2) $(55)

Adjusted cost base of shares [ITA 52(3)]:

<table>
<thead>
<tr>
<th># of shares</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X0 Purchase</td>
<td>1,000 $21,600</td>
</tr>
<tr>
<td>20X1 Stock dividend</td>
<td>100 $1,800</td>
</tr>
<tr>
<td>Dec 15 20X1 Sale</td>
<td>1,100 (23,400)</td>
</tr>
<tr>
<td>Jan 11, 20X2 Purchase</td>
<td>0</td>
</tr>
<tr>
<td>Superficial loss from 20X1 [ITA 53(1)(f)]</td>
<td>1,000 12,200</td>
</tr>
</tbody>
</table>

Summary

In 20X1, Dhillon's property income will increase by $2,592. An allowable capital loss of $396 occurs but can only be used against other capital gains. (No information on other capital transactions is provided). If there are no other capital transactions, the loss remains unused. In 20X2, Dhillon incurs an allowable capital loss of $55 which can only be used if there are capital gains.
PROBLEM FIVE

[ITA: 9(1); 13(1); 18(1)(b); 20(16); 38; 40(1); 44(1), (5)]

For the year ended August 31, 20X0, Zefer Ltd., a Canadian-controlled private corporation, reported a net income before income taxes of $485,000. The statement of income is summarized as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income from operations</td>
<td>$380,000</td>
</tr>
<tr>
<td>Other income:</td>
<td></td>
</tr>
<tr>
<td>Interest</td>
<td>5,000</td>
</tr>
<tr>
<td>Net gain on sale of assets</td>
<td>100,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$485,000</strong></td>
</tr>
</tbody>
</table>

The net gain on the sale of assets consists of the following amounts:

**Gain on sale of franchise—$40,000**

The franchise to operate a retail store was acquired seven years previously at a cost of $110,000. It was sold in 20X0 for $140,000. The sale proceeds included a cash down payment of $20,000, with the balance payable in seven annual instalments of $20,000 plus interest beginning in 20X1. The franchise, which qualified as a class 14 asset, had an undepreciated capital cost of $92,000 at the time of the sale and was the only asset in its class.

**Gain on sale of warehouse property—$80,000**

In July 20X0, a warehouse property was sold for cash proceeds of $430,000 (land $180,000, building $250,000). The property had an original cost of $370,000 (land $60,000, building $310,000). The building, which was the only asset in class 1, had an undepreciated capital cost of $290,000. After the sale of the warehouse, temporary premises were leased until a new, larger warehouse was constructed. New land was purchased in January 20X1 for $200,000. Construction of the new warehouse would be completed by July 20X1.

**Loss on sale of shares of subsidiary—$20,000**

Zefer sold shares of a subsidiary corporation for cash proceeds of $450,000. The shares were acquired five years ago for $470,000. Legal fees of $2,000 were paid to draw up the sale agreement and were charged to the legal expense account.

**Required:**

1. Calculate Zefer’s net income for tax purposes for the 20X0 taxation year.
2. What are the tax implications relating to the construction of the new warehouse in 20X1?
Solution to P 8-5

Part 1

Net income for tax purposes 20X0:

Income per financial statement [ITA 9(1)] $485,000

Net gain on sale of assets [ITA 18(1)(b)] (100,000)

Legal fees for sale agreement of subsidiary shares - capital item [ITA 18(1)(b)] 2,000

Recapture of CCA on franchise [ITA 13(1)]
- (UCC $92,000 – Cost $110,000) 18,000

Terminal loss on sale of building [ITA 20(16)]
- (UCC $290,000 – Proceeds $250,000) (40,000)

Taxable capital gain on the franchise sale:

- Proceeds of disposition $140,000
- ACB (110,000)
- Gain 30,000

Less reserve - lesser of [ITA 40(1)(a)(iii)]:
- 80% x $30,000 = 24,000, or
- $120,000/140,000 x $30,000 = 25,714

Capital gain $ 6,000

Taxable capital gain - ½ x $6,000 3,000

Taxable capital gain on sale of land - ½($180,000 - $60,000) 60,000

Allowable capital loss - ½($450,000 - $470,000 - $2,000 legal fee) (11,000)

Net income for tax purposes $417,000

Part 2

The new warehouse property qualifies as replacement property because it will be acquired within one year after the end of the taxation year in which the former property was sold and it will be used in the business for a similar purpose [ITA 44(1)(d), 44(5)]. Consequently, the capital gain on the former warehouse land can be deferred. The deferred gain of $120,000 ($180,000 - $60,000) will reduce the ACB of the new land to $80,000 ($200,000 - $120,000) [44(1)(f)]. When the new land is eventually sold, the deferred capital gain will be recognized. A similar opportunity would be available for the building for both a capital gain and recapture of CCA. However, in this case no income was generated on the building.
PROBLEM SIX

[ITA: 3; 20(1)(p); 38(c); 39(1)(c); 40(2)(b),(g); 41(1), (3); 46(1); 50(1); 128.1(4)(b),(d); 220(4.5), (4.51)].

Charles Bartello intends to leave Canada and start a new life in southern Florida. Before leaving, he intends to dispose of all his property so that he will have sufficient capital to acquire a business in the United States.

Bartello has provided the following information:

1. He currently owns 40% of the shares of a Canadian small business corporation, which are valued at $70,000. The shares were purchased four years ago for $100,000. Bartello is employed by the corporation and anticipates that his salary up to the date of departure will be $75,000.

2. At the beginning of the current year, he purchased a rental property as an investment. To date, the property has provided rental revenue of $14,000; however, Bartello has incurred cash expenses for property taxes, maintenance, interest, and insurance of $17,000. At the same time, the property has appreciated in value by $12,000. When he purchased the property, Bartello was not yet thinking of leaving Canada.

3. Three years ago, Bartello loaned $10,000 to a small business corporation owned by a friend. The business has suffered serious losses, and he has little hope of being repaid. In addition, no interest has been paid on the loan, although in the past two years Bartello has included interest in income for tax purposes on the anniversary dates. The total interest included is $2,000.

4. His home is worth $180,000 (original cost, $150,000.) He has owned the home for eight years and has lived in it all that time.

5. Bartello owns the following additional properties:

<table>
<thead>
<tr>
<th>Description</th>
<th>Cost</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Motorboat</td>
<td>$14,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>Furniture</td>
<td>21,000</td>
<td>6,000</td>
</tr>
<tr>
<td>Shares of public corporation X</td>
<td>10,000</td>
<td>14,000</td>
</tr>
<tr>
<td>Shares of public corporation Y</td>
<td>50,000</td>
<td>15,000</td>
</tr>
<tr>
<td>Corporate bond</td>
<td>100,000</td>
<td>102,000</td>
</tr>
<tr>
<td>Art collection</td>
<td>600</td>
<td>3,000</td>
</tr>
<tr>
<td>Stamp collection</td>
<td>20,000</td>
<td>16,000</td>
</tr>
<tr>
<td>Grand piano</td>
<td>10,000</td>
<td>14,000</td>
</tr>
</tbody>
</table>

Required:

1. Determine Bartello’s net income for tax purposes for the year in which he leaves Canada.

2. Would Bartello’s net income change if he left Canada, still owning the above mentioned assets? Explain.
Solution to P 8-6

This problem emphasizes that the determination of capital gains and losses must be analyzed in conjunction with the restrictions of the aggregating formula for determining net income for tax purposes.

The amounts and nature of income and losses for the year of departure are identified below followed by a summary in the form of the aggregating formula for net income.

**Small business corporation shares:**

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proceeds</td>
<td>$70,000</td>
</tr>
<tr>
<td>ACB</td>
<td>$(100,000)</td>
</tr>
<tr>
<td>Business investment loss [ITA 39(1)(c)]</td>
<td>$(30,000)</td>
</tr>
<tr>
<td>Allowable business investment loss (1/2) [ITA 38(c)]</td>
<td>$(15,000)</td>
</tr>
</tbody>
</table>

**Salary from corporation (employment income)** | $75,000

**Real estate:**

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rental loss ($14,000 - $17,000)</td>
<td>$(3,000)</td>
</tr>
<tr>
<td>Capital gain</td>
<td>$12,000</td>
</tr>
<tr>
<td>Taxable capital gain (1/2)</td>
<td>$6,000</td>
</tr>
</tbody>
</table>

**Loan to Small Business Corporation:**

The loan is uncollectible and is deemed to have been sold for a value of zero in the year in which it is established to be uncollectible [ITA 50(1)].

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proceeds (deemed)</td>
<td>$0</td>
</tr>
<tr>
<td>ACB</td>
<td>$(10,000)</td>
</tr>
<tr>
<td>Business investment loss [ITA 39(1)(c)]</td>
<td>$(10,000)</td>
</tr>
<tr>
<td>Allowable business investment loss (1/2) [ITA 38(c)]</td>
<td>$(5,000)</td>
</tr>
</tbody>
</table>

The loan also has unpaid interest of $2,000 which Charles has previously accrued and included in property income for tax purposes. The unpaid interest can be deducted in accordance with the rules for income from property. As there is no interest income in the year, a property loss occurs $2,000 [ITA 20(1)(p)].

**Personal Home:**

Results in a capital gain of $30,000 which can be reduced to zero by the principal residence exemption, as Charles occupied the home for all the years that it was owned [ITA 40(2)(b)].
Sale of Other Properties:

Personal use property [ITA 54, 46(1)]:
- Boat $10,000 - $14,000 = $(4,000), loss denied [ITA 40(2)(g)] - NIL
- Furniture $6,000 - $21,000 = $(15,000), loss denied [ITA 40(2)(g)] - NIL
- Piano $14,000 - $10,000 = $4,000 x $2,000

Listed personal property [ITA 41(3), 54]
- Art ($3,000 - $1,000) * $2,000
- Stamps ($16,000 - $20,000) (4,000) (2,000) $0

Other properties:
- Public corporation X ($14,000 - $10,000) $4,000
- Bond ($102,000 - $100,000) 2,000
- $6,000 x ½ $3,000
- Public corporation Y ($15,000 - $50,000) $(35,000) x ½ $(17,500)

* $1,000 floor rule for proceeds and ACB of personal-use property [ITA 46(1)].

Net Income for tax purposes:

3(a) Employment income $75,000
3(b) Taxable capital gains:
- Personal use property $2,000
- Other - real estate 6,000
- Corporation X and the bond 3,000
- Taxable net gains from LPP [ITA 41(1)] 0
- Allowable capital losses Corporation Y (17,500) 0
3(c) Other deductions 0
3(d) Losses:
- Allowable business investment losses:
  - Shares (15,000)
  - Loan (5,000)
  - Total (20,000)
- Property losses:
  - Rental (3,000)
  - Interest (2,000)
  - Total (25,000)
- Net income for tax purposes $50,000
Part 2

If Bartello does not sell his assets before going non-resident, the tax implications will be as follows. On becoming non-resident, Bartello is deemed to dispose of and immediately reacquire before ceasing Canadian residence all assets, except [ITA 128.1(4)(b)]:

a) Real estate located in Canada, Canadian resource properties, and timber resource properties,

b) Assets used in carrying on a business in Canada. This includes capital property, eligible capital property, and inventory.

c) Excluded Right or Interest. This includes RPP, RRSP, RRIF, RESP, TFSA, DPSP, stock options, and retiring allowances [ITA 128.1(10)].

The assets are deemed disposed at fair market value. Any resulting capital gain is taxed under the normal rules for capital gains in the tax return for the year of departure. This is commonly referred to as departure tax.

In this case, Bartello will be deemed to dispose and reacquire all his assets at their fair market value except for his home and his rental property.

An election is available which permits an individual to elect to have a deemed disposition on properties that are exempt from the deemed disposal rules [ITA 128.1(4)(d)]. An individual may choose to do this if it results in a capital loss or the use of the capital gains deduction.

The individual can elect to provide security in lieu of paying the departure tax, in which case, the departure tax becomes payable in the year the asset is sold. Interest does not accrue on the unpaid departure tax. Emigrants are exempt from the requirement to provide security on the first $100,000 in capital gains [ITA 220(4.5), (4.51)].
PROBLEM SEVEN

[ITA: 3; 6(1)(c); 12(1)(c); 12(4); 12(1)(k); 13(1); 38; 39(1)(c); 40; 41(1); 44(1), (5); 69(1)(b)]

The following financial information is provided for the 20X0 taxation year of Virginia Couture:

- Interest income: $20,000
- Net loss from retail store for the year ended December 31, 20X0: (7,000)
- Gain on sale of public corporation shares: 8,000
- Loss on sale of shares of a CCPC qualified as a small business corporation: (10,000)
- Dividends from foreign corporations, net of $300 withholding tax: 2,700
- Loss on sale of land that was originally purchased to build a rental property. The project was cancelled after a rezoning application was lost: (38,000)
- Gain on sale of an oil painting: 4,000
- Director’s fees for attendance at corporate meetings: 6,000
- Loss on sale of personal jewellery: (5,000)

In 20X0, Couture gifted shares of a Canadian-controlled public corporation (CCPC) to her 16-year-old son. The shares, which originally cost $8,000, had a value of $10,000 at the time of the gift.

Also, in 20X0, Couture had a rental loss of $3,000 (before amortization/depreciation and capital cost allowance). The property was originally purchased for $70,000 (land $9,000, building $61,000). The class 1 building had an unamortized capital cost of $50,000 at the end of the previous year. On the last day of 20X0, Couture sold the property for $100,000 (land $12,000, building $88,000). She intends to purchase a new rental property in early 20X1 for $200,000 (land $20,000, building $180,000).

In the previous year, by agreement, Couture obtained the exclusive licence to distribute a certain product in Canada. In 20X0, she divided the country into six sales territories and sold 10-year sub-licences to individuals in each territory. Total proceeds were $24,000.

Required:

1. Calculate Couture’s income for tax purposes for the 20X0 taxation year in accordance with the aggregating formula of section 3 of the Income Tax Act.

2. What are the tax implications if Couture acquires the new rental property in 20X1?
Solution to P 8-7

1. Net Income for Tax Purposes 20X0:

3(a) Employment income – director’s fee [ITA 6(1)(c)] $ 6,000
Business income - sale of licences 24,000
Property income:
   Interest [ITA 12(1)(c), 12(4)] 20,000
   Foreign dividends ($2,700 + $300) [ITA 12(1)(k)] 3,000
   Rental income:
      Loss from rentals $(3,000)
      Recapture of CCA ($50,000 - $61,000) [ITA 13(1)] 11,000 8,000
61,000

3(b) Taxable capital gains:
   Public corporation shares sold - ½($8,000) $ 4,000
   Public corporation shares gifted to son - ½($10,000 - $8,000) [ITA 69(1)(b)] 1,000
   Land - ½($12,000 - $9,000) 1,500
   Building - ½($88,000 - $61,000) 13,500
   Taxable Net gain from Listed Personal Property: ½($4,000 painting - $5,000 jewelry) [ITA 41(1)] 0
   20,000
   Allowable capital loss:
      Sale of land - ½($38,000) (19,000) 1,000
      62,000
3(c) Other deductions 0

3(d) Losses:
   Business Loss from retail store $7,000
   Allowable business investment loss - sale of small business corporation [ITA 39(1)(c)]
      shares - ½($10,000) 5,000 (12,000)
Net income for tax purposes $50,000

2. The purchase of a new rental property in 20X1 will have no effect on the 20X0 income for tax purposes. If the land and building sold in 20X0 had been used to carry on a business rather than earn property income, the capital gain and recapture of CCA realized in 20X0 could have been deferred if a replacement property was acquired within 12 months after the end of the 20X0 taxation year [ITA 44(1)]. This opportunity is not available for rental properties [ITA 44(5)].
PROBLEM EIGHT

[ITA: 3; 5(1); 20(1)(c), (bb); 38(c); 39(1)(c); 39(4); 40(1)(a)(iii); 40(2)(b); 47(1); 49(1); 82(1)(b)]

Cindy Tse retired in April 20X9 and moved from Thunder Bay to Vancouver Island. During her retirement she plans to accept the occasional small consulting contract. Her financial transactions for 20X9 are summarized below.

1. Tse sold her home in Thunder Bay for $240,000. She paid a real estate commission of $8,000 and legal fees of $2,000 to complete the sale. Tse had purchased the home in 20X3 for $110,000. In 20X6, she purchased a summer cottage for $74,000. She sold it in 20X9 for $175,000. She paid a legal fee of $1,000 to draw up the sale agreement. Tse had used the summer cottage regularly for summer vacations.

2. Tse’s gross salary from January 1, 20X9, to her date of retirement was $30,000.

3. Three years ago, Tse purchased 20% of the shares of T Ltd. and 15% of the shares of Q Ltd. Both are Canadian-controlled private corporations. T’s assets consist entirely of investment properties, including shares, bonds, and rental properties. All of Q’s assets are used to operate an active business. Tse sold her shares in both corporations in 20X9. Details of the transactions are outlined below.

<table>
<thead>
<tr>
<th></th>
<th>T Ltd.</th>
<th>Q Ltd.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost</td>
<td>$30,000</td>
<td>$40,000</td>
</tr>
<tr>
<td>Selling price</td>
<td>63,000</td>
<td>28,000</td>
</tr>
</tbody>
</table>

Tse received $9,000 in cash for the T Ltd. shares, with the balance payable at the rate of $9,000 annually for the next six years. The Q Ltd. shares were sold for cash.

4. A local farmer has been trying to purchase Tse’s hobby farm land. Tse purchased the land in 20X2 for $69,000. In July 20X9, Tse received $2,000 from the farmer, for which she granted him an option to purchase the land. The option is open for two years and allows the farmer to purchase the land for $100,000.

5. In February 20X9, Tse paid an investment counsellor $300 for investment advice. The same month, she purchased 5,000 units of ABC mutual fund for $10 per unit. An additional 3,000 units were purchased in April 20X9, at $14 per unit. On October 31, 20X9, ABC fund distributed $1,500 of taxable Canadian dividends, which Tse reinvested in the fund, thereby acquiring another 100 units. On December 3, 20X9, Tse sold 2,000 units of ABC at $16 per unit. At year end, the fund units were valued at $18.

6. To obtain the funds to complete the purchase of the ABC mutual fund units, Tse increased the mortgage on her house by $20,000. She incurred interest of $500 on this amount before paying off the mortgage when the house was sold.

7. In 20X8, Tse invested in a real estate project with her friend, a real estate agent and part-time developer. Together, they purchased a parcel of land and constructed four town homes at a cost of $500,000. In 20X9, the four town homes were sold for $580,000 to a single buyer, who planned to use them as rental properties. Tse’s share of the gain was 40%. No cash was invested in the project, which had been funded entirely with bank financing.
8. Tse sold shares of X Ltd. (a public corporation) for $18,000 during the year. She had acquired the shares in 20X4 for $25,000.

9. Most of Tse’s investments have been in blue-chip shares that pay dividends. Recently, she has decided to invest and trade in speculative Canadian mining shares and commodity futures. Before she does so, she wants to know the tax implications of gains and losses on such trading. 

Required:

1. Calculate Tse’s minimum net income for tax purposes for the 20X9 taxation year in accordance with the aggregating formula of section 3 of the Income Tax Act.

2. Explain to Tse the potential tax consequences of gains and losses realized on trading speculative Canadian mining shares and commodity futures.

3. What will be the tax consequences to Tse if the option on the farmland is exercised the following taxation year?
Solution to P 8-8

1. The house and the cottage both qualify as a principal residence [ITA 54]. However, only one property per year may be designated as such. A choice must be made of the years to designate for each. The choice will be based on which property will have the greatest gain per year of ownership [ITA 40(2)(b)].

<table>
<thead>
<tr>
<th></th>
<th>House</th>
<th>Cottage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proceeds</td>
<td>$240,000</td>
<td>$175,000</td>
</tr>
<tr>
<td>Adjusted cost base</td>
<td>(110,000)</td>
<td>(74,000)</td>
</tr>
<tr>
<td>Costs of disposition</td>
<td>(10,000)</td>
<td>(1,000)</td>
</tr>
<tr>
<td>Gain</td>
<td>$120,000</td>
<td>$100,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Years owned</th>
<th>20X3 – 20X9</th>
<th>20X6 – 20X9</th>
</tr>
</thead>
<tbody>
<tr>
<td>7</td>
<td>4</td>
<td></td>
</tr>
</tbody>
</table>

Gain per year $17,143 $25,000

The cottage has the largest gain per year and should be designated for sufficient years to eliminate the entire gain. The cottage was owned for four years and so, with the benefit of the +1 rule, it is only necessary to designate the cottage for three years to exempt the full gain [ITA 40(2)(b)].

Designate the cottage for 20X7, 20X8 and 20X9 +1 = 4 years. Designate the house for 20X3, 20X4, 20X5, 20X6 +1 = 5 years.

**Cottage gain**

Principal residence exemption

- 4years/4years x $100,000 = (100,000)

Capital gain $0

**House gain**

Principal residence exemption

- 5years/7years x $120,000 = (85,714)

Capital gain $34,286

Taxable capital gain - ½ x $34,286 = $17,143
Net income for tax purposes 20X9:

3(a) Employment income – salary [ITA 5(1)] $30,000

Property income:
  Dividend from mutual fund $1,500 x 141% $2,115
  Less:
    Investment counselor fee [ITA 20(1)(bb)] (300)
    Interest on mortgage [ITA 20(1)(c)] (500) 1,315
  Business income - sale of townhouses
    40%($580,000 - $500,000) 32,000

1,315

3(b) Taxable capital gains:
  House (above) $17,143
  Shares of T Ltd.:
    Gain $63,000 - $30,000) $33,000
    Capital gains reserve - lesser of:
      - 80% x $33,000 = $26,400
      - $54,000/$63,000 x $33,000 = $28,286
    Capital gain $6,600
    Taxable capital gain (1/2) 3,300

3(c) Other deductions 0

3(d) Loss: ABIL [ITA 39(1)(c)]
  Q Ltd shares - ½ ($28,000 - $40,000) (6,000)

Net income $79,718
2. The tax treatment from trading in speculative Canadian mining stocks depends on whether or not Tse has elected in a previous year under section 39(4) of the Income Tax Act to treat Canadian securities as capital property. If the election was made, the trading in Canadian mining stocks will be treated as capital transactions resulting in capital gains or losses. However, if the election was not made, the gains and losses may be treated as business income or loss because the primary purpose for acquiring the shares is to trade them at a profit. Keep in mind that the mining companies invested in may eventually produce income and pay dividends, thus providing a long term benefit. CRA would likely consider the length of the period of ownership and the number and frequency of the trading transactions to establish a pattern of trading before deciding on the tax treatment. If Tse incurs losses from the trading she may want the losses to be treated as business losses so they can be deducted against all sources of income.

Commodity futures do not qualify as Canadian securities for purposes of the capital treatment election. By policy, CRA will allow Tse to choose capital treatment or business income treatment at the time of her first trade. She will have to follow a consistent treatment thereafter.

3. If the option on the farm land is exercised in the following year, Tse will receive $98,000 from the sale ($100,000 minus the $2,000 received in 20X9 for the option to purchase). She must include a taxable capital gain in that year of $15,500 (½ x [$100,000 - $69,000]). She can then amend her 20X9 tax return by removing the taxable capital gain of $1,000 (½ x $2,000) from income for tax purposes.
PROBLEM NINE

[ITA: 12(1)(d); 13(1); 14(1), (5); 20(1)(p); 20(16); 40(1)(a)(iii); 40(2)(b); 41(1); 46(1); 78(4); 56(1)(h); 248(1) SBC definition]

Sheila Ram is a professional engineer. In 20X7, she sold her consulting business and retired. Her financial information for the year 20X7 is outlined below.

1. On January 1, 20X7, Ram sold her engineering consulting business to a senior employee. The business had been operated as a franchised proprietorship with a December 31 fiscal year end. The following assets were sold:

<table>
<thead>
<tr>
<th>Original cost</th>
<th>Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>Goodwill</td>
<td>38,000</td>
</tr>
<tr>
<td>Franchise</td>
<td>40,000</td>
</tr>
<tr>
<td>Library</td>
<td>2,000</td>
</tr>
<tr>
<td>Office equipment</td>
<td>12,000</td>
</tr>
</tbody>
</table>

The sale agreement called for cash proceeds for all assets, except the franchise, which required a down payment of $20,000 at closing, with the balance payable on June 30, 20X8.

The accounts receivable of $90,000 were not sold but were retained by Ram for collection. During 20X7, Ram collected $82,000 of the receivables. The remainder is uncollectible.

On August 15, 20X7, Ram paid $4,000 to a former employee for a bonus awarded on December 31, 20X6. A review of Ram’s 20X6 income tax return showed the following:

- Undepreciated capital cost:
  - Class 8 $ 6,800
  - Class 14 24,000
  - Cumulative eligible capital 20,460
  - Reserve for bad debts 10,000
  - Unused listed personal property loss 800

2. In January 20X7, Ram sold her home for $230,000. She had acquired the house in 20X0 for $200,000. In May 20X7, she sold her Ontario vacation home, which she had acquired in 20X3 for $50,000, for $140,000. She also sold an oil painting for $1,400 that originally had cost $600.

3. Also, in 20X7, she received $30,000 from the sale of her 10% interest in Q Ltd., a Canadian-controlled private corporation. She had purchased the shares in 20X0 for $50,000. Q operates a small manufacturing business, and at the time of sale, its assets were appraised as follows:

| Working capital | $200,000 |
| Manufacturing assets | 300,000 |
| Goodwill | 100,000 |
| Government bonds (three-year term) | 200,000 |

4. In 20X7, Ram withdrew $45,000 from her RRSP.

Required:

Determine Ram’s net income for tax purposes for the 20X7 taxation year.
Solution to P 8-9

Net income for tax purposes 20X7:

Business income:

- Sale of goodwill – Note 1 $ 9,040
- Recapture of CCA, franchise (UCC $24,000 – Cost $40,000) [ITA 13(1)] 16,000
- Terminal loss, office equipment and library (UCC $6,800 – Proceeds $5,000) [ITA 20(16)] (1,800)
- 20X6 reserve for bad debts [ITA 12(1)(d)] 10,000
- 20X7 bad debt expense ($90,000 - $82,000) [ITA 20(1)(p)] (8,000)
- Unpaid 20X6 bonus (more than 179 days) [ITA 78(4)] (4,000)

Business income 21,240

Other income:RRSP withdrawal [ITA 56(1)(h)] 45,000

Taxable capital gains:

- Taxable Net gains from LPP [ITA 41(1)]
  - Painting - ($1,400 - deemed cost $1,000) [ITA 46(1)] $ 400
  - Less LPP loss forward from 20X6 ($800) (400)
- Franchise - ($50,000 - $40,000)
  - Less reserve - lesser of [ITA 40(1)(a)(iii)]
  - 4/5x $10,000 = $8,000 or
  - $30,000/$50,000 x $10,000 = $6,000
  - (6,000)

  $10,000

  $4,000

  Taxable capital gain (1/2) 2,000

  Vacation home - ($140,000 - $50,000)
  - less principal residence exemption
  - (4+1)/5 years x $90,000 (note 2)
  - (90,000) 0

  Home - ($230,000 - $200,000)
  - less principal residence exemption
  - (4+1)/8 years x $30,000 (note 1)
  - (18,750)

  $11,250

  Taxable capital gain (1/2) 5,625

  7,625

Allowable capital loss:

- Q Ltd. shares - ½($30,000 - $50,000) = $10,000
  - limited to taxable capital gains (note 3)
  - (7,625)

  0

Net income for tax purposes $66,240
Note 1

CEC – beginning of year $ 20,460
Sale of goodwill - ¾ ($40,000) [ITA 14(5)] (30,000)
Negative Balance $ (9,540)

Assuming that the CEC account included only the original cost of the goodwill the taxable portion of the negative balance is $9,040 as follows:

Original CEC addition - ¾ ($38,000) [ITA 14(5)] $28,500
Balance of CEC account in year of sale 20,460
CEC previously deducted 8,040
Taxable portion of excess:
2/3 ($9,540 - $8,040) [ITA 14(1)] 1,000
Taxable business income $9,040

Note 2

The vacation home was designated as a principal residence for the maximum number of years because it has the greater gain per year - $140,000 - $50,000 = $90,000/5 years = $18,000 versus the home - $230,000 - $200,000 = $30,000 /8 years = $3,750. Therefore, designate the vacation home for 20X4, 20X5, 20X6 and 20X7 + 1 and the home for 20X0, 20X1, 20X2 and 20X3 + 1 [ITA 40(2)(b)].

Note 3

The Q Ltd. shares do not qualify as small business corporation shares because only 80% of its assets are used in an active business (20% of the assets are invested in 3 year term bonds) [ITA 248 definition of small business corporation].
PROBLEM TEN

[ITA: 13(1); 40(1)(a)(iii)]

Simon Shansky is about to sell his shares in a private corporation for $100,000. He has owned the shares for many years, having originally acquired them at a cost of $20,000. Shansky intends to invest the proceeds from the sale in interest-bearing securities yielding 10%.

Two potential purchasers have made offers on the shares. One purchaser has offered to pay the full purchase price in cash. The other has offered to pay $40,000 at the date of sale and the balance of $60,000 in three annual instalments of $20,000, plus interest of 10% on the unpaid balance. The unpaid balance would be secured with adequate collateral.

Shansky is subject to a 45% tax rate.

Required:

1. Which option should Shansky accept?
2. Calculate the amount of funds that Shansky will have after three years under each option.
3. What rate of return would have to be earned on the invested proceeds of sale under the full cash payment option to provide the same capital value as under the deferred payment option after three years?
4. Indicate, without providing detailed calculations, whether your answer to question 2 would be different if Shansky were selling a building for $100,000 that originally cost $80,000 and had an unamortized capital cost of $35,000.
Solution to P 8-10

1. Shansky should accept the offer with the deferred proceeds because the capital gain reserve provisions permit the recognition of the capital gain to be delayed in proportion to the receipt of funds. Therefore, Shansky can earn 10% interest (5.5% after tax) on the delayed tax liability.

2. Funds after 3 years for each option:

(a) **Full cash payment**

<table>
<thead>
<tr>
<th>Proceeds</th>
<th>$100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax 45% (1/2) ($100,000 - $20,000)</td>
<td>(18,000)</td>
</tr>
<tr>
<td>Cash on year 1</td>
<td>$82,000</td>
</tr>
</tbody>
</table>

Compound value $82,000 x 5.5% x 3 years = $96,288

(b) **Deferred payment option**

Taxable gain $100,000 - $20,000 = $80,000 (1/2) $40,000

**Year of sale**

| Gain ($100,000 - $20,000) | $80,000 |
| Reserve | $60,000 x $80,000 | (48,000) |
| $100,000 | $32,000 |
| Taxable capital gain (1/2) | $16,000 |
| Tax @ 45% | $7,200 |

**Year 2**

| Gain (last year's reserve) | $48,000 |
| Reserve | $40,000 x $80,000 | (32,000) |
| $100,000 | $16,000 |
| Taxable capital gain (1/2) | $8,000 |
| Tax @ 45% | 3,600 |

**Year 3**

| Gain (last year's reserve) | $32,000 |
| Reserve | $20,000 x $80,000 | (16,000) |
| $100,000 | $16,000 |
| Taxable capital gain (1/2) | $8,000 |
| Tax @ 45% | 3,600 |

**Year 4**

| Gain (last year's reserve) | $16,000 |
| Taxable capital gain (1/2) | $8,000 |
| Tax @ 45% | 3,600 |

Total tax $18,000
Compound Value:

<table>
<thead>
<tr>
<th>Year of sale</th>
<th>- Cash</th>
<th>$100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Less tax (above)</td>
<td>(7,200)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>92,800</td>
</tr>
</tbody>
</table>

Year 2 - Interest on $92,800 @ 5.5%

|              | 5,104         |
|              | (3,600)       |
|              | 94,304        |

Year 3 - Interest on $94,304 @ 5.5%

|              | 5,187         |
|              | (3,600)       |
|              | 95,891        |

Year 4 - Interest on $95,891

|              | 5,274         |
|              | (3,600)       |
|              | $ 97,565      |

Therefore

- all cash = $ 96,288
- deferred payments = $ 97,565

Benefit of deferred payments $ 1,277

3. The rate of return required on the cash method to provide the same return as the deferred proceeds method is:

Cash at start $82,000

Cash after 3 years must be $97,565

Rate of return = 5.96% after tax

Pre-tax return

\[ x - .45x = 5.96 \]

\[ x = 10.84\% \]

4. The answer to part 2 would be different. The taxable gain on the sale of real estate would be the same as the shares as follows:

Capital gain $100,000-$80,000 = $20,000 (1/2) $10,000

Recapture (UCC $35,000 – Cost $80,000) 45,000

$55,000

However, the deferred proceeds would not delay the recognition of the recapture.
PROBLEM ELEVEN

Jordana Lea has accumulated a substantial portfolio of investments in bonds and shares of public corporations. She selects shares that provide low dividends and maximum long-term growth but is risk averse and will purchase only shares of corporations in secure industries.

Currently, all of her investments are achieving capital growth but her investment in shares of Cory Corporation is providing the lowest yield. This year, her share value in Cory increased to $50,000, a 10% increase (i.e., from $45,000) over the previous year. Cory has consistently maintained this growth rate. The shares were purchased several years ago at a cost of $20,000.

Lea's investment counsellor has recommended that she sell her shares in Cory and use the proceeds to purchase shares in J2 Industries Ltd. J2 is in the same industry as Cory but has recently achieved industry dominance. There is strong evidence that the shares of J2 will maintain a growth rate of 13% annually for the next five years.

Lea has high earnings from her annual salary, and her marginal tax rate is 45%.

Required:

1. Should Lea dispose of the Cory shares and use the proceeds to acquire the J2 shares?

2. What rate of return on the J2 shares is required to justify the exchange of securities?
Solution to P 8-11

1. In order to make a numerical comparison, an assumption must be made for the ultimate disposition date of the investment. Because the question provides information for five years, this time frame is assumed.

If Jordana keeps the Cory shares, after five years she will have:

\[
\begin{align*}
\text{Initial Investment} &= 50,000 \\
\text{Income for 5 years} &= 50,000 \times 10\% \times 5 \text{ years} = 80,525 \\
\text{Tax on sale after year 5} &= 45\% \times \frac{1}{2} (80,525 - 20,000) = 13,618 \\
\text{Net after-tax proceeds} &= 80,525 - 13,618 = 66,907
\end{align*}
\]

If she sells Cory and buys J2 shares, after five years she will have:

\[
\begin{align*}
\text{Sale of Cory} &= 50,000 \\
\text{Tax on sale} &= 45\% \times \frac{1}{2} (50,000 - 20,000) = 6,750 \\
\text{Net after-tax proceeds} &= 50,000 - 6,750 = 43,250 \\
\text{Value of J2 investment after 5 years} &= 43,250 \times 13\% \times 5 \text{ years} = 79,685 \\
\text{Tax on sale after 5 years} &= 45\% \times \frac{1}{2} (79,685 - 43,250) = 8,198 \\
\text{Net after-tax proceeds} &= 79,685 - 8,198 = 71,487
\end{align*}
\]

Assuming Jordana will dispose of her investment after 5 years, she should sell the Cory shares and purchase J2 shares as her after-tax proceeds are $71,487 versus $66,907.

The decision is more difficult if she will not dispose of her investment after five years.

2. Rate of return required on the J2 shares to justify a sale of the Cory shares:

The J2 shares must earn a sufficient return to provide at least $66,907 after-tax at the end of five years on an investment of only $43,250.

Therefore the selling price after five years must be:

\[
\begin{align*}
\text{Selling price} - \text{tax} &= 66,907 \\
\text{Selling price} - 0.45(1/2) \times (\text{selling price} - 43,250) &= 66,907 \\
\text{Selling price} &= 73,775
\end{align*}
\]

The pre-tax return on $43,250 to yield $73,775 after 5 years is = 11.27%
PROBLEM TWELVE

[ITA: 40(2)(b); 45(1); 45(2); 54 principal residence definition]

Sharon Sutherland owned a home in Toronto, Ontario, a ski chalet in Whistler, BC, and a condominium in Florida, USA until June 15, 20X7 when she sold all three properties and moved into a seniors’ residence. She provided the following information with respect to the properties:

<table>
<thead>
<tr>
<th>Property</th>
<th>Year Acquired</th>
<th>Cost</th>
<th>Selling Price (net of commission and other selling costs)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Home</td>
<td>20X1</td>
<td>$400,000</td>
<td>$460,000</td>
</tr>
<tr>
<td>Condo</td>
<td>20X2</td>
<td>$200,000</td>
<td>$245,000</td>
</tr>
<tr>
<td>Chalet</td>
<td>20X4</td>
<td>$300,000</td>
<td>$336,000</td>
</tr>
</tbody>
</table>

For the years that Sharon owned each property, she ordinarily inhabited it at some time in the year. She tended to spend the winter in Florida, the summer in Toronto, and the fall in Whistler.

Required:

1. Determine the minimum taxable capital gain to be reported by Sharon on the sale of the three properties.

2. How would the answer change if Sharon had moved out of the Toronto home in 20X3 when it was worth $410,000 and earned rental income from the Toronto home from that date until she sold it in 20X7?
Solution to P 8-12

1. The Toronto home, Florida condo and Chalet all qualify for the principal residence designation. They are all housing units owned by Sharon and she ordinarily inhabits each of them during sometime in the year [ITA 54].

Only one property can be designated as a principal residence for each calendar year. Therefore, it is necessary to calculate the gain per year for each property in order to determine the number of years to designate each property to exempt the maximum amount of gains.

<table>
<thead>
<tr>
<th></th>
<th>Home</th>
<th>Condo</th>
<th>Chalet</th>
</tr>
</thead>
<tbody>
<tr>
<td>Years owned</td>
<td>X1-X7 = 7 years</td>
<td>X2-X7 = 6 years</td>
<td>X4-X7 = 4 years</td>
</tr>
<tr>
<td>Gain per year</td>
<td>$8,571</td>
<td>$7,500</td>
<td>$9,000</td>
</tr>
<tr>
<td>Proceeds</td>
<td>$460,000</td>
<td>$245,000</td>
<td>$336,000</td>
</tr>
<tr>
<td>Adjusted cost base</td>
<td>(400,000)</td>
<td>(200,000)</td>
<td>(300,000)</td>
</tr>
<tr>
<td>Gain</td>
<td>60,000</td>
<td>45,000</td>
<td>36,000</td>
</tr>
<tr>
<td>Exemption</td>
<td>(34,286)</td>
<td>(15,000)</td>
<td>(36,000)</td>
</tr>
<tr>
<td>Capital gain</td>
<td>$ 25,714</td>
<td>$ 30,000</td>
<td>$ 0</td>
</tr>
<tr>
<td>Taxable capital gain (1/2)</td>
<td>$ 12,857</td>
<td>$ 15,000</td>
<td>$ 0</td>
</tr>
</tbody>
</table>

Principal residence exemption:

\[
(1+ \text{years designated}) \times \text{gain} = (1+3) \times 60,000 \quad (1+1) \times 45,000 \quad (1+3) \times 36,000
\]

<table>
<thead>
<tr>
<th>Years owned</th>
<th>7</th>
<th>6</th>
<th>4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Years designated</td>
<td>X1, X2, X3</td>
<td>X4</td>
<td>X5, X6, X7</td>
</tr>
</tbody>
</table>

The minimum taxable capital gain to be reported by Sharon on the sale of the three properties is $27,857 ($12,857 + $15,000 + $0).

The Chalet has the highest gain per year. Therefore, three years, X5, X6, and X7 were designated to the Chalet first in order to fully exempt the gain on the Chalet.

The Home has a gain per year of $8,571 whereas the Condo’s gain per year is $7,500. However, it is beneficial to designate one of the remaining four years to the Condo in this case. Because of the 1+ in the formula, designating the Condo for one year exempts two years worth of gain. Since $15,000 (2 \times $7,500) is greater than one year of gain on the Home ($8,571) more gain is exempted by designating the one year to the Condo, X4. The remaining years, X1, X2, and X3 were designated to the Home.
2. When Sharon begins to use the Toronto home as a rental property in 20X3 she is deemed to dispose of it for its fair market value ($410,000) at that time and reacquire it for that same amount [ITA 45(1)]. If she designates the home as her principal residence for 20X1 and 20X2, the entire gain to 20X3 will be exempt from tax.

### Home 20X3 Disposal

<table>
<thead>
<tr>
<th>Years owned</th>
<th>Gain per year</th>
<th>Proceeds</th>
<th>Adjusted cost base</th>
<th>Gain</th>
<th>Exemption</th>
<th>Capital gain</th>
</tr>
</thead>
<tbody>
<tr>
<td>X1-X3 = 3 years</td>
<td>$3,333</td>
<td>$410,000</td>
<td>(400,000)</td>
<td>10,000</td>
<td>(10,000)</td>
<td>$0</td>
</tr>
</tbody>
</table>

Principal residence exemption:

\[(1+ \text{years designated}) \times \text{gain} \times \text{years owned} = (1+2) \times 10,000 \times 3\]

Years designated X1, X2

### 20X7 Sale:

<table>
<thead>
<tr>
<th>Years owned</th>
<th>Gain per year</th>
<th>Proceeds</th>
<th>Adjusted cost base</th>
<th>Gain</th>
<th>Exemption</th>
<th>Capital gain</th>
</tr>
</thead>
<tbody>
<tr>
<td>X3-X7 = 5 yrs</td>
<td>$10,000</td>
<td>$460,000</td>
<td>(410,000)</td>
<td>50,000</td>
<td>0</td>
<td>$50,000</td>
</tr>
<tr>
<td>X2-X7 = 6 yrs</td>
<td>$7,500</td>
<td>$245,000</td>
<td>(200,000)</td>
<td>45,000</td>
<td>(22,500)</td>
<td>$22,500</td>
</tr>
<tr>
<td>X4-X7 = 4 yrs</td>
<td>$9,000</td>
<td>$336,000</td>
<td>(300,000)</td>
<td>36,000</td>
<td>(36,000)</td>
<td>$0</td>
</tr>
</tbody>
</table>

Principal residence exemption:

\[(1+ \text{years designated}) \times \text{gain} \times \text{years owned} = (1+2) \times 45,000 \times 6 = (1+3) \times 36,000 \times 4\]

Years designated X3, X4 X5, X6, X7

Sharon’s taxable capital gain 20X3 and 20X7 combined is $36,250 ($0 + $25,000 + $11,250 + $0). Sharon can reduce the combined taxable capital gain by designating the home for fewer years for the 20X3 disposition.
Sharon can make an election under subsection 45(2) not to recognize the change-in-use on the Toronto home in 20X3 when she commences to use it as a rental property. The home will remain a personal-use-property for tax purposes. The definition of a principal residence in ITA 54 includes a property that has a ITA 45(2) election on it. Such a property can be designated as a principal residence for four years. The four years do not have to be consecutive.

Thus, if Sharon makes the ITA 45(2) election she will not have a disposal of the home in 20X3. In 20X7 when she does dispose of the house, the taxable capital gain will be the same as calculated in 1. above. The home will meet the definition of a principal residence for all years owned (20X1 – 20X7) due to ordinarily inhabiting the home during sometime in 20X1, 20X2, and 20X3 and due to a ITA 45(2) election on the property in 20X4, 20X5, 20X6, and 20X7. She can still designate only one property per year as a principal residence.

Sharon will pay less tax if she makes a ITA 45(2) on the home in 20X3.
CASE

The Concorde Theatre Ltd.

[Capital vs. Income]

The Concorde Theatre Ltd., a local company owned by J. Bleet, operates a small neighbourhood cinema. The business is usually profitable, but this year, because of unusual events, a net loss has occurred. The income statement for the year ended December 31, 20X1, is summarized in the table below.

The company does not usually invest in real estate. The land and building that was sold for a gain of $70,000 was acquired seven months before its sale. An acquaintance of Bleet who ran into some serious financial difficulties required immediate cash to stop bankruptcy proceedings and asked Bleet to purchase his real estate. Bleet had no money to invest in real estate and was not in the market for such an investment.

However, the acquaintance pleaded with Bleet to help him out and kept reducing the purchase price to provoke an immediate cash sale. Bleet, watching the price drop to below what he felt was the fair market value, finally gave in. Concorde Theatre borrowed 100% of the purchase price and bought the property. The loan from the bank was payable on demand.

Four months later, the company received an offer from a local real estate investor to buy the property for $65,000 above the original purchase price. The same day, the original owner, who had improved his financial situation, asked if he could buy the property back. He was upset when Bleet agreed only if the price was $70,000 above the original price. Reluctantly, the acquaintance agreed to pay that much, provided that the closing date was delayed to three months hence.

The land, the sale of which resulted in an $110,000 loss, had been purchased three years earlier. The land was across the road from the theatre, and Bleet had intended to turn it into a parking lot for theatre patrons. However, because of the traffic patterns on the street, the city refused to grant vehicle access for the property. After a long battle, Bleet gave up and posted the land for sale. After six months without an offer, he finally accepted a reduced price to free up needed cash.

Bleet has just met with his accountant, who has informed him that the company will have to pay income tax of $25,000 for the year ended December 31, 20X1. Bleet knows that the corporate tax rate is 25% on income but cannot believe that a tax of $25,000 is payable on a net loss of $10,000.

Bleet asks his accountant to explain how such a result is possible and asks whether there is any possibility of a more logical result.

Required: As the accountant, outline your response to Bleet.
Solution to Case - The Concorde Theatre Ltd.

The result is possible if the gain on the building sale is business income and the parking lot loss is a capital loss. Under the aggregating formula, the capital loss cannot be used because there are no capital gains in the current year.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business income from operations</td>
<td>$30,000</td>
</tr>
<tr>
<td>Business income--sale of land and building</td>
<td>70,000</td>
</tr>
<tr>
<td>Taxable capital gains</td>
<td>0</td>
</tr>
<tr>
<td>Allowable capital losses (parking lot) (1/2 of $110,000)</td>
<td>(55,000)</td>
</tr>
<tr>
<td>Income for tax purposes</td>
<td>$100,000</td>
</tr>
<tr>
<td>Tax $100,000 @ 25% =</td>
<td>$25,000</td>
</tr>
</tbody>
</table>

Arguments to support the above position are:

Land and building (business income):
- The property was held for only a short period of time (7 months) and the deal to sell the property was made after 4 months.
- Bleet was not looking for a long-term real estate investment and made the acquisition only after the purchase price was reduced to a bargain price.
- The property was purchased with a loan payable on demand which indicates an intended temporary holding period.

Parking lot (capital loss):
- The property was purchased to provide a long-term benefit in the form of customer parking for the theatre.
- The intended use was prevented by the action of the city which was beyond his control.
- A significant attempt was made to obtain the sight for auto access.
- There is no indication that the property was purchased for any speculative reason.

In order to match the loss and the gain to reduce the tax liability, the following alternative arguments can be made.

1. Bleet could argue that the land and building sale results in a capital gain of $70,000 because he had not intended to acquire property to resell at a profit, but rather made the acquisition under pressure to help an acquaintance in financial difficulty. The ultimate gain was fortuitous and could not be passed over, especially after the real estate investor offered a substantial price. This argument is weak because if Bleet simply wanted to help the acquaintance, he could have loaned him funds taking the real estate as collateral.

2. A stronger argument may be that the parking lot acquisition had a secondary intention to resell at a profit and the related loss is a business loss which can be offset against the other income. He may have known about the problem of access but purchased the property anyway, with the secondary intention that if access was denied the property could be sold at a gain. The fact that a gain did not occur is beyond his control.
CASE TWO

Pan Li Ltd.

[Sale of Assets vs. Shares]

Pan Li Ltd. is a Canadian private corporation owned 100% by David Benjamin. The corporation operates an active business. Its most recent statement of financial position is summarized in the table below.

**PAN LI LTD.**

**Statement of Financial Position**

<table>
<thead>
<tr>
<th>Assets:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Current assets</td>
<td>$100,000</td>
</tr>
<tr>
<td>Land</td>
<td>50,000</td>
</tr>
<tr>
<td>Building</td>
<td>$400,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>700,000</td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>(400,000)</td>
</tr>
<tr>
<td>Goodwill, at cost</td>
<td>200,000</td>
</tr>
<tr>
<td></td>
<td>$1,050,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities and shareholders’ equity:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liabilities</td>
</tr>
<tr>
<td>Common shares</td>
</tr>
<tr>
<td>Retained earnings</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
</tbody>
</table>

Benjamin purchased the shares of Pan Li seven years ago from the previous shareholders at a cost of $100,000. He is considering retirement and has let it be known that the business is for sale. Recently, he received an offer of $700,000 for the shares of the corporation.

A second potential group of buyers has indicated that it would like to buy the business but does not want to buy the shares of the corporation. Instead, it wants to purchase the individual assets (current assets, land, building, equipment, and goodwill). Benjamin knows that certain of the corporate assets are worth more than their stated value on the financial statement and has asked his advisor to provide an appraisal. If he sold to the asset-buying group, the buyers would assume the corporation’s liabilities of $600,000 as part of the purchase price.

Both potential buyers have indicated that they have sufficient cash resources to pay only 70% of the purchase price and that the remaining 30% will have to be paid over three years, with appropriate interest.

Benjamin does not understand the tax implications of selling the shares, rather than the assets. Once the business is sold, he intends to use the funds to buy investments that will provide an annual return to supplement his retirement income.

**Required:**

1. Keeping in mind Benjamin’s objectives, explain to him the general tax implications of selling the shares of Pan Li, rather than the company’s individual assets.

2. What difference does it make to the purchasers whether they acquire the shares from Benjamin or the individual assets from Pan Li?
Solution to Case Two - Pan Li Ltd.

This case deals with the issue of the purchase and sale of corporate assets versus the shares of the corporation. While the topic is complex, and is reviewed in detail in a subsequent chapter, the student should, at this point, be able to recognize the basic issues and differences between the two from the study of chapters 2 through 7.

1. **Sale of Shares:**

   If Benjamin sells the shares of the corporation, the following occurs:

   - The shares are capital property and the entire gain on sale will be a capital gain.

   The taxable capital gain is:

   - Proceeds $700,000
   - Adjusted cost base (100,000)
   - Capital gain $600,000
   - Taxable capital gain (1/2) $300,000

   - Because 30% of the proceeds are deferred over three years, the capital gain reserve provisions can be used. Therefore, only 70% of the gain must be included in income in the year of sale. The remaining portion of the taxable gain will be recognized over the next three years. Consequently, a greater amount of interest income will be earned (on the unpaid balance) than if the entire proceeds were received in cash.

   At this point the student may not be aware that the capital gain deduction may apply. Because all of the corporate assets are used in an active business, the company qualifies as a small business corporation and Benjamin would be eligible for a capital gain deduction if the amount had not been previously used.

2. **Sale of Assets:**

   Under this alternative, Benjamin would retain ownership of the corporation and the corporation would sell each of its business assets. The following would result:

   - The corporation owns capital property, depreciable property, and eligible capital property. Consequently the sale of assets will likely cause the corporation to have capital gains as well as business income from the recapture of capital cost allowance and the sale of eligible capital property. The amount of these gains cannot be determined because the value of each of the assets has not been provided, nor has the cost amount of the properties been established. However, the amount of these gains will be different from the capital gain from the sale of shares.

   - To the extent that the deferred proceeds (30%) apply to the depreciable property (building and equipment) and eligible capital property (goodwill), the resulting recapture is not eligible for deferred recognition. Therefore the timing of the tax liability may be sooner than the sale of shares.
Because the shareholder and the corporation are separate taxable entities, Benjamin will be subject to further taxes when the corporation distributes its retained earnings as dividends. It should be recognized that such a distribution can be delayed indefinitely but if this is done, a deemed disposition of the shares will occur on Benjamin's death. In the meantime, the corporation can invest the after-tax proceeds from the sale of its assets creating investment returns that are regularly distributed as dividends to Benjamin providing his desired retirement income.

2. From the purchaser's perspective, the following should be noted.

- If the purchaser acquires shares, the shares are capital property to the purchaser and cannot be written-off for tax purposes. The corporation that is acquired will retain the cost amounts of the assets owned and therefore future capital cost allowance and the write-off of eligible capital property will continue on the same basis as prior to the sale.

- If the individual assets are purchased, the purchaser will acquire capital property, depreciable property and eligible capital property at the costs established as the purchase price. Therefore, future capital cost allowance and eligible capital property deductions will be based, not on the old values but rather, on the new values established. Therefore, the future taxable income will be different under each alternative.
CHAPTER 9

OTHER INCOME, OTHER DEDUCTIONS, AND SPECIAL RULES FOR COMPLETING NET INCOME FOR TAX PURPOSES

Review Questions

1. In addition to income from employment, business, property, and capital gains, taxpayers must include income from “other sources” when determining their income for tax purposes. How does the Income Tax Act limit the scope of “other sources of income”?

2. Explain why the receipt of property from an inheritance is not included in net income for tax purposes.

3. Can an individual deduct for tax purposes the amount of regular support payments to a former spouse? Would it matter if that individual’s only source of income were from interest on bond investments? Explain.

4. Why is the category “other deductions” considered to be the last test for determining the deductibility of an expenditure?

5. Briefly explain why an RRSP is an attractive investment.

6. If you hold investments both inside and outside an RRSP and usually invest in both corporate bonds and corporate shares, which type of investment would you prefer to hold within the RRSP? Explain.

7. Briefly explain why a TFSA is an attractive investment. How does a TFSA differ from an RRSP?

8. Briefly explain the tax treatment of a RESP.

9. What is the significance of the special rules for net income determination, and how do they relate to the five categories of income that are taxable?

10. “When in doubt, it is always best to claim a deduction for an expenditure because the worst possible result is that the CRA will simply deny the deduction.” Is this statement true? Explain.

11. If a group of business assets is being sold for a total agreed price, is it important that the vendor and the purchaser seriously consider how the total price will be allocated to the separate assets in the group? Explain.

12. What are the tax consequences if a parent sells property to a child at a price that is less than the actual value of the property? What difference would it make if the property were simply gifted to the child?

13. What are the tax consequences if an individual sells property to his or her spouse at a price that is less than the property’s market value but more than its cost?
14. How are property income (losses) and capital gains (losses) treated for tax purposes if the funds used to acquire the property were provided by the taxpayer's spouse? How does the tax treatment differ if the funds are provided by the taxpayer's parent?

15. What is the implication to the employer and to the employee if the employer delays the payment of remuneration to the employee?

16. What difference does it make for tax purposes when an individual's last will and testament bequeaths property to a spouse, rather than to a child?

17. The scope of the income tax system is defined by five specific types of income—employment, business, property, capital gains, and other sources. This being so, why is it necessary for the Income Tax Act to specifically list a number of items that are not included in income?

18. Briefly outline the process that can be used to establish the tax treatment of a particular transaction.
Solutions to Review Questions

R9-1. "Other sources of income" is a catch-all category that includes taxable items of income that do not qualify as employment income, business income, property income or capital gains. Its scope is limited because the Income Tax Act defines other sources of income as a specific list of items described in sections 56 through 59. Therefore, the term "other sources" is not open-ended as it suggests.

R9-2. The receipt of property from an inheritance would be included in the recipient’s net income for tax purposes only if it qualified as one of the five designated types of income. The inheritance is not income from employment because it was not earned from providing services to an employer. It is not business income because it was not earned from carrying on a business involving the sale of goods or services. It does not constitute a return on invested capital and, therefore, is not property income. It is not a capital gain because it did not result from the disposition of capital property. The inheritance can only be taxable if it qualifies as "other sources of income." A review of the limited list of items in this category does not include wealth enhancement from an inheritance and, therefore, by a process of elimination, it is not part of net income for tax purposes.

R9-3. Yes, support payments to a former spouse are deductible as part of the "other deductions" category provided that the support payments are pursuant to a legal agreement or court order and are on a periodic basis (not a lump sum) [ITA 56.1(4), 60(b), 60.1(4)]. It does not matter that the payer's only source of income is interest from bonds (which is property income). Items that qualify as "other deductions" are deducted as part of the aggregating formula after income from employment, business, property and capital gains have first been included. Therefore, support payments, as part of "other deductions" can be deducted from any source of income.

R9-4. Each of the primary categories of income (employment, business, property, and capital gains) permit certain items of expenditure to be deducted in arriving at the net income from that source. If those categories do not permit an expenditure to be deducted, the only remaining area of the tax system which may permit its deduction is the category of "other deductions." If this category does not mention the specific item then it is not deductible for tax purposes. Therefore, the category of "other deductions" is important because it is the last test in the income tax scheme to determine the deductibility of an expenditure [ITA 60].

R9-5. Investing in an RRSP is attractive for four reasons:

- Contributions to an RRSP are deductible (within limits) from income and, therefore, reduce the amount of tax otherwise payable. Therefore, the cost of a $5,000 RRSP contribution to a taxpayer subject to a 40% tax rate is only $3,000 ($5,000 - 40% of $5,000 = $3,000). Effectively the tax deduction means that a certain amount of income can be invested before tax rather than after-tax.

- Investment returns on amounts invested within the plan are not subject to taxation when earned and, therefore, compound annually on a pre-tax basis compared to an investment outside of the plan which compounds at a substantially reduced after-tax amount.

- Funds within the plan continue to be tax sheltered until they are withdrawn from the fund. Therefore, even when the plan is converted into regular pension payments, the undistributed funds continue to earn investment returns without tax. Tax is payable only in proportion to the periodic annual payments from the fund to the beneficiary [ITA 56(1)(h)].

- By contributing to a spousal RRSP, future retirement income can be split between wife
and husband, which may result in lower tax costs at that time [ITA 146(5.1)].

R9-6. Given that an individual will invest in both bonds and stocks, it is preferable to hold the bond investments within the RRSP and the stocks personally. Stocks will yield both dividends and capital gains, both of which receive preferential tax treatment. Dividends receive the dividend tax credit, and capital gains are only one-half taxable. By including stocks in the RRSP, the gains will be ultimately returned to the owner as pension income that is fully taxable and the otherwise preferential treatment is lost. On the other hand, bond interest is fully taxable when earned [ITA 12(1)(c), 12(4)] and, therefore, including these returns in the RRSP provides a tax deferral. The income is fully taxable when removed from the plan [ITA 56(1)(h)].

R9-7 The TFSA is an attractive investment because all investment income (interest, dividends and capital gains) are tax free when earned and when withdrawn from the account. Unlike an RRSP, contributions to a TFSA are not deductible and withdrawals are not taxable. The annual contribution limit for a TFSA is $5,000 [ITA 146.2].

R9-8 Contributions to an RESP are not deductible. Income earned in an RESP is not taxable until withdrawn and in that year is normally taxed as the student’s income. The RESP can receive a Canada Education Savings Grant for children up to age 17. The grant is limited to 20% of the first $2,500 contribution, annually. Additional grants may be available for low income families.

R9-9. The determination of the primary sources of income (employment, business, property, and capital gains) is governed by a set of fundamental rules for each source. However, within each source, unusual transactions may occur for which the treatment cannot be ascertained by the basic rules. In addition, taxpayers often attempt to structure transactions in a manner that will avoid the application of those rules. The special rules for net income determination outlined in sections 67 through 81 of the Income Tax Act are important because they are designed to deal with unusual transactions and tax avoidance schemes. Although, the special rules are provided separately, they effectively modify the general rules of the primary categories of income and, therefore, form an integral part of the rules for determining income from employment, business, property and capital gains.

R9-10. The statement is not true. In some circumstances, the denial of a deduction is accompanied by a penalty cost to the taxpayer or a related party. For example, if a corporation pays an unreasonable salary to a shareholder or a member of the shareholder’s family, the unreasonable portion of the salary is denied as a deduction to the payer [ITA 67] but remains fully taxable to the recipient [ITA 5(1)]. Therefore, amongst the related parties, double taxation will occur. This penalty is severe, and caution must be used for transactions involving related parties.

R9-11. When a group of assets are being sold for a total agreed price, it is important for the vendor and the purchaser to consider the allocation of the price amongst the assets involved [ITA 68]. For the vendor, the allocation will establish the type of income on the sale (recapture, capital gain or gain from eligible capital property) and consequently the amount of the related tax. For the purchaser, the allocation of the price determines the amount of CCA and eligible capital property deductions that are available in the future. A variance in the allocation can alter the amount of tax payable for the vendor and the amount of tax savings from deductions for the purchaser.

As the decision to buy is influenced by future cash flows, it is important that the purchaser accurately determine what the future tax costs will be. The special rules for determining net income permit the tax authorities to allocate the total purchase price in relation to the fair
value of each separate asset. Consequently, to avoid unanticipated tax costs, the vendor and the purchaser should give advance consideration to establishing a proper allocation.

R9-12. The parent is deemed to have sold the property at its fair market value [ITA 69(1)(b)(i)], even though that amount has not been received as payment, and the gain or loss will be determined accordingly. However, the cost of the property to the child remains at the actual purchase price (i.e., less than the fair value). Therefore, when the child sells the property for its fair value, a taxable gain occurs to the extent the selling value exceeds the purchase cost. Consequently, both the parent and the child are liable for tax on the same gain and double taxation occurs.

If the parent had gifted the property to the child, the parents position is unchanged from that above [ITA 69(1)(b)(ii)] but the child is deemed to have acquired the gifted property at its fair value [ITA 69(1)(c)]. Therefore, double taxation does not occur when a gift is made but it does when an attempt is made to avoid tax by selling to a related person at less than fair value.

R9-13. The sale of property to a spouse is treated differently than the sale of property to other related persons. In this case, assuming the property is capital property, the vendor spouse is deemed to sell the property for tax purposes at his/her adjusted cost base resulting in no taxable income on the sale [ITA 73(1)(a)(ii), 73(1.01)]. This occurs even though the actual selling price was higher than the cost amount. Similarly if the property was depreciable property, the deemed selling price would be equal to the property's undepreciated capital cost [ITA 73(1)(a)(i)]. However, the vendor may elect that the transfer price for tax purposes is the fair market value and accordingly recognize the related gain [ITA 73(1)].

R9-14. If the funds were provided from a spouse either as a gift or a non-interest or low-interest loan, both the future property income earned and capital gains from a future sale are included in the income for tax purposes of the spouse who provided the funds [ITA 74.1(1), 74.2(1)]. This result could have been avoided if the spouse providing the funds had done so by way of a loan with normal commercial terms and a proper rate of interest and the interest for each taxation year was paid not later than 30 days after the end of the taxation year [ITA 74.5(2)].

If the funds had been provided by the taxpayer’s parent, by way of a gift or a non-interest loan, and if the child was under 18 years of age, only the property income would attribute to the parent but not the capital gain [ITA 74.1(2)]. If the child was 18 years of age or older attribution of income normally will not occur regardless of how the funds were transferred.

Two exceptions exist. First, if a loan is made to a non-arm’s length person who is 18 years of age or older and one of the main purposes for making the loan was to reduce or avoid tax, the resulting income earned by the debtor from the borrowed funds will be included in the income of the lender [ITA 56(4.1)]. Second, dividends from a private corporation received by a person who is under the age of 18 are taxable to that individual at the highest marginal tax rate but are not subject to the attribution rules [ITA 120.4].

R9-15. If the payment of remuneration by the employer is delayed beyond 179 days after the taxation year in which the expense occurred, the employer cannot deduct the remuneration for tax purposes until the year in which the remuneration is actually paid [ITA 78(4)]. In other words, the accrual method is denied and the cash method is substituted. The tax treatment to the employee follows the normal rules of employment income. Remuneration is included for tax purposes as employment income in the year in which it is received, not when it is earned [ITA 5(1)].
R9-16. On death, a deemed disposition of all property occurs. If the property is left to a spouse, depreciable property is deemed to be sold at a price equal to its undepreciated capital cost, and capital property is deemed to be sold at a price equal to its adjusted cost base [ITA 70(6)]. Therefore, no taxable income is created. The executors of the decedent's estate may elect, if they so desire, to have the deemed disposition occur at fair market value and recognize the related gains [ITA 70(6.2)]. On the other hand, property left to children is treated differently. Capital property and depreciable property left to a child is deemed to be sold at fair market value [ITA 70(5)]. Therefore, capital gains and recapture of capital cost allowance may occur.

R9-17. Although the five primary types of income define the scope of the Canadian tax system, certain types of income which do not fall within the five categories may be exempt for special reasons. These exceptions are all listed together in section 81 of the Income Tax Act. For example, employment income includes allowances received from the employer [ITA 6(1)(b)]. However, allowances received by a member of a provincial legislature are not taxable as stated in the specific list of items that are not included in income [ITA 81(2)]. The list may affect any of the five normal categories of income.

R9-18. The process used to establish the tax treatment of a particular transaction is:

- Define the nature of the transaction to determine which of the five income sources it relates to.
- Apply the principles of income determination for that source.
- Determine whether or not the special rules for income determination may override the established principles.
- Relate the item to the aggregating formula to determine its overall impact.
Key Concept Questions

QUESTION ONE

Fred contributed $12,000 to his RRSP in November, 20X7 and $10,000 to a spousal RRSP in February of 20X8. Fred had earned income of $80,000 in 20X6 and $100,000 in 20X7. Fred’s notice of assessment showed unused RRSP deduction room at the end of 20X6 of $5,000. His T4 for 20X6 showed a pension adjustment (PA) of $3,000.

Determine Fred’s maximum RRSP deduction for 20X7. *Income tax reference: ITA 60(i), 146(1), (5), (5.1).*

QUESTION TWO

Victoria had income for tax purposes for the current year as follows:

<table>
<thead>
<tr>
<th>Income Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salary</td>
<td>$65,000</td>
</tr>
<tr>
<td>Taxable benefits</td>
<td>5,000</td>
</tr>
<tr>
<td>Registered pension plan deduction</td>
<td>(3,000)</td>
</tr>
<tr>
<td>Employment income for tax purposes</td>
<td>67,000</td>
</tr>
<tr>
<td>Loss from a part-time business</td>
<td>(6,000)</td>
</tr>
<tr>
<td>Spousal support received</td>
<td>12,000</td>
</tr>
<tr>
<td>Interest income</td>
<td>1,000</td>
</tr>
<tr>
<td>Rental income</td>
<td>22,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$96,000</strong></td>
</tr>
</tbody>
</table>

Determine Victoria’s earned income for RRSP purposes for the current year. *Income tax reference: ITA 146(1) earned income definition.*

QUESTION THREE

Tom retired from X Corp. on June 30th of the current year after turning 65 in December of last year. He plans to travel with his wife who is 45 years of age. On retirement, Tom received a retiring allowance of $40,000 for his years of loyal service. Tom started his employment with X Corp. in 1990.

Determine the income tax consequences of the retiring allowance for Tom. *Income tax reference: ITA 56(1)(a), 60(j.1).*

QUESTION FOUR

In November of the current year, Beth withdrew $24,000 from her spousal RRSP. Her husband had contributed $2,500 to the spousal RRSP on February 1st of each of the last 20 years. She also withdrew $8,000 from her TFSA. All contributions to her TFSA were made by her husband.

Determine the tax implications of the RRSP withdrawal. *Income tax reference: ITA 56(1)(h), 146.2, 146(8.3).*
QUESTION FIVE

Wendy received the following amounts in the current year:

- Support payments from her former spouse ($4,000 x 12) $48,000
- Employment insurance benefits 4,100
- Inheritance 20,000
- Scholarship 5,000
- RRSP withdrawal (LLP) 10,000
- Canada child tax benefit 3,450
- Universal child care benefit ($100 x 12) 1,200
- Lottery winnings 300

The support payments are in accordance with Wendy’s divorce agreement, which calls for monthly support payments of $1,500 for Wendy and $2,500 for her 4-year-old daughter. Wendy became frustrated during the year with not being able to find suitable employment and returned to school. She enrolled as a full-time student at the University of Toronto. She withdrew $10,000 from her RRSP to help finance her education.

Determine the amount to be included in Wendy’s income for tax purposes for the current year. Income tax reference: ITA 56(1)(a), (b), (n), (h), (h.2), 56(3),(6) 56.1(4), 60(b), 122.6, 146.02.

QUESTION SIX

Norman moved from the Ottawa office of Safety Corp. to the head office in Toronto, in October of the current year. He incurred a loss of $35,000 on the sale of his Ottawa home after it had sat empty for five months while the real estate agent tried to sell it. The real estate commission of $20,000 and legal fees of $1,200 are included in the $35,000 loss. In addition, he incurred the following costs with respect to the move:

- Airline ticket and hotel room for two nights stay when Norman and his wife made a trip to Toronto to search for a new home—$1,500
- Purchase price of new home—$420,000
- Legal fees and land transfer tax on purchase of new home—$1,800
- Moving company to pack their belongings and move them to their new home in Toronto—$6,000
- Gasoline and other car expenses plus two meals for each of the five family members. Norman drove himself and his family from Ottawa to their new home in Toronto (450 km)—$210
- Cost of carrying Ottawa house for five months while vacant (mortgage interest, property tax, and utilities)—$7,200
- Cost of revising legal documents to reflect the new address—$25

Norman’s T4 slip showed employment income for the year of $120,000 of which $30,000 was earned after his move to Toronto.

QUESTION SEVEN

Dan and Janet have three children, ages 6, 9, and 17. While Janet was a full-time student at university, January through April (15 weeks), her mother looked after the children. Janet found full-time employment in July. Her 17-year-old son looked after the younger two children during July while Janet worked. In August, the two younger children spent four weeks at an overnight camp in northern Ontario. Janet hired a live-in nanny to look after the children from September through December.

Dan paid all of the child care costs for the year, which totalled $17,600 (Janet’s mother $6,000 + son $1,600 + camp $4,000 ($2,000 per child) + nanny $6,000). Dan is employed full time as a salesman. He received commission income of $125,000 during the current year. He was able to claim sales expenses of $25,000 on this tax return. Janet had the following sources of income in the current year—scholarships $3,000; spousal support from her former spouse $12,000; rental income $8,000, and salary plus taxable benefits $36,000.

Determine the maximum tax deduction for child care available to Dan and Janet for the current year. *Income tax reference: ITA 63.*

QUESTION EIGHT

Neil owns 100% of the issued shares of N Ltd. His wife, Susan, owns 60% of the issued share of S Ltd. Their son, Ron, owns 50% of the shares of R Ltd. The remainder of the shares of S Ltd. and the remainder of the shares of R Ltd. are owned by Susan’s sister, Mary.

Determine which of the corporations and individuals are related. *Income tax reference: ITA 251.*

QUESTION NINE

Early in the current year, Alex gifted shares of a public corporation to his 16-year-old son. Alex had paid $1,000 for the shares. They were worth $15,000 at the time of the gift. After receiving the gift, his son received dividends of $800 on the shares. Also in the current year, Alex sold shares of a public corporation to his wife. The shares, which had a value of $10,000 at the time of the sale, originally cost $2,000. Alex sold them to his wife for $7,000. His wife received dividends of $500 on these shares.

Determine the tax consequences of these transactions. *Income tax reference: ITA 69(1), 73(1), 74.1, 74.2.*

QUESTION TEN

Brody has a lawn care business, which he incorporated in the current year. On incorporation, Brody and his 15-year-old son, who often works with him, each subscribed for 1 common share at $100 per share. Brody paid the $200 for both the shares. The corporation will pay dividends to Brody and his son, annually.

Describe the tax treatment of the dividend income received by Brody’s son. *Income tax reference: ITA 120.4.*
QUESTION ELEVEN

X Ltd. is in financial difficulty. It has just learned that its major supplier is willing to forgive $100,000 of the debt owed by X Ltd. in order that X Ltd. will not be forced to declare bankruptcy. X Ltd. has built up non-capital losses of $80,000 over the last few years. It still owns the following assets: land (cost $70,000), building (cost $120,000; UCC $92,000), equipment (cost $40,000; UCC $32,000), intangibles (cost $5,000; CEC $4,700).

Determine the tax implications of the debt forgiveness. *Income tax reference: ITA 80.*

QUESTION TWELVE

Irene died in the current year. At the time of her death she owned the following assets:

- Antique furniture (FMV $30,000; cost $10,000)
- Rental property—land (FMV $100,000; cost $60,000); building (FMV $60,000; cost $50,000; UCC $45,000)
- RRSP (FMV $80,000)

In her will, Irene directed her executors to transfer the antique furniture to her husband and the rental property to her son. Her husband was the named beneficiary on her RRSP.

Determine the tax implications for the above assets on Irene’s death. *Income tax reference: ITA 60(l), 70(5), 70(6).*
Solutions to Key Concept Questions

KC 9-1

[ITA: 60(i), 146(1),(5),(5.1) - RRSP]

RRSP deduction:
Lesser of -

- Prescribed dollar limit (2011) $22,450
- 18% x earned income (18% x $80,000) $14,400

Deduct: pension adjustment (PA) (3,000)

Add: unused RRSP deduction room 5,000

Maximum RRSP deduction $16,400

Fred can deduct RRSP contributions of up to $16,400 on his 20X7 tax return, provided he makes the RRSP contributions either during 20X7 or within 60 days after 20X7 to his RRSP or to a spousal RRSP [ITA 60(i); 146(1),(5),(5.1)]. Fred made RRSP contributions totalling $22,000; $12,000 to his RRSP during 20X7 and $10,000 to a spousal RRSP in February 20X8. Therefore, Fred’s 20X7 RRSP deduction is $16,400. The remainder of his spousal contribution can be deducted in 20X8. Fred can continue to have an RRSP until December 31 of the year he turns 71 [ITA 146(2)(b.4)]. After that he can continue to make spousal contributions provided he has earned income.

KC 9-2

[ITA 146(1) - RRSP earned income definition]

Victoria’s earned income for RRSP purposes is $98,000 calculated in accordance with the definition in ITA 146(1).

Employment income for tax purpose $67,000
Add: RPP deduction 3,000
Rental income 22,000
Spousal support received 12,000
Deduct: Business loss (6,000)
Earned income $98,000

KC 9-3

[ITA: 56(1)(a), 60(j.1) – Retiring allowance]

The $40,000 retiring allowance must be included in Tom’s other sources of income for the current year [ITA 56(1)(a)]. To the extent he contributes $12,000 to his RRSP by 60 days after the end of the current year, he is entitled to an RRSP deduction of $12,000 [ITA 60(j.1)].
The deduction is calculated as follows:

- $2,000 x number of pre-1996 years (or part years) that Tom was employed by this employer ($2,000 x 6 years = $12,000)

plus

- $1,500 x number of pre-1989 years (or part years) that Tom was employed by this employer ($1,500 x 0 years = 0).

This RRSP contribution cannot be made to a spousal plan.

**KC 9-4**

[ITA: 56(1)(h), 146.2, 146(8.3) - Spousal RRSPs and attribution]

In order to prevent abuses of the income splitting provided by spousal RRSPs, there is an anti-avoidance rule stating that the withdrawal is included in the contributing spouse’s income to the extent of any contributions made by the spouse in the year of the withdrawal and the two preceding years [ITA 146(8.3)].

In this case, the spouse contributed $2,500 in the year of the withdrawal and in each of the two preceding years. Therefore, $7,500 ($2,500 x 3) must be included in the spouse’s income for tax purposes. The remaining $16,500 (withdrawal $24,000 - $7,500) is included in Beth’s income for tax purposes [ITA 56(1)(h)].

The $8,000 withdrawn from the TFSA is received tax-free. All funds withdrawn from a TFSA are not taxable.

**KC 9-5**

[ITA: 56(1)(a),(b),(n),(h),(h.2), 56(3),(6) 56.1(4), 60(b), 122.6, 146.02 – Other income]

Wendy must include $22,100 of income from other sources.

Support payments of $18,000 ($48,000 - $2,500 x 12) are included [ITA 56(1)(b)]. Child support payments are not taxable. Since the child is 4 years old, the child support is being paid pursuant to an agreement entered into after April 30, 1997 [ITA 56.1(4)]. Where spousal support is included in income, an offsetting deduction is normally allowed to the payer [ITA 60(b)].

The employment insurance benefits, $4,100, are included [ITA 56(1)(a)].

The scholarship is not taxable assuming it does not exceed the tuition and cost of program-related materials [ITA 56(1)(n), 56(3)].

The RRSP withdrawal is not taxable. The Lifelong Learning Plan (LLP) allows withdrawal of funds, tax-free, from an RRSP to fund full-time post-secondary education. The maximum withdrawal is $10,000 per year ($20,000 cumulative limit over 4 years). The amount withdrawn must be repaid over a period of time, failing which they are included into income [ITA 146.02].

The universal child care benefit (UCCB), $1,200, is included in income [ITA 56(6)]. If Wendy were married, the UCCB would be included in her income, only if she was the lower-income-earning spouse. As a single parent, Wendy has the option of including the UCCB in the income of the child.
claimed for the equivalent-to-married tax credit or, if no such credit is claimed, in the income of one of the children. The solution assumes the UCCB will be included in the income of the 4-year-old daughter.

The inheritance, the Canada Child tax benefit and the lottery winnings are not taxable because they are not included in the other sources of income, specifically listed in the ITA.

**KC 9-6**

[ITA: 62; IT-178R3 – Moving expenses]

Moving expenses in respect of an eligible relocation are deductible. The deduction is limited to the income earned at the new location which in this case is $30,000 [ITA 62(1)].

The move from Ottawa to Toronto is an eligible relocation as defined in ITA 248 –

- The relocation occurred to enable Norman to be employed at a new work location in Canada,
- His old home and his new home are both in Canada, and
- His new home is at least 40 km closer to the new work location than his old home would be.

Norman’s deductible moving expenses total $34,445 as calculated below. His deduction for the current year is limited to $30,000 (Norman’s income from his new work location). The excess can be carried forward and deducted next year.

**ITA 62(3)(a)** travel costs in the course of moving Norman and members of his household from the old house to the new house - $418.

Travel expenses can optionally be calculated under the simplified method without receipts: $17/meal (up to $51/day per person) and vehicle expenses based on a prescribed amount per km for the province in which the move starts [the prescribed amounts for each province can be found at www.cra.gc.ca/travelcosts].

<table>
<thead>
<tr>
<th>Actual cost (receipts required)</th>
<th>$210</th>
</tr>
</thead>
<tbody>
<tr>
<td>Simplified method: Meals - $17 x 2 meals x 5 people</td>
<td>$170</td>
</tr>
<tr>
<td>Car - $0.55 (Ontario rate) x 450 km</td>
<td>$418</td>
</tr>
</tbody>
</table>

**ITA 62(3)(b)** cost of transporting household effects from the old home to the new home - $6,000.

**ITA 62(3)(e)** selling costs in respect of the old home – $21,200 (legal fees $1,200 + commission $20,000).

**ITA 62(3)(f)** legal fees and land transfer tax on the purchase of the new home - $1,800.

**ITA 62(3)(g)** cost of carrying the Ottawa home while vacant and trying to sell – limited to $5,000.

**ITA 62(3)(h)** cost of revising legal documents - $25
KC 9-7

[ITA: 63 – Child care]

Dan can claim a child-care deduction of $4,125 and Janet can claim a child-care deduction of $6,875 for a total of $11,000.

Child-care expenses paid [ITA 63(3)] $17,600
Less:  - amount paid to 17 year old child (related & under 18) (1,600)
    - camp amount paid (4,000)
Add:  camp amount deductible ($175 x 4 wk) + ($100 x 4 wk) 1,100
Child-care expenses eligible for deduction [ITA 63(3)] $13,100

<table>
<thead>
<tr>
<th></th>
<th>Dan</th>
<th>Janet</th>
</tr>
</thead>
<tbody>
<tr>
<td>Earned income [ITA 63(3)]</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Commission income</td>
<td>$125,000</td>
<td>$36,000</td>
</tr>
<tr>
<td>Salary plus taxable benefits</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Deductible amount [ITA 63(1)] - least of
(a) amount paid $13,100 $13,100
(b) $7,000 + $4,000 $11,000 $11,000
(c) 2/3 x earned income $83,333 $24,000

Lowest amount

Deduction for higher income spouse is limited $4,125
$175 x 15 weeks + $100 x 15 weeks [ITA 63(2)]

Janet’s deduction is reduced by Dan’s deduction (4,125)
$ 6,875

If Janet had attended school part-time, instead of full-time, Dan’s deduction would have been limited to $1,100 ($175 x 4 months + $100 x 4 months) [ITA 63(2)].

KC 9-8

[ITA: 251 - Related]

Related individuals [ITA 251(2)(a)]:

- Neil is related to Susan, Mary and Ron. He is related to Ron by blood relationship [ITA 251(6)(a)]. He is related to Susan and Mary by marriage [ITA 251(6)(b)].

- Susan is related to Mary and Ron by blood relationship and to Neil by marriage.

- Mary is related to Susan and to Neil by blood relationship. She is not related to her nephew, Ron.

- Ron is related to Neil and Susan by blood relationship. He is not related to his aunt, Mary.

Individuals related to corporations [ITA 251(2)(b)]:

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Solutions Manual Chapter Nine
• Neil is related to N Ltd., the corporation he controls. Likewise, Susan is related to S Ltd. Ron does not control R Ltd. nor does Mary control S Ltd.

• Neil is related to S Ltd. since he is related to Susan, the person who controls S Ltd. Likewise, Susan is related to N Ltd.

• Mary is related to N Ltd. and S Ltd. since she is related to the people who control these corporations. Likewise, Ron is related to N Ltd. and S Ltd.

Related corporations [ITA 251(2)(c)]:

N Ltd. and S Ltd. are related [ITA 251(2)(c)(ii)].
N Ltd. and R Ltd. are related [ITA 251(2)(c)(iv)].
S Ltd. and R Ltd. are related [ITA 251(2)(c)(iv)].

KC 9-9

[ITA: 69(1), 73(1), 74.1, 74.2 – Related party transactions and attribution]

Gift to 16-year-old son –

• Alex is deemed to receive proceeds of $15,000 (FMV) for the shares gifted to his son [ITA 69(1)(b)]. Thus, he has a taxable capital gain on the transaction of $7,000 (1/2 x ($15,000 - $1,000)).

• The son has an ACB for the shares of $15,000 (FMV) [ITA 69(1)(c)]. When the son resells the shares, the capital gain/loss is not subject to attribution. The gain will be taxed in the son’s income.

• The dividend income received by the son attributes to Alex and is included in Alex’s income for tax purposes. This attribution of income will continue until the year the son turns 18 [ITA 74.1(2)].

Sale to wife –

• Alex is deemed to receive proceeds of $2,000 (ACB) for the shares sold to his wife [ITA 73(1)]. Thus, the capital gain on these shares is deferred until the shares are resold by his wife.

• The wife has an ACB for the shares of $2,000 [ITA 73(1)]. When the wife resells the shares, the capital gain/loss will attribute to Alex and be included in his income for tax purposes [ITA 74.2(1)].

• The dividend income received by the wife will attribute to Alex and be included in his income.

• If the wife resells the shares and reinvests the proceeds, any income earned on the reinvested proceeds will also attribute to Alex and be included in his income for tax purposes. When the wife sells the substituted property, the gain/loss will also attribute to Alex.
Sale to wife; elect out of spousal rollover [ITA 73(1)] –

- Alex is deemed to receive proceeds of $10,000 (FMV) for the shares sold to his wife [ITA 69(1)(b)]. Thus, he has a taxable capital gain on the transaction of $4,000 (1/2 x ($10,000 - $2,000)).

- The wife has an ACB for the shares of $7,000 (her cost). When the wife resells the shares, the capital gain/loss will attribute to Alex and be included in his income for tax purposes [ITA 74.2(1)]. The effect is that the gain between $7,000 and $10,000 is taxed twice.

- The dividend income received by the wife will attribute to Alex and be included in his income.

- If the wife resells the shares and reinvests the proceeds, any income earned on the reinvested proceeds will also attribute to Alex and be included in his income for tax purposes. When the wife sells the substituted property, the gain/loss will also attribute to Alex.

KC 9-10

[ITA: 120.4 – Tax on split income]

In this case, a child under age 18 is receiving dividend income from a private corporation. This income does not attribute to Brody. This income is not included in the son’s income for his normal tax calculation (Part I tax) [ITA 20(1)(ww)]. Instead, the son is subject to a special tax on split income [ITA 120.4]. This tax is calculated at the top marginal tax rate (less any applicable dividend tax credit). Because the dividends are taxed at the top rate, the benefit of splitting dividend income from private corporations is eliminated.

KC 9-11

[ITA: 80 – Debt forgiveness]

Forgiven amount $100,000

Applied in accordance with the ordering rules [ITA 80(2)(c)]:

- Reduce non-capital losses [ITA 80(3)] (80,000)
- Reduce capital cost and UCC of depreciable property [ITA 80(5)]
  - Building (selected first as has a lower CCA rate) (20,000)

Balance $ Nil

The non-capital loss balance is now Nil. The Class 1 UCC (building) is now $72,000.

If there remains an unapplied portion of the gain after the reduction of the losses, then the gain is applied to reduce the capital cost and UCC of depreciable property, the CEC balance of eligible capital property and the ACB of capital assets, at the election of the taxpayer, through a series of designations. However, these reductions must be applied in order and to the maximum extent possible. If all of the forgiven debt is not consumed by applying it to the above items, one-half of any remaining balance is included in income.
KC 9-12

[ITA: 60(l), 70(5), 70(6) – Dispositions on death]

All capital property, including depreciable property, owned by Irene is deemed to have been sold at its fair market value immediately before her death [ITA 70(5)]. However, assets left to a spouse, or a spouse trust, are deemed to have been sold at their cost amount [ITA 70(6)].

The antique furniture left by will to Irene’s husband is deemed to be sold at its tax value, $10,000. Thus, the capital gain is deferred until the husband disposes of the furniture. The husband is deemed to have acquired the furniture at a cost of $10,000.

The rental property, left to her son, is deemed to be sold at its fair market value resulting in recapture of $5,000 and taxable capital gains of $25,000 being included in Irene’s final tax return.

Recapture on Building (UCC $45,000 – Cost $40,000) $ 5,000
Taxable capital gain
- Building ($60,000 - $50,000) x ½ $ 5,000
- Land ($100,000 - $60,000) x ½ 20,000 25,000 $30,000

Where there is an unmatured RRSP, the deceased is considered to have received from the RRSP, immediately before death, an amount equal to the value of the assets held in the RRSP. Where the spouse is the beneficiary, the spouse has the income inclusion, not the deceased [ITA 146(8.8),(8.9) refund of premiums]. The spouse is entitled to an equal RRSP deduction [ITA 60(l)] provided the amount (refund of premiums) is transferred to an RRSP in the spouse’s name in the year he receives it or within 60 days after the end of the year.
Problems

PROBLEM ONE

[ITA: 70(5), (6)]

Harvey Caseman died on July 15, 20X1. At the time of his death, he owned the assets listed in the table below.

<table>
<thead>
<tr>
<th></th>
<th>Cost</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>$10,000</td>
<td>$15,000</td>
</tr>
<tr>
<td>Building</td>
<td>40,000</td>
<td>60,000</td>
</tr>
<tr>
<td>Piano</td>
<td>5,000</td>
<td>8,000</td>
</tr>
</tbody>
</table>

The building is a rental property, and over the years Caseman had claimed capital cost allowance. Its undepreciated capital cost is $28,000.

In his last will and testament, Caseman directed his executors to transfer the rental property to his two children and the piano to his spouse.

Required:

1. Determine to what extent, if any, Caseman’s net income for tax purposes for 20X1 will be affected by his death.

2. What are the tax implications to the spouse and children if they sell the property immediately after they receive ownership?
Solution to P 9-1

1. Property left to children:

   Capital property left to children is deemed to be disposed of at fair market value [ITA 70(5)].

   - Land
     | Deemed proceeds | $15,000 |
     | Adjusted cost base | 10,000 |
     | Capital gain | $5,000 |
     | Taxable capital gains (1/2) | $2,500 |

   - Building
     | Deemed proceeds | $60,000 |
     | Adjusted cost base | 40,000 |
     | Capital gain | $20,000 |
     | Taxable capital gain (1/2) | $10,000 |
     | Undepreciated capital cost | $28,000 |
     | Disposal (to a maximum of cost) | (40,000) |
     | Recapture of CCA | $12,000 |

Property left to spouse:

   Piano is personal use property [ITA 54]. Capital property left to a spouse is deemed to be disposed of at adjusted cost base [ITA 70(6)].

   | Deemed proceeds | $5,000 |
   | Adjusted cost base | 5,000 |
   | Capital gain | $0 |

2. The adjusted cost base of the properties received by the beneficiaries is equal to the deemed proceeds to the deceased [ITA 70(5)(b), 70(6)(d)]. If the spouse sells the piano for $8,000 she will incur a capital gain of $3,000 ($8,000 - $5,000 = $3,000). The cost of the land to the children is $15,000 and therefore an immediate sale for $15,000 does not result in a capital gain. The cost of the building to the children is equal to the deemed proceeds of $60,000, and a sale at the market value does not result in a capital gain to them.
PROBLEM TWO

ITA: 69(1)(a), (b)

Blue Ltd. is a Canadian corporation owned 100% by Karen Samson. Blue manufactures hockey sticks that are marketed to retail sporting goods stores across Canada and Europe. Green Ltd. is a Canadian corporation also owned 100% by Samson. Green operates a retail sporting goods store. It purchases hockey sticks from Blue.

Blue charges $10 a stick to all of its customers in Canada, except Green, which pays only $8 a stick. Each stick costs Blue $4 to manufacture. Last week, Green purchased 1,000 sticks from Blue and sold them to retail customers for $14 each.

Required:

1. With respect to the 1,000 sticks, determine the income for tax purposes of both Blue and Green.

2. How would your answer to question 1 change if Blue charged Green $12 per stick?
Solution to P 9-2

1. Blue Ltd. is deemed to sell to Green Ltd. at fair market value ($10 per stick) [ITA 69(1)(b)(i)].

   Income to Blue:
   - Proceeds 1,000 x $10  $10,000
   - Cost 1,000 x $4    (4,000)
   - Income to Blue  $ 6,000

   Green Ltd. has a cost of $8 per stick -- being the actual price paid.

   Income to Green:
   - Proceeds on sale 1,000 x $14 $14,000
   - Cost 1,000 x $8    (8,000)
   - Income to Green $ 6,000

2. If Blue charged Green $12 per stick, the price would be greater than fair market value. For tax purposes, Blue's selling price remains at $12 (actual selling price) but Green's cost is deemed to be $10 (the fair market value of wholesale sales) [ITA 69(1)(a)].

   Income to Blue:
   - Proceeds 1,000 x $12  $12,000
   - Cost 1,000 x $4    (4,000)
   - Income to Blue $ 8,000

   Income to Green:
   - Proceeds 1,000 x $14  $14,000
   - Cost 1,000 x $10 $10,000
   - Income to Green $ 4,000
PROBLEM THREE

[ITA: 38(a); 56(4.1), (4.2); 69(1)(b), (c); 73(1)(a), (b); 74.1(1), (2); 74.2(1); 74.5(2); 82(1)(b); 120.4]

For each of the following independent transactions, determine the amount of net income or loss for tax purposes and the taxpayer to which it applies.

1. A woman purchased a $10,000 bond for her 15-year-old daughter. During the year, the bond paid interest of $1,000.
2. A student who is 20 years old borrowed $20,000 from his parent and used the funds to purchase shares in a public corporation. After receiving a dividend of $1,000, the student sold the shares for $24,000. (How would your answer change if the student were 17 years old?)
3. A woman gifted to her husband shares of a public corporation, for which she had paid $15,000. At the time of the gift, the shares had a value of $30,000. After receiving the gift, the husband received a dividend of $1,000 and then sold the shares for $26,000.
4. A man loaned money to his wife, who used the borrowed funds to purchase a rental property. During the year, the rental property earned net rentals of $7,000. The amount of the loan, which is interest-free, is $60,000. (How would your answer change if the loan were subject to a reasonable interest rate of 10% and was secured by a mortgage on the rental property?)
5. A man gifted common shares of a Canadian-controlled private corporation to his 16-year-old daughter. At the time of the gift, the shares were valued at $10,000. Their original cost was $6,000. During the year, the daughter received a dividend of $1,000 from the shares and then sold them for $15,000. All of the corporation’s income was subject to the small business deduction.
6. A woman contributed $5,000 to her husband’s TFSA. The funds were invested in bonds earning interest.
Solution to P 9-3

1. Interest income of $1,000 is included in the parents' income annually until the child's 18th birthday. Thereafter, it is included in the child's income [ITA 74.1(2)].

2. Income:
   
   Dividend: $1,000 x 141% = $1,410
   
   Capital gain:
   $24,000 - $20,000 = $4,000 (1/2)  2,000
   
   The above amount is included in the student's income. If the loan to the 20 year old child is without interest or at a low rate of interest, the dividend income may be attributed to the parent if it can reasonably be considered that one of the main reasons for the loan was to reduce or avoid tax [ITA 56(4.1), (4.2)]. If the student was 17 years old and a commercial rate of interest was not paid on the loan from the parents, the dividend of $1,410 would be included in the parent's income [ITA 74.1(2), 74.5(2)] but the capital gain would remain taxable to the student. 74.1(2)

3. The wife (who made the gift) is deemed to have sold the shares at the ACB of $15,000 (inter-vivos transfer between spouses) [ITA 73(1)(a)(ii)], therefore there is no gain on the transfer. The husband (who received the shares) is deemed to acquire them at a cost of $15,000 [ITA 73(1)(b)].

   Income:
   
   Dividend: $1,000 x 141% = $1,410
   
   Capital gain:
   $26,000 - $15,000 = $11,000 (1/2)    5,500
   
   The entire $6,910 is attributed to the wife who owned the shares originally [ITA 74.1(1), 74.2(1)].

4. The rental income of $7,000 is attributed to the husband who made the interest free loan [ITA 74.1(1)]. If a 10% interest rate was put on the loan and that is considered to be a normal commercial rate, no attribution would result [ITA 74.5(2)]. Incomes would then be as follows:

   Spouse who made the loan:
   Interest income ($60,000 @ 10%) $ 6,000

   Spouse receiving the loan:
   Rental income $ 7,000
   Less interest expense (6,000)  
   Net rental income $ 1,000


5. The gift results in a deemed disposition at fair market value to the father [ITA 69(1)(b)(ii)] creating a taxable capital gain of $2,000 \( \frac{1}{2} \times (10,000 - 6,000) \). The adjusted cost base of the shares to the daughter is the value of the shares at the time of the gift [ITA 69(1)(c)]. She will realize a taxable capital gain of $2,500 from their sale \( \frac{1}{2} \times (15,000 - 10,000) \). This capital gain is not attributed to the parent. The dividend received by the daughter from the Canadian-controlled private corporation is also not attributed to the parent [ITA 74.1(2)], but is taxable to the daughter at the highest tax bracket [ITA 120.4].

6. The bond interest earned in the TFSA is not taxable when earned or when withdrawn.
PROBLEM FOUR

[ITA: 2(3); 5(1); 6(1)(a), (b); 18(1)(b); 20(1)(b), (c), (e), (aa); 78(4); 212(1)(b); 253; Reg. 1100(1)(b), (c); 1100(11)]

Health Kicks Ltd. is a Canadian-controlled private corporation owned 100% by Wally Bose. The company’s year end is December 31, and its 20X1 fiscal period has just come to a close.

Following is certain information in the accounting records of the company for the year ended December 31, 20X1:

Rent expense ($22,000)

The company rents a warehouse building for $2,000 per month from Joe Holy, a schoolteacher. As of December 31, 20X1, the December rent had not been paid owing to an employee error. Holy had purchased the building as an investment several years ago for $180,000. During 20X1, he incurred operating expenses for the building (taxes, insurance, interest, and the like) totalling $20,000. The undepreciated capital cost (UCC) of the building is $120,000.

Repairs and maintenance expense ($70,000)

This account includes snow removal and lawn-care costs, in addition to $62,000 for building improvements: the installation of an air-conditioning system and three additional loading docks (ramps and doors). The $62,000 was paid to a warehouse contractor that is an American corporation operating a branch office in Winnipeg.

Accounting and legal expense ($16,000)

This amount was paid to a law firm for the following services:
— Registering of a debenture against the company’s assets on a loan from the bank ($4,000).
— Drawing up of a legal agreement to purchase all of the common shares of Dash Ltd. which now operates as a wholly owned subsidiary ($9,000).
— Preparing of articles of amendment to revise the company’s articles of incorporation ($3,000).

Interest expense ($22,000)

Several years ago, the company purchased a small warehouse in Winnipeg. The previous owner, a resident of England, permitted Health Kicks to pay a small amount down and the balance over eight years, with interest at 11%. Of the above interest, $7,000 represents interest paid on this obligation. The remaining interest of $15,000 was paid to a shareholder, Bose, on a loan he made to his own company.

Land cost ($19,000)

This represents the cost of landscaping the grounds around the company’s office building (trees, shrubs, and flower beds), and was added to the capital cost of the land. The $19,000 was paid to Wesley Perkins, a management student who operates a summer lawn service.
Salary and remuneration expense ($290,000)

This account is made up of the following items:

- Salaries $238,000
- Sales commissions accrued but not paid until 20X2 $30,000
- Retirement gift to the sales manager $1,000
- Clothing allowance to senior executives so that they can acquire expensive wardrobes to maintain their image $21,000

$290,000

Licence cost ($120,000)

Health Kicks purchased a licence to manufacture a health product that was patent-protected by another company. The licence permitted Health Kicks to manufacture and sell the product for six years. The licence was acquired from Bobo Enterprises Ltd., which sold several licences for this product to other companies in certain geographic areas. Health Kicks can sell the product only in western Canada.

Required:

Discuss, in point form, the tax implications of the preceding transactions from the point of view of (a) Health Kicks, and (b) the other party to each transaction.
**Solution to P 9-4**

**Rent**

Health Kicks: deducts full rent of $24,000 on the accrual basis.

Holy: rental activity is property income, therefore, the rent receivable is included in rental revenues on the accrual basis in 20X1. However, deductions are limited due to CCA restriction on rental properties [Reg. 1100(11)].

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rental revenue</td>
<td>$24,000</td>
</tr>
<tr>
<td>Less operating expense</td>
<td>(20,000)</td>
</tr>
<tr>
<td>CCA (available)</td>
<td>(4,000)</td>
</tr>
<tr>
<td>Income</td>
<td>$0</td>
</tr>
</tbody>
</table>

**Repairs and Maintenance**

Health Kicks: Can assume that the repairs relate to the rental building above or a separate building owned by Health Kicks. If it is the rental building, the $62,000 is a capital expenditure and qualifies as a leasehold improvement (Class 13). CCA can be claimed on a straight-line basis over the life of the lease plus one option period [Reg. 1100(1)(b)]. If it is for an owned building, the repairs are capital items and not deductible in the current year [ITA 18(1)(b)]. Instead, the $62,000 is added to the building (Class 1) and CCA claimed at 4% declining balance.

American Branch: The operation of branch in Canada means that the non-resident is carrying on business in Canada [ITA 253]. The $62,000 is part of the branch’s revenues and is taxable in Canada [ITA 2(3)].

Legal

Health Kicks: *Debenture* is an account of capital but, as a cost incurred to borrow money, it is an exception under section 20 and the cost is deducted over five years at 1/5 per year [ITA 20(1)(e)].

*Share purchase* is on account of capital and therefore not deductible [ITA 18(1)(b)]. The fees are added to the cost of the shares purchased.

*Articles of Amendment* is on account of capital and not deductible [ITA 18(1)(b)]. However, the cost qualifies as eligible capital property and three-quarters of this cost can be written-off at 7%, declining balance, annually [ITA 14(5), 20(1)(b)].

Legal firm: All legal fees are business revenues.
Interest Expense

Health Kicks
• The full amount of interest is deductible if it was incurred for the purpose of earning income or to purchase property that is used to earn income [ITA 20(1)(c)].

Resident of England
• Interest paid to England is subject to a Canadian withholding tax [Part XIII, ITA 212(1)(b)].

Wally Bose
• Interest is property income.

Land Cost

Health Kicks
• The cost of landscaping is specifically permitted as a deduction even through it is a capital item [ITA 20(1)(aa)].

Wesley Perkins
• Is carrying on a business and the $19,000 is included as part of his business income.

Salary and Remuneration

Health Kicks
• Salary is deductible. Commissions unpaid are normally deductible on the accrual basis. However, if they are not paid before 180 days after the 20X1 year end no deduction is permitted in 20X1. Instead, the deduction is delayed until the year paid [ITA 78(4)].

Gift is deductible as compensation. Allowance is deductible as compensation.

Employees
Commission is not taxable until the year received [ITA 5(1)(a)]. Gift is a taxable benefit (cost exceeds $500) [ITA 6(1)(a)]. Clothing Allowance is taxable [ITA 6(1)(b)].

Licence Cost

Health Kicks
The licence is not deductible because it is a capital item [ITA 18(1)(b)]. However, because it has a limited life it qualifies as a Class 14 property and CCA can be claimed annually on a straight-line basis over the legal life (or at a faster rate if it conforms to the asset’s economic value) [Reg. 1100(1)(c)].

Bobo Enterprises
Sells licences to a number of licensees and therefore it is likely that Bobo earns business income and not a capital gain.
PROBLEM FIVE

[ITA: 3; 5(1); 8(1)(f), (j), (m); 9(1); 12(1)(j), (k); 13(1); 20(1)(a), (c), (bb); 20(10); 38(a), (b), (c); 39(1)(a), (b), c); 45(1); 50(i); 57.1]

The following information relates to Perry Somer’s financial affairs in 20X1:

1. Somer is employed as a salesman and is remunerated by commissions. He must pay all of his own expenses. During 20X1, he earned commissions of $28,000. His expenses were as follows:

   - Automobile (operating costs) $3,000
   - Entertainment 1,000
   - Convention (related to his employment) 500
   - Donations 500
   - Telephone long-distance charges (personal use was 80%) 1,000

   The personal-use portion of his automobile expense is 20%. The UCC of his automobile at the end of the previous year was $5,000.

2. He made the following capital transactions:

<table>
<thead>
<tr>
<th>Gain (loss)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shares of public corporation A $10,000</td>
</tr>
<tr>
<td>Shares of public corporation B (18,000)</td>
</tr>
<tr>
<td>Shares of Canadian-controlled private corporation C (a small business corporation) (6,000)</td>
</tr>
</tbody>
</table>

3. In 20X0, Somer acquired two residential rental properties.

<table>
<thead>
<tr>
<th>Property X</th>
<th>Property Y</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land $10,000</td>
<td>$15,000</td>
</tr>
<tr>
<td>Building 70,000</td>
<td>60,000</td>
</tr>
<tr>
<td>$80,000</td>
<td>$75,000</td>
</tr>
</tbody>
</table>

   Maximum capital cost allowance was claimed in 20X0. In 20X1, the city expropriated property Y for $77,000 (land $17,000, building $60,000). Perry was pleased because property Y was vacant for part of the year after a tenant vacated unexpectedly. In 20X1, net rental income from both properties (after all expenses but before capital cost allowance) was $1,000.

4. Somer’s other income and expenses are as follows:

   **Income:**
   - Taxable dividends—Canadian public corporations $2,000
   - Interest on foreign bonds (net of 15% withholding tax) 1,700

   **Expenses:**
   - Interest on a loan used to acquire the foreign bonds 1,300
   - Investment counsel fee 800

5. During the year, he made a contribution to a registered pension plan of $1,000, which was matched by his employer. In addition, Somer contributed $2,000 to his RRSP.
6. Somer currently lives in rented premises but is considering moving into rental property X and occupying one-half of the building sometime in 20X2.

Required:

1. Calculate Somer’s minimum 20X1 net income in accordance with the aggregating formula for determining net income for tax purposes.

2. What would be the tax consequences, if any, if Somer occupied rental property X?
Solution to P 9-5

Part 1

The solution analyzes each of the various types of income separately and then summarizes them in terms of the aggregating formula for determining net income for tax purposes.

<table>
<thead>
<tr>
<th>ITA</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>5(1)</td>
<td>Commissions revenue</td>
<td>$28,000</td>
</tr>
<tr>
<td>8(1)(f)</td>
<td>Automobile</td>
<td>$3,000</td>
</tr>
<tr>
<td></td>
<td>Less personal use 20%</td>
<td>(600)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2,400</td>
</tr>
<tr>
<td>8(1)(f)</td>
<td>Entertainment (50% deductible - 67.1) Assumed to be meals and beverages)</td>
<td>500</td>
</tr>
<tr>
<td>8(1)(f)</td>
<td>Telephone (business portion)</td>
<td>200</td>
</tr>
<tr>
<td></td>
<td></td>
<td>3,100</td>
</tr>
<tr>
<td>8(1)(j)</td>
<td>CCA on automobile: 30% x $5,000 = $1,500 (80%)</td>
<td>1,200</td>
</tr>
<tr>
<td>8(1)(m)</td>
<td>Contribution to RPP</td>
<td>(1,000)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(5,300)</td>
</tr>
</tbody>
</table>

Employment income $22,700

The donations were excluded because they were not incurred to earn the commission income. Also, the convention expenses were excluded because they are on the account of capital. Salespeople can deduct expenses incurred to earn commissions except capital items (other than CCA on an automobile or aircraft and interest to acquire these items). Normally, the convention increases the person's business knowledge and therefore has a long-term benefit causing it to be classified as a capital item. No specific exception is provided in the employment income rules. However, to determine business income, a specific exception is made for conventions even though it is a capital item [ITA 20(10)]. If the taxpayer had been self-employed rather than employed, the convention expense would have been deductible.

| ITA 39(1)(a) | Capital Gains: Shares of Corporation A | $10,000 |
|              | Expropriation of Property Y Land ($17,000 - $15,000) | 2,000 |
|              | Building ($60,000 - $60,000)               | 0      |
|              |                                             | $12,000|
| ITA 38(a)    | Taxable capital gains (1/2)                 | $ 6,000|

| ITA 39(1)(b) | Capital Losses: Shares of Corporation B | $18,000|
| ITA 38(b)    | Allowable capital loss (1/2)              | $ 9,000|

| ITA 39(1)(c) | Allowable Business Investment Loss: Shares of private Corporation C | $ 6,000|
| ITA 38(c)    | Allowable business investment loss (1/2)  | $ 3,000|
ITA 9(1) Property Income:

Rentals:
- Net rents before CCA $1,000
- Recapture of CCA (see below) 1,200
- CCA (see below) (2,200)
- Net rental income $0

The two rental properties were acquired in the previous year. Maximum CCA was claimed in the previous year. Because each of the two rental properties (the buildings) cost more than $50,000 they fall into separate pools of Class 1 [Reg. 1101(1ac)].

<table>
<thead>
<tr>
<th></th>
<th>Pool X</th>
<th>Pool Y</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X0 cost</td>
<td>$70,000</td>
<td>$60,000</td>
</tr>
<tr>
<td>CCA 20X0 (4% x 1/2)</td>
<td>(1,400)</td>
<td>(1,200)</td>
</tr>
<tr>
<td>UCC</td>
<td>68,600</td>
<td>58,800</td>
</tr>
<tr>
<td>Sale in 20X1</td>
<td>(60,000)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>$68,600</td>
<td>$(1,200)</td>
</tr>
</tbody>
</table>

ITA 20(1)(a) CCA available (4%) $(2,744)
ITA 13(1) Recapture $1,200

CCA in 20X1 is limited to $2,200, being the net rental income from both properties [Reg.1100(110)].

Other Property Income:

| ITA 12(1)(j) | Dividends ($2,000 x 1.41) $2,820 |
| ITA 12(1)(k) | Foreign interest before withholding tax | $2,000 |
|              | 4,820 |

Less:

| ITA 20(1)(c) | Interest expense (1,300) |
| ITA 20(1)(bb) | Investment counsel fees (800) |
|              | Net property income $2,720 |

Other deductions:

| ITA 60(i) | RRSP $2,000 |

Aggregating Formula:

3(a) Employment income $22,700
Property income 2,720

3(b) Taxable capital gains $6,000
Exceed
Allowable capital losses (9,000)

3(c) Other deductions (2,000)

3(d) Losses:
Allowable business investment loss (3,000)

Net income for tax purposes $20,420
Part 2

If Somer occupies one-half of Property X for personal use, a change of use occurs resulting in a deemed disposition of half of the property at fair market value [ITA 45(1)]. To the extent that the fair market value exceeds one-half of the cost of the land and building, a capital gain will occur. In addition, the undepreciated capital cost of property X will be reduced and future CCA will decline accordingly.
PROBLEM SIX

[ITA: 40(2)(b); 70(5)(a); 70(6)(d); 73(1); 74.1(2); 74.5(1); 146 (8.8)]

It is assumed that Carletti’s personal tax rate is 45%.

Peter Carletti is a professional architect employed by a Halifax-based architectural firm. He is 58 years old and married, and has a 22-year-old son. Peter’s wife, Carla, recently returned to university and will complete a law degree in three or four years. Their son, who lives with them, also attends university and will continue to do so for at least three years.

Peter has asked you to review his family’s financial position and tell him what tax planning opportunities are available. Also, he does not have a will and would like you to tell him what tax consequences may occur at the time of his death. He provides you with the following information:

1. The Carlettis’ home in Halifax is owned by Carla. She had acquired the property five years ago for $200,000 with funds received from her father’s estate. The home is now worth $230,000 and has no mortgage. She has no other assets.
2. Last year, Peter purchased a vacation home on the Atlantic coast. The property cost $150,000 and has already increased in value to $180,000. Upon purchase, Peter assumed the mortgage of $90,000, which has an interest rate of 8%.
3. Peter owns a term life insurance policy that will pay $400,000 upon his death.
4. Peter’s annual salary is over $100,000. Carla currently has no income. Annually, Peter contributes to an RRSP, which is now worth $200,000. The plan invests primarily in secure common shares and earns capital gains and dividends.
5. Peter owns a rental property, for which he paid $240,000 (land $40,000, building $200,000) five years ago. It is debt-free and currently worth $300,000 (land $50,000, building $250,000). The UCC of the building is $166,000.
6. Peter owns the following other investments:
   • $50,000 of Nova Scotia Hydro Bonds, which earn interest of 10%.
   • Bank term deposits (one-year terms) of $170,000, which earn 9% interest.
   • Common shares of a Canadian public corporation that are valued at $90,000. He purchased the shares two years ago for $40,000. Peter has not sold any capital property in the past 10 years.

Required:

Prepare a brief report for Peter Carletti outlining the tax consequences that may occur on his death. The report should also suggest what he might do now to minimize annual taxes during his lifetime.
Solution to P 9-6

Tax implications on death:

The tax treatment that applies to the various assets on the death of Carletti depends upon who the beneficiary is.

Life insurance:
The receipt of life insurance proceeds from a term life policy is not taxable regardless of who is the beneficiary.

Rental property:
On death, the rental property is deemed to be disposed of at fair market value unless the beneficiary is a spouse or spouse trust [ITA 70(5)(a)]. If the spouse is the beneficiary, the deemed disposition amount for the land is its adjusted cost base and for the building its undepreciated capital cost [ITA 70(6)(d)]. If the property is not left to the spouse the potential tax, based on current values, is $28,800 as follows:

Land – 1/2 x ($50,000 - $40,000) = $ 5,000
Building – 1/2($250,000 - $200,000) = 25,000
Building - $200,000 - $166,000 = 34,000
Taxable income $64,000
Tax - 45% x $64,000 = 28,800

Vacation home:
The vacation property is capital property (personal use) and is deemed to be disposed of at fair market value [ITA 70(5)(a)] unless the beneficiary is the spouse in which case the deemed proceeds is the adjusted cost base [ITA 70(6)(d)]. The property can qualify as a principal residence and, if it is so designated [ITA 40(2)(b), 54], the gain can be exempt from tax.

Common shares:
The shares are deemed to sold at fair market value [ITA 70(5)(a)] unless the spouse is the beneficiary in which case they are deemed to be sold at the adjusted cost base [70(6)(d)]. The potential tax, based on current values is $11,250 (45% x ½ [$90,000 - $40,000]).

RRSP:
The RRSP is fully taxable on death unless the beneficiary is the surviving spouse in which case the plan is simply transferred to the spouse and can be maintained as a tax sheltered plan [ITA 146(8.8-8.91)]. The potential tax on death is $90,000 (45% x $200,000).

The above indicates that Carletti has a potential tax liability of $130,050 ($90,000 + $28,800 + $11,250). Therefore, if he wants to delay the tax he should prepare a will designating his spouse or a spouse trust as the beneficiary of specific assets.
**Tax planning during his lifetime:**

Carletti is subject to a high tax rate on his investment income because of his high salary. He also has two family members who have little or no income. In addition, he pays interest on a personal mortgage that is not deductible for tax purposes and at the same time earns taxable interest income. The following planning activities should be considered:

**Mortgage on vacation home:**

Carletti should consider cashing $90,000 of his term deposits (which earn taxable interest of 9%) and use the funds to pay off the $90,000 mortgage on the vacation home (interest @ 8% is not deductible). This will result in annual cash savings of $2,745 as follows:

| Loss of income: Term deposit (9% x $90,000) | $8,100 |
| Less income tax (45% x $8,100) | (3,645) |
| **Gain on elimination of mortgage interest:** (8% x $90,000) | **$7,200** |
| **Increase in cash flow** | **$2,745** |

**RRSP:**

The RRSP earns capital gains and dividend income. If this income was earned personally the dividends would be subject to a dividend tax credit and the capital gains would be only 1/2 taxable. While they do not attract any immediate tax in the RRSP, they will be fully taxable when removed from the plan in future years. Effectively this eliminates the special tax status on this type of income.

Carletti should consider using the RRSP to hold his interest bearing investments (which in his own name are fully taxable) and hold the stock investments in his personal name to take advantage of the special treatment of capital gains and dividends.

In addition, he should contribute to a spousal RRSP so that on retirement some of the income would flow to his spouse and would be taxed at a lower rate.

**Income splitting:**

His spouse currently has no income but owns the family home which was acquired with funds received from her parents’ estate. Carletti should consider purchasing the house from his spouse which would provide her with funds to invest and earn income taxed at a lower rate than Carletti's. The sale of the house would not create taxable income as property transferred between spouses has a deemed disposition amount equal to the cost base [ITA 73(1)]. Alternatively, the spouse could elect to have the house transferred at fair market value and claim the principal residence deduction [ITA 73(1), 74.5(1)(c)].

Carletti should also consider gifting a certain amount of funds to his 22 year old son which he could invest to earn income taxed at a lower rate. The attribution rules would not apply to the income earned by the son because he is over 18 [ITA 74.1(2)].
PROBLEM SEVEN

[ITA: 3; 5(1); 8(1)(f), (j), (m); 12(1)(c), (j); 20(1)(p), (bb); 40(2)(b); 46(1)(a); 50(1); 56(1); 60(i), (o); 62; 67.1; 74.1(2); Reg. 1100(11)]

In 20X3, Carol Fortier was transferred by her employer to Vancouver from Toronto. She has made a number of financial transactions related to the move. Fortier has asked you for help in determining her 20X3 income for tax purposes. She has provided the following information:

1. Fortier is divorced and supports her two children Lise (age 17) and Randy (age 19). In the summer of 20X3, Randy earned net profits of $4,000 as a street vendor. Lise’s only source of income was from an investment purchased for her by her mother. The investment, bonds of a Canadian public corporation, paid interest of $1,000 during the year.

2. Fortier began work in Vancouver in February 20X3, as a senior saleswoman for a clothing manufacturer. During 20X3, she received a gross salary of $110,000 as well as selling commissions of $5,000. In addition, on June 30, 20X3, her employer’s year end, she was awarded a bonus of $12,000 payable in 12 monthly instalments of $1,000 beginning July 31, 20X3. During 20X3, she contributed $3,700 to the company’s registered pension plan, and her employer contributed the same amount. She also paid $2,217 to the Canada Pension Plan and made Employment Insurance contributions of $787.

3. Fortier’s employer has certified that she is required to pay some of her own expenses as part of her selling duties. In 20X3, she incurred the following costs:

<table>
<thead>
<tr>
<th>Expense</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchase of computer</td>
<td>$3,000</td>
</tr>
<tr>
<td>Advertising and promotion</td>
<td>1,800</td>
</tr>
<tr>
<td>Entertainment</td>
<td></td>
</tr>
<tr>
<td>Meals and drinks</td>
<td>2,000</td>
</tr>
<tr>
<td>Golf club dues</td>
<td>2,400</td>
</tr>
<tr>
<td>Automobile—gas, repairs, and insurance</td>
<td>4,200</td>
</tr>
<tr>
<td>Total</td>
<td>$13,400</td>
</tr>
</tbody>
</table>

Fortier uses her own car for business activities. At the end of 20X2, the car had an unamortized capital cost of $20,000 (original cost in 20X2, $22,000). In 20X3, she drove the car 30,000 kilometres, of which approximately 12,000 was for personal use. In 20X3, she acquired a computer (see table), which she uses at home to maintain customer files and industry information. She estimates that 90% of her 20X3 computer time was employment related.

4. On January 15, 20X4, Fortier contributed $7,000 to an RRSP. On the same date she contributed $4,000 to a TFSA. For the 20X2 taxation year, her earned income was $63,889. In 20X2, the combined (employer and employee) contribution to her employer RPP was $6,400.
5. Fortier drove herself and her two children from Toronto to Vancouver. The 4,400 km trip took five days. She paid $400 for gasoline, $480 for accommodation for four nights, and $500 for meals for five days. As well, she incurred the following relocation costs:

- Real estate commission on sale of former home: $19,000
- Moving furniture: $14,000
- Legal fees to purchase new home: $2,000
- Legal fees on sale of former home: $2,500
- Temporary lodging and meals, in Toronto after the sale of the former home and in Vancouver before taking possession of the new home (30 days): $6,000

Total relocation costs: $43,500

Her employer, in accordance with company policy, paid her the maximum $10,000 as a partial reimbursement for transporting furniture to Vancouver.

6. Fortier wrote an article on selling strategies in the fashion industry. It was published in a national trade journal. The article received wide acclaim. In September 20X3, she was awarded a $2,000 prize for the best article of the year.

7. In January 20X3, Fortier sold her home in Toronto for $300,000. She had acquired the home in 20X0 for $180,000 and had occupied it until the move to Vancouver.

8. Five years ago, Fortier purchased 5% of the common shares of Prentice Ltd. for $20,000. Prentice is a Canadian-controlled private corporation manufacturing specialized furniture. In June 20X0, when the company had cash-flow problems, Fortier lent Prentice $10,000. The loan was unsecured and payable on demand. Although Fortier has received no interest to date, in 20X1 and 20X2, she included in her taxable income interest of $1,500 ($750 \times 2 \times \frac{1}{2} = $1,500) based on the agreed 7½% interest rate on each anniversary date. In 20X3, she demanded payment of the loan and accrued interest, but the company was unable to pay. The company’s only assets, other than the leased manufacturing equipment, were inventory and receivables, which were pledged on a bank loan; these were insufficient to meet even that obligation. In March 20X4, Prentice closed operations and declared bankruptcy.

9. Fortier sold the following properties in 20X3:

<table>
<thead>
<tr>
<th>Property</th>
<th>Original cost</th>
<th>Selling price net of disposal costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>4,000 shares of Teulon Ltd.</td>
<td>$22,000</td>
<td>$114,000</td>
</tr>
<tr>
<td>Oil painting</td>
<td>800</td>
<td>4,000</td>
</tr>
<tr>
<td>Commodity futures contract</td>
<td>16,000</td>
<td>28,000</td>
</tr>
</tbody>
</table>

The sale of the commodity futures contract was Fortier’s second commodity transaction. In 20X1, she purchased and sold a similar contract but lost $14,000. She deducted the full $14,000 in computing her 20X1 taxable income.

10. Fortier owns a residential rental property in Toronto. She acquired the property in 20X2 for $414,000 (land $54,000, building $360,000). She incurred a substantial loss in 20X2 as a result of an unexpected vacancy. She found a new tenant in 20X3. She received gross rents of $46,000 in 20X3. Expenses for utilities, taxes, insurance, interest, and maintenance were $47,100 that year. One of the tenants failed to pay its December 20X3 rent of $2,000. However, she received that payment on January 20, 20X4.
11. Fortier received the following additional amounts in 20X3:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Eligible dividends from taxable Canadian public corporations</td>
<td>$6,000</td>
</tr>
<tr>
<td>Interest on bank deposits</td>
<td>$7,000</td>
</tr>
<tr>
<td>Winnings from a provincial lottery</td>
<td>$800</td>
</tr>
</tbody>
</table>

12. Fortier hired an investment counsellor in 20X3. On his recommendation, she used $40,000 of the $200,000 mortgage loan on her new home to acquire Canadian public securities. Her mortgage interest payments in 20X3 totalled $22,000. She paid the investment counsellor $2,000 for his advice.

13. In 20X3, Fortier made donations to registered charities of $4,000.

14. During 20X3, Fortier’s 20X1 tax return was reassessed. She hired a lawyer to prepare an appeal. The legal fee was $1,200. The appeal was not successful.

**Required:**

For the 20X3 taxation year, calculate Fortier’s net income for tax purposes. Prepare the calculation in accordance with the net income formula, and organize the items of income by the categories described in that formula.
Solution to P 9-7

A summary of the net income for tax purposes appears below followed by the detailed calculations of each item.

3(a) Employment income $108,700
    Property income 8,560
    Business income 12,000
    Other income 1,500
    130,760

3(b) Taxable capital gains $46,000
    Net gains from LPP 1,500
    47,500
    Allowable capital losses 0
    47,500

3(c) Other deductions (40,465)

3(d) Allowable business investment loss (5,000)

Net income for tax purposes $132,795

Employment income:

Salary [ITA 5(1)] $110,000
Commissions [ITA 5(1)] 5,000
Bonus (6 months x $1,000) [ITA 5(1)] 6,000

Deduct:
Registered pension plan [ITA 8(1)(m)] (3,700)
Sales expenses [ITA 8(1)(f)] (note 1) (5,000)
Auto (capital portion) [ITA 8(1)(j)] CCA
$20,000 x 30% x 18,000/30,000 (3,600)

Employment income $108,700

Note 1:
Expenses to earn commission [ITA 8(1)(f)]:
    Advertising $1,800
    Entertainment (50% x $2,000) [ITA 67.1]) 1,000
    Auto - operating ($4,200 x 18,000/30,000) 2,520
    Total - restricted to commissions of $5,000 $5,320

Purchase of computer is a capital item - no
deduction for cost or CCA.
Club dues are not deductible [ITA 8(1)(f)].
### Property income:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest earned by daughter (attribution) [ITA 74.1(2)]</td>
<td>$1,000</td>
</tr>
<tr>
<td>Canadian dividends ($6,000 x 1.41) [ITA 12(1)(j)]</td>
<td>8,460</td>
</tr>
<tr>
<td>Interest – bank [ITA 12(1)(c)]</td>
<td>7,000</td>
</tr>
<tr>
<td><strong>Rental income:</strong></td>
<td></td>
</tr>
<tr>
<td>Rent received</td>
<td>$46,000</td>
</tr>
<tr>
<td>Rent receivable</td>
<td>2,000</td>
</tr>
<tr>
<td><strong>Expenses before CCA</strong></td>
<td>48,000</td>
</tr>
<tr>
<td><strong>CCA limited [Reg. 1100(11)] ($360,000 x 4%) – property purchased the previous year and no CCA was claimed as there was a loss. The 1/2 rule does not apply in the 2nd year.</strong></td>
<td>900</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>16,460</td>
</tr>
<tr>
<td><strong>Deductions:</strong></td>
<td></td>
</tr>
<tr>
<td>Bad debt re: interest (anniversary dates) [ITA 20(1)(p)]</td>
<td>(1,500)</td>
</tr>
<tr>
<td>Investment counselor fee [ITA 20(1)(bb)]</td>
<td>(2,000)</td>
</tr>
<tr>
<td>Interest on mortgage ($40,000/$200,000 x $22,000)</td>
<td>(4,400)</td>
</tr>
<tr>
<td><strong>Property income</strong></td>
<td>$8,560</td>
</tr>
</tbody>
</table>

### Business income:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gain on commodity sale ($28,000 - $16,000)</td>
<td>$12,000</td>
</tr>
</tbody>
</table>

### Other income:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prize for achievement ($2,000-$500 exemption) [ITA 56(1)]</td>
<td>$1,500</td>
</tr>
</tbody>
</table>

### Taxable capital gains:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sale of house ($300,000 - $180,000)</td>
<td>$120,000</td>
</tr>
<tr>
<td>less principal residence deduction [ITA 40(2)(b)]</td>
<td>(120,000)</td>
</tr>
<tr>
<td>Teulon shares (1/2 x [$114,000 - $22,000])</td>
<td>46,000</td>
</tr>
<tr>
<td>Listed personal property (painting) ($4,000 - $1,000 deemed cost) x (1/2) [ITA 46(1)(a)]</td>
<td>1,500</td>
</tr>
<tr>
<td><strong>Taxable capital gains</strong></td>
<td>$47,500</td>
</tr>
</tbody>
</table>
Other deductions:

Fees for tax appeal – [ITA 60(o)] $1,200

RRSP [ITA 60(i), 146]
  Contribution $7,000
  Limit - lesser of $22,450 (2011)
  or 18% of Previous years earned income -
  18% x $63,889 = $11,500
  Less PA (6,400)
  $5,100

TFSA – contributions are Not deductible 0

Moving expenses [ITA 62]
  Travel costs in the course of moving Fortier and her
two children from the old house to the new house:
  Accommodation $480
  Meals & vehicle
    - Actual costs ($400+ 500) = $900
    - Simplified method:
      Meals - $51 x 5 days x 3 people = $765
      Vehicle - $0.55 * x 4,400 km = 2,420 3,185
  Other moving expenses (Total)
    less not allowed – lodging & meals
    (15 days/30 days x $6,000)
    ($43,500 - $3,000)
    40,500 44,165
    less reimbursement (10,000) 34,165

Other deductions $40,465

Loss:
  Allowable business investment loss – the
  loan to Prentice Ltd. is deemed to be
  Disposed of for nil. The loss on shares
  Cannot be recognized until 20X4. [ITA 50(1)]
  ($10,000 x ½) $5,000

* The rate for the province in which the trip starts; in this case, Ontario. The flat rate to be used for the each province under the simplified method can be found at www.cra.gc.ca/travelcosts
PROBLEM EIGHT

[ITA: 3; 5(1); 6(1)(a), (b); 7(1); 8(1)(i); 8(2); 12(1)c), (j); 13(1); 20(1)(a), (c); 40(1)(a)(iii); 40(2)(g)(i), (iii); 46(1); 47(1); 60(i); 69(1)(b); 70(5)(a), (b); 73(1); 74.1(2)]

A Review of Net Income for Tax Purposes
Mr. Active holds a job, operates a small farm, and makes numerous investments. A description of his financial activities for 20X1 is given below.

1. Active is a lawyer and is employed in the legal department of a large public corporation. In 20X1, he received a gross salary of $72,000. In addition, the corporation provided the following items of remuneration:

   • A car allowance of $400 a month to cover costs of travel in the performance of his duties. During 20X1, Active used his own car to travel from his home to work and back. Rarely was the car used during working hours on company business.
   • A contribution of $3,000 to a deferred profit-sharing plan.
   • A group term life insurance policy for $100,000 (premium cost, $800).
   • A cash bonus of $3,000 that was awarded to him in the previous year and that he received in the current year.

2. Active’s employer gives all senior executives the option to acquire a certain number of shares of the corporation at a price that is guaranteed for two years. In 20X0, the employer granted Active an option to purchase up to 5,000 of its shares for a price of $10 per share. At the time the option was granted, the shares were valued at $10.75 per share. During 20X1, Active purchased 500 shares at a cost of $10 per share. At the date of purchase, the corporation’s shares were trading at $14 per share.

3. Active purchased a small parcel of land (20 hectares) in 20X1 and began raising goats. In 20X1, he lost $1,000 from this operation.

4. In 20X1, Active purchased 1,000 shares of Canadian public corporation X for $20 per share and received a stock dividend of 100 additional shares of the same class. During the year, he sold the 100 shares at $21 per share, for the same value as on their date of issue.

5. Three years ago, Active had purchased three residential rental properties and has provided you with the following information:

<table>
<thead>
<tr>
<th>Property 1</th>
<th>Property 2</th>
<th>Property 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land cost</td>
<td>$10,000</td>
<td>$4,000</td>
</tr>
<tr>
<td>Building cost</td>
<td>60,000</td>
<td>40,000</td>
</tr>
<tr>
<td>Building UCC (31/12/20X0)</td>
<td>52,000</td>
<td>37,000</td>
</tr>
<tr>
<td>20X1 net rents (before CCA)</td>
<td>3,000</td>
<td>(5,000)</td>
</tr>
</tbody>
</table>

In 20X1, Active sold property 1 for $80,000 (land $12,000, building $68,000), and property 2 for $50,000 (land $6,000, building $44,000). Also, in 20X1, he purchased property 4 for $90,000 (land $30,000, building $60,000). In 20X1, property 4 had net rentals before capital cost allowance of $1,000.

6. During the year, Active gifted 1,000 shares of Shell Canada Ltd. (a public corporation) to his daughter. The shares had cost him $10 each and had a value at the time of the gift of $12
each. In 20X1, his daughter (16 years old) received dividends of $1,000; she then sold the shares for $30 each.

7. In 20X1, Active gifted 2,000 shares of Exxon Ltd. (a public corporation) to his wife. The shares had a value of $40 each at the time of the gift. He had paid $30 per share several years before. His wife sold the shares in 20X1 for $28 per share during a market slump.

8. Active’s mother died in 20X0 and left him her house. The house cost $40,000 at the time of purchase and had a value in 20X0 of $60,000. Active sold the house in 20X1 for $66,000.

9. Three years ago, Active purchased 15% of the shares of two private corporations. Each carried on an active business. He sold the shares of both corporations in 20X1. Information relating to the shares is as follows:

<table>
<thead>
<tr>
<th></th>
<th>PC 1</th>
<th>PC 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost</td>
<td>$40,000</td>
<td>$35,000</td>
</tr>
<tr>
<td>Proceeds of sale</td>
<td>56,000</td>
<td>20,000</td>
</tr>
<tr>
<td>Terms of payment</td>
<td>8,000/yr for 7 yrs</td>
<td>All cash</td>
</tr>
</tbody>
</table>

10. In 20X1, during a market slump, Active sold 500 shares of public corporation A for $30,000; the shares had cost him $40,000. Two weeks later, as the market began to strengthen, he purchased 500 shares of the same corporation for $29,000.

11. Active also sold the following assets in 20X1:

<table>
<thead>
<tr>
<th></th>
<th>Cost</th>
<th>Proceeds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Public corporation B shares</td>
<td>$10,000</td>
<td>$12,000</td>
</tr>
<tr>
<td>Public corporation C shares</td>
<td>47,500</td>
<td>20,000</td>
</tr>
<tr>
<td>Stamp collection</td>
<td>8,000</td>
<td>12,000</td>
</tr>
<tr>
<td>Jewellery</td>
<td>6,000</td>
<td>1,000</td>
</tr>
<tr>
<td>Boat</td>
<td>5,000</td>
<td>2,000</td>
</tr>
<tr>
<td>Stereo set</td>
<td>800</td>
<td>900</td>
</tr>
</tbody>
</table>

12. Active had the following additional receipts in 20X1:

- Dividends from Canadian public companies: $4,000
- Interest on bonds: 1,000
- Lottery winnings: 6,000

13. Active paid out the following in 20X1:

- To purchase a computer for use at home when working on his employer’s business: $700
- Interest on bank loan to purchase shares of public corporation: 2,000
- Interest on house mortgage (mortgage funds of $60,000 were used — $40,000 for the purchase of the house, $20,000 for the purchase of shares): 6,000
- Lump-sum alimony settlement to ex-wife: 9,000
- Tuition fees for attending university: 1,000
- Donations: 4,000
- Gift to a registered federal political party: 1,000
- Contribution to an RRSP: 2,800
- Annual dues to the provincial law society: 1,000

Required: Calculate Active’s net income for tax purposes for 20X1.
Solution to P 9-8

This problem is an extensive review of net income for tax purposes. To complete the solution without confusion it is necessary to review each item in the context of the various items in the aggregating formula. A summary of the aggregating formula is presented below followed by an analysis of each category within the formula.

\[
\begin{align*}
3(a) & \quad \text{Employment income (Note 1)} & 81,600 \\
& \quad \text{Business income (Note 2)} & 0 \\
& \quad \text{Property income (Note 3)} & 15,331 \\
& \quad \text{Other income} & 0 \\
& \text{Total} & 96,931 \\
3(b) & \quad \text{Taxable capital gains (Note 4)} & 14,646 \\
& \quad \text{Net gains from LPP ($3,000 - $3,750)} & 0 \\
& \quad \text{Allowable capital losses (Note 5)} & (15,750) \\
& \quad \text{Net Income for Tax Purposes} & 94,131 \\
3(c) & \quad \text{Other deductions (Note 6)} & (2,800) \\
& \quad \text{Net Income for Tax Purposes} & 91,331 \\
3(d) & \quad \text{Losses:} \\
& \quad \text{Employment} & 0 \\
& \quad \text{Business (Note 2)} & (1,000) \\
& \quad \text{Property} & 0 \\
& \quad \text{Allowable Business Investment Losses (Note 7)} & (7,500) \\
& \quad \text{Net Income for Tax Purposes} & 85,631
\end{align*}
\]

(Note 1) Employment Income

\[
\begin{align*}
\text{ITA 5(1)} & \quad \text{Salary} & 72,000 \\
6(1)(b) & \quad \text{Car allowance ($400 x 12)} & 4,800 \\
6(1)(a) & \quad \text{Group-term life insurance [ITA 6(4)]} & 800 \\
5(1) & \quad \text{20X0 bonus received in 20X1} & 3,000 \\
7(1) & \quad \text{Stock option ($14 - $10 = $4 x 500)} & 2,000 \\
& \quad \text{Deduct:} \\
8(1)(i) & \quad \text{Dues to law society} & (1,000) \\
& \quad \text{Employment income} & \text{81,600}
\end{align*}
\]

Employment items not included above:

- The DPSP, although a benefit, is specifically designated as not taxable [ITA 6(1)(a)(i)].
- The cost of a computer is not deductible because of the general rule that denies all expenses except those specifically permitted [ITA 8(2)]. An employee can deduct the cost of supplies consumed in the performance of duties [ITA 8(1)(i)], but the computer is not an item that is consumed when used and therefore does not qualify. Even if this employee was a salesperson (and permitted to deduct all expenses to earn commissions) the cost of the computer would be denied because it is of a capital nature.
(Note 2) Business Income

The only business activity is the new farming operation which incurred a loss of $1,000. It is possible for the loss to be denied if there is no reasonable expectation of earning a profit from the farm (i.e., it is merely a hobby farm). However, there is no evidence provided that suggests this is the case.

(Note 3) Property Income

Rental properties:

<table>
<thead>
<tr>
<th></th>
<th>Pool A</th>
<th>Pool B</th>
<th>Pool C</th>
</tr>
</thead>
<tbody>
<tr>
<td>Building 1</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Opening UCC</td>
<td>$52,000</td>
<td>$77,000</td>
<td>--</td>
</tr>
<tr>
<td>Purchase</td>
<td>--</td>
<td>--</td>
<td>$60,000</td>
</tr>
<tr>
<td>Sales</td>
<td>(60,000)</td>
<td>(40,000)</td>
<td>--</td>
</tr>
<tr>
<td>Recapture [ITA 13(1)]</td>
<td>8,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>CCA (4%, ½ of 4% for Pool C) [ITA 20(1)(a)]</td>
<td>(8,000)</td>
<td>(1,480)</td>
<td>(1,200)</td>
</tr>
<tr>
<td>Recapture of CCA</td>
<td></td>
<td></td>
<td>$0</td>
</tr>
<tr>
<td>CCA (above, $1,480 + $1,200)</td>
<td></td>
<td>$35,520</td>
<td>$58,800</td>
</tr>
</tbody>
</table>

- Rental income (loss):
  - Property 1: $3,000
  - Property 2: (5,000)
  - Property 3: 4,000
  - Property 4: 1,000
  - Recapture of CCA: 8,000
  - CCA (above, $1,480 + $1,200): (2,680)
  - Net rental income: 8,320

- Other property income:
  - Dividend income [ITA 12(1)(j)]
    - Stock dividend (100 x $21 = $2,100 x 141%): 2,961
    - Dividends received by daughter on shares gifted ($1,000 x 141%): 1,410
    - Other dividends ($4,000 x 141%): 5,640
  - Bond interest [12(1)(c)]: 1,000
  - 19,331

Less expenses to earn income

- Bank loan interest for shares [ITA 20(1)(c)]: (2,000)
- House mortgage interest $20,000/$60,000 x $6,000 [ITA 20(1)(c)]: (2,000)
- 15,331
(Note 4) Capital Gains (Losses)

Listed personal property gains:

Stamp collection ($12,000 - 8,000 = $4,000) (1/2) $2,000

Listed personal property losses:

Jewelry ($1,000 - $6,000 = $5,000) (1/2) $(2,500)

Personal use property gains losses:

Boat ($2,000 - $5,000 = $3,000)
  deemed loss [ITA 40(2)(g)(iii)] $0

Stereo set -
  deemed proceeds [ITA 46(1)] 1,000
  deemed ACB [ITA 46(1)] (1,000) $0

Other capital gains:

- Stock dividend shares:
  Proceeds of disposition (100 x $21) $2,100
  ACB (weighted average) [ITA 47(1)]
    Cost of 1,000 shares @ $20 $20,000
    Stock dividend shares 100 @ $21 2,100
    $22,100
  Average cost $22,100/1100 shares= $20.09
  100 shares @ $20.09 (2,009)
  Capital gain $91
  Taxable gain (1/2) $46

- Real estate:

  
<table>
<thead>
<tr>
<th></th>
<th>Property 1</th>
<th>Property 2</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land sale</td>
<td>$12,000</td>
<td>$6,000</td>
<td></td>
</tr>
<tr>
<td>Land ACB</td>
<td>(10,000)</td>
<td>(4,000)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>$2,000</td>
<td>$2,000</td>
<td>$4,000</td>
</tr>
<tr>
<td>Building sale</td>
<td>$68,000</td>
<td>$44,000</td>
<td></td>
</tr>
<tr>
<td>Building cost</td>
<td>(60,000)</td>
<td>(40,000)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>$8,000</td>
<td>$4,000</td>
<td>$12,000</td>
</tr>
<tr>
<td>Capital gain</td>
<td></td>
<td></td>
<td>$16,000</td>
</tr>
<tr>
<td>Taxable gains (1/2)</td>
<td></td>
<td></td>
<td>8,000</td>
</tr>
</tbody>
</table>

- Shares gifted to daughter: [ITA 69(1)(b)]
  Deemed proceeds 1,000 x $12 $12,000
  ACB 1,000 x $10 10,000
  Capital gain $2,000
  Taxable gains (1/2) 1,000

(Note: The daughter also realizes a capital gain but it is not attributed to the parent)
• Gift of shares to spouse: [ITA 73(1)]
  Deemed proceeds (2,000 x $30) 60,000
  ACB (60,000)
  Capital gain $ 0

• Mother's house:
The mother is deemed to have sold her house at fair market
value at death [ITA 70(5)(a)] and Active acquires the home
at a cost of the same amount [ITA 70(5)(b)]. The gain on
sale is likely a capital gain because the home was not
acquired for the purpose of resale, but was acquired by an
event beyond his control. The increase in value between the
date of sale and date of acquisition is apparently fortuitous
($66,000 -$60,000 = $6,000) (1/2)
  3,000

• Shares of PC1:
  Proceeds $56,000
  ACB 40,000
  Gain 16,000
  Less reserve for deferred proceeds:
    lesser of: [ITA 40(1)(a)(iii)]
      1) $48,000/$56,000 x $16,000 = $13,714
      2) 80% of $16,000 $12,800
  Capital gain $ 3,200
  Taxable capital gain (1/2) 1,600

• Public Corporation B
  $12,000 - $10,000 = $2,000 (1/2) 1,000

TOTAL TAXABLE CAPITAL GAINS $14,646

(Note 5) Capital losses:
• The Exxon shares gifted to his wife were subsequently sold by her
  at a loss. This loss is attributed to Mr. Active. The cost base of the
  shares to Mrs. Active is the deemed proceeds to Mr. Active. 74.2(1)
  Proceeds 2,000 x $28 = $56,000
  ACB 2,000 x $30 60,000
  Capital loss $(4,000)
  Allowable loss (1/2) $(2,000)

• Public Corporation A shares were sold at a loss of $10,000
  ($30,000 - $40,000) but were reacquired 15 days later. The loss is
  a superficial loss deemed to be nil [ITA 54, 40(2)(g)(i)] 0

• Public Corporation C shares
  $20,000 - $47,500 = ($27,500) (1/2) (13,750)

Total allowable capital losses $(15,750)
(Note 6) Other Deductions

The only other deduction is the RRSP contribution which is below the contribution limits [ITA 60(i)].

$2,800

(Note 7) Allowable Business Investment Loss

Shares of PC 2:
$20,000 - $35,000 = ($15,000) (1/2)

$(7,500)
CASE

TRANS-AM SUPPLIERS LTD.

[ITA: 40(1)(a)(iii); 68]

Trans-Am Suppliers Ltd. is just completing negotiations to sell its manufacturing division to a competitor. The purchaser has agreed to purchase the inventory, manufacturing equipment, licence, and goodwill for $1,200,000.

The payment terms require that the purchaser pay $900,000 on the closing date, with the balance of $300,000 deferred for two years. The unpaid balance is subject to annual interest of 10%. Trans-Am intends to use the proceeds from the sale to expand its wholesale division, which is expected to generate returns of 24% annually before tax. The company’s tax rate is 25%.

Although the total price and payment terms have been agreed to, a conflict has arisen between Trans-Am and the purchaser regarding the price of each asset sold. The sources of the dispute are as follows:

• **Inventory** Trans-Am’s accounting records indicate that the inventory amounts to $300,000, valued at the lower of cost or market. Traditionally, the company has been conservative in establishing the market value. The purchaser, after examining the merchandise, feels that the proper value is $340,000 and expects that it could all be sold within one year.

• **Equipment** The manufacturing equipment, which originally cost $600,000, has a book value for accounting purposes of $300,000. The undepreciated capital cost is $320,000. Trans-Am has valued the equipment at $400,000, but the purchaser’s appraiser is confident that the equipment has a value of $450,000 in the used-equipment market.

• **Licence** One of Trans-Am’s products is manufactured under licence from a company that holds the patent. The licence, which has a life of 10 years, was purchased only six months earlier for $100,000. Shortly after the purchase, the product gained wide recognition; the company that holds the patent rights now sells licences in other geographic areas at a price of $300,000. Both Trans-Am and the purchaser agree on this value.

• **Goodwill** No discussion was held with respect to the goodwill, as both parties acknowledge that its value reflects the difference between the total purchase price of $1,200,000 and the combined values of the other specific assets.

The president of Trans-Am is concerned that the negotiation process will be stalled if the above issues are not settled. He is prepared to make some concessions but feels that before doing so, he must understand what the differences mean to Trans-Am. Also, the president thinks it would be useful to know the impact of his own stance on the purchaser, as this will suggest how rigid he should appear at the next round of discussions.

The president has asked you to report to him and provide the information requested. In addition, he has asked you to separately examine the tax implications of the deferred payment terms and determine whether the agreement should state the terms of payment for each asset as opposed to the total package.

**Required:** Prepare an outline of the report, including any necessary calculations.
Solution to Case - TRANS-AM SUPPLIERS LTD.

This case deals with two basic issues:

1. The impact on cash flow to both the vendor and the purchaser resulting from the allocation of the total sales prices of a group of assets to each specific asset.

2. The structuring of the sale agreement for deferred payments to maximize the deferral of income recognition to the vendor.

To isolate each of the above issues, the allocation problem is examined first and does not take into account the issue deferred payments for the vendor.

Alternative Allocations for Trans-Am (Vendor)

Based on the asset values assigned by Trans-Am, the following taxable incomes are created.

- The sale of inventory for $300,000 (being its cost amount) results in no gain.
- Sale of the equipment results in a recapture of capital cost allowance of $80,000 ($400,000 - $320,000). It is assumed that the assets sold represent all of the manufacturing equipment owned by the company (Class 43).
- The licence has a limited life of 10 years and is therefore classified as Class 14 depreciable property. As the licence was acquired in the same year as its sale, no CCA is claimed. The selling price of $300,000, therefore, results in a taxable capital gain of $100,000 ($300,000 - $100,000 = $200,000 x 1/2) and no recapture.
- The remaining portion of the $1,200,000 total price is allocated to goodwill ($200,000) which is eligible capital property. No information was provided concerning any balance in the cumulative eligible capital account and it is, therefore, assumed to be NIL. Consequently, 2/3's of 3/4 x $200,000 = $100,000 is taxable as business income.

As a result of the above, Trans-Am will incur a tax cost of $70,000 summarized as follows:

<table>
<thead>
<tr>
<th>Asset</th>
<th>Taxable Value</th>
<th>Taxable Income</th>
<th>Tax @ 25%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory</td>
<td>$300,000</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>Equipment</td>
<td>400,000</td>
<td>80,000</td>
<td>20,000</td>
</tr>
<tr>
<td>Licence</td>
<td>300,000</td>
<td>100,000</td>
<td>25,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>200,000</td>
<td>100,000</td>
<td>25,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$1,200,000</strong></td>
<td><strong>$280,000</strong></td>
<td><strong>$70,000</strong></td>
</tr>
</tbody>
</table>

The tax rate of 25% was provided in the case. The student may recognize that the corporate tax rate on manufacturing income may be lower than 25%. As this is not reviewed until a later chapter, the tax rate provided in the case can be used as a reasonable estimate.

If Trans-Am accepts the values proposed by the purchaser, their taxable income will increase to $343,333 (Inventory: $340,000 - $300,000 = $40,000, Equipment: $450,000 - $320,000 = $130,000, Licence: unchanged at $100,000, Goodwill: 2/3 x 3/4 of $110,000 = $73,333). Consequently, the tax cost will increase to $85,833 as follows:


<table>
<thead>
<tr>
<th>Asset</th>
<th>Taxable Value</th>
<th>Taxable Income</th>
<th>Tax @ 25%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory</td>
<td>$340,000</td>
<td>$40,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>$450,000</td>
<td>$130,000</td>
<td>$32,500</td>
</tr>
<tr>
<td>Licence</td>
<td>$300,000</td>
<td>$100,000</td>
<td>$25,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>$110,000</td>
<td>$73,333</td>
<td>$18,333</td>
</tr>
</tbody>
</table>

| Total         | $1,200,000    | $343,333       | $85,833   |

Therefore, if Trans-Am accepts the entire proposal of the purchaser, they will incur an additional tax cost of $15,833 ($85,833 - $70,000).

**Alternative Allocation for the Purchaser**

The values proposed by the purchaser will alter the amount and timing of future deductions from income and, therefore, the after-tax cost of the acquisition is changed. Inventory is deductible for tax purposes when sold. Therefore increasing the inventory value by $40,000 and reducing goodwill means that the full $40,000 is deductible within one year, compared to goodwill of which only $30,000 (3/4 of $40,000) would be deductible at the rate of 7% annually (declining balance). Similarly, increasing equipment by $50,000 results in a deduction for manufacturing equipment at 50% straight-line annually versus 7% annually on 3/4’s of the goodwill.

The after-tax cost for each alternative can be calculated by reducing the purchase price by the present value of future tax savings that occur from their write-off. Neither the tax rate nor the appropriate discount rate for the purchaser is known. Therefore, the vendor's tax rate and discount rate can be used as a rough estimate. The vendor's discount rate is 24% which is approximately 18% after-tax (24% - tax of 25%).

<table>
<thead>
<tr>
<th>Vendor's Values</th>
<th>Purchaser's Values</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory:</td>
<td></td>
</tr>
<tr>
<td>Cost</td>
<td>$300,000</td>
</tr>
<tr>
<td>Tax saving (present value)</td>
<td></td>
</tr>
<tr>
<td>25% of $300,000 = $75,000 (one year)</td>
<td>(61,500)</td>
</tr>
<tr>
<td>25% of $340,000 = $85,000 (one year)</td>
<td>(69,700)</td>
</tr>
<tr>
<td>After-tax cost</td>
<td>$238,500</td>
</tr>
</tbody>
</table>

Equipment (Class 29):
Using the formula described in Chapter 6 and ignoring the one-half rule, the after-tax cost is:

| Cost            | $400,000          | $450,000          |
| Less present value of tax savings |
| $400,000 x .25 x .50 = (73,529) | |
| $450,000 x .25 x .50 = (82,721) |
| After-tax cost  | $326,471          | $367,279          |
Licence:

Cost $300,000 $300,000

Tax saving (present value)

Class 14 asset - CCA is 1/10 per year (straight-line)

$30,000 x 25% = $7,500 for 10 years (33,675) (33,675)

After-tax cost $266,325 $266,325

Goodwill:

Eligible capital property, only 3/4 of the cost is amortized at 7%

Cost $200,000 $110,000

Less tax savings (present value)

\[
\begin{align*}
30,000 \times 0.25 \times 0.07 &= 150,000 \times 0.25 \times 0.07 = 10,500 \\
0.07 + 0.18 &= 0.07 + 0.18
\end{align*}
\]

After-tax cost $189,500 $104,225

Summary

Vendor's Values Purchaser's Values

Inventory $238,500 $270,300

Equipment 326,471 367,279

Licence 266,325 266,325

Goodwill 189,500 104,225

$1,020,796 $1,008,129

If the purchaser's values are used, the purchaser stands to gain a tax saving (in present value terms) of $12,667 ($1,020,796 - $1,008,129 = $12,667). In comparison, Trans-Am will incur a cost of $15,833. For both parties, it does not represent a significant amount in relation to the purchase price of $1,200,000. Knowing these parameters will now permit Trans-Am to conduct their negotiations in an informed manner.

Both parties should be aware that the Income Tax Act permits CRA to adjust the agreed values if they do not represent the real values of the specific assets [ITA 68]

Deferred Payments

$300,000 of the $1,200,000 selling price is deferred for a two year period. Therefore, Trans-Am may defer the recognition of a portion of its income due to the capital gain reserve (Chapter 8) [ITA 40(1)(a)(iii)]. The deferral does not apply to the inventory sale, the recapture of CCA and the goodwill gain even if a portion of the proceeds are deferred.

If the agreement simply states that the total price of $1,200,000 is to be paid with an immediate payment of $900,000 and $300,000 after two years, the deferred portion will apply proportionately to each specific asset. The delayed recognition of income is determined accordingly.
Alternatively, the agreement could describe the terms of payment for each asset separately, and all of the deferred portion could be allocated to the asset that is eligible for delayed income recognition (i.e., the licence).

The timing of the tax is calculated for each method assuming the assets are sold at the values suggested by the purchaser. The student may choose the opposite.

**Payment Terms on Total Price:**

<table>
<thead>
<tr>
<th></th>
<th>Total Price</th>
<th>Cash Payment (75%)</th>
<th>Delayed Payment (25%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory</td>
<td>$340,000</td>
<td>$255,000</td>
<td>$85,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>450,000</td>
<td>337,500</td>
<td>112,500</td>
</tr>
<tr>
<td>Licence</td>
<td>300,000</td>
<td>225,000</td>
<td>75,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>110,000</td>
<td>82,500</td>
<td>27,500</td>
</tr>
<tr>
<td></td>
<td>$1,200,000</td>
<td>$900,000</td>
<td>$300,000</td>
</tr>
</tbody>
</table>

Tax in year of sale (year 1):

- Inventory (previously calculated) $10,000
- Equipment (previously calculated) 32,500
- Goodwill (previously calculated) 18,333
- Licence:
  - Gain $200,000
  - Reserve, lesser of
    1) $75,000/$300,000 x $200,000 = $50,000
    2) $80% of $200,000 = $160,000 (50,000)
  - Capital gain $150,000
  - Taxable capital gain $75,000
  - Tax @ 25% $18,750

Tax in Year 2:

No amounts were received and no income is recognized $0

Tax in Year 3:

- Licence:
  - Gain (The previous reserve) is taxable ($50,000 x ½ @ 25%) $6,250

**Payment Terms for Each Asset:**

The maximum delayed payment is allocated to the licence.

<table>
<thead>
<tr>
<th></th>
<th>Total Price</th>
<th>Cash Payments</th>
<th>Delayed Payment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory</td>
<td>$340,000</td>
<td>$340,000</td>
<td>$0</td>
</tr>
<tr>
<td>Equipment</td>
<td>450,000</td>
<td>450,000</td>
<td>0</td>
</tr>
<tr>
<td>Licence</td>
<td>300,000</td>
<td>0</td>
<td>300,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>110,000</td>
<td>110,000</td>
<td>0</td>
</tr>
<tr>
<td></td>
<td>$1,200,000</td>
<td>$900,000</td>
<td>$300,000</td>
</tr>
</tbody>
</table>
Tax in year of sale (year 1):

Inventory (as above) $10,000
Equipment (as above) 32,500
Goodwill (as above) 18,333

Licence:
Gain $200,000
Reserve, lesser of:
1) $300,000/$300,000 x $200,000 = $200,000
2) 80% of $200,000 $160,000
Capital gain $40,000
Taxable (1/2) $20,000
Tax @ 25% 5,000
Total tax $65,833

Tax in year 2:

Licence:
Previous reserve $160,000
Less new reserve, lesser of:
1) $300,000/$300,000 x $200,000 = $200,000
2) 60% of $200,000 = $120,000
Capital gain $40,000
Taxable (1/2) $20,000
Tax @ 25% 5,000

Tax in year 3:
Licence 25% x $120,000 x ½ $15,000

Comparative Summary of Tax:

<table>
<thead>
<tr>
<th></th>
<th>Total Terms</th>
<th>Specific Terms</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year of sale</td>
<td>$79,583</td>
<td>$65,833</td>
</tr>
<tr>
<td>Year 2</td>
<td>0</td>
<td>5,000</td>
</tr>
<tr>
<td>Year 3</td>
<td>6,250</td>
<td>15,000</td>
</tr>
<tr>
<td>Total tax</td>
<td>$85,833</td>
<td>$85,833</td>
</tr>
<tr>
<td>Present value</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Discounted at 18%</td>
<td>$71,459</td>
<td>$68,708</td>
</tr>
</tbody>
</table>

Therefore, without changing the actual total terms of payment, but merely expressing the terms of payment for each specific asset and applying the deferred payment to the assets which are eligible for deferred recognition, an actual present value tax saving of $2,751 occurs ($71,459 - $68,708) even though the actual tax payments over the term is the same.
CHAPTER 10

INDIVIDUALS: DETERMINATION OF TAXABLE INCOME
AND TAXES PAYABLE

Review Questions

1. Briefly explain the difference, for individuals, between net income for tax purposes and taxable income.

2. Explain the difference between an allowable capital loss and a net capital loss.

3. Describe the tax treatment of net capital losses.

4. Explain how a non-capital loss is created and how it is treated for tax purposes.

5. Is it always worthwhile to utilize a net capital loss or a non-capital loss as soon as the opportunity arises? Explain.

6. Is it possible for taxpayers to pay tax on more income than they actually earned over a period of years? Explain.

7. How does the risk of not being able to utilize a business loss for tax purposes vary for each of the following individuals?
   • Individual A operates the business as a proprietorship.
   • Individual B is the sole shareholder of a corporation that owns the business.
   • Individual C is a 30% shareholder of a corporation that operates the business.
   • Individual D is a 30% partner in a business partnership.

8. What can a taxpayer do to reduce the risk of not being able to utilize a net capital loss or a non-capital loss?

9. Two separate taxpayers are considering investing in shares of the same public corporation. How is it possible that the risk associated with that investment may be greater for one taxpayer than for the other?

10. If an individual has a net taxable capital gain in a year that qualifies for a capital gain deduction, is there any advantage to not claiming the applicable portion of the deduction in that year? Explain.

11. If an individual is considering selling his business to a daughter, does it make any difference to him whether that business is a proprietorship or is housed within a corporation?

12. What is the difference between the basic federal tax and the total federal tax?
13. What is the difference between a tax deduction and a tax credit?

14. An individual usually has taxable income in a year of $130,000 and pays federal and provincial taxes totalling $43,000. Would this information be relevant when the implications of investing in a partnership that operates a small retail business are considered?

15. Does an individual who lives in Alberta and receives a $100 dividend obtain the same tax reduction from the dividend tax credit as an individual who resides in New Brunswick? Explain.

16. In what circumstances may an individual be subject to provincial tax in more than one province in a particular year?

17. An individual resides in Manitoba and operates a business that has no profit from its Alberta operations. Is it possible for that person to have a tax liability in Alberta in a particular year?
Solutions to Review Questions

R10-1. Net income for tax purposes consists of the aggregate of a taxpayer's current year's income from employment, business, property, capital gains and other sources, taking into account the losses from those sources. Net income for tax purposes is not the base to which the tax rates are applied. Taxable income consists of net income for tax purposes minus certain reductions. For individuals, those reductions consist primarily of losses from other years that were unable to be used in the year incurred and the lifetime capital gain deduction on qualified property. Taxable income is the base to which the annual tax rates apply.

R10-2. An allowable capital loss is one-half of the loss incurred on the sale of capital property in a particular year, and forms part of that year's calculation of net income for tax purposes. To the extent that the aggregating formula for a particular year restricts the deduction of allowable capital losses because there are insufficient taxable capital gains, the restricted portion is classified as a net capital loss. Net capital losses, therefore, may consist of the unused allowable capital losses of a number of years, and may be available for deduction in other years in arriving at the taxable income of those other years (see 3 below) [ITA 111(1)(b)].

R10-3. Net capital losses can be carried back three years and forward indefinitely from the year in which they were incurred. During the carry-over period, the net capital losses can be deducted in arriving at taxable income only to the extent that the taxpayer has realized net taxable capital gains (gains minus losses) for that year [ITA 111(1)(b), 111(1.1)]. There is an exception to this rule for the year of death and the preceding year. In those two years, an individual may deduct net capital losses against all sources of income [ITA 111(2)].

R10-4. If, in a particular year, the aggregating formula for determining a taxpayer's net income for tax purposes does not permit the full deduction of employment losses, business losses, property losses, and allowable business investment losses because there is insufficient income in that year, the unused portion is classified as a non-capital loss. Non-capital losses can be carried back three years and forward twenty years from the year in which they are incurred, and can be deducted in arriving at the taxable income of those other years, regardless of the type of income earned in those other years [ITA 111(1)(a)]. [Note the carry forward for non-capital losses incurred in taxation years that end prior to March 22, 2004 is seven years. For non-capital losses incurred in taxation years ending between March 23, 2004 and December 31, 2005 the carry forward is ten years.]

R10-5. It is not always desirable to utilize a loss carry-over as soon as possible. The decision to use the loss carry-over must consider both the timing and the amount of the tax savings that will occur. Obviously, the sooner they are used, the sooner after-tax cash flow will be increased. However, consideration must also be given to the rates of tax that are applicable in the particular year. By forgoing the use of a loss carry-over in a year of relatively low income in order that it can be used in a subsequent year when income is anticipated to be high (and therefore subject to a higher rate of tax) the amount of tax saved will be greater. The decision to delay the use of a loss carry-over must consider both the time value of money as well as the degree of certainty for the anticipated earnings.

R10-6. Yes, it is possible to pay tax on more earnings than were actually achieved over a period of time. Because non-capital losses have a defined and restricted time period in which they can be used, it is possible that they will remain unused indefinitely. For example, if a taxpayer earns taxable income before the three year carry-back and after the twenty year carry-forward of non-capital losses, the losses simply expire, but income in those other years is subject to tax.
R10-7. The risk of not being able to utilize a business loss for tax purposes differs for each taxpayer as follows:

- **Individual A** - As a proprietorship, the business loss belongs to the individual and can be offset against all of his/her sources of income. Therefore, the individual will only lose the loss if he/she cannot generate sufficient income in the required time limit.

- **Individual B** - Incurs the loss in a wholly-owned corporation. The loss is locked in the corporation and can only be used if the corporation earns sufficient income for offset. As the individual shareholder is a separate taxpayer, income earned by the individual cannot be offset against the corporation's loss. Therefore, there is a greater risk of the business loss remaining unused. As the sole controlling shareholder, the individual has some opportunity to transfer income producing activity into the corporation to diminish this risk.

- **Individual C** - The risk in this situation is similar to Individual B (above) except that Individual C does not control the corporation that incurs the losses. Therefore, Individual C is at greater risk of not being able to use the business loss because it is much more difficult for him/her to transfer income producing activities to the corporation. Investing in a business venture with other parties using a corporate structure substantially reduces the shareholders flexibility for loss utilization.

- **Individual D** - Even though this individual is investing with other parties, the use of the partnership structure reduces the risk of not being able to use the business losses. The business losses are allocated directly to the individual and can be used against all of his/her sources of income. Maximum flexibility is therefore achieved.

R10-8. A taxpayer can use the following discretionary actions to reduce the risk of not being able to utilize a non-capital or net capital loss:

- Delay the deduction of discretionary items such as capital cost allowance, allowance for bad debts and so on.
- Speed up the timing of taxable income by not claiming income reserves from deferred proceeds on the sale of capital property or inventory.
- Trigger the realization of capital gains and/or recapture of capital cost allowance by selling assets. The assets can be sold to a related entity and leased back for the business operations. The created gains will offset the losses that are about to expire in exchange for an increased tax value for the assets transferred to the related corporation. Alternatively, the property can be sold to a third party under a sale and leaseback arrangement.

R10-9. Two separate taxpayers investing in shares of the same public corporation may be subject to different risk because of their abilities to utilize a capital loss from that investment if it should occur. For example, one investor may already own other capital properties that have appreciated in value and have potential capital gains. This investor has little risk of incurring a capital loss on the new investment that will remain unused. On the other hand, another investor may have no other capital properties, in which case a capital loss on the new share investment can only be used to reduce taxes if a future capital gain can be created. Therefore, the first investor is ensured that a loss will create a tax saving which reduces the potential cash loss that can occur, whereas, the second investor runs the risk that any loss will not create a tax saving and his potential cash loss is greater.
R10-10. The use of the capital gains deduction on specific qualified property is optional and in some circumstances it may be desirable to forgo its use until a later year. For example, a person may not want to claim the deduction in a year of low income, and preserve the deduction for a subsequent year when a gain would be taxable at a high rate of tax. Such a decision should not be made unless there is reasonable certainty that a future capital gain on qualified property will occur. In addition, one should be aware that the capital gains deduction, as a tax preference, is subject to continual debate regarding its fairness and runs the risk of being canceled at some future time [ITA 110.6].

R10-11. If the business is a proprietorship, the sale of the business involves the sale of each separate asset. To the extent that capital gains occur from the sale, the taxpayer cannot use the capital gains deduction to reduce the amount of tax. If the business is housed within a corporation the sale would involve the sale of shares of the corporation rather than the individual assets of the business. In this case, provided that the corporation is a qualified small business corporation (QSBC), a capital gains deduction of $375,000 ($750,000 x ½) is available [ITA 110.6].

R10-12. Basic federal tax consists of the normal federal tax based on the standard rate structure minus certain, but not all, tax credits. Total federal tax is the amount determined after deducting all of the permitted tax credits. The distinction may be important because some federal taxes are determined as a specific rate applied to the basic federal tax rather than to the taxable income or total federal tax (for example, the special federal tax for non-residents in place of a provincial tax).

R10-13. A tax deduction reduces a taxpayer’s taxable income and the resulting tax saving is based upon the marginal tax rate of the taxpayer. For example, a $100 tax deduction will reduce taxes by $45 for a taxpayer subject to a 45% tax rate and by $30 for a taxpayer subject to a 30% tax rate. On the other hand, a tax credit is a specific reduction of tax otherwise payable. A $100 tax credit reduces the taxpayer’s tax by $100 regardless of whether they are subject to a 45% tax rate or a 30% tax rate.

R10-14. The fact that the individual paid $43,000 of tax on $130,000 of income is not relevant to the decision to invest in the business partnership. This information simply provides the effective rate of tax paid (33 1/3% - $43,000/$130,000). What is relevant is the marginal rate of tax applicable to the investor. In other words, the rate of tax applicable on each additional dollar of income earned [ITA 117(2)]. Because personal tax rates are progressive, the $43,000 tax amount consists of several rates of tax on different levels of income. This individual will be taxed on each additional dollar of income at the highest rate. The new venture is structured as a partnership, therefore, profits earned or losses incurred are allocated directly to the investor creating additional tax on income at the high rate, and will save tax from losses at the same rate (unless the losses cross the rate boundary).

R10-15. An individual in Alberta will not receive the same tax reduction from the dividend tax credit on a $100 dividend as an individual in New Brunswick. Although the federal dividend tax credit is the same, the provincial taxes are different. Each province and territory has their own provincial dividend tax credit.

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1 $750,000 applies to transactions after March 19, 2007; previous limit was $500,000.
R10-16. Normally an individual is taxable in a particular province if he or she resided in that province on the last day of the calendar year. An exception to this rule requires that an individual, who resides in a particular province but carries on business from a permanent establishment in other provinces, allocate a portion of the business income to those other provinces [Reg. 2600].

R10-17. Yes, it is possible for this to occur. A taxpayer residing and operating a business in Manitoba that also has operations in Alberta must allocate a portion of the business profits for tax in Alberta provided that the Alberta operations are carried on from a permanent establishment in that province. The profit allocation is based on an arbitrary formula that relates to the percentage of sales earned and salaries paid in Alberta and not to the actual profits in Alberta. Therefore, as long as the Alberta operation has sales and salaries, a percentage of the total business profits (Manitoba and Alberta) is allocated to Alberta and is subject to Alberta tax rather than Manitoba tax. The fact that the Alberta operation did not actually earn a profit is irrelevant [Reg. 402(3)].
Key Concept Questions

QUESTION ONE

In the current year, Beth has a taxable capital gain of $20,000 from disposing of shares of various
public companies. She has a net capital loss of $7,500 from 1998 when the capital gains inclusion
rate was 3/4.

Determine the maximum net capital loss deduction for the current year. *Income tax reference: ITA
111(1)(b), 111(1.1).*

QUESTION TWO

Kendra disposed of shares of A Ltd., a qualified small business corporation (QSBC), in the current
year realizing a taxable capital gain of $350,000. She has net capital losses from last year of
$10,000 which she wants to claim in the current year. Her cumulative net investment loss (CNIL)
account at the end of the year is $3,000. Kendra claimed an allowable business investment loss
(ABIL) of $12,000 on her previous year’s tax return. She incurred a taxable capital gain of $75,000
on QSBC shares four years ago and claimed an equivalent capital gains deduction.

Determine the capital gains deduction claimable by Kendra in the current year. *Income tax
reference: ITA 110.6(1), (2), (2.1).*

QUESTION THREE

At the end of last year, Ryan had a balance in his cumulative net investment loss (CNIL) account of
$14,500. In the current year, Ryan earned net rental income of $5,000 and received eligible
dividends from Canadian corporations of $1,000. He incurred interest expense of $3,000 relating to
his stock portfolio.

Determine Ryan’s CNIL balance at the end of the current year. *Income tax reference: ITA 110.6(1).*

QUESTION FOUR

X Ltd. is a Canadian-controlled private corporation carrying on business in Canada. The net fair
market value of X Ltd. is estimated to be $80,000, calculated as follows:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>1,000</td>
</tr>
<tr>
<td>Marketable securities</td>
<td>16,000</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>11,000</td>
</tr>
<tr>
<td>Furniture and equipment</td>
<td>32,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>40,000</td>
</tr>
<tr>
<td>Bank loan</td>
<td>(20,000)</td>
</tr>
<tr>
<td></td>
<td><strong>80,000</strong></td>
</tr>
</tbody>
</table>

The shares of X Ltd. have been owned by Alexander for the last two years and throughout that time,
the relative values of the assets and liabilities have remained constant. Determine if X Ltd. is a
qualified small business corporation. *Income tax reference: ITA 110.6(1).*
QUESTION FIVE

In 20X1 Jack loaned $10,000 to a small business corporation. By the end of the current year, it was established that the loan was bad and that Jack would not be receiving the $10,000 principal. Jack has sheltered $4,000 of capital gains with the capital gains exemption in prior years.

Determine the tax consequences for Jack for the current year. *Income tax reference: ITA 39(1)(c), 39(9), 50(1).*

QUESTION SIX

Angelina has taxable income of $130,000 for the current year, including $120,000 of employment income. She is not married and lives alone. Angelina’s employer withheld CPP and EI premiums of $3,004 as well as income tax.

Determine Angelina’s federal tax payable for the current year. *Income tax reference: ITA 117(2), 117.1(1), 118(1)(c), 118(10), 118.7.*

QUESTION SEVEN

Mr. Senior turned 65 in the current year and received pension income from the following sources:

- Old-age security pension $ 5,800
- Canada Pension Plan 7,300
- Pension income from former employer 32,000

$45,100

Mr. Senior had no other income for the year. His wife, age 66, had net income of $6,000 (OAS and interest income) in the current year. *Income tax reference: ITA 56(1)(a.2), 60(c), 60.03, 117(2), 117.1(1), 118(1)(a), 118(2),(3), 118.8.*

Determine Mr. Senior’s federal tax payable for the current year assuming –

(i) He does not elect to split his pension income.
(ii) He elects to split his pension income.

QUESTION EIGHT

Brent is unmarried and lives alone. During the current year he earned employment income of $120,000. He has a portfolio of investments that generated eligible dividends from Canadian corporations of $10,000. He donated public company shares worth $1,000 to the Canadian Cancer Society. The adjusted cost base (ACB) of the shares donated was $400.

Determine Brent’s federal tax payable for the current year. *Income tax reference: ITA 38(a.1), 117(2), 117.1(1), 118(1)(c), 18.01(5), 118.1(3), 118.7, 121.*

QUESTION NINE

Michelle attended a Canadian university on a full-time basis for eight months during the current year. Her only income for the year was $4,500 of employment income earned during the summer. She paid tuition fees of $7,000 for the current year.
Determine the amount of tuition, education, and textbook credit available to Michelle. What options are available with respect to the unused education credits? *Income tax reference: ITA 118.5, 118.6, 118.61, 118.81, 118.9.*

**QUESTION TEN**

Glen and Kelly have two children, Ben, age 14, and Cody, age 20. The medical expenses and net income for each member of the family for the current year is as follows:

<table>
<thead>
<tr>
<th></th>
<th>Medicals</th>
<th>Net income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Glen</td>
<td>$2,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Kelly</td>
<td>3,000</td>
<td>40,000</td>
</tr>
<tr>
<td>Ben</td>
<td>600</td>
<td>500</td>
</tr>
<tr>
<td>Cody</td>
<td>12,000</td>
<td>9,000</td>
</tr>
</tbody>
</table>

All of the medical expenses were paid by Glen in the 12-month period ending December 31. Determine the maximum medical expense credit for the current year. *Income tax reference: ITA 118.2(1).*

**QUESTION ELEVEN**

Carol registered her daughter, Kristin, in an eligible physical activity program and paid the registration fee of $650 on January 5th of the current year. The program started on February 1st and continued, one night a week for thirteen weeks.

Determine the children’s fitness tax credit claimable for the current year. *Income tax reference: ITA 118.03.*

**QUESTION TWELVE**

Ellen received old-age security (OAS) payments during the current year totalling $6,200. Her net income for the current year is $85,000. No amount was withheld from the OAS payments as her income was lower in previous years.

Determine Ellen’s OAS repayment (Part I.2 tax) for the current year. *Income tax reference: ITA 60(w), 180.2.*

**QUESTION THIRTEEN**

In 20X0 Jonathan, who is single, earned employment income of $10,000, capital gains of $100,000, and Canadian non-eligible dividends of $20,000. He is exempt from CPP and EI. In addition, Jonathan is a limited partner in a Canadian Limited partnership from which he was allocated a business loss of $34,000.

Does Jonathan have to pay any alternative minimum federal tax in the year and if so, how much? Also, briefly explain how any federal minimum tax in excess of the normal federal tax will be dealt with in future years. *Income tax reference: ITA 127.5 to 127.55.*
Solutions to Key Concept Questions

KC 10-1

[ITA: 111(1)(b), 111(1.1) – Net capital losses]

The maximum net capital loss deduction for the current year is $5,000. The 1998 net capital loss is stated at the inclusion rate for the year incurred (3/4). The net capital loss must first be grossed-up to the full capital loss and then multiplied by the current year inclusion rate (1/2).

\[ \$7,500 \times \frac{4}{3} = \$10,000 \times \frac{1}{2} = \$5,000 \]

KC 10-2

[ITA: 110.6(1), (2), (2.1) – Capital gains deduction]

The capital gains deduction claimable by Kendra in the current year is $300,000 being the least of three amounts; unused capital gains deduction ($300,000), cumulative gains limit ($325,000) and annual gains limit ($340,000).

Unused capital gains deduction available:
- Lifetime limit ($750,000 \times 1/2) $375,000
- Claimed previously (75,000)
- Available $300,000

Annual gains limit:
- Lesser of
  - Net taxable capital gains (all assets) $350,000, and
  - Net taxable capital gain (QSBC) $350,000 $350,000
- Deduct Net capital losses (in excess of other net gains) (10,000)
- Deduct ABIL (0)
- $340,000

Cumulative gains limit:
- Qualifying taxable capital gains (1985-2011)($75,000 + $350,000) $425,000
- Net capital losses in excess of other net gains (1985-2011) (10,000)
- ABILs deducted (1985-2011) (12,000)
- Capital gains deductions claimed (1985-2010) (75,000)
- CNIL at end of current year (3,000)
- $325,000

KC 10-3

[ITA: 110.6(1) - CNIL]

Ryan’s CNIL balance at the end of the current year is

- Opening balance $14,500
- Interest expense 3,000
- Rental income (5,000)
- Eligible dividends $1,000 \times 141\% (1,410)
- $11,090
KC 10-4

[ITA: 110.6(1) – QSBC]

X Ltd. is not currently a QSBC since it is not a SBC at this time. X Ltd. can be turned into a QSBC by selling the marketable securities and using the proceeds to repay a portion of the bank loan. If X Ltd. did this, 100% of the fair market value of its assets would be used in an active business.

For to be a qualified small business corporation, X Ltd. must meet the following tests:

1) At the determination time, X Ltd. must be a small business corporation (SBC).

2) Throughout the preceding 24 months, the shares of X Ltd. must not have been owned by an unrelated person.

3) Throughout the preceding 24 months, more than 50% of the value of the assets must be used in an active business carried on primarily in Canada, or shares of a connected corporation (greater than 10% ownership) meeting the more than 50% asset test.

Test 1) Currently X Ltd. is not a SBC. It does not have 90% or more of the fair market value of its assets used in an active business. The marketable securities represent 16% of the fair market value of the assets.

Test 2) Alexander has owned the shares of X Ltd. throughout the preceding 24 months. Therefore, at no time in the past 24 months, were the shares owned by an unrelated person.

Test 3) 84% of the fair market value of the assets have been used in an active business carried on in Canada throughout the past 24 months. Therefore, test (3) is met.

Since X Ltd. is a not a SBC (test 1), X Ltd. is not a QSBC.

KC 10-5

[ITA: 39(1)(c); 39(9); 50(1) – ABIL]

The $10,000 loan has become a bad debt in the current year. Jack can make an election under ITA 50(1) to be deemed to dispose of the loan at the end of the current year for proceeds of Nil and to have reacquired it on the first day of next year for a cost of Nil. If Jack makes the election, he will have an allowable business investment loss (ABIL) of $3,000 and an allowable capital loss (ACL) of $2,000 in the current year. The ABIL is deductible against all sources of income while the ACL is deductible against taxable capital gains only.

Loan to small business corporation (SBC):

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proceeds</td>
<td>$ 0</td>
</tr>
<tr>
<td>ACB</td>
<td>$(10,000)</td>
</tr>
<tr>
<td>Loss</td>
<td>$(10,000)</td>
</tr>
<tr>
<td>Gains sheltered by capital gains exemption in prior years</td>
<td>4,000</td>
</tr>
<tr>
<td>Business investment loss</td>
<td>$(6,000)</td>
</tr>
<tr>
<td>Allowable business investment loss</td>
<td>$(3,000)</td>
</tr>
<tr>
<td>Allowable capital loss</td>
<td>$(2,000)</td>
</tr>
</tbody>
</table>
The portion of the loss that is disallowed BIL treatment (gains sheltered by the capital gains exemption in prior years) remains a capital loss.

KC 10-6

[ITA: 117(2), 117.1(1), 118(1)(c), 118(10), 118.7 – Federal tax and basic credits]

Federal income tax [ITA 117]

\[
\begin{align*}
15\% \times 41,544 &= 6,232 \\
22\% \times 41,544 &= 9,140 \\
26\% \times 45,712 &= 11,885 \\
29\% \times 1,200 &= 348 \\
\text{Total} &= 130,000 \\
\end{align*}
\]

Deduct non-refundable tax credits:

\[
\begin{align*}
\text{ITA 118(1)(c)} & \quad \text{Basic personal amount} \quad 10,527 \\
\text{ITA 118.7} & \quad \text{CPP & EI contributions} \quad 3,004 \\
\text{ITA 118(10)} & \quad \text{Canada Employment amount} \quad 1,065 \\
\text{Total} &= 14,596 \\
15\% \times 14,596 &= 2,189 \\
\end{align*}
\]

Federal tax payable

\[
\begin{align*}
\text{Total} &= 27,605 \\
\text{Federal tax payable} &= 25,416 \\
\end{align*}
\]

KC 10-7

[ITA: 56(1)(a.2), 60(c), 60.03, 117(2), 117.1(1), 118(1)(a), 118(2),(3), 118.8 – Federal tax and Senior credits]

(i) Pension income not split:

Federal income tax:

\[
\begin{align*}
15\% \times 41,544 &= 6,232 \\
22\% \times 3,556 &= 782 \\
\text{Total} &= 45,100 \\
\end{align*}
\]

Deduct non-refundable tax credits:

\[
\begin{align*}
\text{ITA 118(1)(a)} & \quad \text{Basic personal amount} \quad 10,527 \\
\text{ITA 118(1)(a)} & \quad \text{Spouse amount} \quad 4,527 \\
\text{ITA 118(2)} & \quad \text{Age amount} 4,716 \\
\text{ITA 118(3)} & \quad \text{Pension amount} 2,000 \\
\text{ITA 118.8} & \quad \text{Amounts transferred from spouse (Age)} 6,537 \\
\text{Total} &= 28,307 \\
15\% \times 28,307 &= 4,246 \\
\end{align*}
\]

Federal tax payable

\[
\begin{align*}
\text{Total} &= 7,014 \\
\text{Federal tax payable} &= 2,768 \\
\end{align*}
\]

(ii) Pension income split:

Mr. and Mrs. Senior are assumed to split eligible pension income ($32,000) so that each reports an equal amount ($16,000). [50% of the eligible pension income is the maximum allocation allowed]. This increases Mrs. Senior’s net income to $22,000 [ITA 56(1)(a.2)] and reduces Mr. Senior’s net income and taxable income to $29,100 [ITA 60(c) & 60.03].
Federal income tax:
15% x $29,100 = $4,365

Deduct non-refundable tax credits:

<table>
<thead>
<tr>
<th>Provision</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>118(1)(a)</td>
<td>Basic personal amount $10,527</td>
</tr>
<tr>
<td>118(1)(a)</td>
<td>Spouse amount ($10,527 - $22,000) 0</td>
</tr>
<tr>
<td>118(2)</td>
<td>Age amount $6,537 – 15% ($29,100 - $32,961) 6,537</td>
</tr>
<tr>
<td>118(3)</td>
<td>Pension amount 2,000</td>
</tr>
<tr>
<td>118.8</td>
<td>Amounts transferred from spouse – 0</td>
</tr>
</tbody>
</table>

Age amount $  6,537
Pension amount 2,000
8,537

Income         $22,000
Basic amount         (10,527) (11,473)
Available for transfer $        0
$19,064 x 15%  (2,860)

Federal tax payable $1,505

Mr. Senior’s wife will pay federal tax of $440 (15% ($22,000 - $10,527 - $6,537 - $2,000)). Combined they will pay federal tax of $1,945 ($1,505 + $440). Splitting the pension income resulted in a federal tax savings of $823 ($2,768 - $1,945).

**KC 10-8**

[ITA: 38(a.1), 117(2), 117.1(1), 118(1)(c), 18.01(5), 118.1(3), 118.7, 121 – Federal tax, Dividend tax credit and Donation of securities]

Employment income $120,000
Dividend income $10,000 x 141% 14,100
Taxable capital gain 0
Net income & Taxable income $134,100

Note: Gains on donations to charities of publicly listed securities are not taxable [ITA 38(a.1)].

Federal income tax [ITA 117]
15% x $  41,544 $  6,232
22% x $  41,544 9,140
26% x $  45,712 11,885
29% x $  5,300 1,537
$134,100 28,794

Federal non-refundable tax credits:

<table>
<thead>
<tr>
<th>Provision</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>ITA 118(1)(c)</td>
<td>Basic personal amount $10,527</td>
</tr>
<tr>
<td>ITA 118.7</td>
<td>CPP&amp; EI contributions 3,004</td>
</tr>
<tr>
<td>ITA 118(1)</td>
<td>Canada Employment amount 1,065</td>
</tr>
<tr>
<td></td>
<td>$14,596 x 15% (2,189)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Provision</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>ITA 118.1</td>
<td>Donation Credit - the first $ 200 x 15% $ (30)</td>
</tr>
<tr>
<td></td>
<td>- remainder 800 x 29% (232)</td>
</tr>
<tr>
<td></td>
<td>$1,000</td>
</tr>
</tbody>
</table>
**ITA 121**  
Dividend tax credit $10,000 x 41% x 13/23  
\[(2,317)\]

Federal tax payable  
\[\$24,026\]

**KC 10-9**

[ITA: 118.5, 118.6, 118.61, 118.81, 118.9 – Education credits]

Federal non-refundable education credits:

- Tuition amount  
  \[7,000\]

- Education & textbook amount ($465 x 8 months)  
  \[3,720\]

\[10,720 \times 15\%\]  
\[1,608\]

Since Michelle’s taxable income is less than the amounts she is entitled to claim as tax credits, she does not require any of her education credits. The unused credit amount is determined after deducting the carry-forward amount, plus the following credits, if applicable: personal credits (basic, employment, etc), CPP/EI, disability, adoption, public transit pass, and children’s fitness credit.

Michelle has two options with respect to the unused education credits -

- Carry forward indefinitely,
- Transfer up to $5,000 of the federal education amounts ($10,720) to a parent or a grandparent and carry the remainder forward.

**KC 10-10**

[ITA: 118.2(1) – Medical expense credit]

The maximum medical expense credit is $2,420. To receive the maximum credit, the family medical expenses should be claimed by Kelly, being the lower-income-earning spouse.

Medical expenses for Glen, Kelly and son under 18  
\[5,600\]

Less 3% x Kelly’s income $40,000 (limited to $2,052)  
\[(1,200)\]

\[4,400\]

Medical expenses for dependant 18 and over (Cody)  
\[12,000\]

Less 3% x Cody’s net income $9,000 (limited to $2,052)  
\[(270)\]

\[11,730^*\]

\[16,130\]

\[x \ 15\%\]

\[2,420\]

- $10,000 limit for each dependant age 18 and over was removed in the 2011 Federal Budget applicable for 2011 and subsequent years.

**KC 10-11**

[ITA: 118.03 - Children’s fitness tax credit]

Parents are allowed to claim a maximum of $500 per year for eligible fees paid in the year for each child who is under age 16 at the beginning of the year. The credit may be claimed by one parent or shared. The year in which the tax credit can be claimed is determined by the date the fees are paid, not when the activity takes place.
In this case a federal non-refundable fitness tax credit of $75 ($500 x 15%) can be claimed.

**KC 10-12**

[ITA: 60(w), 180.2 – OAS clawback]

Pensioners with net income above $67,668 (2011) must repay part or all of the maximum OAS pension. The repayment amounts are normally deducted from their monthly pension payments.

The following repayment of Ellen’s OAS is required:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net income before ITA 60(w) deduction</td>
<td>$85,000</td>
</tr>
<tr>
<td>OAS repayment threshold</td>
<td>(67,668)</td>
</tr>
<tr>
<td>Excess</td>
<td>17,332</td>
</tr>
<tr>
<td>x 15%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>$ 2,600</td>
</tr>
</tbody>
</table>

The OAS received ($6,200) is included in Ellen’s other income for tax purposes [ITA 56(1)(a)]. The OAS repayment ($2,600) is included in other deductions [ITA 60(w)].

**KC 10-13**

[ITA: 127.5 to 127.55]

The alternative minimum tax (AMT) rules are designed to impose a minimum level of tax on individuals when the normal amount of tax has been reduced as a result of certain tax preferences.

<table>
<thead>
<tr>
<th>Description</th>
<th>Normal taxable income</th>
<th>Taxable income for AMT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employment income</td>
<td>$ 10,000</td>
<td>$ 10,000</td>
</tr>
<tr>
<td>Dividends (non-eligible)</td>
<td>25,000 (125%)</td>
<td>20,000 (100%)</td>
</tr>
<tr>
<td>Capital gains</td>
<td>50,000 (50%)</td>
<td>80,000 (80%)</td>
</tr>
<tr>
<td>Ltd partnership loss</td>
<td>(34,000)</td>
<td>(0)</td>
</tr>
<tr>
<td></td>
<td>51,000</td>
<td>110,000</td>
</tr>
<tr>
<td>AMT exemption</td>
<td>0</td>
<td>(40,000)</td>
</tr>
<tr>
<td>Taxable income</td>
<td>$51,000</td>
<td>$70,000</td>
</tr>
</tbody>
</table>

Federal tax:
- $6,232 + 22% x ($51,000 - $41,544) = $8,312
- $70,000 x 15% = $10,500

Federal non-refundable tax credits:

<table>
<thead>
<tr>
<th>Description</th>
<th>Normal</th>
<th>Taxable</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basic</td>
<td>$10,527</td>
<td></td>
</tr>
<tr>
<td>Employment</td>
<td>1,065</td>
<td></td>
</tr>
<tr>
<td></td>
<td>11,592</td>
<td></td>
</tr>
<tr>
<td>x 15%</td>
<td>(1,739)</td>
<td>(1,715)</td>
</tr>
<tr>
<td>Dividend tax credit</td>
<td>(3,333)</td>
<td>0</td>
</tr>
<tr>
<td></td>
<td>$3,240</td>
<td>$8,785</td>
</tr>
</tbody>
</table>
Jonathan pays AMT of $8,785 which is $5,545 higher than normal federal income tax. This additional tax is not a permanent tax. The $5,545 AMT can be carried forward for up to seven years to reduce the normal federal tax of a future year (where the normal federal tax is higher than the AMT for that year).
### Problems

**PROBLEM ONE**

[ITA: 3; 41(2); 111(1)(a), (b)]

The financial results of an individual are outlined below for three years.

<table>
<thead>
<tr>
<th></th>
<th>20X1</th>
<th>20X2</th>
<th>20X3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employment income</td>
<td>$22,000</td>
<td>$27,000</td>
<td>$40,000</td>
</tr>
<tr>
<td>Capital gains:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Listed personal property</td>
<td>–0–</td>
<td>–0–</td>
<td>5,000</td>
</tr>
<tr>
<td>Other capital property</td>
<td>40,000</td>
<td>–0–</td>
<td>12,000</td>
</tr>
<tr>
<td>Capital losses:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Listed personal property</td>
<td>–0–</td>
<td>(9,000)</td>
<td>–0–</td>
</tr>
<tr>
<td>Shares of a small business corp.</td>
<td>–0–</td>
<td>(40,000)</td>
<td>–0–</td>
</tr>
<tr>
<td>Other capital property</td>
<td>–0–</td>
<td>(48,000)</td>
<td>–0–</td>
</tr>
<tr>
<td>Share of a business partnership's Income (loss)</td>
<td>7,000</td>
<td>(57,000)</td>
<td>–0–</td>
</tr>
<tr>
<td>Actual dividends from</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Canadian corporations —Non-eligible</td>
<td>12,000</td>
<td>4,000</td>
<td>–0–</td>
</tr>
<tr>
<td>RRSP contributions</td>
<td>4,000</td>
<td>–0–</td>
<td>–0–</td>
</tr>
</tbody>
</table>

**Required:**

1. Determine the individual’s net capital losses, non-capital losses, and unused listed personal property losses for 20X2.

2. Determine the individual’s minimum taxable income for 20X1 and 20X3.
## Solution to P 10-1

1. **20X2**

   3(a) Employment income $27,000
   
   Property income (dividends)
   
   $4,000 \times 1.25
   
   $5,000
   
   **Total:** $32,000
   
   3(b) Taxable capital gains
   
   $0
   
   net LPP gains (0-9,000)
   
   $0
   
   Allowable capital losses
   
   $(24,000)
   
   **Total:** $32,000
   
   3(c) Other deductions
   
   $0
   
   3(d) Losses:
   
   Business loss $(57,000)
   
   Allowable business
   
   Investment loss $(20,000)
   
   **Total losses in 20X2:** $(77,000)
   
   **Less used in 20X2** $(32,000)
   
   **Net income for tax purposes:** $0
   
   Taxable income $0

## Loss Balances:

- **Net capital losses [ITA 111(1)(b)]:** $24,000
- **Non-capital losses: [ITA 111(1)(a)]:**
  - **Total losses in 20X2: $77,000**
  - **Less used in 20X2** $(32,000)
  - **Unused LPP losses [ITA 41(2)]:** $9,000
2.

<table>
<thead>
<tr>
<th></th>
<th>20X1</th>
<th>20X3</th>
</tr>
</thead>
<tbody>
<tr>
<td>3(a) Employment income</td>
<td>$22,000</td>
<td>$40,000</td>
</tr>
<tr>
<td>Business income</td>
<td>7,000</td>
<td>-</td>
</tr>
<tr>
<td>Property income:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dividend ($12,000 x 1.25)</td>
<td>15,000</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td>44,000</td>
<td>40,000</td>
</tr>
<tr>
<td>3(b) Taxable capital gains</td>
<td>20,000</td>
<td>6,000</td>
</tr>
<tr>
<td>Net gains from LPP (20X3, $5,000-$5,000)</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Allowable capital losses</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td></td>
<td>20,000</td>
<td>6,000</td>
</tr>
<tr>
<td>3(c) RRSP</td>
<td>64,000</td>
<td>46,000</td>
</tr>
<tr>
<td>(4,000)</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>3(d) Losses</td>
<td>60,000</td>
<td>46,000</td>
</tr>
<tr>
<td>0</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>Net income</td>
<td>60,000</td>
<td>46,000</td>
</tr>
<tr>
<td>Taxable income deductions:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net capital losses</td>
<td>(20,000)</td>
<td>(4,000)</td>
</tr>
<tr>
<td>Non-capital losses</td>
<td>(40,000)</td>
<td>(5,000)</td>
</tr>
<tr>
<td>Taxable income</td>
<td>$ 0</td>
<td>$37,000</td>
</tr>
</tbody>
</table>

At the end of 20X3, the net capital losses and non-capital losses have been fully utilized. However, as only $5,000 of the 20X2 LPP losses were used in 20X3 (limited to LPP gains of $5,000 in that year) a balance of $4,000 ($9,000 -$5,000 = $4,000) remains and can be carried forward for an additional six years. Notice that the LPP loss carry-overs are applied in arriving at net income for tax purposes rather than in arriving at taxable income [ITA 41(2)].

Normally it is not necessary to reduce taxable income to zero in order to eliminate tax. Remember that the individual can reduce the tax otherwise payable by certain tax credits, for example, the basic personal credit, employment credit, CPP & EI, and the dividend tax credit. Therefore, the loss carry-back should be used only to the extent that it reduces taxable income to the level that will permit the use of the available credits. Also, consideration should be given to potential future tax rates. It may be beneficial to reduce the 20X1 income to a point that will eliminate tax only on the higher tax bracket and save the remaining amount for a future year that will also have a high tax rate.
PROBLEM TWO

[ITA: 3; 31(1); 40(2)(g)(iii); 60(b),(e); 110.6; 111(1)(b) Reg. 1100(11)]

Barbara Legault operates a full-time law practice in southwestern Ontario. In her spare time, she maintains a small rural acreage for the purpose of growing and selling Christmas trees. In addition, she derives income from various investments and is an art collector. Below are her financial results for 20X1.

- Net income from law practice: $97,000
- Loss on tree farm operation: $(12,500)
- Gross rents received on rental property: $28,000
- Operating expenses on rental property before capital cost allowance: $37,000
- Gain on sale of shares of public corporations: $80,000
- Loss on sale of summer cottage: $4,000
- Gain on sale of oil painting: $8,000
- Gain on sale of shares of a small business corporation: $20,000
- Lump-sum payment to ex-husband as part of divorce settlement: $40,000
- Loss on sale of shares of a public corporation: $14,000

At the end of 20X0, the following tax accounts existed:

- Net listed personal property losses forward from 20X0 (represents the actual loss): $4,000
- Undepreciated capital cost allowance on rental property: $160,000
- Net capital losses: $7,000
- Cumulative net investment loss: $14,000

Legault had not previously used any of her lifetime capital gain deduction.

**Required:**

What is Legault’s taxable income for 20X1?
Solution to P 10-2

3(a) Income from law practice (business) $97,000

3(b) Taxable capital gains:
   - Public corporation shares – 1/2($80,000) $40,000
   - Small business corporation shares (assumed to be QSBC) 1/2 ($20,000) 10,000
   - Net gains from listed personal property
     - 20X1 gain – ½ x $8,000 $4,000
     - 20X0 carry forward – 1/2($4,000) (2,000)
   - Allowable capital loss – 1/2 ($14,000) (7,000)

50,000

3(c) Other deductions (see Note 2)
   - CPP contributions on self-employed earnings [ITA 60(e)] (2,217)

52,000

3(d) Property loss – rental
   - ($28,000 - $37,000) (no CCA) [Reg. 1100(11)] ($9,000)
   - Farm loss - restricted [ITA 31(1)&(1.1)]
     - $2,500 + 1/2($12,500 - $2,500) (7,500)

$106,283

Deduct:
   - Net capital loss forward [ITA 111(1)(b)] (7,000)
   - Capital gains deduction (see Note 1) (10,000)

Taxable income

Note 1:

Capital gain deduction [ITA 110.6]

Unused capital gains deduction available:
   - Lifetime limit ($750,000 x1/2) $375,000
   - Claimed previously (0)
   - Available $375,000
Annual gains limit:
Lesser of
Net taxable capital gains $45,000, and
Net taxable capital gain (QSBC) $10,000
Deduct Net capital losses (in excess of other net gains) $(10,000)
Deduct ABIL

Cumulative gains limit:
Qualifying Taxable capital gains (1985 – 2011)
Net capital losses in excess of other gains (1985–2011) $10,000
ABILs deducted (1985 – 2011) (0)
Capital gains deductions claimed (1985 – 2010) (0)
CNIL at end of current year (0)

Cumulative net investment loss (CNIL):
The CNIL balance consists of post 1987 investment expenses in excess of investment income for the same period
Opening CNIL balance $14,000
Investment expenses claimed in current year
- rental loss $9,000
- net capital losses claimed $7,000
Investment income reported in current year 30,000
- Property income
  - Taxable capital gains $45,000 (0)
  - Qualifying taxable capital gains (10,000)
  - Non-eligible taxable capital gains (35,000)

$ Nil

Note 2:
- The divorce settlement is not deductible because it is not a periodic payment [ITA 60(b)].
- The summer cottage is a personal-use property. Therefore the capital loss cannot be recognized [ITA 40(2)(g)(iii)].
PROBLEM THREE

[ITA: 3; 111(1)(a); 117; 118(1)(c)]

In 20X1, Gary Kwok, who is single, earned the following income and incurred the following losses: employment income, $16,000; business loss, $4,000; taxable capital gains, $7,000; property income (interest), $18,000; allowable capital loss from the sale of shares of public corporations, $9,000; allowable capital loss from the sale of shares of a Canadian-controlled private corporation that qualifies as a small business corporation, $2,000.

At the end of 20X0, Kwok had unused net capital losses of $16,000 and unused non-capital losses of $37,000. Kwok does not want to pay any federal tax in 20X1. For 20X1, Kwok is entitled to the basic personal tax credit, the Canada employment credit and a CPP&EI credit amount of $900.

Required:

Assuming Kwok's wishes are met, what is the maximum amount of non-capital losses remaining for carry-forward after 20X1?
Solution to P 10-3

3(a) Employment income $16,000  
    Property income  18,000  
                   34,000  

3(b) Taxable capital gains $7,000  
    Allowable capital loss (9,000)  0  
                                 34,000  

3(c) 0  

3(d) Business loss (4,000)  
    Allowable business investment loss (2,000) (6,000)  

Net income for tax purposes 28,000  

Deduct:  
ITA 111(1)(b) Net capital loss (limited to TCG) (0)  
ITA 111(1)(a) Non-capital loss (15,508)  

Taxable income $12,492  

Federal income tax – 15% x $12,492 $1,874  

Deduct non-refundable tax credits:  
ITA 118(1)(c) Basic personal amount $10,527  
ITA 118.7 CPP & EI $900  
ITA 118(10) Canada Employment Credit 1,065  

$12,492 x 15% $1,874  

Federal tax payable 0  

The losses remaining for carry forward are:  
- non-capital loss of $21,493 ($37,000 - $15,508), and  
- net capital loss is $18,000 ($16,000 + $2,000).  

Note:  
Carry forward losses should be claimed only to the extent that taxable income is $12,492 or greater allowing full use of the federal tax credits for an individual. Also, consider not claiming any loss carryover this year if it is anticipated that future income will be higher and subject to a higher tax rate. The loss could be used to save a greater amount of tax. Such a choice would have to consider both the time value of money and the possibility that the anticipated future income levels may not be achieved.
PROBLEM FOUR

[ITA: 3; 5(1); 7(1), (8); 8(1)(m); 12(1)(j), (k); 38(a); 60(h); 110(1)(d); 111(1)(a); 117(2); 118(1)(c); 118.1(3); 118.5; 118.6(2); 118.7; 121; 126(1); 127(3)]

Abra Swan is 30 years old and single. She is employed as a middle-level manager with a national Canadian company. After living and working for five years in Regina, Saskatchewan, she was transferred to her employer's office in Winnipeg on December 15, 20X1.

Her financial transactions for the 20X1 taxation year are shown below.

1. Swan received an annual salary of $50,000, but her take-home pay for the year was only $35,090 (see below).

   | Gross salary       | $50,000 |
   | Amounts withheld by employer: | |
   | Income tax          | (10,000) |
   | Company pension contribution | (2,000) |
   | Canada Pension Plan  | (2,217)  |
   | Employment Insurance | (787)    |

   $34,996

2. During the current year, Swan purchased 1,000 shares of her employer's company (a public corporation) under a stock-option program. The shares cost $10 each and at the time of purchase had a market value of $14 per share. When the stock option was granted two years ago, the share price was $11. To fund the purchase, she borrowed $10,000 from her bank. During the year, she paid interest of $800 on the loan.

3. The previous year, Swan had unwisely invested in commodity futures and lost a large portion of her savings. She considered this loss to be a business loss but was unable to use the full amount for tax purposes because her other income was not sufficient. Of the total loss, $6,000 was unused.

4. As well, Swan had the following receipts for 20X1:

   | Dividends from taxable Canadian corporations (Eligible) | $4,000 |
   | Dividends of $2,000 from a foreign corporation, less foreign taxes of $200 | 1,800 |
   | Cash received from RRSP cancellation | 2,000 |
   | Proceeds from the sale of public corporation shares (originally purchased for $20,000) | 26,000 |

5. In 20X1, she made the following disbursements:

   | Mortgage payments on her new home | $1,000 |
   | Life insurance | 400 |
   | Charitable donations | 800 |
   | Contribution to a federal political party | 800 |
   | Tuition fees to a university (one-day course) | 300 |
Required:

For the 20X1 taxation year, determine Swan’s

a) net income for tax purposes;

b) taxable income; and

c) federal tax liability.

To which province will Swan pay provincial tax?
**Solution to P 10-4**

**Calculation of net income for tax purposes:**

3(a) Employment:
   - Salary [ITA 5(1)] $50,000
   - Stock option benefit ($14,000 - $10,000) [ITA 7(1)] 4,000
   - Less RPP [ITA 8(1)(m)] (2,000)
   - **Net employment income** 52,000

   Property:
   - Canadian dividends ($4,000 x 141%) [ITA 12(1)(j)] $5,640
   - Foreign dividends [ITA 12(1)(k)] 2,000
   - Less interest on loan for shares [ITA 20(1)(c)] (800) 6,840

   Other income:
   - Cancellation of RRSP [ITA 60(h)] 2,000

3(b) Taxable capital gains [ITA 38(a)]
   - $26,000 - $20,000 = $6,000 (1/2) 3,000

3(c) Other deductions 2
   - 0

3(d) Losses
   - 0

   **Net income for tax purposes** $63,840

**Calculation of taxable income:**

   - Net income for tax purposes (above) $63,840
   - ITA 110(1)(d) Stock option reduction (note below) (0)
   - ITA 111(1)(a) Non-capital loss (from commodity losses) (6,000)

   **Taxable income** $57,840

**NOTE:** The stock option shares had a value of $11 per share at the time the option was granted for a price of $10 per share. Consequently, the stock option deduction is not available. [ITA 110(1)(d)].

---

2 Solution assumes moving expenses have been reimbursed by the employer
Calculation of tax:

The calculation is based on federal rates and tax credits applicable to 2011.

Federal income tax [ITA 117]
- 15% x $41,544 = $6,232
- 22% x $16,296 = 3,585
- $57,840

Deduct non-refundable tax credits:
- ITA 118(1)(c) Basic personal amount = $10,527
- ITA 118.7 CPP & EI contributions = 3,004
- ITA 118(10) Canada Employment amount = 1,065
- $14,596 x 15% = 2,189

ITA 118.5 Tuition 15% x $300 (note) = 45

ITA 118.1 Donation 15% x $200 = 30
- 29% x $600 = 174
- $800

ITA 121 Dividend tax credit $4,000 x 41% x 13/23 = 927

Basic federal tax = 6,452

Less other tax credits:
- ITA 126(1) Foreign tax credit = 200

ITA 127(3) Political donations
- 75% x $400 = 300
- 50% x 350 = 175
- 33 1/3% x 50 = 17
- $800

Federal tax payable = 5,760

NOTE:

The federal education tax credit of 15% x $120 per month for part-time students does not apply as the class hours were less than the required 12 hours per month [ITA 118.6(2)]. The textbook tax credit is not available to a student who does not qualify for the education tax credit.

Although Swan lived most of the year in Saskatchewan, she will pay provincial tax to Manitoba because that is her province of residence on the last day of the calendar year.
Carl Kay is the vice-president of KM Ltd., a Canadian-controlled private corporation located in Halifax, Nova Scotia. KM operates a real estate development business constructing and selling commercial buildings and residential apartments. Kay’s 20X3 financial transactions include the following:

• Kay received a salary of $95,000 from KM. From this amount, KM deducted CPP and EI of $3,004 and income tax of $30,000. The company provided him with a car that cost $40,000 and that has an undepreciated capital cost of $18,000. The operating costs of $3,000 were paid by KM. In 20X3, Kay drove the car 20,000 km, of which 8,000 km was for employment purposes. KM contributed $4,000 on Kay’s behalf to a deferred profit sharing plan. Although KM does not have a group life insurance plan, it paid Kay’s personal life insurance premium of $1,000 (coverage – $75,000).

• During the year, Kay sold 1,000 shares of KM Ltd. for $10 per share. He had acquired the shares three years earlier for $6 per share as part of a company stock-option plan. At the time of purchase, the shares were valued at $7 per share.

• In 20X2, Kay constructed a 10-suite apartment block. He sold the property in 20X3 for $800,000, which was $150,000 more than the original land and building cost. He received $80,000 of the proceeds in cash, with the balance due in five annual instalments beginning in 20X4. The property incurred a net rental loss of $7,000 (before amortization).

• Kay sold his summer cottage for $90,000 after it was announced that a waste disposal site would be developed in the area. He had purchased the cottage six years earlier for $120,000.

• In 20X0, Kay loaned $16,000 to Alloy Ltd., a Canadian-controlled private corporation. All of the company’s assets are used in an active business. The 20X2 interest of $1,400, which Kay included in income, has not been received. The company is in severe financial difficulty and may not survive beyond next year.

• Kay sold shares of a public corporation, purchased in 20X1 for $12,000, for $20,000.

• In November, Kay received a legal bill for $2,000 relating to a dispute over a tax reassessment. Kay paid $1,200 in December 20X3 and the balance in January 20X4.

• Kay received Eligible dividends of $2,000 and Non-eligible dividends of $1,000 from Canadian corporations and $1,800 from a foreign corporation. The foreign corporation remitted a 10% withholding tax to its government.

• Kay celebrated his 65th birthday in December 20X3. He supports his spouse, who is retired. She had investment income of $4,000 in 20X3. During the year, Kay made gifts of $3,000 to a local charity. He paid tuition fees of $900 to attend a three-month evening course at a university.

• Kay has used his entire capital gain deduction. At the end of 20X2, he had unused net capital losses of $12,000 and non-capital losses of $7,000.
Required:

Calculate Kay’s minimum 20X3 net income for tax purposes, taxable income, and federal income tax.
Solution to P 10-5

Employment income:
Salary [ITA 5(1)] $  95,000
Standby charge $40,000 x 2% x 12 months [ITA 6(1)(e)] 9,600
Operating benefit 24¢ x 12,000 km [ITA 6(1)(k)] 2,880
Life insurance benefit [ITA 6(1)(a) & 6(4)] 1,000
Stock option $1,000 x ($7 - $6) [ITA 7(1.1)] 1,000
109,480

Business income:
Apartment sale (note 1) $150,000
less reserve $720,000/$800,000 x $150,000 [ITA 20(1)(n)] (135,000) 15,000

Property income:
Canadian dividends – Eligible $2,000 x 141% [ITA 12(1)(j)] $2,820
Canadian dividends – Non-eligible $1,000 x 125% [ITA 2(1)(j)] 1,250
Foreign dividend $1,800 + $200 [ITA 12(1)(k)] 2,000
6,070
Less bad debt – interest [ITA 20(1)(p)] (1,400) 4,670
129,150

Taxable capital gains: [ITA 38(a)]
KM shares ½ x 1,000($10 - $7) $1,500
Public corporation ½ ($20,000 - $12,000) 4,000
5,500
Deemed disposition on loan to small business corporation [ITA 50(1)] - ABIL status denied (note 2) (8,000)
Loss on sale of cottage is deemed nil (PUP) [ITA 40(2)(g)(iii)] 0 0
129,150

Other deduction - legal, limited to amount paid [ITA 60(o)] (1,200)
127,950

Losses:
Rental loss 7,000
ABIL - denied (note 2) 0 (7,000)

Net income for tax purposes
120,950

Stock option - ½ ($1,000) [ITA 110(1)(d.1)] (500)
Net capital loss forward - limited to net taxable gains [ITA 111(1)(b)] (0)
Non-capital loss [ITA 111(1)(a)] (7,000)

Taxable income $113,450
Note 1:
The apartment sale was treated as business income because Kay is in the real estate development business and it appears that the property was constructed for the purpose of re-sale.

Note 2:
The loss on the loan to the small business corporation does not qualify as an allowable business investment loss (ABIL) because the taxpayer had claimed the full capital gain deduction in prior years [ITA 39(9)].

Federal income tax: [ITA 117(1&2)]

\[
\begin{align*}
15\% \times 41,544 & \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad 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PROBLEM SIX (Comprehensive)

[ITA: 3; 5(1); 6(1)(a), (e), (k); 6(9); 7(1.1); 8(2); 9(1); 12(1)(d), (j); 18(1)(a), (b), (l), (t); 20(1)(a), (b), (c); 20(10); 34; 38(a); 40(2)(g)(iii); 47(1); 60(i); 67.1; 80.4(1); 80.5; 110(1)(d.1); 110.6; 117(2); 118(1)(c); 118.1(3); 118.2(1); 118.7; 121; 127(3); 146(8.3); Reg. 1100(1), (2), (3), (11); 7307]

Sandra Dumont is a lawyer. For five years, until June 30, 20X5, she had been employed by Calco Ltd., a national restaurant company. On July 1, 20X5, she began to practise law as a sole proprietor from an office in her home.

Dumont has asked you to prepare her 20X5 income tax return. At a recent meeting, you gathered the information provided in Exhibits I and II.

Required:

1. Determine Dumont’s minimum income for tax purposes in accordance with the aggregating formula of section 3 of the Income Tax Act and her minimum taxable income for the 20X5 taxation year.

2. Based on your answer to question 1, calculate Dumont’s federal income tax for the 20X5 taxation year.

3. Why did the CRA deny the deduction of Dumont’s 20X3 convention expenses? Can she obtain a deduction for the proposed 20X6 convention? If so, why?

EXHIBIT I

Sandra Dumont Information Regarding Work at Calco and Law Practice

1. Dumont’s salary to June 30, 20X5, was $51,200. From this, Calco deducted CPP and EI of $3,004, income tax of $16,000, and $300 for Dumont’s portion of the private group medical insurance premium. An additional premium of $300 was paid by Calco. Also, Calco paid the $200 premium for Dumont’s group term life insurance coverage of $50,000.

2. On June 30, 20X5, Dumont returned the company car that Calco had provided her. The car had a cost of $32,000, and Calco’s undepreciated balance was $18,000. Calco also had paid the operating costs for the car, which amounted to $2,100. Dumont had driven her car 16,000 km, of which 12,000 km were for business use.

3. Dumont travelled by air when working for Calco. Dumont used her personal credit card and accumulated frequent-flyer points. She submitted monthly expense reports and was reimbursed by Calco for the travel costs. In March 20X5, she and her husband used some of her accumulated frequent-flyer points to obtain free airline tickets for a vacation. As a result, they each saved the $800 airfare.

4. In 20X3, Dumont borrowed $20,000 from Calco. She has paid interest at 5% on the loan. Dumont used the borrowed funds for the down payment to purchase a rental property. The CRA’s prescribed interest rate was 9% in 20X5. Dumont repaid the loan on June 30, 20X5.

5. On June 30, 20X5, Dumont sold 500 shares of Calco Ltd. for $20 per share to the company’s controlling shareholder. Calco had issued the shares to Dumont at $10 in 20X2. At that time, the shares were appraised at $12. Calco Ltd. is a Canadian-controlled private corporation. At the time of the share sale, all of Calco’s assets were being used in an active business.
6. Dumont began practising law from her home office on July 1, 20X5 and registered for HST. She purchased the client list and files of a retiring lawyer for $50,000. She also purchased a computer for $4,000 and a legal library for $5,600.

7. On July 4, 20X5, Dumont purchased an automobile for $34,000, plus HST. She used the car 60% of the time for her law practice.

8. For the six months ended December 31, 20X5, the financial statements of Dumont’s law practice showed a profit of $41,000. The gross revenue of $88,000 consisted of the following:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fees billed and received</td>
<td>$47,000</td>
</tr>
<tr>
<td>Fees billed but unpaid at the year end</td>
<td>24,000</td>
</tr>
<tr>
<td>Work in progress—not billed</td>
<td>17,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$88,000</strong></td>
</tr>
</tbody>
</table>

Dumont indicated that she wanted to elect under section 34 of the Income Tax Act.

9. Operating expenses for the law practice included the following:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liability insurance</td>
<td>$2,200</td>
</tr>
<tr>
<td>Depreciation and amortization</td>
<td>9,100</td>
</tr>
<tr>
<td>Reserve for bad debts</td>
<td>1,200</td>
</tr>
<tr>
<td>Golf club dues—while attending the club, clients are entertained approximately 30% of the time</td>
<td>1,600</td>
</tr>
<tr>
<td>Charitable donations</td>
<td>800</td>
</tr>
<tr>
<td>Promotion—client lunches</td>
<td>400</td>
</tr>
<tr>
<td>Secretarial services</td>
<td>12,000</td>
</tr>
<tr>
<td>Computer software—word processing and billing program</td>
<td>900</td>
</tr>
</tbody>
</table>

10. Dumont uses 12 square metres of her house exclusively as an office for her law practice. Expenses for the entire 80-square-metre home for all of 20X5 consist of the following:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Insurance</td>
<td>$700</td>
</tr>
<tr>
<td>Mortgage interest</td>
<td>9,000</td>
</tr>
<tr>
<td>Property taxes</td>
<td>2,300</td>
</tr>
<tr>
<td>Utilities</td>
<td>3,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$15,000</strong></td>
</tr>
</tbody>
</table>

The financial statements do not include the home-office costs.
EXHIBIT II
Sandra Dumont Other Financial Information

1. Dumont owns a residential rental property, which she had purchased in 20X3. Details of the rent and expenses in 20X5 are as follows:

   Rental $6,000
   Repairs and maintenance $1,200
   Property tax 900
   Interest on first mortgage 3,300 (5,400)
   **$600**

   As of December 31, 20X5, there were no unpaid rents from the tenant.

2. In 20X3, while employed at Calco, Dumont attended a national law convention. She deducted her expenses of $2,300 on her 20X3 tax return. Her employer willingly gave her the time off from work to attend the convention, even though it was not directly related to her work. In 20X5, Dumont received a reassessment notice from the CRA disallowing the entire convention expense deduction. Now that Dumont is practicing law, she will attend the 20X6 convention to upgrade her skills.

3. In 20X5, Dumont contributed $11,000 to her RRSP and another $1,000 to a spousal RRSP. She has contributed the same amount to the spousal plan for the past four years. On December 20, 20X5, her husband withdrew $4,000 from this spousal account.

4. The following additional receipts and disbursements occurred during 20X5:

   Paid dental fees $2,900
   Paid contributions to a registered federal political party 1,400
   Paid interest on late payment of 20X4 income tax 240
   Received cash dividends (Non-eligible) on Calco shares 1,000
   Received proceeds from the sale of a silver tea set (original cost—$1,600) 1,100

5. In 20X5, Dumont received 100 shares of Parla Ltd., a public corporation. The shares were a stock dividend (Eligible) on the 2,000 shares she had purchased in 20X1 at $4 per share. At the time of the stock dividend, the shares were at $8. She sold the 100 stock dividend shares in December 20X5, at $7.

6. Dumont’s husband earned $110,000 in 20X5.

7. A review of Dumont’s 20X4 tax return showed the following:

   Maximum RRSP deduction available in 20X5 $10,500
   Capital gain deductions claimed in past years 75,000
   Net income from real estate rentals (after deducting a reserve for uncollectible rents of $500) 860
   Undepreciated capital cost—class 1 (rental property) 52,000
   Reserve for unpaid rents 500
### Solution to P 10-6

#### 1. Income for tax purposes and taxable income

<table>
<thead>
<tr>
<th>ITA 3(a)</th>
<th>Employment income</th>
<th>$55,101</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Business income</td>
<td>31,718</td>
</tr>
<tr>
<td></td>
<td>Property income</td>
<td>2,378</td>
</tr>
<tr>
<td></td>
<td>Other income</td>
<td>3,000</td>
</tr>
<tr>
<td></td>
<td><strong>Total</strong></td>
<td>92,197</td>
</tr>
<tr>
<td>ITA 3(b)</td>
<td>Taxable capital gains</td>
<td>2,141</td>
</tr>
<tr>
<td></td>
<td><strong>Total</strong></td>
<td>94,338</td>
</tr>
<tr>
<td>ITA 3(c)</td>
<td>Other deductions</td>
<td>(10,500)</td>
</tr>
<tr>
<td></td>
<td><strong>Total</strong></td>
<td>83,838</td>
</tr>
<tr>
<td>ITA 3(d)</td>
<td>Losses &amp; ABILs</td>
<td>(0)</td>
</tr>
</tbody>
</table>

Net income = $83,838

Deduct:
- Capital gains deduction [ITA 110.6] (2,000)
- Stock option deduction [ITA 110(1)(d.1)] (500)

Taxable income = $81,338

#### Employment income

- Salary [ITA 5(1)] $51,200
- Group term life insurance premium [ITA 6(1)(a), 6(4)] 200
- Standby charge – (2% x $32,000 x 6mo) x 4,000km/(1,667km x 6mo) 1,536
  - [ITA 6(1)(e), 6(2)]
- Auto operating benefit - least of: [ITA 6(1)(k)]
  - $24¢ x 4,000 km = $960; 1/2 x $1,536 (standby charge) = $768 768
- Frequent flyer points 0
- Employee loan [ITA 6(9), 80.4(1)] -
  - [ITA 80.4(1)(a)] $20,000 x 9% x 181/365 = $893
  - [ITA 80.4(1)(c)] $20,000 x 5% x 181/365 = (496) 397
- Stock option benefit - 500 shares x ($12 - $10) [ITA 7(1.1)] 1,000

**Total** $55,101

#### Business income

- Income per financial statement [ITA 9(1)] $41,000
- Work in progress election [ITA 34] (17,000)
- Amortization [ITA 18(1)(b)] 9,100
- Club dues [ITA 18(1)(l)] 1,600
- Donations [ITA 18(1)(a)] 800
- Promotion - 50% ($400) [ITA 67.1] 200
- Computer software - capital item [ITA 18(1)(b)] 900
- CCA (prorated for short taxation year – 184 days)
  - [ITA 20(1)(a), Reg. 1100(1), (2), (3)]
  - Class 50 computer - 4,000 x 55% x ½ x 184/365 (555)
  - Class 8, library - $5,600 x 20% x ½ x 184/365 (282)
  - Class 10.1, car [Reg. 7307] –
    - $30,000(limit) x 30% x ½ x 184/365 x 60% (1,361)
  - Class 12, software - $900 x 100% x ½ x 184/365 (227)
CEC deduction - $\frac{3}{4} \times 50,000 \times 7\% \times \frac{184}{365} [\text{ITA 20(1)(b)}] \quad (1,323)
Home office - $15,000 (12/80) \times \frac{184}{365} \quad (1,134) \quad $31,718

Property income

Rental property
Reported income [ITA 9(1)] \quad 600
Add 20X4 reserve for unpaid rents [ITA 12(1)(d)] \quad 500
Deduct interest on employee loan - [ITA 20(1)(c), 80.5] 
Interest paid \quad $496
Interest deemed paid \quad (893)
\quad 207
CCA - $4\% \times 52,000 = $2,080,
limited to rental income [Reg. 1100(11)] \quad (207)

Dividends [ITA 12(1)(j)]
Received from Calco - $1,000 \times 125\% \quad $1,250
Stock dividend from public co- 100 \times $8 = $800 \times 141\% \quad 1,128 \quad $2,378

Other income

Spousal RRSP withdrawal - $1,000 \times 3 \text{ years} [\text{ITA 146(8.3)}] \quad $3,000

Taxable capital gains [ITA 38(a)]
Calco shares - proceeds - 500 \times $20 \quad $10,000
ACB - 500 \times 12 \quad (6,000)
\quad $4,000
Taxable - 0.5 \times 4,000 \quad $2,000
Parla shares - proceeds - 100 \times $7 \quad $700
ACB – weighted average [ITA 47(1)]
[(2,000 \times $4) + (100 \times $8)] = $8,800/2,100 shares
$4.19/ share \times 100 \text{ shares sold} \quad (419)
\quad $281
Taxable – 0.5 \times 281 \quad 141 \quad $2,141

Other deductions

RRSP – [ITA 60(i), 146(5)] least of –
$22,450; $10,500; and contributions $12,000 \quad $(10,500)

Note: Several items were excluded from the calculation - private medical premiums paid
by employer are not taxable [ITA 6(1)(a)(i)]; frequent-flyer points [Income Tax Technical
News – CRA, June 11, 2009]; interest on late tax instalment is not deductible [ITA
18(1)(t)]; loss on silver tea set is deemed to be nil because it is a personal-use property
[ITA 40(2)(g)(iii)].

2. Federal income tax [ITA 117(2)]
15\% \times 41,544 \quad $6,232
22\% \times 39,794 \quad 8,755
\quad $81,338
\quad 14,987
Deduct non-refundable tax credits:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>ITA 118(1)(c) Basic personal amount</td>
<td>$10,527</td>
</tr>
<tr>
<td>ITA 118.7 CPP and EI</td>
<td>3,004</td>
</tr>
<tr>
<td>ITA 118(10) Employment credit</td>
<td>1,065</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$14,596</strong></td>
</tr>
<tr>
<td>x 15%</td>
<td><strong>(2,189)</strong></td>
</tr>
<tr>
<td>ITA 118.2(1) Medical (dental + insurance premiums ($2,900 + $300)</td>
<td>$3,200</td>
</tr>
<tr>
<td>Less: lesser of (3% x $82,722 = $2,482) or $2,052</td>
<td><strong>(2,052)</strong></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$1,148</strong></td>
</tr>
<tr>
<td>x 15%</td>
<td><strong>(172)</strong></td>
</tr>
<tr>
<td>ITA 118.1(3) Donations (15% x $200 + 29% x $600)</td>
<td><strong>(204)</strong></td>
</tr>
<tr>
<td>ITA 121 Dividend tax credit - eligible – $800 x 41% x 13/23</td>
<td><strong>(185)</strong></td>
</tr>
<tr>
<td>- non-eligible - $1,000 x 25% x 2/3</td>
<td><strong>(167)</strong></td>
</tr>
<tr>
<td><strong>Basic federal tax</strong></td>
<td><strong>12,070</strong></td>
</tr>
</tbody>
</table>

Other tax credit

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>ITA 127(3) Political contribution (75% x $400) + (50% x $350) + (33 1/3% x $650) MAX.</td>
<td><strong>(650)</strong></td>
</tr>
<tr>
<td><strong>Federal tax payable</strong></td>
<td><strong>$11,420</strong></td>
</tr>
</tbody>
</table>

3. The convention expenses were not allowed as a deduction in 20X3 because in calculating employment income, section 8 of the Income Tax Act does not specifically permit the deduction [ITA 8(2)]. The proposed 20X6 convention expense will be allowed because it will be a deduction in arriving at business income and ITA 20 (10) specifically permits the deduction for two conventions annually.
PROBLEM SEVEN

[ITA: 5(1); 6(1)(a), (e), (f), (k); 7(1); 12(1)(j); 38(a); 41(1),(2); 47(3); 73(1); 74.1(1); 117(2); 118(1)(a); 118.2; 118.7; 121; 146(1), (5)]

Victor is 63 years old and retired from his employment with Meter Ltd., a Canadian public corporation, on September 30, 20X8. Victor has asked you to help him prepare his 20X8 tax return and to advise him on certain other tax matters. Information regarding his financial activities for 20X8 is summarized below.

1. Victor’s gross salary to September 30, 20X8, was $85,000. From this amount, Meter deducted income tax of $22,000 and CPP and EI of $3,004. In addition to salary, Meter paid $9,000 directly into Victor’s RRSP at a local bank. Victor paid the annual RRSP administration fee of $100. During the year, until September 30, 20X8, Victor had the use of the employer’s automobile. Meter paid the monthly lease cost of $400 plus monthly operating expenses of $200. Victor drove the car a total of 16,000 km, of which 4,000 km was for personal use.

2. Victor suffered an illness in 20X8 and was off work for six weeks. During this period, the employer’s group sickness and accident insurance policy paid Victor $4,000 for lost salary. The entire premium of $500 was paid by Meter in 20X8. Due to his illness, Victor incurred and paid medical expenses of $3,000 in 20X8.

3. In 20X5, Meter granted Victor an option to acquire up to 5,000 of its shares at $8 per share. At that time, the shares were trading at the same price. In January 20X8, he purchased 2,000 shares when they were trading at $10 per share. He purchased an additional 1,000 shares in July 20X8, when they were trading at $15 per share. In November 20X8, Victor sold 2,000 shares at $20 per share after receiving a cash dividend (Eligible) of $800.

4. In 20X7, as a sideline, Victor began carving wood bowls for sale. He hoped to generate a small profit and keep himself occupied during his retirement. He made his first sales in 20X8, which resulted in a loss of $8,850. This excludes amortization but includes a deduction of $4,000 for the full cost of woodworking equipment purchased in 20X8.

5. On January 2, 20X8, Victor gifted his stamp collection to his grandson. He had acquired the collection over the past 15 years at a cost of $7,000. The collection has recently been appraised at $12,000. At the same time, he gifted a convertible bond valued at $20,000 to his wife. The bond had been purchased in 20X3 for $16,000.

6. On November 15, 20X8, Victor received $1,000 from an acquaintance in exchange for an option to purchase a small piece of land he had acquired four years earlier with the intention of constructing a rental property. For financial reasons, the construction plan had been terminated.

7. Victor is married and lives with his wife. She retired in 20X7 and will begin receiving her pension in 20X9. During 20X8, she earned interest income of $5,000, which includes $900 from the convertible bond she received from her husband.
8. Victor’s tax return from the previous year showed the following balances:

| Listed personal property losses forwarded to 20X8 | $ 1,000 |
| Maximum RRSP deduction available in 20X8         | 11,000  |

**Required:**

1. Determine Victor’s minimum net income for tax purposes in accordance with the format of section 3 of the Income Tax Act for the 20X8 taxation year.

2. Based on your answer to question 1, calculate Victor’s minimum federal income tax liability for the 20X8 taxation year.

3. Now that Victor is retired, can he make a contribution to his RRSP in 20X9? If so, estimate the maximum deduction available.
Solution to P 10-7

Part 1

Net income for tax purposes:

<table>
<thead>
<tr>
<th>Employment income:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>ITA 5(1) Salary</td>
<td>$85,000</td>
</tr>
<tr>
<td>ITA 6(1)(a) Contribution to RRSP</td>
<td>9,000</td>
</tr>
<tr>
<td>ITA 6(1)(e) Standby charge [ITA 6(2)] – 2/3 ($400 x 9m) x 4000km/(1667km x 9m)</td>
<td>640</td>
</tr>
<tr>
<td>ITA 6(1)(k) Operating benefit - (24¢ x 4000km)= $960 or 50% of standby charge = $320</td>
<td>320</td>
</tr>
<tr>
<td>ITA 6(1)(f) Income from group sickness and accident policy</td>
<td>4,000</td>
</tr>
<tr>
<td>ITA 7(1) Stock option - [2,000 x ($10 - $8) + 1,000 x ($15 - $8)]</td>
<td>11,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Property income:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>ITA 12(1)(j) Canadian dividend - $800 x 141%</td>
<td>$1,128</td>
</tr>
<tr>
<td>ITA 74.1(1) Bond interest - attributed from spouse</td>
<td>900</td>
</tr>
<tr>
<td>ITA 38(a) Taxable capital gains:</td>
<td></td>
</tr>
<tr>
<td>Meter shares - proceeds (2,000 x $20)</td>
<td>$40,000</td>
</tr>
<tr>
<td>ACB - (2,000 x $11.67) (Note 1)</td>
<td>(23,340)</td>
</tr>
<tr>
<td>Capital gain</td>
<td>$16,660</td>
</tr>
<tr>
<td>Taxable - ½ x $20,000</td>
<td>8,330</td>
</tr>
<tr>
<td>Option on land - ½ x $1,000</td>
<td>500</td>
</tr>
<tr>
<td>ITA 73(1) Convertible bond - deemed disposal at ACB</td>
<td>0</td>
</tr>
<tr>
<td>Net gains from LPP [ITA 41(1),(2)]:</td>
<td></td>
</tr>
<tr>
<td>½(12,000 - 7,000 - LPP loss carryover $1,000)</td>
<td>2,000</td>
</tr>
<tr>
<td></td>
<td>10,830</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Other deductions:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>ITA 60(i) RRSP – least of $22,450 (2011 limit); $11,000; and Contribution $9,000</td>
<td>(9,000)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Losses:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>ITA 9(1) Business loss - as reported</td>
<td>$(8,850)</td>
</tr>
<tr>
<td>Add - capital item [ITA 18(1)(b)]</td>
<td>4,000</td>
</tr>
<tr>
<td>Deduct - CCA class 29* [ITA 20(1)(a)]</td>
<td>$(1,000)</td>
</tr>
<tr>
<td>$4,000 x 50% x 1/2</td>
<td>(5,850)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Net income for tax purposes</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Less:</td>
<td></td>
</tr>
<tr>
<td>Stock option deduction – ½ x $11,000 [ITA 110(1)(d)]</td>
<td>(5,500)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Taxable income</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$102,468</td>
</tr>
</tbody>
</table>

* Manufacturing and processing equipment acquired between March 19, 2007 and December 31, 2013 is subject to a 50% straight-line CCA rate (Class 29).
Note 1: ACB of Meter Shares

For capital gains purposes the shares acquired are “identical properties” [ITA 47(3)]. Therefore, the ACB of the shares sold is calculated as a weighted average.

January 20X8  2,000  2,000 x $10 = $20,000
July 20X8    1,000  1,000 x $15 = $15,000
3,000       $35,000 $35,000/3,000 = $11.67/sh.

Part 2

Federal income tax:
15% x $41,544 $6,232
22% x 41,544 9,140
26% x 19,380 5,039
$102,468 20,411

Deduct non-refundable tax credits:
ITA 118(1)(a) Basic personal amount $10,527
ITA 118(1)(a) Spouse (($10,527 – ($5,000 - $900)) 6,427
ITA 118.7 CPP and EI 3,004
ITA 118(10) Employment credit 1,065
$21,023 x 15% (3,153)
ITA 118.2 Medical ($3,000 – 2,052) x 15% (142)
ITA 121 Dividend tax credit $800 x 41% x 13/23 (185)
$16,931

Part 3

Victor can continue making contributions to an RRSP up to and including the year he reaches 71 years of age, provided that he meets other contribution requirements. If Victor’s wife is younger than him, he can continue to make RRSP contributions to a spousal plan up to and including the year his wife turns 71. His limit for 20X9 is $20,740 calculated as follows: [ITA 146(1),(5)]

20X8 earned income ($109,960 employment - $5,850 business loss) $104,110
Lesser of: 18% x $104,110 = $18,740 and Annual limit = $22,450 (in 2012) $18,740
Plus:
Unused contribution room previous year ($11,000 - $9,000) 2,000
$20,740
PROBLEM EIGHT

[Reg. 402(3)]

Harvey and Walter Bachynski operate a welding supply business as a partnership in Sackville, New Brunswick. Over the years, their sales territory has expanded steadily, as they maintain an efficient, customer-oriented business.

However, their success has created problems. More and more customers are demanding their services, and the time required to reach those customers has increased. The brothers feel that because of this, service to distant areas is suffering from a lack of efficiency. In response, during the current year, they opened their first service depot in Amherst, Nova Scotia, 50 km away, just across the provincial boundary.

The new depot is in rented premises. It maintains a supply of inventory and is staffed by two new employees. Because of the start-up costs, the new depot operation has suffered a loss of $20,000 in the current year. However, the brothers are convinced that they have made the right decision.

A summary of the partnership income statement for the year is provided in the following table:

<table>
<thead>
<tr>
<th>Sales</th>
<th>$400,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of sales</td>
<td></td>
</tr>
<tr>
<td>Gross profit</td>
<td>100,000</td>
</tr>
<tr>
<td>Expenses:</td>
<td></td>
</tr>
<tr>
<td>Salaries and wages</td>
<td>$100,000</td>
</tr>
<tr>
<td>Travel and delivery</td>
<td>20,000</td>
</tr>
<tr>
<td>Rent</td>
<td>12,000</td>
</tr>
<tr>
<td>Advertising and promotion</td>
<td>4,000</td>
</tr>
<tr>
<td>Office and supplies</td>
<td>2,000</td>
</tr>
<tr>
<td>Insurance</td>
<td>4,000</td>
</tr>
<tr>
<td>Utilities</td>
<td>6,000</td>
</tr>
<tr>
<td></td>
<td>148,000</td>
</tr>
<tr>
<td>Net loss from new depot operation</td>
<td>(20,000)</td>
</tr>
<tr>
<td>Net income before taxes</td>
<td>$132,000</td>
</tr>
</tbody>
</table>

The brothers are pleased with the profit, although a large portion of it is a result of their own efforts. As the business is a partnership of two individuals, the brothers do not pay themselves salaries. Instead, they simply draw out some of their profits for personal living expenses.

The net loss of $20,000 from the new depot is calculated in the following table:

<table>
<thead>
<tr>
<th>Sales</th>
<th>$ 70,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of sales</td>
<td>30,000</td>
</tr>
<tr>
<td>Gross profit</td>
<td>40,000</td>
</tr>
<tr>
<td>Expenses:</td>
<td></td>
</tr>
<tr>
<td>Rent</td>
<td>$ 7,000</td>
</tr>
<tr>
<td>Salaries</td>
<td>40,000</td>
</tr>
<tr>
<td>Advertising</td>
<td>10,000</td>
</tr>
<tr>
<td>Supplies</td>
<td>2,000</td>
</tr>
<tr>
<td>Insurance</td>
<td>1,000</td>
</tr>
<tr>
<td>Net loss</td>
<td>60,000</td>
</tr>
<tr>
<td></td>
<td>(20,000)</td>
</tr>
</tbody>
</table>

Each brother has other sources of income that generate approximately $30,000 annually.
Required:

For each brother, determine the amount of taxable income that will be subject to provincial income tax in New Brunswick and Nova Scotia for 20X1.
Solution to P 10-8

The partnership is not a taxable entity. Instead, its income is allocated to the two partners, who are individuals. Individuals are taxable in the province which they reside on the last day of the calendar year -- in this case, New Brunswick. However, through the partnership, the individuals carry on a portion of their business in Nova Scotia from a permanent establishment in that province. As a result, a portion of the partnership's business profits, as determined by an arbitrary formula, are subject to Nova Scotia provincial taxes [Reg. 402(3)].

The allocation of profits between the provinces is determined below, at the partnership level, and then allocated to each partner.

<table>
<thead>
<tr>
<th>Sales</th>
<th>%</th>
<th>Wages</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>New Brunswick</td>
<td>$400,000</td>
<td>85%</td>
<td>$100,000</td>
</tr>
<tr>
<td>Nova Scotia</td>
<td>70,000</td>
<td>15%</td>
<td>40,000</td>
</tr>
<tr>
<td>Total</td>
<td>$470,000</td>
<td>100%</td>
<td>$140,000</td>
</tr>
</tbody>
</table>

Allocated to Nova Scotia:
- % of sales: 15%
- % of wages: 29%
- Average: ½ (15 + 29) = 22%
- Arbitrary profit allocation: 22% x $132,000 = $29,040

Allocated to New Brunswick:
- % of sales: 85%
- % of wages: 71%
- Average: ½ (85 + 71) = 78%
- Arbitrary profit allocation: 78% x $132,000 = $102,960

Notice that the allocation by the formula is considerably different from the actual results. The tax allocation and the actual results are compared below.

<table>
<thead>
<tr>
<th></th>
<th>Tax Allocation</th>
<th>Actual</th>
</tr>
</thead>
<tbody>
<tr>
<td>New Brunswick</td>
<td>$102,960</td>
<td>$152,000</td>
</tr>
<tr>
<td>Nova Scotia</td>
<td>29,040</td>
<td>(20,000)</td>
</tr>
<tr>
<td></td>
<td>$132,000</td>
<td>$132,000</td>
</tr>
</tbody>
</table>

The formula has shifted $49,040 of profits from New Brunswick to Nova Scotia ($152,000 - $102,960 = $49,040).
PROBLEM NINE

Sam Collins had been investing for several years. Most of his investments were in the stock market. For several years, he made substantial capital gains. As his success grew, he began to invest in riskier shares.

Last year, after a serious market downturn, Collins suffered significant losses that left him with cash resources of only $50,000. He was unable to use all of the capital losses for tax purposes and was left with unused net capital losses of $70,000. The substantial losses have shattered his confidence in the stock market. He has requested that his broker find him a secure bond in which to invest his remaining $50,000.

Collins is not destitute, as he has a substantial annual salary of $130,000. His broker has suggested a five-year corporate bond that will provide an interest return of 13%, and at the same time, he has tried to convince Collins to remain in the stock market but to acquire only high-level blue-chip shares. In this vein, he has suggested, as a possible alternative to the bond, a common-share investment in a utility company that historically provides an annual dividend return (eligible dividends) of 5% as well as capital growth of 6%.

In addition, the broker has indicated that any annual cash returns can be invested in treasury bills earning 13% annually.

Required:

1. Which investment will best help Collins recover his lost capital? (Use a five-year period for your analysis.)

2. What rate of return must the bond offer in order for it to yield the same return as the share investment?
Solution to P 10-9

The issue in this problem is whether Collins should invest in a 13% bond or stock yielding 11% (5% dividend plus 6% growth). Although the bond yields a greater amount, the return is fully taxable. On the other hand, the blue chip stock earns dividends and a capital gain. The dividend is subject to the dividend tax credit and the capital gain will not be taxable because of the unused net capital loss carry over.

The applicable tax rates must be assumed. Because Collins earns a substantial salary, he is in the highest personal tax bracket. The following marginal tax rates are assumed (federal and provincial):

<table>
<thead>
<tr>
<th>Income Type</th>
<th>Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest income</td>
<td>45%</td>
</tr>
<tr>
<td>Dividend income (net of the dividend tax credit)</td>
<td>28%</td>
</tr>
</tbody>
</table>

1. **Accumulated investment after 5 years.**

**Bond:**

The bond of $50,000 earns 7.15% after-tax (13% - 45% tax = 7.15%). The annual interest will be reinvested in treasury bills also earning 7.15% after-tax. After five years, the after-tax values of the investment are:

\[
\text{\$50,000 at 7.15\% compounded x 5 years} = \$70,620
\]

**Stock:**

The stock value will compound at a rate of 6% and will not be taxable at the end of five years because of the loss carry-over. After five years, the stock value is:

\[
\text{\$50,000 at 6\% x 5 years} = \$66,911
\]

In addition, an annual dividend of $2,500 (5% of $50,000) is received which amounts to $1,800 after-tax ($2,500 - 28% tax = $1,800). This amount is reinvested in treasury bills earning 7.15% after-tax. Therefore, interest on the invested dividend will not occur until year 2. Value of the dividends after five years is:

\[
\text{\$1,800 annual at 7.15\% x 4 years} + \$1,800 = \$10,287
\]

Total value of stock investment ($66,911+$10,287) $77,198

Although the blue chip stock investment may have slightly more risk than the bond investment it provides an additional amount of $6,578 ($77,198 - $70,620) even though its pre-tax yield is lower.
2. **Comparative rates of return**

In order to yield the same rate of return on a bond, Collins would have to purchase a bond for $50,000 that accumulates to $77,198 after-tax. Using an internal rate of return calculation, the bond would have to yield 9.07 annually after-tax and be reinvested at that same rate:

$$50,000 \times (1 + 0.07)^5 = 77,198$$

This is equivalent to a pre-tax return of:

$$x - 0.45x = 9.07$$

$$x = 16.5\%$$

on both the bond and the treasury bills.

Because of Collins’ preferential tax position for capital gains, a secure stock investment yielding 11% is equivalent to a bond investment yielding 16.5%.
PROBLEM TEN

[Proprietorship vs. Corporation]

Jennifer Jones has decided to open a small business that will be supervised by a hired manager. With her current cash resources, she will be able to acquire the necessary assets for the business and provide basic working capital. However, any losses that occur will have to be funded by an infusion of additional capital.

Jones and the new manager have just finished drawing up a business plan. It projects the following operating results over the next five years:

<table>
<thead>
<tr>
<th>Year</th>
<th>Loss</th>
<th>$(20,000)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>loss</td>
<td>(10,000)</td>
</tr>
<tr>
<td>2</td>
<td>break even</td>
<td>–0–</td>
</tr>
<tr>
<td>3</td>
<td>profit</td>
<td>10,000</td>
</tr>
<tr>
<td>4</td>
<td>profit</td>
<td>20,000</td>
</tr>
<tr>
<td>Profit after 5 years</td>
<td>–0–</td>
<td></td>
</tr>
</tbody>
</table>

Although Jones has substantial wealth, all of her capital will be tied up for several years. In addition, all of her after-tax annual income is committed to personal living expenses. Her pre-tax annual income is over $130,000. Jones has made an arrangement with her bank, which will provide an annual loan to cover any losses from the business. The bank will charge 10% interest. As cash flow is generated from the business, the loan will be repaid. She has yet to decide whether the business will be operated as a proprietorship or a separate corporation owned by her.

Required:

Determine the amount of the outstanding loan at the end of year 5 under both the corporate structure and the proprietorship structure. Assume that any bank loans will be obtained or repaid at the end of each year. Assume Jennifer lives in a province with a combined federal and provincial income tax rate of 45% in the top tax bracket.
### Solution to P 10-10

This problem emphasizes the importance of loss utilization on cash flow. If Jones organizes the new venture as a corporation, the losses will remain in the corporation and unused until the business becomes profitable in years 4 and 5. Therefore, the bank loans required are equal to the actual losses that occur.

If, however, the venture is organized as a proprietorship, the annual losses can be used immediately by Jones and will create cash flows for her that are not otherwise available under the corporate structure. This additional cash flow, which is uncommitted, can be used to fund a portion of the losses and so requires fewer funds from the bank loan. Of course, future profits in years 4 and 5 will be fully taxable to her leaving a lower amount for the loan repayment.

#### New Venture - Corporation:

Under this option, the required bank loans and the amount outstanding after five years is as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Bank Loan Increase (Decrease)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>Loss for the year $20,000</td>
</tr>
<tr>
<td>Year 2</td>
<td>Loss for the year $10,000</td>
</tr>
<tr>
<td></td>
<td>Add interest on loan $20,000 (10%)</td>
</tr>
<tr>
<td></td>
<td>Total loss $12,000</td>
</tr>
<tr>
<td></td>
<td>Loan required $12,000</td>
</tr>
<tr>
<td>Year 3</td>
<td>Profits $0</td>
</tr>
<tr>
<td></td>
<td>Interest on loss (10%) $3,200</td>
</tr>
<tr>
<td></td>
<td>Total loss $3,200</td>
</tr>
<tr>
<td></td>
<td>Loan required $3,200</td>
</tr>
<tr>
<td>Year 4</td>
<td>Profit $10,000</td>
</tr>
<tr>
<td></td>
<td>Less interest (3,520)</td>
</tr>
<tr>
<td></td>
<td>Net profit $6,480</td>
</tr>
<tr>
<td></td>
<td>Loan repaid $6,480</td>
</tr>
<tr>
<td>Year 5</td>
<td>Profit $20,000</td>
</tr>
<tr>
<td></td>
<td>Less interest (2,872)</td>
</tr>
<tr>
<td></td>
<td>Net profit $17,128</td>
</tr>
<tr>
<td></td>
<td>Loan repaid (17,128)</td>
</tr>
<tr>
<td></td>
<td>Bank loan after 5 years $11,592</td>
</tr>
</tbody>
</table>

Notice that years in 4 and 5 no taxes were paid even though profits occurred. The losses of the first three years totaled $35,200 and, therefore, offset those profits. $11,592 of the losses remain as a carry-over to future years ($35,200 - $6,480 - $17,128 = $11,592).
New Venture - Proprietorship:

It is assumed that Jones is subject to a 45% tax rate.

<table>
<thead>
<tr>
<th>Year</th>
<th>Loss for the year</th>
<th>Cash from tax saving (45%)</th>
<th>After-tax loss</th>
<th>Loan required</th>
<th>Bank Loan Increase (Decrease)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$20,000</td>
<td>(9,000)</td>
<td>$11,000</td>
<td>$11,000</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>$10,000</td>
<td>(4,995)</td>
<td>$  6,105</td>
<td>6,105</td>
<td>17,105</td>
</tr>
<tr>
<td>3</td>
<td>0</td>
<td>(770)</td>
<td>$  940</td>
<td>940</td>
<td>17,105</td>
</tr>
<tr>
<td>4</td>
<td>(1,805)</td>
<td>(3,688)</td>
<td>$  4,507</td>
<td>(4,507)</td>
<td>18,045</td>
</tr>
<tr>
<td>5</td>
<td>20,000</td>
<td>(1,354)</td>
<td>18,646</td>
<td>(10,256)</td>
<td>13,538</td>
</tr>
</tbody>
</table>

Loan repaid

Bank loan after 5 years $ 3,282
CHAPTER 11

CORPORATIONS—AN INTRODUCTION

Review Questions

1. “A corporation is an artificial person separate and distinct from its owners.” Briefly explain this statement.

2. Identify the types of relationships that can exist between a corporation and its shareholders.

3. What factors may influence the value of a corporation’s common share capital?

4. Identify two ways in which a shareholder can realize a return on a share investment. Describe the relationship between them.

5. “Given the choice, individual shareholders of a corporation prefer to receive their return on investment by way of dividends, rather than from the sale of shares at a profit.” Is this statement true? Explain.

6. “A shareholder may have a primary relationship as well as secondary relationships with the corporation. The difference between the (two relationships relates to the tax treatment of income flows between the corporation and the shareholder.” Explain.

7. Corporations and individuals determine their taxable income in different ways. What are the differences?

8. How are the net capital losses and non-capital losses of a corporation affected when voting control of the corporation shifts from one shareholder to another?

9. If the shares of a corporation that has non-capital losses are about to be sold and if those losses arise from business operations, why is it important for the vendor to consider the nature of the purchaser?

10. An existing corporation that operates a profitable retail business is considering expanding its activities to include manufacturing. The expansion business can be organized in either of two basic ways. Describe them. Also, what factors must be considered when a choice is being made between the two structures?

11. How does the tax treatment of intercorporate dividends affect the relationship between dividends and capital gains when one corporation invests in shares of another corporation? (Assume that both entities are taxable Canadian corporations.)

12. Explain why the federal tax reduction of 13% (in 2012) or a provincial tax reduction on manufacturing and processing activities may apply to an amount that is greater than or less than the corporation’s actual income from manufacturing. Is it possible for a corporation that earns $500,000 from retail activities and suffers a loss of $50,000 from manufacturing activities to be eligible for the 13% (in 2012) manufacturing reduction?
13. What is the marginal tax rate for a public corporation in Ontario on income derived from a chain of restaurants? Show calculations.

14. Because income earned by a corporation is first subject to corporate tax and then taxed a second time when after-tax profits are distributed to individual shareholders, shareholders are entitled to claim a dividend tax credit. Does the dividend tax credit eliminate the double taxation of corporate profits? Explain.

15. The following statement appeared in the media: “There are 60,000 Canadian corporations that earned a profit for the year but incurred no income tax liability.” Is it possible that this statement is true? If it is, explain the principal reasons why, and state your opinion as to whether changes to the tax system are warranted.
Solutions to Review Questions

R11-1. By law, a corporation is recognized as an entity which has the power to act on its own behalf and enter into enforceable legal agreements. It can own property, sell and lease property, and borrow funds in the same way that an individual can. Although the corporation is owned by its shareholders, the affairs of the corporation are separate from the affairs of its owners. Therefore, property owned by the corporation is not property owned by the shareholder, and debts of the corporation are not debts of the shareholders. As a separate entity, the corporation is subject to income tax on its profits. However, when those after-tax profits are distributed to the shareholders they are again included in the shareholders income for tax purposes [ITA 12(1)(j)].

R11-2. A shareholder can have both a primary and a secondary relationship with the corporation. Under a primary relationship, the shareholder provides equity capital to the corporation in exchange for shares. The shareholder can receive a return from the shares in the form of dividend distributions and/or share value enhancement. Under a secondary relationship, the shareholders may also act as a creditor, supplier, customer, employee, or lessor to the corporation. They can, therefore, loan money to the company in exchange for interest, lease property to the company in exchange for rent, provide services in exchange for salary and so on.

R11-3. The following factors may influence the value of a corporation's common share capital.

- Profits earned or losses incurred by the corporation. Profits retained belong to the common shareholders and the share value increases accordingly.
- Dividends paid by the corporation. Dividend distributions reduce the equity of the corporation and the share value declines accordingly.
- Increases or decreases in the value of assets owned by the corporation, including tangible assets such as land and buildings, and intangible assets such as goodwill.

R11-4. A shareholder who provides share capital to a corporation can realize a return on investment from dividends or capital gains when shares that have increased in value are sold. The two are related because dividend payments alter the value of the shares, thereby affecting the potential capital gain (loss) on sale. If after-tax corporate profits are retained by the corporation, the value of the shares increases, which may create a capital gain if the shareholder sells the shares. On the other hand, if corporate earnings are distributed as a dividend, the value of the shares decline, and reduce the amount of capital gain that would otherwise occur when the shares are sold.

R11-5. It is not always true that a shareholder prefers a dividend over a capital gain. First of all, the shareholder may be entitled to the capital gains deduction on shares of a qualified small business corporation (QSBC), in which case a capital gain is preferable to a dividend. Both dividends and capital gains have preferential treatment (dividends - the dividend tax credit, capital gains – 1/2 taxable). The tax rate on non-eligible dividends is higher than the rate on capital gains, except in the lowest tax bracket where the opposite is usually true. The tax rate on eligible dividends is normally lower than the rate on capital gains in first three tax brackets. However, the opposite usually occurs in the top tax bracket. See Exhibit 10-8 for the actual marginal tax rates for the top income tax bracket by source for each province. Using the marginal rates developed in Chapter 10 (Exhibit 10-7) for a particular province, the rates can be compared as follows:

<table>
<thead>
<tr>
<th>Capital Gains</th>
<th>Eligible Dividends</th>
<th>Non-eligible Dividends</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low bracket</td>
<td>12%</td>
<td>0%</td>
</tr>
<tr>
<td>2nd bracket</td>
<td>16%</td>
<td>10%</td>
</tr>
<tr>
<td>3rd bracket</td>
<td>20%</td>
<td>21%</td>
</tr>
<tr>
<td>High bracket</td>
<td>23%</td>
<td>28%</td>
</tr>
</tbody>
</table>

Keep in mind that the timing of the tax may be different for each option. Capital gains are taxed only when the property is sold whereas dividends are taxed when received.

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Solutions Manual Chapter Eleven
R11-6. In the primary relationship, dividends paid by the corporation are not deductible by the corporation when determining its income for tax purposes, but the receipt of the dividends is taxable to the shareholder. Therefore, corporate income distributed to shareholders as dividends are subject to two levels of tax. In secondary relationships, payments to the shareholder for salary, interest, and rents are all deductible for tax purposes by the corporation and fully taxable to the recipient. Because such payments reduce corporate income before tax it effectively shifts corporate income from the corporation to the shareholder with the result being that there is only one level of tax.

R11-7. The conversion of net income for tax purposes to taxable income for corporations is different because it includes several special reductions that are not permitted for individuals. In arriving at taxable income a corporation, in addition to deducting net capital losses and non-capital losses, can also deduct:

- dividends from taxable Canadian corporations included in net income [ITA 112(1)],
- dividends from foreign affiliate corporations included in net income [ITA 113], and
- charitable donations [ITA 110.1(1)].

A further difference is that a corporation is not entitled to the capital gains deduction which exempts $750,000 of gain on certain qualified properties.

R11-8. If voting control of a corporation shifts from one shareholder or group of shareholders to another, any net capital and non-capital losses are affected as follows:

- Net capital losses are deemed to expire [ITA 111(4)(a)].
- Non-capital losses that were incurred from a business operation continue to be carried forward, but can only be offset against profits earned by the business that incurred the loss or a similar business. In addition, the loss business must be carried on at a profit or with a reasonable expectation of profit throughout the taxation year in which the losses carried forward are deducted. If the loss business is terminated before the losses are used, the loss carry-overs will not be available [ITA 111(5)].
- Non-capital losses that were incurred from ABILs and property losses, i.e., rent, are deemed to expire [ITA 111(5)].
- A deemed year end occurs at the date of the control change [ITA 249(4)]. This causes operating losses (if any) up to that date to be included as restricted non-capital losses.
- Depreciable property, eligible capital property and capital property are deemed to be sold at FMV on the date of the control change if the specific property is valued below its tax cost [ITA 111(4), (5.1) & (5.2)]. This has the effect of triggering unrealized losses and including them in the above restrictions.

(Note: control must be acquired by an arm's length party for the above to apply [ITA 256(7)(a)])

R11-9. A change in control from a sale of the shares will restrict the use of the loss carry-overs so that they can be used only by the business that incurred the loss or a similar business [ITA 111(5)]. If the purchaser is in a similar line of business they can, after the share acquisition, take steps to combine their profitable operations with the acquired loss corporation.

The loss carry-overs can then be used against the future profits of the purchaser's operations.
This would not be the case if the purchaser was in a different line of business. Therefore, a loss corporation has greater value to a purchaser in the same line of business that can easily use the prior losses to create tax savings. The vendor should seek out such buyers.

R11-10. The existing profitable retail corporation can expand its new manufacturing activity by using a separate corporation to house the new activity, or it could operate the manufacturing operation as a division of the existing corporation. In addition to any legal and administrative considerations, the following tax items should be considered when making the choice:

- If the new manufacturing operation should incur losses, they could not be immediately used if a separate corporation structure was used, as those losses would belong to the new corporation as a separate taxpayer. However, under a division structure, any losses from the manufacturing operation could be immediately offset against the retail profits creating additional cash flow from tax savings. This cash flow could be used to help fund the cost of the expansion. If the new venture fails, the divisional structure leaves the existing corporation fully liable for the obligations, whereas the separate corporation structure may limit the liability.

- The alternate structures will have an impact on the amount of income that is subject to the Manufacturing and processing profits (M&P) deduction (13% - 2012) [ITA 125.1(1)]. The general tax reduction (13% - 2012) [ITA 124.4] is applicable to other types of income. Therefore, most corporate income is subject to a net federal tax rate of 15%. Certain provinces have special rates for manufacturing and processing income. It is the possibility of provincial tax savings that makes the allocation of M&P income important.

Under the separate corporation structure, the maximum profit eligible for the reduction is the actual manufacturing profits earned. However, when the operations are combined in the same corporation with the profitable retail activity, the manufacturing profits available for the M&P deduction is determined by an arbitrary formula -- based on the ratio of manufacturing capital and labour to total capital and labour of the combined operating profit [Reg. 5200]. This formula may produce an arbitrary manufacturing income for tax purposes that is greater than or less than actual. The magnitude of this difference can be estimated and once determined should be considered as part of the decision process.

R11-11. The owner of shares of a corporation can realize a return on that investment from dividends and/or capital gains when the shares are sold. The payment of dividends reduces the value of the share and therefore reduces the potential capital gain on the shares. With respect to corporate shares, dividends and capital gains are closely related.

However, when one corporation invests in shares of another corporation, the consequence of the capital gain/dividend relationship is altered. Dividends received by a corporation from another Canadian corporation can be deducted from the recipient's net income when arriving at taxable income thereby providing a tax free return on investment [ITA 112(1)]. In comparison, if dividends are not paid, allowing the share value to grow, the capital gain on the future sale of shares will be taxable to the investor corporation. This difference in tax treatment is significant and creates a strong incentive for dividend returns compared to capital gains. This is quite different than the relationship of dividends and capital gains where the shareholder is an individual. (Certain refundable taxes may be applicable to particular dividends received by a private corporation - see Chapter 13)
R11-12. The 13% federal tax reduction on manufacturing profits may apply to an amount that is different from the actual manufacturing profits because manufacturing profit for purposes of the tax calculation is based upon an arbitrary formula as follows: [Reg.5200]

\[
\frac{\text{Manufacturing Capital} + \text{Manufacturing Labour}}{\text{Total Capital} + \text{Total Labour}} \times \text{Total business profits}
\]

The above formula arbitrarily allocates a portion of the total business profits as "manufacturing profits" based upon the ratio of manufacturing capital and labour to total capital and labour of the whole corporation. For example, assume that the ratio in the above formula is 20% (i.e. MC + ML is 20% of TC + TL) and the corporation's profits are as described in the question.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retail profits</td>
<td>$500,000</td>
</tr>
<tr>
<td>Manufacturing loss</td>
<td>(50,000)</td>
</tr>
<tr>
<td>Total profits</td>
<td>$450,000</td>
</tr>
</tbody>
</table>

For tax purposes, the manufacturing profits would be $90,000 (20% of $450,000) even though the manufacturing activity actually suffered a loss of $50,000. The arbitrary formula converted $140,000 of retail profits into manufacturing profits eligible for the 13% (2012) M&P deduction (and certain provincial and territorial reductions) ($90,000 + $50,000 loss = $140,000). The availability of the small business deduction may limit the use of the M&P deduction (see Chapter 13).

R11-13. The marginal tax rate is 26% (2012) calculated as follows:

- Federal rate: 38%
- Less federal abatement: (10)
- General tax reduction: (13)
- Federal tax: 15
- Provincial tax: Exhibit 11-8: 11

Combined rate: 26%

A portion of the restaurant profits may be considered as manufacturing and processing income because the conversion of raw food into cooked meals represents a processing activity [ITA 125.1(3)]. Therefore, the tax rate on income of this nature (based on the arbitrary formula) may be reduced due to a provincial reduction of 1.2%.

R11-14. The dividend tax credit is designed to reduce or eliminate double taxation that would otherwise occur when after-tax corporate profits are distributed as dividends to shareholders who are individuals. The federal dividend tax credit, together with the corresponding provincial dividend tax credit, reduces the shareholder's personal tax in recognition of the fact that the corporation has already paid tax on its corporate income. However, this reduction makes the assumption that the corporate tax rate is approximately either 27.5% or 20%. If the corporate tax rate is higher than these assumed rates (27.5% and 20%) an element of double taxation will occur. If the corporate rate is lower than these assumed rates, an element of tax savings will occur. Provincial tax rates vary widely. Thus, the element of double tax or tax savings depends on the province in which the income is earned. Business income eligible for the
small business deduction provides a small tax savings when passed through a corporation in all but one province, Quebec [Text page 406]. There is some amount of double taxation when business income not eligible for the small business deduction is passed through a corporation, for all provinces [Text page 405].

R11-15. Yes, it is possible for corporations to earn income in a year but pay no tax in that year. There are two primary reasons why this may occur:

- The corporation may have suffered losses in previous or subsequent years which are carried forward or back and deducted against the profits of the year in question. This reduces the corporation’s net income when arriving at its taxable income and no tax is payable [ITA 111(1)(a)]. Therefore, although there is net income for the year there is no taxable income.

- The corporation may simply be a holding corporation that owns shares of another corporation. For example, the corporation in question may own all of the shares of its subsidiary corporation that in turn operates an active business. The subsidiary corporation earns business income and pays tax on that income. When the after-tax profits are transferred to the parent corporation as dividends, the parent corporation has dividend income but can deduct that amount in arriving at taxable income, thereby paying no tax [ITA 112(1)].

It is the authors’ opinion that no changes to the tax system are warranted. The carry forward of unused losses seems fair and equitable. Individuals are also entitled to the same treatment. Also, taxing intercorporate dividends would magnify the amount of double taxation as profits that have already been taxed would be taxed again and again as they pass from one corporation to another. Although, it can be argued that a fully refundable tax on intercorporate dividends could avoid excessive taxation (see the discussion on refundable dividend taxes in Chapter 13).

The process of publicly comparing corporate taxes to net income for the year, rather than to taxable income, is misleading and is usually stressed for political reasons rather than for tax reasons.
Key Concept Questions

QUESTION ONE

A Canadian corporation with a December year end has incurred the following losses:

<table>
<thead>
<tr>
<th>Amount</th>
<th>Year Incurred</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-capital loss $10,000</td>
<td>2009</td>
</tr>
<tr>
<td>Non-capital loss $12,000</td>
<td>2005</td>
</tr>
<tr>
<td>Non-capital loss $14,000</td>
<td>2002</td>
</tr>
<tr>
<td>Net capital loss $16,000</td>
<td>2000</td>
</tr>
</tbody>
</table>

Determine the expiry date for each of the above losses. *Income tax reference: ITA 111(1)(a),(b).*

QUESTION TWO

Moon Corp., a Canadian public corporation, has correctly computed its income (loss) for the current taxation year.

Income from property including dividends of $12,000 received from taxable Canadian corporations $ 50,000
Taxable capital gains $18,000
Allowable capital losses (8,000)
Loss from business (100,000)

$ (40,000)

Moon Corp. contributed $5,000 to various charities in the current year. Moon Corp. has net capital losses of $15,000 available. These losses were incurred last year.

Determine Moon Corp.’s maximum non-capital loss for the current taxation year. *Income tax reference: ITA 110.1(1), 111(8), 112(1).*

QUESTION THREE

Nelson Ltd. has net income for tax purposes of $300,000 for the current taxation year. Included in this amount are dividends of $20,000 received from taxable Canadian corporations and taxable capital gains of $15,000. During the year, Nelson Ltd. donated $40,000 to the Canadian Cancer Society. Nelson Ltd. has non-capital losses of $10,000 (incurred last year) and net capital losses of $18,000 (incurred in 2000) available.

Determine Nelson’s taxable income for the current taxation year. *Income tax reference: ITA 110.1(1), 111(1)(a), (b), 112(1).*

QUESTION FOUR

Loser Ltd. has non-capital losses of $60,000 from business operations and net capital losses of $40,000 (both incurred two years ago). On October 1 of the current year, the shares of Loser Ltd. were acquired by an arm’s-length person.

Determine the tax implications for Loser Ltd. *Income tax reference: ITA 111(4), (5), 249(4).*
QUESTION FIVE

On November 1st of the current year, X Ltd. purchased 80% of the shares of Y Ltd. from an unrelated person. Details of the assets owned by Y Ltd. at that time are summarized below:

<table>
<thead>
<tr>
<th>Class 1</th>
<th>Class 8</th>
<th>Class 12</th>
<th>CEC</th>
</tr>
</thead>
<tbody>
<tr>
<td>FMV</td>
<td>$400,000</td>
<td>$20,000</td>
<td>$5,000</td>
</tr>
<tr>
<td>Cost</td>
<td>300,000</td>
<td>30,000</td>
<td>25,000</td>
</tr>
<tr>
<td>UCC/CEC</td>
<td>275,000</td>
<td>27,000</td>
<td>0</td>
</tr>
</tbody>
</table>

Determine the adjustments required to the tax values of the assets owned by Y Ltd. and the effect on Y’s business income for its taxation year ended October 31. Income tax reference: ITA 111(5.1),(5.2), 249(4).

QUESTION SIX

On April 1st of the current year, Carl purchased 60% of the shares of P Ltd. from an unrelated person. Details of the inventory and other assets owned by P Ltd. at that time are summarized below.

<table>
<thead>
<tr>
<th></th>
<th>FMV</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in A Ltd.</td>
<td>$10,000</td>
<td>$24,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>50,000</td>
<td>30,000</td>
</tr>
<tr>
<td>Land</td>
<td>100,000</td>
<td>80,000</td>
</tr>
<tr>
<td>Building (UCC $75,000)</td>
<td>120,000</td>
<td>90,000</td>
</tr>
</tbody>
</table>

Determine the tax implications for P Ltd. Income tax reference: ITA 10(1); 111(4)(a),(c),(d),(e); 249(4).

QUESTION SEVEN

Free Corp. is a Canadian public corporation that operates a retail store in Ontario. Free Corp.’s taxable income for the current year is $100,000.

Determine the federal tax payable for the current year. Income tax reference: ITA 111(4), 123(1), 124(1), 123.4(2).

QUESTION EIGHT

Easy Corp., a Canadian public corporation, carries on business in Canada and in the United States. The revenue and salaries allocated to the permanent establishment in each location are as follows for the current year:

<table>
<thead>
<tr>
<th>Location</th>
<th>Revenue</th>
<th>Salaries</th>
</tr>
</thead>
<tbody>
<tr>
<td>Canada</td>
<td>$8,000,000</td>
<td>$600,000</td>
</tr>
<tr>
<td>United States</td>
<td>2,000,000</td>
<td>400,000</td>
</tr>
<tr>
<td>Total</td>
<td>$10,000,000</td>
<td>$1,000,000</td>
</tr>
</tbody>
</table>

Easy Corp. has taxable income of $600,000 for the current year.

Determine the federal tax payable for Easy Corp. for the current year. Income tax reference: ITA 123(1), 124(1), 123.4(2); Reg. 402.
QUESTION NINE

Manu Corp. is a Canadian public corporation that carries on manufacturing and distribution operations in British Columbia. Manu Corp.’s taxable income for the current year is $900,000.

The balance sheet shows that the cost of all depreciable property owned by Manu Corp. at the end of the year is $1,100,000. Of this amount, $800,000 is used in the manufacturing business. The income statement shows income from the manufacturing operations of $300,000, income from the wholesaling operations of $500,000 and investment income of $100,000.

The total payroll for the year is $2,200,000, of which $1,000,000 is paid to employees directly involved in manufacturing activities.

Income tax reference: ITA 125.1; Reg. 5200, 5201, 5202.

Determine the federal manufacturing and processing deduction for the current year.

QUESTION TEN

Gold Corp., a Canadian public corporation, carries on business in Canada. For the current year, Gold Corp. has manufacturing and processing profits (M&P) of $300,000, calculated in accordance with prescribed rules. Gold Corp. has total taxable income of $1,000,000.

Solutions to Key Concept Questions

KC 11-1

[ITA: 111(1)(a),(b) – Expiry dates for losses]

Generally, non-capital losses expire after 20 years. However, non-capital losses incurred in taxation years ending from March 23, 2004 to December 31, 2005 expire after 10 years and those incurred in taxation years ending before March 23, 2004 expire after 7 years. Net capital losses have an indefinite carry forward.

The $10,000 non-capital loss incurred in 2009 expires in 2029.
The $12,000 non-capital loss incurred in 2005 expires in 2015.
The $14,000 non-capital loss incurred in 2002 expires in 2009.
The $16,000 net capital loss can be carried forward indefinitely.

KC 11-2

[ITA: 110.1(1), 111(8), 112(1) – Non-capital loss]

Moon Corp’s maximum non-capital loss for the current year is $62,000.

Net income (loss) $(40,000)
Dividends from taxable Canadian corporations (12,000)
Donations (limited to 75% x net income) 0
Net capital losses (limited to net taxable capital gains) (10,000)
Non-capital loss for the year $(62,000)

KC 11-3

[ITA: 110.1(1), 111(1)(a),(b), 112(1), 127(3) – Taxable income, Political tax credit]

Nelson Ltd’s taxable income is $215,000.

Net income $300,000
Dividends from taxable Canadian corporations (20,000)
Donations (limited to 75% x net income) (40,000)
Net capital losses (limited to net taxable capital gains) (15,000)
Non-capital losses (10,000)
Taxable income $215,000
KC 11-4

[ITA: 111(4), (5), 249(4) – Acquisition of control]

Control of Loser Ltd. has been acquired by an unrelated party on October 1st. This has the following tax implications:

- Loser Ltd.’s year-end is deemed to end immediately before the acquisition of control, September 30. This counts as a taxation year for purposes of determining the expiry date of the non-capital losses. Loser Ltd. can select a new year-end for tax purposes.

- The net capital losses are deemed to have expired immediately before control was acquired, September 30th.

- The non-capital losses that resulted from a business operation continue to be carried forward but can be utilized only against income generated from the business that incurred the loss or against income of a business that is similar to the business that incurred the loss. The business that incurred the loss must be carried on at a profit or with a reasonable expectation of profit throughout the taxation year in which the losses are deducted.

KC 11-5

[ITA: 111(5.1),(5.2), 249(4) – Acquisition of Control]

Depreciable property and eligible capital property are deemed to have been sold immediately before the acquisition of control at their fair market value if that value is below the tax value [ITA 111(5.1),(5.2)].

Class 1 – no adjustment; FMV is not below the tax value.
Class 8 – UCC is reduced to from $27,000 to $20,000.
Class 12 – no adjustment; FMV is not below the tax value.
CEC – The CEC is reduced from $3,500 to $3,000, being ¾ x FMV $4,000.

The reduction to the UCC of Class 8 ($7,000) and the reduction to the CEC ($500) will decrease Y Ltd.’s business income (or increase the business loss) for the taxation year ended October 31 by $7,500.

KC 11-6

[ITA: 10(1), 111(4)(c),(d),(e), 249(4) – Acquisition of Control]

P Ltd.’s taxation year is deemed to end on March 31, immediately before Carl acquired control. P Ltd. can select a new year-end for tax purposes [ITA 249(4)].

The assets of P Ltd. are deemed to have been sold at their market value immediately before Carl acquired control if that value is below the tax cost [ITA 111(4)(c)].

Investment in A Ltd. – the cost is reduced from $24,000 to $10,000 and that $14,000 write-down is deemed to be a capital loss for the year deemed to have ended on March 31 [ITA 111(4)(d)].

Inventory – no adjustment is required since the FMV is not below the cost [ITA 10(1)].
Land & building – no adjustment is required since the FMV is not below the cost.

The $7,000 ($14,000 x \(\frac{1}{2}\)) allowable capital loss on the investment becomes a net capital loss and expires on March 31 if unused [ITA 111(4)(a)]. P Ltd. can elect to recognize all or a portion of the accrued gains and recapture on assets [ITA 111(4)(e)]. Unless there are non-capital losses expiring, P Ltd. should not elect to recognize recapture. It would be beneficial for P Ltd. to elect to recognize a $14,000 capital gain on the land to offset the expiring capital loss. To do this, P Ltd. elects to recognize proceeds of $94,000 ($80,000 + $14,000) for the land. By making the election, the ACB of the land is increased to $94,000.

**KC 11-7**

[ITA: 123(1), 124(1), 123.4(2) – Corporate tax calculation]

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>ITA 123(1) Basic federal tax - $100,000 x 38%</td>
<td>$38,000</td>
</tr>
<tr>
<td>ITA 124(1) Federal abatement - $100,000 x 10%</td>
<td>(10,000)</td>
</tr>
<tr>
<td>ITA 123.4(2) General tax reduction - $100,000 x 13% (2012)</td>
<td>(13,000)</td>
</tr>
<tr>
<td><strong>Federal tax</strong></td>
<td><strong>$15,000</strong></td>
</tr>
</tbody>
</table>

**KC 11-8**

[ITA: 123(1), 124(1), 123.4(2); Reg. 402 – Federal Abatement]

Since Easy Corp carries on business outside of Canada, the taxable income earned in Canada must be calculated before the federal abatement can be calculated. Foreign business income does not qualify for the federal abatement.

Taxable income earned in Canada is calculated in a prescribed manner as follows [Reg 402]:

\[
\frac{1}{2} \times (80\% + 60\%) \times 600,000
\]

\[
= 70\% \times 600,000 = 420,000
\]

Therefore $420,000 being 70% of taxable income is earned in Canada.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>ITA 123(1) Basic federal tax - $600,000 x 38%</td>
<td>$228,000</td>
</tr>
<tr>
<td>ITA 124(1) Federal abatement - $420,000 x 10%</td>
<td>(42,000)</td>
</tr>
<tr>
<td>ITA 123.4(2) General tax reduction - $600,000 x 13% (2012)</td>
<td>(78,000)</td>
</tr>
<tr>
<td><strong>Federal tax</strong></td>
<td><strong>$108,000</strong></td>
</tr>
</tbody>
</table>
Before determining the M&P deduction, it is necessary to derive the M&P profit in accordance with the prescribed rules.

Manufacturing capital (MC)
Manufacturing depreciable property $800,000 \times 10\% \times \frac{100}{85} = $94,118

Total capital (TC)
Total depreciable property $1,100,000 \times 10\% = $110,000

Manufacturing labour (ML) = $1,000,000 \times \frac{100}{75} = $1,333,333

Total labour (TL) = $2,200,000

Adjusted business income = $300,000 + $500,000 = $800,000

\[
\text{M&P profit} = \frac{\text{MC} \times \$94,118 + \text{ML} \times \$1,333,333 \times \$800,000}{\text{TC} \times \$110,000 + \text{TL} \times \$2,200,000} = \$494,355
\]

M&P deduction – 13\% \times \$494,355 = \$64,266

[ITA: 123(1), 124(1), 123.4(2), 125.1 – Corporate tax calculation]

\[
\begin{align*}
\text{ITA 123(1)} & \quad \text{Basic federal tax} - \$1,000,000 \times 38\% & = & \$380,000 \\
\text{ITA 124(1)} & \quad \text{Federal abatement} - \$1,000,000 \times 10\% & = & (100,000) \\
\text{ITA 125.1} & \quad \text{M&P deduction} \$300,000 \times 13\% (2012) & = & (39,000) \\
\text{ITA 123.4(2)} & \quad \text{General tax reduction} (\$1,000,000 - \$300,000) \times 13\% (2012) & = & (91,000) \\
\end{align*}
\]

\[
\text{Federal tax} = \$150,000
\]
Problems

PROBLEM ONE

[ITA: 111(1)(a), (b); 112(1); 123(1); 123.2; 124(1); 125.1(1); Reg. 402(3); Reg. 5200 – 5202]

U.P.I. Industries Ltd., a Canadian corporation, has recently been designated a public corporation. Its shares are traded on the Winnipeg Stock Exchange. Over the past year, the company has pursued an aggressive expansion policy. Sales personnel based at head office have travelled to North Dakota and Minnesota and have achieved moderate success in developing new customers in the United States. In addition, the company has opened a branch location in Alberta by establishing an office and manufacturing plant staffed by new Alberta personnel. The Alberta manufacturing plant is the company’s first venture into manufacturing.

Selected financial information for the company’s current fiscal period is presented below.

1.

<table>
<thead>
<tr>
<th></th>
<th>Head office</th>
<th>Alberta branch</th>
</tr>
</thead>
<tbody>
<tr>
<td>Canadian sales</td>
<td>$7,000,000</td>
<td>$1,300,000</td>
</tr>
<tr>
<td>Foreign sales</td>
<td>700,000</td>
<td>0</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>4,620,000</td>
<td>910,000</td>
</tr>
<tr>
<td>Salaries and wages</td>
<td>1,200,000</td>
<td>200,000</td>
</tr>
<tr>
<td>Profit from operations</td>
<td>1,200,000</td>
<td>10,000</td>
</tr>
<tr>
<td>Dividend income</td>
<td>80,000</td>
<td>0</td>
</tr>
<tr>
<td>Taxable capital gains</td>
<td>70,000</td>
<td>0</td>
</tr>
</tbody>
</table>

2. At the end of the previous year, the company had net capital losses of $90,000 and non-capital losses of $120,000 that were available for carry-forward.

3. The Alberta branch location includes a building and equipment. The company’s accountant is in the process of determining the corporation’s tax liability and indicates that the annualized cost of manufacturing capital employed in the Alberta branch is $200,000 and that the corporation’s total annualized cost of tangible property used amounts to $800,000. The accountant also indicates that the manufacturing labour in the Alberta branch amounts to $120,000. This amount has been calculated in accordance with the income tax rules for determining manufacturing labour.

4. The assumed provincial corporate income tax rate is 12% in Manitoba and 10% in Alberta. When organizing the Alberta expansion, management had considered establishing a separate corporation. They decided instead on the branch structure because of anticipated losses in the first year of expansion. As it turned out, the branch generated a small profit of $10,000. Management is now considering converting the branch into a separate subsidiary corporation. U.P.I. already owns two separate subsidiaries in Manitoba that account for the dividend income described earlier.

Required:

1. For the current year, determine U.P.I.’s
   (a) net income for tax purposes;
   (b) taxable income; and
   (c) federal and provincial tax liabilities.

2. How would the overall federal and provincial tax liabilities be different if the Alberta branch had been incorporated from the outset? Show calculations.
Solution to P 11-1

Part 1

(a) Net income for tax purposes:
   Profits from operations
   Head office $1,200,000
   Alberta branch 10,000
   1,210,000
   Dividend income 80,000
   Taxable capital gains 70,000
   Net income for tax purposes $1,360,000

(b) Taxable income:
   Net income for tax purposes $1,360,000
   Deduct:
   Net capital losses (limited to capital gains, above) [ITA 111(1)(b)] (70,000)
   Non-capital losses [ITA 111(1)(a)] (120,000)
   Dividends [ITA 112(1)] (80,000)
   Taxable income $1,090,000

(c) Federal and provincial taxes:

Before calculating the federal and provincial tax liability, it is necessary to separately determine the manufacturing and processing profits eligible for the federal M & P tax reduction [Reg. 5200 - 5202], and the allocation of business income to Manitoba and Alberta for the calculation of provincial tax [Reg. 402(3)].

Manufacturing profits - The formula for deriving the M & P profits is significantly more complex than described in Chapter 11. For example, manufacturing labour is grossed up by 100/75 and the annualized cost of manufacturing capital is based on 10% of the cost of depreciable property grossed up by 100/85. However, the problem provides information in point 3 which can be used directly in the formula (i.e., the gross-up has already been calculated). In addition, the formula is applied to total profits earned from an active business carried on in Canada. However, the student should recognize (from the discussions in Chapter 3) that direct sales to the U.S. do not constitute "carrying on business" in that country because the business is not conducted from a U.S. permanent establishment. The foreign direct sales are, therefore, a part of the Canadian resident corporation's Canadian business activity. The total profit from business is $1,210,000 ($1,200,000 + $10,000 in Alberta). Notice that this is the business profit included in net income before the calculation of taxable income. The M & P profits are $176,000 calculated as follows: [Reg.5200 – 5202]

\[
\text{MC + ML} \quad \frac{\text{MC + ML}}{\text{TC + TL}} \times 1,210,000
\]

\[
\frac{200,000 + 120,000}{800,000 + 1,400,000} \times 1,210,000 = 176,000
\]
Provincial allocation - Because the Alberta activity is conducted from a permanent establishment in that province, a portion of the taxable income is subject to Alberta provincial tax. The percentage of taxable income allocated to Alberta is 14.36% calculated as follows [Reg 402(3)]:

Sales in Alberta $1,300,000 = 14.44%
Total sales $9,000,000

Wages in Alberta $200,000 = 14.28%
Total wages $1,400,000

Average sales % and wages %

\[
\frac{14.44\% + 14.28\%}{2} = 14.36\%
\]

Taxable Income - Alberta:
$1,090,000 x 14.36% = $156,525

Taxable Income - Manitoba:
100% - 14.36% = 85.64% x $1,090,000 = 933,475

Total $1,090,000

The following tax calculation uses rates applicable to 2012. Provincial surtaxes and any provincial manufacturing incentives are ignored.

Federal:
Basic rate 38% x $1,090,000 [ITA 123(1)] $414,200
Abatement 10% x $1,090,000 [ITA 124(1)] (109,000) 305,200
M&P reduction: [ITA 125.1(1)] 13% of $176,000 (22,880)
General tax reduction – 13% ($1,090,000 - $176,000 M&P) [ITA 123.4] (118,820)

Federal Tax 163,500

Provincial
Manitoba 12%* x $933,475 112,017
Alberta 10%* x $156,525 15,653

Total Tax $291,170

* Actual provincial tax rates may be different.
Part 2

Operating the Alberta operation as a branch of the main corporation resulted in two tax benefits:

- The arbitrary provincial allocation formula caused $156,525 of taxable income to be taxed in Alberta at the lower provincial rate of 10% (versus 12% in Manitoba) when the actual Alberta profit was only $10,000. If a separate corporation had been used, total provincial taxes would increase because only $10,000 of the total taxable income of $1,090,000 would be taxed in Alberta.

Therefore, if the Alberta branch had been incorporated from the outset, the taxes for the year would have increased by $2,931 calculated as follows:

\[
\text{Provincial profits:}
\begin{align*}
\text{Branch} & \quad $156,525 \\
\text{Corporation} & \quad (10,000) \\
\hline
\text{Total} & \quad $146,525
\end{align*}
\]

\[
\text{Tax cost 12\% - 10\% = 2\% x $146,525 = $2,931}
\]

Note: Some provinces, such as Ontario, have a provincial manufacturing tax reduction.
PROBLEM TWO

[ITA: 80; 111(1)(a), (b); 123(1); 123.2; 123.4; 124(1); 125(1) ]

During the current taxation year, K2 Ltd., a Canadian-controlled private corporation located in Nova Scotia earned $160,000 of active business income. In addition, the company made the following capital transactions:

- Gain on sale of shares of a public corporation $48,000
- Loss on shares of a public corporation (12,000)
- Gain from settling a long-term debt of $300,000 for a reduced amount of $240,000 60,000

At the end of the previous taxation year, the following unused losses were available for carry-forward:

- Net capital losses $29,000
- Non-capital losses 42,000

Required:

For the current taxation year of K2 Ltd., calculate

(a) net income for income tax purposes;
(b) taxable income; and
(c) total federal income tax.
### Solution to P 11-2

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business income</td>
<td>$160,000</td>
</tr>
<tr>
<td>Taxable capital gain – ½ ($48,000)</td>
<td>$24,000</td>
</tr>
<tr>
<td>Allowable capital loss – 1/2 ($12,000)</td>
<td>(6,000)</td>
</tr>
<tr>
<td>Net income</td>
<td>178,000</td>
</tr>
<tr>
<td>Non-capital loss [ITA 111(1)(a)]</td>
<td>$42,000</td>
</tr>
<tr>
<td>less gain on settlement of debt (note 1)</td>
<td>(42,000)</td>
</tr>
<tr>
<td>Net capital loss  [ITA 111(1)(b)]</td>
<td>$29,000</td>
</tr>
<tr>
<td>Capital loss</td>
<td>58,000</td>
</tr>
<tr>
<td>less balance of gain on settlement of debt ($60,000-42,000)</td>
<td>(18,000)</td>
</tr>
<tr>
<td></td>
<td>40,000</td>
</tr>
<tr>
<td></td>
<td>x 1/2</td>
</tr>
<tr>
<td></td>
<td>20,000</td>
</tr>
<tr>
<td>Taxable income</td>
<td>$160,000</td>
</tr>
</tbody>
</table>

**Federal tax (2012):**

38% x $160,000  [ITA 123(1)]  $ 60,800

Abatement - 10% x $160,000  [ITA 124(1)]  (16,000)

Refundable tax on CCPC investment income [ITA 123.3]
6 2/3% x ($18,000 - $18,000)  0

Small business deduction:  [ITA 125(1)]
17% x $160,000 (note 3)  (27,200)

**Federal tax (note 4)**  $17,600

**NOTES:**

1) ITA 80(3) to 80(13) provide rules with respect to the gain on the settlement of debt. These sections must be applied to the forgiven amount in numerical order [ITA 80(2)(c)]. First, non-capital losses are reduced for the forgiven amount [ITA 80(3)]. If there remain a forgiven amount after the reduction for the non-capital losses, then capital losses are reduced by the forgiven amount [ITA 80(4)].

2) The reduction of the non-capital losses and capital losses is mandatory. If there remains a forgiven amount after the reduction of the non-capital losses and capital losses, then the rules provide that various other tax attributes (e.g. UCC, CEC, ACB of capital property) may be reduced by the forgiven amount, at the election of the taxpayer, through a series of designations [ITA 80(5) to 80(12)]. However, these sections must be applied in order and to the maximum extent possible. If there remains an unapplied balance of the forgiven amount, 50% of the balance of the forgiven amount would be included in income [ITA 80(13)].
3) Small business deduction: [ITA 125(1)]
   17% of the lesser of:
   a) Active business income - $160,000
   b) Taxable income less foreign source income - $160,000
   c) Business Limit - $500,000

4) The General tax reduction does not apply because all of the taxable income is subject to the small business deduction.
PROBLEM THREE

[ITA: 125(1), (2)]

Patrice Dupuis is the sole shareholder of Dupuis Distributors Ltd., a successful Canadian-controlled private corporation that wholesales automobile parts. The corporation’s profits are in excess of $550,000.

Inventory for the corporation’s business is stored in a warehouse owned by Dupuis. He acquired the building five years ago and began charging his corporation an annual rent of $20,000. At the time the building was acquired, the annual rent of $20,000 was considered realistic in terms of the real estate market at the time.

The lease is renewed annually on an informal basis, but the rental amount has never been adjusted, even though rental rates for similar properties have increased substantially. Dupuis has never considered a rental adjustment important because “it would just be transferring money from one pocket to the other.”

Both Dupuis and the corporation are located in Winnipeg, where there is little available warehouse space. A leasing agent recently informed Dupuis that the building could be rented to a third party under a five-year lease for $38,000 per year.

Required:

Should Dupuis enter into a five-year lease with Dupuis Distributors, charging an annual rent of $38,000? What tax savings could Dupuis and the company achieve as a result of this adjustment?
Solution to P 11-3

By not paying the higher rent of $38,000, the profits of Dupuis Distributors will be higher. These higher profits are subject to corporate taxes, and then are again subject to an additional tax when they are ultimately distributed to Patrice Dupuis as a dividend, or, if not distributed, subject to a tax on a capital gain when the shares are sold. Because the corporate profits are above the $500,000 small business deduction limit [ITA 125(2)], the corporate tax rate on some of the income is high and may result in some double taxation upon distribution.

On the other hand, if the rent is increased to the proper amount, corporate profits are reduced because the additional rent payment is deductible from its income. Although Patrice Dupuis will pay personal tax on the increased rent, the shifting of income from the corporation to himself will eliminate any incidence of double taxation.

To calculate the advantage of the increased rent, the corporate and personal tax rates must be assumed. These, of course, should be the tax rates applicable to the particular province and the year in question. The following tax rates are assumed for demonstration:

| Corporate rate on income above $500,000 | 25% |
| Personal rate | 45% |
| Personal rate on Eligible dividends (net of the dividend tax credit) | 28% |

If the rent is not increased by $18,000 ($38,000 - $20,000 = $18,000) corporate profits are higher and the resulting tax is as follows:

Immediate corporate tax:  
25% x $18,000  
$4,500

Future tax when income is distributed:
Profit  
$18,000
Less corporate tax  
(4,500)
Potential dividend  
$13,500

Personal tax: 28% x $13,500  
3,780

Total tax  
$8,280

Tax rate $8,280/$18,000  
46%

If the rent is increased, corporate profits are reduced by $18,000.

Immediate corporate tax  
$0
Immediate personal tax on rent $18,000 x 45%  
8,100
Total tax  
$8,100

Tax rate $8,100/$18,000  
45%
Increasing the rent to $38,000 from $20,000 will eliminate potential double taxable of $180 ($8,280 – $8,100) annually. Over five years, this amounts to $900 ($180 x 5). Keep in mind that the immediate taxes are higher when the rent is increased ($8,100 - $4,500 = $3,600).

A decision must be made as to whether or not the greater immediate tax that results from the higher rent is worth avoiding the double taxation at some future time. This depends on when the double taxation will occur. If the dividend (after-tax corporate earnings) will not be paid for a number of years, then the benefit of the 20% tax-deferral (personal 45% - corporate 25%) resulting from having the income taxed in the corporation outweighs the additional tax cost.

It should be noted that the potential double tax on business income over $500,000 can be avoided by increasing the salary or bonus of the shareholder/employee to the extent the amount is reasonable.
PROBLEM FOUR

[ITA: 121; 123(1); 123.2; 123.4; 124(1); 125(1); 125.1]

MX Wholesale Ltd. is a Canadian-controlled private corporation located in Ontario. The company regularly earns pre-tax profits of $600,000.

The common shares of MX are owned 50/50 by Mr. and Mrs. Waldman. Only Mrs. Waldman works for the business, and she is paid a substantial salary for her efforts. Mr. Waldman is a lawyer and earns a large income from his law firm. In addition, the Waldmans receive annual dividends from MX. The company has consistently maintained a policy of distributing half its after-tax profits to the shareholders.

The Waldmans are dismayed at the amount of tax both they and the corporation must pay when corporate profits are distributed. They have asked you to explain to them the tax effect of distributing the corporate profits. In addition, they intend to sell the shares of the company in the next two or three years and want you to explain what the effect would be if they stopped paying dividends from MX.

The assumed provincial income tax rate in Ontario is 11% for corporations. However, the corporate rate is reduced to 4.5% on income eligible for the small-business deduction. Both Waldmans have already used up their capital gain exemption. The marginal tax rate the Waldmans personally pay is 46% on regular income, 30% on Eligible dividends, and 33% on Non-eligible dividends.

Required:

1. What rate of tax are the Waldmans paying on the profits of MX that are distributed to them annually? Show calculations.

2. Should the Waldmans stop paying dividends? Your answer should indicate how their overall tax rate would be affected.
Solution to P 11-4

Part 1

Before determining the overall tax rate on corporate profits distributed to the shareholders, it is necessary to determine the applicable tax rates of the corporation and the shareholders in the province of Ontario.

Corporate tax rates:

<table>
<thead>
<tr>
<th>Income Subject to the SBD</th>
<th>Income Over $500,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporate income</td>
<td>$1,000</td>
</tr>
<tr>
<td>Corporate tax</td>
<td>(155)</td>
</tr>
<tr>
<td>Available for distribution</td>
<td>$ 845</td>
</tr>
<tr>
<td>Dividend income</td>
<td>$845</td>
</tr>
<tr>
<td>Personal tax – Eligible dividends (30%)</td>
<td>(222)</td>
</tr>
<tr>
<td>– Non-eligible dividends (33%)</td>
<td>(279)</td>
</tr>
<tr>
<td>Combined tax</td>
<td>$566</td>
</tr>
<tr>
<td>Corporation</td>
<td>$155</td>
</tr>
<tr>
<td>Individual</td>
<td>$260</td>
</tr>
</tbody>
</table>

Note: The General tax reduction of 13% does not apply as all income is either subject to the small business deduction [ITA 123.4].

The company's policy of distributing half of its after-tax profits as dividends means that a portion of the dividends originate from corporate income taxed at 26% and a portion from income taxed at 15.5% (the corporation's pre-tax profit is $600,000). The combined corporate and personal rate of tax on this income is calculated below for each category of corporate income.
Profits of MX in excess of $500,000 are subject to a total tax rate on distribution of 48.2% which is higher than the shareholders’ personal rate of 46%. However, income subject to the lower corporate rate has a combined tax of only 43.4% which is lower than the shareholders’ personal rate of tax.

Part 2

If the Waldmans cease paying dividends, in anticipation of the sale of the shares in the next two, or three years, the tax on the dividends will be avoided. However, the value of the shares will increase accordingly which will result in a higher capital gain when the shares are sold. As one-half of capital gains are taxable at full personal rates, the rate of tax applicable on the increased capital gains would be approximately 23% (1/2 of 46% = 23%). This is 10% lower than the rate of tax on non-eligible dividends (33%) and 7% lower than the rate of tax on eligible dividends (30%).

Therefore, capital gains are preferred to dividend distributions. As well, the tax on the capital gain is deferred until the shares are sold, whereas, if dividends are continued, the tax will occur annually on the dividend income.
PROBLEM FIVE

Hope Enterprises Ltd. is a Canadian-controlled private corporation that operates a jewellery manufacturing business in southwestern Ontario. The company was profitable for a number of years until a new competitive environment put the company in financial difficulty. For the past eight years, Hope Enterprises has suffered serious losses. Currently, it has unused non-capital losses of $650,000. Jean Talouse, the president and sole shareholder, has called a meeting of his senior staff to review the company’s operations for the year and to plan a survival strategy. The meeting begins with the accountant presenting the current year’s financial statements and a projection of operating results for the next three years. Part of this information is outlined in the tables on the next page.

The accountant reports the following additional information:

1. The company realized a gross profit of 20% on sales of $4,000,000, which is considerably lower than normal. However, all of the bad inventory has been cleaned out, and the current inventory can be sold to realize a 25% gross profit.

2. The accounts receivable represents a true evaluation of what can be collected. A reasonable reserve has been taken into account, and the credit policy has been adjusted to reduce the losses on future sales.

3. Both the bank loan and the loan from the shareholders are payable on demand and require interest payments of 9%. The bank is not uncomfortable with the current level of debt and has adequate security in the receivables and inventory.

4. To ensure that only a minor loss will result this year, expenses have been cut to the bone. The projections are that over the next three years, if conditions remain basically the same, the company will suffer minor losses or perhaps break even.

5. The $650,000 loss carry-forward for tax purposes is a cause for concern. Some of this loss was incurred eighteen years ago, and so there is a possibility that the company will not generate profits in time to meet the time limit for carry-forwards.

The president is pleased that the company has got the losses under control. He instructs the accountant to determine whether any action can be taken to minimize the risk of the losses expiring. Although he did not say so at the meeting, the president has decided to investigate the possibility of selling the company, as he feels that things may get worse in spite of the accountant’s projections.

Required:

1. What steps can be taken to ensure that the loss carry-forward of $650,000 will not expire before profits are generated? Be specific, and indicate the amount of losses that will be preserved by your actions.

2. What can the president do to maximize the value of the shares in the event that he actively solicits a buyer for the company?
### Balance Sheet

<table>
<thead>
<tr>
<th>Assets</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$20,000</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>$1,250,000</td>
</tr>
<tr>
<td>Allowance for doubtful accounts</td>
<td>$310,000</td>
</tr>
<tr>
<td>Inventory, at lower of cost or market</td>
<td>$750,000</td>
</tr>
<tr>
<td>Equipment, at cost</td>
<td>$400,000</td>
</tr>
<tr>
<td>Accumulated amortization</td>
<td>$150,000</td>
</tr>
<tr>
<td><strong>Total Assets</strong></td>
<td><strong>$1,860,000</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts payable</td>
<td>$699,000</td>
</tr>
<tr>
<td>Bank loan</td>
<td>$500,000</td>
</tr>
<tr>
<td>Due to shareholder</td>
<td>$400,000</td>
</tr>
<tr>
<td><strong>Total Liabilities</strong></td>
<td><strong>$1,599,000</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Shareholder’s equity</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Share capital</td>
<td>$1,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>260,000</td>
</tr>
<tr>
<td><strong>Total Shareholder’s equity</strong></td>
<td><strong>261,000</strong></td>
</tr>
</tbody>
</table>

| **Total Liabilities**        | **$1,860,000** |

### Statement of Income (Loss)

<table>
<thead>
<tr>
<th>Sales</th>
<th>$4,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of sales</td>
<td>3,200,000</td>
</tr>
<tr>
<td><strong>Gross profit</strong></td>
<td>800,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Expenses</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Selling and administrative salaries</td>
<td>$300,000</td>
</tr>
<tr>
<td>Shareholder’s salary</td>
<td>60,000</td>
</tr>
<tr>
<td>Delivery</td>
<td>50,000</td>
</tr>
<tr>
<td>Rent</td>
<td>79,000</td>
</tr>
<tr>
<td>Utilities</td>
<td>12,000</td>
</tr>
<tr>
<td>Amortization (equal to CCA)</td>
<td>40,000</td>
</tr>
<tr>
<td>Insurance</td>
<td>9,000</td>
</tr>
<tr>
<td>Legal and accounting</td>
<td>12,000</td>
</tr>
<tr>
<td>Interest</td>
<td>108,000</td>
</tr>
<tr>
<td>Other expenses (including bad debts, office, repairs)</td>
<td>160,000</td>
</tr>
<tr>
<td><strong>Net loss for the year</strong></td>
<td>$(30,000)</td>
</tr>
</tbody>
</table>
Solution to P 11-5

Part 1

In order to reduce the risk of the $650,000 loss carry-forward from expiring, the company can take a number of discretionary steps that will increase income currently in exchange for deductions at a later time. This action will reduce the loss carry-forward but preserve the discretionary items to reduce income at some future time. Some of or all of the following can be done:

(a) **Capital cost allowance:**
CCA is discretionary and if it is not claimed in the current year, the UCC of the class will be higher allowing greater CCA to be claimed in future years. Based on the current year's financial statement, this could increase income by $40,000.

(b) **Salary to owner:**
The sole shareholder of the company receives a salary of $60,000. By not paying this salary to the owner, income can increase by $60,000 annually. This step will also reduce the tax payable by the shareholder. If the shareholder needs funds for personal living expenses, the corporation can repay a portion of the shareholder's loan of $400,000 which results in no tax to the shareholder. The amount of the annual shareholder debt repayment required (to meet the owner's personal needs) is equal to the after-tax salary previously received, which is considerably less than $60,000. As less cash is being paid out of the company, its financial strength is enhanced.

(c) **Allowance for Doubtful Accounts:**
The company has claimed a reserve of $310,000 for doubtful accounts receivable. Deducting this reserve is discretionary. The current year's reserve is first added to next year's income and a new reserve is claimed. If no reserve is claimed next year, income will increase by $310,000. A new reserve can be deducted in any future year provided that it is reasonable.

(d) **Interest on shareholder's loan:**
The amount owing to the shareholder bears interest at 9% which reduces the corporate income and increases the shareholder's taxable income. This amounts to $36,000 annually ($400,000 x 9%). If the demand loan is renegotiated without interest, corporate income will increase and the shareholder's personal tax cost will decrease. If the shareholder needs the funds for personal reasons, annual repayments of the loan can be made similar to the salary adjustment above.

If the current year's tax return has not been filed, some of the above items can be implemented in the current year. The potential adjustments total $446,000 as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>CCA</td>
<td>$40,000</td>
</tr>
<tr>
<td>Salary to owner</td>
<td>60,000</td>
</tr>
<tr>
<td>Reserve for bad debts</td>
<td>310,000</td>
</tr>
<tr>
<td>Interest on shareholder loan</td>
<td>36,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$446,000</strong></td>
</tr>
</tbody>
</table>

Therefore, the potential adjustments are sufficient to use up a large portion of the loss carry-over of $650,000 and preserve the deductions for future years.
Part 2

The sale of shares of the corporation will result in a corporate change of control. If the loss carry-over of $650,000 exists at that time, its use will become restricted. The loss can then be deducted only against profits from the company's jewelry manufacturing business or a similar business. Therefore, the unused losses are more valuable to a purchaser corporation that is already in a similar line of business.

Such a purchaser could take steps to combine their profitable similar operations with the acquired losses of Hope Enterprises Ltd. Therefore, the president should seek out such buyers as they would be prepared to pay a higher price for the shares because of their special ability to generate tax savings from the acquired loss carry-over.
PROBLEM SIX

[ITA: ITA 125.1(1); Reg. 5200 - 5202]

Norex Distributors Inc. is a small Canadian public corporation that derives all of its business income from the wholesale distribution of floor coverings. Currently, Norex does not manufacture any of its products and purchases all of its inventory from manufacturers in eastern Canada. Norex has decided to acquire a small manufacturing plant in Saskatchewan. The following assets will be acquired:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>$80,000</td>
</tr>
<tr>
<td>Building</td>
<td>300,000</td>
</tr>
<tr>
<td>Manufacturing equipment</td>
<td>600,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>50,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$1,030,000</strong></td>
</tr>
</tbody>
</table>

The planned acquisition date is July 1, 20X1, the day after the year-end of Norex. The company’s vice-president realizes that the manufacturing business can be purchased and operated through a newly created subsidiary corporation and that the subsidiary’s manufacturing profit of $240,000 (see below) can result in a federal manufacturing and processing deduction of $31,200 at the most. The province of Saskatchewan also offers a 2% rate reduction on manufacturing income.

As an alternative, Norex can purchase the assets and operate the manufacturing business as a division. The vice-president has asked you to determine, from a tax perspective, whether this alternative is preferable to the other. Norex has provided you with estimated results for the first year of operations after the acquisition (i.e., year ended June 30, 20X2). These results are summarized below.

Information relating to new manufacturing plant

1. Manufacturing activities take up 80% of the building’s space. The remaining space is used for storing finished products and for administrative offices.

2. Estimated net income for tax purposes is $240,000, after appropriate deductions for capital cost allowance, eligible capital property, and the following:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct labour</td>
<td>$320,000</td>
</tr>
<tr>
<td>Utilities</td>
<td>14,000</td>
</tr>
<tr>
<td>Property taxes</td>
<td>4,000</td>
</tr>
<tr>
<td>Raw materials</td>
<td>610,000</td>
</tr>
<tr>
<td>Administrative and office salaries allocated From Norex (see below)</td>
<td>80,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$1,028,000</strong></td>
</tr>
</tbody>
</table>
Information relating to Norex
(excluding new manufacturing plant)

1. Estimated net income for tax purposes is $4,730,000, including:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest income on long-term bonds</td>
<td>$130,000</td>
</tr>
<tr>
<td>Administrative salaries</td>
<td>630,000</td>
</tr>
<tr>
<td>Warehouse and sales salaries</td>
<td>340,000</td>
</tr>
<tr>
<td>Salaries allocated to new plant</td>
<td>80,000</td>
</tr>
<tr>
<td>Rent for fleet of delivery trucks</td>
<td>80,000</td>
</tr>
<tr>
<td>Total</td>
<td>970,000</td>
</tr>
</tbody>
</table>

2. In estimating the net income of $4,730,000, an appropriate deduction for CCA was made on the following properties:

<table>
<thead>
<tr>
<th>Class</th>
<th>Original cost of assets in class</th>
<th>UCC (after CCA)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Class 1</td>
<td>$1,340,000</td>
<td>$965,000</td>
</tr>
<tr>
<td>Class 8</td>
<td>190,000</td>
<td>75,000</td>
</tr>
<tr>
<td>Class 10</td>
<td>360,000</td>
<td>190,000</td>
</tr>
<tr>
<td></td>
<td>$1,890,000</td>
<td>$1,230,000</td>
</tr>
</tbody>
</table>

**Required:**

Should Norex operate the proposed new manufacturing operation as a separate subsidiary corporation or as a division? Provide calculations to support your answer.
Solution to P 11-6

In computing federal tax for a public corporation there is no tax benefit to be obtained by claiming the M&P deduction (13% in 2012) since other income receives the general tax reduction (13% in 2012). However, there is a provincial benefit in some provinces.

If the manufacturing business is operated as a division of NDI the M & P profits will be $1,542,375 as follows: [Reg. 5200 – 5202]

Business profits:
Manufacturing operations $ 240,000
NDI existing operations 4,730,000
4,970,000
Less interest on bonds ( 130,000)
Adjusted business income $4,840,000

Manufacturing capital (MC)
Cost of depreciable manufacturing property
Building (80% x $300,000) $240,000
Manufacturing equipment 600,000
$840,000

MC - $840,000 x 10% x 100/85 $98,824

Total capital (TC)
Owned assets:
Building acquired $ 300,000
Manufacturing equipment 600,000
Cost of NDI's existing depreciable assets 1,890,000
Leased assets - rent of trucks 80,000

TC - ($2,790,000 x 10%) + $80,000 $ 359,000

Manufacturing labour (ML)
Direct labour $320,000
ML - $320,000 x 100/75 $426,667

Total labour (TL)
Direct labour - manufacturing $ 320,000
Administrative salaries 630,000
Warehouse and sales salaries 340,000
TL $1,290,000

M & P Profits: MC + ML -------------- x ABI TC + TL
$98,824 + $426,667 ------------------ x $4,840,000 = $1,542,375
$359,000 + 1,290,000

The Saskatchewan provincial tax reduction – 2% x $1,542,375 = $30,848

If the manufacturing plant is structured as a separate corporation the maximum M & P profits could not exceed $240,000 (the profits for the corporation). The maximum Saskatchewan tax reduction would be $4,800 (2% x $240,000). Therefore, the division structure increases the provincial M&P tax reduction by $26,048 ($30,848 - $4,800). Assuming profit levels are maintained, this is an annual amount.
**PROBLEM SEVEN**

[ITA: 88(1.1); 111(1)(a); 111(4); 111(5)]

Global Inc., an international cosmetics wholesaler, has a history of substantial profits. It is now October 1, 20X6. For its current year ending December 31, 20X6, it projects pretax profit of $7,000,000.

Frost Foods Inc. is a distributor of frozen Canadian beef. Frost Foods Inc. was profitable until 20X0. Large losses were incurred in years 20X0 through 20X3. Since then, it has managed to break even. At the beginning of its current taxation year, Frost Foods Inc. had the following unused losses:

<table>
<thead>
<tr>
<th>Incurred in its year ended Dec. 31, 20X3</th>
<th>Non-capital</th>
<th>Net capital</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$300,000</td>
<td>$75,000</td>
</tr>
<tr>
<td>Incurred in its year ended Dec. 31, 20X4</td>
<td>$500,000</td>
<td></td>
</tr>
</tbody>
</table>

Global Inc. plans to purchase all of the issued shares of Frost Foods Inc. on November 1, 20X6 and immediately amalgamate Frost Foods Inc. and Global Inc. into one corporation. The plan is to reduce Global Inc.’s taxable income for 20X6 by $875,000 by deducting the losses incurred by Frost Foods Inc. Global Inc. and Frost Foods Inc. are unrelated Canadian corporations.

**Required:**

Comment on Global Inc.’s ability to utilize the Frost Foods Inc. losses.
Solution to P 11-7

Comments on Global Inc.'s ability to utilize the Frost Foods Inc. losses:

- An acquisition of control occurs when Global Inc. acquires the shares of Frost Foods Inc. on November 1, 20X6.
  - Frost Foods Inc. is deemed to have a year-end immediately before the acquisition of control takes place (October 31, 20X6).
  - The $75,000 net capital loss expires on the acquisition of control and, thus, is not available after October 31, 20X6[ITA 111(4)(a)].
  - The unexpired non-capital losses are deductible after October 31, 20X6 only if the distribution of frozen Canadian beef (the loss business) is carried on throughout the year the deduction is claimed at a profit or with a reasonable expectation of profit [ITA 111(5)].
  - If these conditions are met, the non-capital losses may be deducted to the extent there is income from the frozen Canadian beef business and/or from a business selling similar products or providing similar services.
  - Wholesaling cosmetics is not similar to distributing frozen Canadian beef. Thus, the unexpired non-capital losses will be deductible after October 31, 20X6 only to the extent there is income from the frozen beef distribution business.

- Global Inc. and Frost Foods Inc are deemed to have a taxation year-end immediately before the amalgamation (October 31, 20X6). The losses are available immediately to the new corporation formed on the amalgamation. The losses continue to be subject to the restrictions discussed above. [Note that the tax implications of an amalgamation will be discussed later in the course. The information has been included here so that the solution is complete.]

- The non-capital losses were incurred in 20X0 through 20X3. There are a limited number of years that these losses can be carried forward before they expire. Non-capital losses incurred in taxation years ending before March 23, 2004 are limited to a 7-year carry forward. Those incurred in taxation years ending between March 24, 2004 and December 31, 2005 are limited to a 10-year carry forward. Non-capital losses incurred in taxation years ending after 2005 have a 20-year carry forward.
PROBLEM EIGHT

[ITA: 88(1.1); 111(4)(a), (e); 111(5), (5.1); 249(4)]

On September 1, 20X6 Perfect Ltd., a steel recycling company, purchased 90% of the issued voting shares of Loser Ltd., a distributor of sportswear, from an arm’s length person. Loser Ltd. had incurred the following losses in prior years:

<table>
<thead>
<tr>
<th>Year ended</th>
<th>Dec 31/X4</th>
<th>Dec 31/X5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-capital losses (business)</td>
<td>$40,000</td>
<td>$60,000</td>
</tr>
<tr>
<td>Net capital losses (100%)</td>
<td>15,000</td>
<td>5,000</td>
</tr>
</tbody>
</table>

Loser Ltd. incurred an additional loss of $75,000 in carrying on the sportswear distribution business for the period January 1, 20X6 through August 31, 20X6. No further capital losses were incurred.

On September 1, 20X6, Loser Ltd.’s assets had the following values:

<table>
<thead>
<tr>
<th>Asset</th>
<th>Cost</th>
<th>UCC</th>
<th>Fair Market Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Marketable securities*</td>
<td>$50,000</td>
<td>N/A</td>
<td>$300,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>33,000</td>
<td>N/A</td>
<td>45,000</td>
</tr>
<tr>
<td>Land</td>
<td>90,000</td>
<td>N/A</td>
<td>200,000</td>
</tr>
<tr>
<td>Building</td>
<td>120,000</td>
<td>$83,000</td>
<td>180,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>85,000</td>
<td>34,000</td>
<td>20,000</td>
</tr>
</tbody>
</table>

* Perfect Ltd. planned to sell the marketable securities as soon as possible after purchasing Loser Ltd.

The amalgamation of Loser Ltd. and Perfect Ltd. took place on September 1, 20X6. The corporation formed on the amalgamation chose December 31 as its year end. Income for 20X6 and 20X7 was as follows:

<table>
<thead>
<tr>
<th></th>
<th>Income from Steel recycling</th>
<th>Income from Sportswear distribution</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X6</td>
<td>$500,000</td>
<td>$30,000*</td>
<td>$530,000</td>
</tr>
<tr>
<td>20X7</td>
<td>400,000</td>
<td>60,000</td>
<td>460,000</td>
</tr>
</tbody>
</table>

* Income for the period September 1 through December 31, 20X6
Required:

1. Using the assumption that Loser Ltd. does NOT use any elections to minimize the unused net capital loss balance, calculate the amount of non-capital and net capital losses that would remain after the acquisition of the shares by Perfect Ltd. on September 1, 20X6.

2. If Loser Ltd. makes the election(s) necessary to utilize those losses which would expire at the acquisition of control, indicate the asset(s) on which the election should be made and the amount that should be elected.

3. Indicate the September 1, 20X6 adjusted cost base (ACB) and undepreciated capital cost (UCC), where applicable, for each of the assets listed, assuming the election(s) in part B is made.

4. What conditions must be met in order to deduct the non-capital loss balance at September 1, 20X6 in a future taxation year? Are these conditions are met? Indicate the maximum amount of non-capital loss carry forward that can be used at December 31, 20X6 and December 31, 20X7 respectively. Give a brief explanation for your answer.
Solution to P 11-8

Part 1

The non-capital loss balance after Perfect Ltd. acquired the shares of Loser Ltd. on September 1, 20X6 is as follows:

<table>
<thead>
<tr>
<th>Date</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>December 31, 20X4</td>
<td>$ 40,000</td>
</tr>
<tr>
<td>December 31, 20X5</td>
<td>$ 60,000</td>
</tr>
<tr>
<td>August 31, 20X6:</td>
<td></td>
</tr>
<tr>
<td>Business loss (given)</td>
<td>$75,000</td>
</tr>
<tr>
<td>Deemed CCA on equipment [ITA 111(5.1)]</td>
<td>$14,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$189,000</strong></td>
</tr>
</tbody>
</table>

Loser Ltd. is deemed to have a year-end immediately before control was acquired by Perfect Ltd. [ITA 249(4)]. Since the fair market value of the equipment ($20,000) is lower than the UCC of the Class ($34,000), the UCC is reduced to $20,000 and the $14,000 deduction is deemed to have been claimed as CCA in the deemed year end [ITA 111(5.1)].

The net capital loss balance at September 1, 20X6 is Nil. Net capital losses expire on the acquisition of control [ITA 111(4)(a)].

Part 2

Net capital losses of $20,000 expire on the acquisition of control. To utilize this loss Loser needs to elect to recognize a gain of $40,000 [ITA 111(4)(e)]. Loser could elect to recognize the gain on the marketable securities, the land, or the building. If the election is made on the building recapture will result which will reduce the August 31, 20X6 non-capital loss. This is not desirable if the non-capital losses can be used in the future. An election on the marketable securities is preferred over the land since the marketable securities are to be sold soon.

Loser Ltd. should elect a deemed disposal of the marketable securities for proceeds of $90,000. This results in a $40,000 capital gain ($20,000 taxable capital gain) which can be fully offset by the net capital losses which will otherwise expire. The election will increase the ACB of the marketable securities to $90,000. This is beneficial since the sale of the marketable securities is imminent.

Calculation of non-capital loss for August 31, 20X6 year end, assuming election to recognize a capital gain on the marketable securities is made:

| ITA 3(a) | Income (Business & Property) | $0 |
| 3(b) | Taxable capital gain (elected) | $20,000 |
| | Allowable capital loss | (0) |
| | Total | 20,000 |
| 3(c) | Other deductions | 0 |
| 3(d) | Business loss (calculated above) | (89,000) |
| | Net income * | (69,000) |
| | Net capital loss (limited to taxable capital gains) | (20,000) |
| | Non-capital loss | (89,000) |
Part 3

The adjusted cost base and undepreciated capital cost of the applicable assets after the ITA 111(4)(e) election at September 1, 20X6 is as follows:

<table>
<thead>
<tr>
<th></th>
<th>ACB</th>
<th>UCC</th>
</tr>
</thead>
<tbody>
<tr>
<td>Marketable securities</td>
<td>$ 90,000</td>
<td>N/A</td>
</tr>
<tr>
<td>Land</td>
<td>$ 90,000</td>
<td>N/A</td>
</tr>
<tr>
<td>Building</td>
<td>$120,000</td>
<td>$83,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>$ 85,000</td>
<td>$20,000</td>
</tr>
</tbody>
</table>

Part 4

In order to deduct the non-capital losses, the sportswear distribution business, which incurred the losses, must be carried on throughout the taxation year at a profit or with a reasonable expectation of profit [ITA 111(5)].

These conditions are met in 20X6 and 20X7. The sportswear distribution business is carried on at a profit throughout both of these years.

The non-capital losses can be deducted to the extent there is income from the business that incurred the losses or income from a business selling similar products or providing similar services as the sportswear distribution business [ITA 111(5)]. In this case there are no similar businesses being carried on. Non-capital losses of $30,000 and $60,000 can be deducted in 20X6 and 20X7, respectively.
PROBLEM NINE

Michael purchased 100% of the issued shares of Sentry Inc., a Canadian-controlled private corporation, which owns and operates an assisted-living retirement home in Ontario. Sentry has a December 31, fiscal year end. The transaction closed on October 1, 20X4. At that time, the values of certain assets owned by Sentry were as follows:

<table>
<thead>
<tr>
<th></th>
<th>Cost</th>
<th>UCC/CEC</th>
<th>FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>$120,000</td>
<td>N/A</td>
<td>$300,000</td>
</tr>
<tr>
<td>Building</td>
<td>240,000</td>
<td>$90,000</td>
<td>290,000</td>
</tr>
<tr>
<td>Furniture and fixtures</td>
<td>100,000</td>
<td>65,000</td>
<td>50,000</td>
</tr>
<tr>
<td>Computer equipment</td>
<td>12,000</td>
<td>6,000</td>
<td>8,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>55,000</td>
<td>N/A</td>
<td>52,000</td>
</tr>
<tr>
<td>Marketable securities</td>
<td>24,000</td>
<td>N/A</td>
<td>10,000</td>
</tr>
<tr>
<td>Incorporation/organization costs</td>
<td>10,000</td>
<td>1,000</td>
<td>500</td>
</tr>
</tbody>
</table>

Michael selected December 31, 20X4 as the first fiscal year-end for Sentry after his purchase. The following is a schedule of Sentry's income and unused losses for the period January 1, 20X3 through December 31, 20X5.

<table>
<thead>
<tr>
<th></th>
<th>Business Income (loss)</th>
<th>Taxable Capital gain</th>
<th>Net capital loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 20X3 – December 31, 20X3</td>
<td>($100,000)</td>
<td>$ nil</td>
<td>($22,000)</td>
</tr>
<tr>
<td>January 1, 20X4 – September 30, 20X4</td>
<td>(200,000)</td>
<td>Nil</td>
<td>Nil</td>
</tr>
<tr>
<td>October 1, 20X4 – December 31, 20X4</td>
<td>(70,000)</td>
<td>Nil</td>
<td>Nil</td>
</tr>
<tr>
<td>January 1, 20X5 – December 31, 20X5</td>
<td>40,000</td>
<td>10,000</td>
<td>Nil</td>
</tr>
</tbody>
</table>

Required:

1. Assuming Sentry does not make an election to recognize accrued gains or recapture under paragraph 111(4)(e) of the Income Tax Act,
   a. Calculate the business loss for tax purposes for the period January 1, 20X4 through September 30, 20X4.
   b. State the tax value (e.g., ACB, UCC, or CEC) for each of the assets at October 1, 20X4.
   c. What conditions must be met in order for the non-capital losses incurred in the period January 1, 20X3 through December 31, 20X4 to be deductible by Sentry in 20X5 and future taxation years?
   d. What is the maximum amount of non-capital losses that can be deducted for the year ended December 31, 20X5? Explain.
   e. What is the maximum amount of net capital losses that can be claimed for the year ended December 31, 20X5? Explain.
2. Assume Michael expects to be able to use Sentry’s losses by amalgamating Sentry with another corporation that he owns. Should Sentry make an election (ITA 111(4)(e)) to recognize capital gains and recapture at September 30, 20X4? Explain, including the benefit, if any, to Sentry of making such an election. Show all calculations.

3. Michael is the sole shareholder of two other corporations, M Ltd. which operates a food distribution business (annual profits $600,000) and R Ltd. which operates a retirement home (annual profits $200,000). Both corporations are located in Ontario. Which one of these two corporations should be amalgamated with Sentry in order to save income tax? Explain.
Solution to P 11-9

Part 1

(a) Business loss (given) $200,000
Supplies inventory decline in value  3,000
Deemed CCA on furniture & equipment  15,000
Deemed CECA on organization costs  625
Business loss for tax purposes $218,625

(b) Tax Value

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land (ACB)</td>
<td>$120,000</td>
</tr>
<tr>
<td>Building (UCC)</td>
<td>90,000</td>
</tr>
<tr>
<td>Furniture and equipment (UCC)</td>
<td>50,000</td>
</tr>
<tr>
<td>Computer equipment (UCC)</td>
<td>6,000</td>
</tr>
<tr>
<td>Supplies inventory (Cost)</td>
<td>52,000</td>
</tr>
<tr>
<td>Marketable securities (ACB)</td>
<td>10,000</td>
</tr>
<tr>
<td>Incorporation &amp; organization costs (CEC)</td>
<td>375</td>
</tr>
</tbody>
</table>

(c) The non-capital loss balance at December 31, 20X4 is $388,625 ($100,000 + $218,625 + $70,000). In order for the $100,000 non-capital loss incurred in 20X3 and the $218,625 non-capital loss incurred in the period ended September 30, 20X4 to be deductible in 20X5 and future years (subject to the 20-year carry-forward limit), the business in which the losses were incurred, the retirement home, must be carried on throughout 20X5 or any future year in which the losses are to be deducted, at a profit or with a reasonable expectation of profit.

The $70,000 non-capital loss for the period ended December 31, 20X4 was incurred after the acquisition of control and, therefore, can be deducted in 20X5 or any future year, without any restrictions.

(d) The maximum non-capital loss claim in 20X5 is $50,000. The non-capital loss claim is limited to the amount required to reduce taxable income for the year to Nil. In addition, since there has been an acquisition of control, there is an added restriction. The non-capital losses incurred prior to October 1, 20X4 are deductible against income from the retirement home business and against income from a business selling similar products or providing similar services. In this case there is no such similar business. Thus, only $40,000 of these losses can be deducted. The additional $10,000 deduction is from the non-capital loss incurred in the period ended December 31, 20X4. This loss is not subject to the restriction as it was incurred after the acquisition of control.

(e) Nil. The net capital losses incurred in 20X3, prior to the acquisition of control, cannot be used after the acquisition of control, October 1, 20X4. The net capital loss balance expires when Michael acquires control of Sentry Inc.
Part 2

Sentry should make an election under paragraph 111(4)(e) of the *Income Tax Act*. The election is beneficial, provided the amount of income created by the election is limited to the amount of losses that are otherwise expiring on September 30, 20X4.

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Net capital loss from 20X3</td>
<td>$22,000</td>
</tr>
<tr>
<td>Allowable capital loss on Marketable securities recognized on September 30, 20X4</td>
<td>7,000</td>
</tr>
<tr>
<td>Total losses expiring on September 30, 20X4</td>
<td><strong>$29,000</strong></td>
</tr>
</tbody>
</table>

Sentry should elect to recognize a taxable capital gain of $29,000 ($58,000 capital gain).

The land, the building, and the computer equipment are eligible assets for the election. However, an election on the computer equipment will result in recapture of $2,000 and no capital gains. An election on the building will result in recapture of $150,000 in addition to the desired capital gain. Since recapture will reduce the 20X4 business loss, it is not beneficial to elect on either of these assets. Thus, the election should be made on the land only. The elected proceeds should be $178,000 (cost $120,000 + $58,000). This results in the desired taxable capital gain of $29,000 and enables Sentry to deduct the $29,000 of losses that would otherwise expire. The benefit to Sentry is that the ACB of the land is increased by $58,000 to $178,000 and, thus, tax will be saved on a sale of the land in the future.

Part 3

R Ltd. should be amalgamated with Sentry. Since R Ltd. is carrying on a business which provides services similar to those provided by the business carried on by Sentry, the non-capital losses of Sentry will be deductible against the income earned from the retirement home business of R Ltd. Since the retirement home business earns annual income of $200,000, the remaining non-capital losses of Sentry, $338,625 ($388,628 - $50,000 used in 20X5) will be used within two years and result in tax savings of approximately $84,656 ($338,625 x 25%).

Amalgamating Sentry with M Ltd. will not provide the same tax savings since the losses cannot be deducted against the income earned from the food distribution business.
CASE

National Industries Ltd.

[ITA: 112(1); 55(2)]

National Industries Ltd. is a Canadian venture corporation that holds investments in several industries. The company owns shares in a number of active business corporations in both Canada and the United States. Its income consists of dividends and management fees from the subsidiaries.

Charles Prokopchuk is a vice-president of National and is responsible for acquiring companies in the transportation industry. Currently, National owns three subsidiary corporations in this industry. Prokopchuk monitors their progress and provides head office management services.

Three months ago, Prokopchuk sought a buyer for and negotiated the sale of Tri-Lon Transport Ltd. The shares of Tri-Lon were sold for $14,000,000. He is extremely pleased with the sale because he was instrumental in acquiring the shares of Tri-Lon seven years earlier for a price of $2,000,000. At that time, Tri-Lon was in its early growth stages; Prokopchuk is happy that he recognized the company’s potential so early on. After acquiring Tri-Lon, Prokopchuk had hired new managers, streamlined the operations, and focused expansion in the areas where the company was strong. Profits grew rapidly, so that by the time the shares were sold, Tri-Lon had retained earnings of $8,000,000.

The president of National Industries congratulates Prokopchuk for a job well done and indicates that the cash generated from the sale of Tri-Lon shares was vital, as the company is facing the termination date of one of its major bond issues. However, even after receiving the additional cash from the Tri-Lon sale, National will still have to restructure its debt and obtain new long-term financing. The president has indicated that it is critical for the company to get a high rating on its bonds in order to secure the lowest possible interest costs. He informs Prokopchuk:

“Our success with Tri-Lon will make a big impact on our bottom line and earnings per share for the current year. Stock prices should improve and our proposed new bond issue will be better accepted in the market. You have carried out your responsibilities perfectly.”

Historically, the shares of National Industries have traded on the Toronto Stock Exchange at a price equivalent to 12 times after-tax earnings. The company has 8,000,000 shares outstanding, and the president is certain that the share price will be $60 after the current year’s earnings have been released.

Required:

Do you agree with the president’s assessment of Prokopchuk’s success? Explain.
CASE SOLUTION

National Industries Ltd.

Assuming that the corporate tax rate for National Industries Ltd. is 25%, the after tax profit on the sale of shares amounted to $10,500,000 as follows:

<table>
<thead>
<tr>
<th>Proceeds from Tri-Lon shares</th>
<th>$14,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of shares</td>
<td>(2,000,000)</td>
</tr>
<tr>
<td>Pre-tax profit</td>
<td>12,000,000</td>
</tr>
<tr>
<td>Less tax on capital gain:</td>
<td></td>
</tr>
<tr>
<td>1/2 of $12,000,000 = $6,000,000 x 25%</td>
<td>(1,500,000)</td>
</tr>
<tr>
<td>After-tax profit</td>
<td>$10,500,000</td>
</tr>
</tbody>
</table>

A large portion of the value of Tri-Lon's shares was the result of its retained earnings of $8,000,000. Because Tri-Lon was a wholly-owned subsidiary of National Industries a portion of the share value could have been realized from a dividend distribution which would flow tax-free to National Industries. For example, if, just prior to the sale, Tri-Lon paid a tax-free dividend of $8,000,000 (the full amount of its retained earnings), the value of the shares would have decreased to $6,000,000 ($14,000,000 - $8,000,000). Consequently, the tax on the share sale would have decreased from $1,500,000 to $500,000 as follows:

<table>
<thead>
<tr>
<th>Proceeds from share sale</th>
<th>$6,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less cost</td>
<td>(2,000,000)</td>
</tr>
<tr>
<td>Capital gain</td>
<td>$4,000,000</td>
</tr>
<tr>
<td>Tax on sale:</td>
<td></td>
</tr>
<tr>
<td>1/2 of $4,000,000 = $2,000,000 x 25%</td>
<td>$500,000</td>
</tr>
</tbody>
</table>

The after-tax profits would then have been $11,500,000 instead of $10,500,000 as follows:

<table>
<thead>
<tr>
<th>Income:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividends</td>
<td>$8,000,000</td>
</tr>
<tr>
<td>Gains on sale of shares</td>
<td>4,000,000</td>
</tr>
<tr>
<td>Pre-tax profit</td>
<td>$12,000,000</td>
</tr>
<tr>
<td>Less tax on sale (above)</td>
<td>500,000</td>
</tr>
<tr>
<td></td>
<td>$11,500,000</td>
</tr>
</tbody>
</table>

Therefore, National Industries realized $1,000,000 ($11,500,000 - $10,500,000) less than it could have because the dividend option was not used. It should be pointed out that Tri-Lon could have paid the $8,000,000 dividend even if it did not have sufficient cash resources to do so. By agreement with the purchaser, the dividend could have been paid by issuing a note payable to National Industries. Immediately after the share sale for $6,000,000, the purchase would contribute an additional $8,000,000 to the acquired company which would be used to repay the amount payable to National Industries. Thus, the purchaser has a cost of $14,000,000 (as before) by way of a $6,000,000 share purchase and an $8,000,000 contribution to Tri-Lon.

The additional $1,000,000 of cash profit to National Industries would help the proposed bond issue in two ways. The additional cash could reduce the amount of the required bond issue. Also, the increased reported profit may increase the share value. As there are 8,000,000 shares outstanding,
earnings per share would increase by an additional 12.5 cents per share ($1,000,000/8,000,000). As stock prices normally trade at 12 times earnings, the stock value may increase by a further $1.50 (12 x 12.5 cents). This represents a 2.5% increase in the current stock value ($1.50/60.00 = 2.5%). The higher stock price, in turn, may ensure a high rating on the proposed bond issue which will minimize future financing costs.

Based on the above, it appears that the president's assessment of Charles' success was incorrect.

Note: The extent of the tax-free dividends paid to a corporate shareholder as part of a series of steps to dispose of the shares may be restricted by section 55 of the Income Tax Act. Normally, the tax-free dividend permitted is equal to the owner's share of "safe earnings" which in most cases approximates the corporation's retained earnings. Notice that in the above solution, the dividend paid prior to the sale was equivalent to the owner's share of retained earnings at the time (100%).
CHAPTER 12

ORGANIZATION, CAPITAL STRUCTURES, AND INCOME DISTRIBUTIONS OF CORPORATIONS

Review Questions

1. “To function, a corporation must have some capital contributed by its shareholders. When capitalizing a corporation, the shareholder must provide only share capital.” Is this statement true? Explain.

2. Why is it that a corporate debt owed to a shareholder may be considered as part of the shareholder’s equity of the corporation? How is a shareholder’s loan treated for tax purposes?

3. “When a corporation is partly capitalized with shareholder debt, the amount of corporate income that may be subject to double taxation is reduced.” Explain. Does it matter whether the shareholder debt pays interest or not?

4. If a corporation that is in financial difficulty has been capitalized with shareholder debt and a small amount of share capital as opposed to the reverse, the shareholder may be at less financial risk and the corporation may have a better chance of surviving. Why is this so?

5. A corporation owned solely by shareholder A has a value of $100,000. Individual B intends to acquire a 50% equity interest in the corporation. The cost to that individual of acquiring 50% of the corporation’s shares may be either $100,000 or $50,000. Explain.

6. What is a buy-back of corporate shares?

7. Describe the tax treatment to the shareholder when a corporation buys back its own shares. Is the tax treatment to the shareholder different if that shareholder sells the shares to another party, rather than back to the corporation that issued them?

8. “If a corporation no longer requires the initial common share capital provided by the shareholders, all or a portion of it can be returned to the shareholders without any tax consequences to the shareholders.” Is this statement true? Explain.

9. Would your answer to question 8 be different if the share capital consisted of nonparticipating preferred shares or if the initial capital had been provided by the shareholders as a shareholder loan?

10. Identify and briefly explain two alternative tax treatments that can apply when assets are transferred to a corporation by a shareholder or a proposed shareholder.
11. When a shareholder sells property to his or her corporation at fair market value for tax purposes, what impact may the sale have on the shareholder and on the corporation?

12. If a shareholder sells property to a corporation at fair market value for legal purposes but elects an alternative price for tax purposes, what are the tax implications to the shareholder and to the corporation acquiring the asset? Why is this election option referred to as a “roll-over”?

13. When a shareholder sells property to a corporation, that property has a value greater than its cost amount, and the shareholder chooses to use the elective option for tax purposes, what is the maximum amount of non-share consideration that the shareholder can receive from the corporation as payment?

14. A corporation purchases an asset from a shareholder for the market value price of $20,000 and pays the shareholder by issuing preferred shares of $8,000 and a note payable to the shareholder for $12,000. Both the shareholder and the corporation elect that the transfer price for tax purposes is $12,000. What are the tax consequences for the shareholder if the corporation pays the debt and buys back the shareholder’s preferred shares? What would the tax consequences be if the shareholder sold the acquired preferred shares to another party?

15. What types of property, if any, are not eligible for the elective option when they are transferred to a corporation?

16. Can the elective option be used when one corporation transfers property to another corporation?

17. What are the tax consequences to a corporation and its shareholder when that corporation declares a dividend but, instead of paying cash, distributes to the shareholder property that has a value greater than the cost amount to the corporation?
Solutions to Review Questions

R12-1. The statement is not true. A shareholder may capitalize a corporation by providing share capital only or by providing a combination of share capital and debt. In other words, the shareholder can act both as shareholder and as a creditor in providing capital funds to the corporation.

R12-2. In some circumstances, a shareholder will loan money to their corporation for terms that are favorable compared to the terms that would be required if funds were borrowed from a third party. This normally occurs in closely held corporations, where the affairs of the corporation and the shareholder are closely linked. For example, a shareholder may capitalize a new corporation with $50,000 consisting of $1,000 of share capital and a shareholder loan of $49,000. It is unlikely that the corporation could have borrowed $49,000 from an arm's length party with an equity base of only $1,000. In such circumstances, the shareholder debt is, in fact, a part of the shareholder's equity. It is a debt in form only, but not in substance. However, for tax purposes, a shareholder loan is always considered to be a debt and is treated accordingly.

R12-3. A debt owing to a shareholder may require that the corporation pay interest on that debt. Interest paid by the corporation is deductible from its income and is taxable to the shareholder. Because corporate income is reduced by the amount of interest paid to the shareholder, the amount of corporate income that is subject to two levels of tax (corporate tax plus shareholder tax on future dividends) is reduced. Capitalization by shareholder debt provides the shareholder with a return in the form of interest which is taxed only once in the hands of the shareholder. In comparison, capitalization with share capital provides a return in the form of dividends which means that two levels of tax are paid and, if the corporate tax rate exceeds the rate where perfect integration occurs, either 28% or 20%, an element of double taxation will occur. The element of double taxation is not avoided if the shareholder debt does not pay interest, as this increases corporate income and converts a portion of the shareholder's return to dividends where double taxation may occur.

R12-4. Capitalization with more shareholder debt and less share capital may provide a tax advantage when a corporation experiences financial difficulty. The tax advantage is provided to the shareholder and relates to the timing of the loss recognition for tax purposes. A loss on a shareholder loan is recognized by the shareholder/creditor for tax purposes when it is established to be uncollectible. In comparison, a loss on share capital is only recognized when the shares are actually sold, the corporation has become legally bankrupt or when it is insolvent and the business operation has ceased [ITA 50(1)].

Therefore, a loss on a shareholder loan can normally be recognized for tax purposes before a loss on share capital. Provided that the related capital loss, or allowable business investment loss, as the case may be, can be used to reduce the shareholder's taxable income, cash flow from tax savings may be created sooner from a loan loss. This cash flow can be reinvested in the corporation to enhance its chances of survival, or can simply be retained by the shareholder to diminish the real loss in after-tax cash terms from the investment.

R12-5. The cost of acquiring 50% of the equity for a company valued at $100,000 may be $50,000 or $100,000 as a consequence of the method by which the shares are acquired. The new shareholder can acquire a 50% interest in the corporation either by purchasing 50% of the existing shareholder's stock, or by purchasing new shares directly from the corporation. If shares are acquired from the existing shareholder, the cost will be $50,000 (1/2 of $100,000) and cash will be paid to the existing shareholder. The value of the company remains at $100,000.
However, if new shares are acquired directly from the corporation, the existing shareholder will retain all of his/her shares in the corporation which must remain at a value of $100,000. The contribution of new share capital increases the resources and the value of the corporation. Therefore, to obtain a 50% interest, the new shareholder must contribute an amount equal to the existing shareholder's value of $100,000. After the issue of new shares, the corporation has an increased value of $200,000 of which 50% ($100,000) belongs to the existing shareholder and 50% ($100,000) belongs to the new shareholder.

R12-6. A buy-back of corporate shares means that a shareholder sells previously issued shares back to the corporation that issued them. The transaction is also referred to as a share redemption, and involves the distribution of corporate property (normally cash) to the shareholder in return for the cancellation of all or a portion of the shares. A share buy-back diminishes the resources and the value of the corporation as it involves the direct return of share equity to the shareholders.

R12-7. When a corporation buys back its own shares, the shareholder is deemed to have received a dividend and also has a disposal of shares for capital gains purposes. The deemed dividend is equal to the amount by which the redemption price (i.e., the fair value of the shares) exceeds the paid-up capital (normally the original issue price) of the shares [ITA 84(3)]. The treatment is identical to when the corporation pays a dividend to its shareholders. The shareholder, who is an individual, is entitled to claim a dividend tax credit on the deemed dividend.

Because the shareholder has given up shares, a disposition also occurs. For tax purposes, the proceeds of disposition is equal to the redemption price minus the amount that is deemed to be a dividend [ITA 54]. Effectively, the proceeds of disposition is equal to the paid-up capital of the shares. The proceeds of disposition is compared to the shareholder's cost base of the shares to determine whether or not a capital gain or loss occurs. Keep in mind that the shareholder's cost base of the shares is not always equal to the paid-up capital as the shares may have been acquired from other shareholders and not from the corporation.

If the shareholders had sold the shares to a new shareholder rather than back to the corporation, only a capital gain or loss would occur as opposed to a deemed dividend. Therefore, the sale of shares back to the corporation is referred to as the dividend option whereas the sale of shares to new shareholders is referred to as the capital gain option. The tax consequences to the shareholder are quite different.

R12-8. The statement is not true for public corporations. The amount of retained earnings within the corporation and the enhanced value of any corporate assets belong to the common shares. Normally, if a public corporation does not require all of its common share capital it can return it to the shareholders by buying back a portion of the issued common stock. The buy-back price must be the proportionate value of the common shares, which means that for each share redeemed both the initial paid-up capital plus the value increase is distributed, resulting in a deemed dividend. However, a private corporation can, if it takes the appropriate legal steps, return its share capital to the shareholders without triggering a taxable dividend.

R12-9. If a public corporation obtains capital by a combination of common shares plus non-participating preference shares, the accumulated earnings and any asset value increases would accrue only to the common share equity and would not affect the value of the preference shares. Therefore, the preferred shares normally can be repaid to the shareholder without tax consequence. For example, the redemption price of preferred shares would likely be equal to the paid-up capital (the initial issue price) and no deemed dividend would occur.
Therefore, capitalizing a public corporation with a small amount of common shares and greater amount of preferred shares permits the return of the initial share capital to the shareholder without returning the proportionate value increase of the corporation.

For private corporations, shareholder loans, preferred share and common share capital can all be returned without tax consequences. However, it is simpler to carry this out through the repayment of a shareholder loan.

R12-10. For tax purposes, an existing or proposed shareholder can transfer assets to a corporation either:
- at a price that is equal to fair market value, or
- at an elected price that is normally equal to the asset's cost amount for tax purposes [S.85(1)]

The transfer of assets to the corporation constitutes a sale for tax purposes. Therefore, regardless of which of the above options are chosen for tax purposes, the transfer price for legal and accounting purposes is usually the fair market price and includes an equivalent amount of consideration.

R12-11. In general terms, when property is sold at fair market value by a shareholder to the corporation, the fair market price becomes the proceeds of disposition. Where the value of the property is greater than the cost amount, the shareholder will incur taxable income such as capital gains, recapture of capital cost allowance or business income from the sale of eligible capital property. However, the corporation having acquired the property at fair market value has an increased cost which forms the basis for determining future deductions in arriving at taxable income.

The reader should be aware that a number of specific exceptions may modify the general treatment described above, and reference should be made to the following sections of the Income Tax Act.

- ITA 13(7)(e) does not permit the corporation to claim capital cost allowance on a portion of the purchase price of depreciable property. For example, where the shareholder realizes a capital gain on the transfer, the non-taxable portion of the gain (i.e., 1/2) is not eligible for CCA in the corporation. The capital cost is limited to the shareholder's cost for the property plus the taxable capital gain. This applies where the shareholder and the corporation do not deal at arm's length.

- Where the shareholder has a capital loss on the transfer, the recognition of the capital loss is deferred until the corporation disposes of the asset. This applies where the shareholder and the corporation are affiliated persons. The loss is a superficial loss [ITA 54] and is denied [ITA 40(2)(g)]. The denied loss is added to the ACB of the property acquired by the corporation [ITA 53(1)(f)]. Where the shareholder is a corporation, the denied capital loss remains with the transferor corporation [ITA 40(3.4)] and cannot be recognized until one of the following occurs:
  1) asset no longer owned by affiliated person,
  2) asset deemed disposed under other provisions of the ITA, or
  3) control of transferor is acquired by an unrelated person.

- Where the shareholder has a terminal loss on the transfer to an affiliated person, the terminal loss is denied [ITA 13(21.2)]. The positive balance remains in the UCC of the class. CCA can continue to be claimed on the positive balance. The remaining terminal loss cannot be recognized until one of the following occurs:
1) asset no longer owned by affiliated person,
2) asset deemed disposed under other provisions of the ITA, or
3) control of transferor is acquired by an unrelated person.

R12-12. The shareholder is considered to have sold the property to the corporation at the price elected notwithstanding that the legal sale price and fair market value is higher [ITA 85(1)]. If the elected price is equal to the property's cost amount for tax purposes, the shareholder will not incur taxable income on the sale. For example, no taxable gain will occur if the elected price of depreciable property is equal to its undepreciated capital cost, or the elected price for non-depreciable capital property is equal to its adjusted cost base. Similarly, if the property is eligible capital property an elected price that is 4/3 of the balance in the cumulative eligible capital (CEC) account will create no income because only 3/4 of the elected price is credited to the CEC account. [ITA 85(1)(a)-(e)].

The corporation, even though the legal price was at fair market value, has a cost amount for tax purposes that is tied to the elected amount [ITA 85(1)(a)]. Therefore, the adjusted cost base of non-depreciable capital property acquired by the corporation is equal to the elected amount for tax purposes. If the corporation subsequently sells the property it will incur a capital gain to the extent that the selling price exceeds the original elected amount. If the property transferred is depreciable property and the elected amount is equal to the UCC, the corporation is deemed to have a UCC equal to the elected amount and future CCA is based on that amount. The corporation is also deemed to have a cost of the property equal to the shareholder's cost [ITA 85(5)]. For example, depreciable property that had an original cost of $10,000, but at the time of transfer had a UCC of $6,000, means that the corporation takes over the asset with a cost of $10,000 and a UCC of $6,000. If the corporation subsequently sells the property, say for $11,000, the corporation will incur a recapture of $4,000 ($10,000 - $6,000) and a capital gain of $1,000 ($11,000 - $10,000).

The election option is referred to as a rollover because the potential taxable income that would have been incurred by the vendor (shareholder), and had been avoided by the election, is effectively transferred to the corporation. In other words, the potential taxable income is not eliminated but is "rolled over" to the corporation.

R12-13. When the legal price or fair market value of the asset transferred to the corporation is greater than the elected price for tax purposes, the maximum non-share consideration (i.e., cash, debt to the shareholder, or assumption of the shareholder's liabilities by the corporation) that can be given to the shareholder as payment is equal to the elected amount [ITA 85(1)(b)]. For example, an asset transferred at an elected price of $4,000 that has a legal price of $6,600 can receive only $4,000 in non-share consideration. The balance of $2,600 ($6,600 - $4,000) must consist of share capital if the taxable income is to be deferred.

R12-14. After the asset transfer, the shareholder owns two capital properties -- a note receivable of $12,000 and preferred shares of $8,000. The maximum adjusted cost base that can be assigned to these properties is the amount elected for the transfer price of the property -- in this case $12,000. This amount is first assigned to the non-share consideration and then to the share consideration [ITA 85(1)(f), (g), (h)]. The cost base of the note is, therefore, $12,000 and the cost base of the preferred shares is zero. The repayment of the note for $12,000 would have no tax consequences to the shareholder.

The preferred shares of $8,000 have a cost base of zero but upon redemption are also deemed to have a paid-up capital of zero. Therefore, if the corporation buys back the preferred shares, a deemed dividend of $8,000 will occur for the shareholder [ITA 84(3)]. Since the proceeds of disposition are reduced by the deemed dividend [ITA 54] no capital
gain results. If the shareholder sold the preferred shares to another party, the tax consequences would be different than the buy-back. The sale to a third party results in a capital gain of $8,000 ($8,000 - ACB of zero) of which one-half is taxable.

R12-15. Most types of property are eligible for the elective option with only a couple of exceptions. The most significant exception is real estate (raw land or land and building) that is not held as capital property but instead is classified as inventory because it is being held for resale. The other notable exception is real estate owned by a non-resident [ITA 85(1.1)].

R12-16. Yes, the elective option is available when property is transferred from one corporation to another [ITA 85(1)].

R12-17. When a corporation distributes property other than cash in satisfaction of a dividend payment, the following occurs [ITA 52(2)]:

- The shareholder is considered to have received a dividend for tax purposes equal to the fair market value of the property distributed.
- The corporation that distributed the property is deemed to have sold that property at its fair market value. If the property has a market value greater than its cost amount, taxable income will be created (capital gain and/or recapture of CCA depending on the nature of the property).
Key Concept Questions

QUESTION ONE

William owns 100% of the issued common shares of W Ltd., which have an adjusted cost base (ACB) and paid-up capital (PUC) of $100 and are currently worth $200,000. William wants Victor to acquire a 50% interest in W Ltd. Victor can acquire his 50% interest by purchasing shares from William or by purchasing previously unissued shares from W Ltd.

For both alternatives, determine the purchase price for Victor, the ACB and PUC of the shares acquired by Victor, and the tax implications for William. Income tax reference: ITA 89(1).

QUESTION TWO

Veronica owns shares of a Canadian private corporation that are worth $100,000 and have an adjusted cost base (ACB) and paid-up capital (PUC) of $60,000.

Determine the tax implications for Veronica if the shares are

a) Sold to an arm’s-length party for $100,000; or,

b) Redeemed by the corporation for $100,000.

Income tax reference: ITA 54 (definition of proceeds), 84(3).

QUESTION THREE

Eric owns a building that originally cost $100,000 and has an undepreciated capital cost of $70,000. Eric sells the building to a corporation at the fair market value price of $140,000 in exchange for debt of $80,000 and preferred shares with a value of $60,000. Eric and the corporation will make a Section 85 election with respect to the sale.

Determine the minimum elected transfer price under Section 85. Income tax reference: ITA 85(1).

QUESTION FOUR

Pat owns a non-depreciable capital asset that originally cost $20,000 and is now worth $80,000. Pat transfers the asset to a corporation, receiving as payment debt of $60,000 and preferred shares with a value of $20,000. Pat and the corporation will elect under Section 85 to avoid paying tax on the transfer.

Determine the appropriate transfer price under Section 85. Determine the cost of the asset for the corporation, and the ACB and PUC for the preferred shares received as consideration. Income tax reference: ITA 85(1), (2.1).
**QUESTION FIVE**

Cathy owns equipment that originally cost $40,000 and that has an undepreciated capital cost of $25,000. She sells the equipment to a corporation at the fair market value price of $30,000 in exchange for a combination of preferred shares and debt. Cathy and the corporation will make a Section 85 election in order that Cathy can avoid paying tax on the sale.

Determine the appropriate transfer price under Section 85. Determine the amount of debt and share consideration that Cathy can accept without any adverse tax consequences. Determine the corporation’s ACB and UCC for the equipment acquired. Determine the ACB and PUC of the preferred shares received as consideration. *Income tax reference: ITA 85(1), (2.1).*

**QUESTION SIX**

Susan owns a non-depreciable capital asset that originally cost $40,000 and is now worth $160,000. She transfers the asset to a corporation receiving as payment debt of $10,000, preferred shares of $20,000, and common shares of $130,000. Susan and the corporation will elect under Section 85 to avoid paying tax on the transfer.

Determine the appropriate transfer price under Section 85. Determine the ACB and PUC for the preferred shares and common shares received as consideration. *Income tax reference: ITA 85(1), (2.1).*
Solutions to Key Concept Questions

KC 12-1

[ITA: 89(1) - PUC]

If Victor purchases 50% of William’s shares, the purchase price will be $100,000. This will result in a capital gain of $99,950 for William or a taxable capital gain of $49,975. If W Ltd. is a qualified small business corporation, then, the capital gain may be sheltered from tax by the capital gains deduction. Victor’s shares will have an ACB of $100,000 (purchase price) and a PUC of $50. The paid-up capital value on the corporate balance sheet remains unchanged at $100. Since Victor owns one-half the shares, the PUC of his share is $100 x ½.

If Victor purchases a 50% interest by buying previously unissued shares from the treasury of W Ltd., the purchase price will be $200,000. Since William has not disposed of any shares, even though his ownership interest diminished from 100% to 50%, he has no income to recognize for tax purposes. Victor’s shares will have an ACB of $200,000 (purchase price) and a PUC of $100,050. The paid-up capital value on the corporate balance sheet is $200,100 after Victor purchases his shares. Since Victor owns one-half of the shares, the PUC associated with half of the shares is $100,050 (1/2 x $200,100).

KC 12-2

[ITA: 54, 84(3) – Share redemption vs. sale]

Veronica will have a capital gain of $40,000 if the shares are sold. She will have a dividend of $40,000 if the shares are redeemed. Only one-half of the capital gain is taxable. She will include the dividend in income at the grossed-up amount and claim the dividend tax credit.

a) Sales proceeds $100,000
   ACB (60,000)
   Capital gain $ 40,000
   Taxable capital gain $ 20,000

b) Redemption price $100,000
   PUC (60,000)
   Deemed dividend [ITA84(3)] $ 40,000

   Proceeds (PUC) [ITA54] $ 60,000
   ACB (60,000)
   Capital gain $ Nil
KC 12-3

[ITA: 85(1) – Elected transfer price]

The minimum elected transfer price under Section 85 is $80,000. The elected amount cannot be less than the non-share consideration received of $80,000 [ITA 85(1)(b)]. This will result in recapture of $10,000 (UCC $70,000 – Proceeds $80,000).

KC 12-4

[ITA: 85(1), (2.1) – Non-depreciable capital asset; Excess debt]

The elected amount can never be less than the non-share consideration received [ITA 85(1)(b)], therefore, it is not possible to elect at the tax value. The minimum elected transfer price is $60,000. This results in a capital gain of $40,000 (Proceeds $60,000 – ACB $20,000).

The corporation’s cost for the asset received is the elected amount, $60,000 [ITA 85(1)(a)].

The cost of the consideration received by Pat is $60,000 (elected amount). The elected amount is allocated on a sequential basis; first to the debt up to its fair market value ($60,000) leaving nothing to be allocated to the preferred shares [ITA 85(1)(f),(g)].

The PUC of the preferred shares is reduced from its legal stated capital of $20,000 to Nil [ITA 85(2.1)].

\[
\begin{array}{l|c|c|c}
\text{Pat’s consideration} & \text{FMV} & \text{ACB} & \text{PUC} \\
\hline
\text{Debt} & $60,000 & $60,000 & \text{N/A} \\
\text{Preferred shares} & 20,000 & 0 & \text{Nil} \\
\hline
\text{Total} & $80,000 & $60,000 & \text{Nil} \\
\end{array}
\]

KC 12-5

[ITA: 85(1), (2.1), (5) Depreciable property]

Taxable income can be avoided if Cathy and the corporation agree that the transfer price for tax purposes is $25,000, which is the equipment’s UCC. With proceeds of $25,000 there is no recapture (UCC $25,000 – Proceeds $25,000).

Payment must include some shares in order to make a Section 85 election and the non-share consideration must not exceed the elected amount. Therefore the payment should consist of debt of $25,000 and preferred shares of $5,000 for total consideration of $30,000, which equals the fair market value of the equipment sold to the corporation.

Although the corporation’s legal purchase price of the equipment is $30,000 the corporation is deemed to have a UCC of $25,000 (elected amount) and a capital cost of $40,000 [ITA 85(5)]. Note that all three values (FMV, cost and UCC) to the corporation are identical to those before the transfer. As a result, if the corporation subsequently sells the asset for $30,000, there will be recapture of $5,000 (UCC $25,000 – Proceeds $30,000).

After the transfer, the shareholder will own a note receivable from the corporation of $25,000 and preferred shares worth $5,000. The elected amount of $25,000 is allocated first to the debt, up to its fair market value ($25,000) leaving nothing to be allocated to the shares [ITA 85(1)(f),(g)].
shareholder subsequently sells the shares for $5,000 there will be a capital gain of $5,000 (Proceeds $5,000 – ACB $0). Note that this equals the amount of recapture that Cathy would have incurred upon selling the equipment without a Section 85 election.

The paid-up capital (PUC) of the preferred shares received by Cathy is Nil since the non-share consideration equals the elected amount [ITA 85(2.1)]. If those shares are subsequently redeemed, a deemed dividend occurs for the full redemption amount ($5,000).

KC 12-6

[ITA: 85(1), (2.1) – Non-depreciable capital asset; Two classes of shares]

Susan and the corporation should jointly elect a transfer price equal to the tax value of the asset transferred, $40,000, in order to avoid tax on the transfer. Susan’s capital gain will be Nil (Proceeds $40,000 – ACB $40,000).

Where more than one class of shares is taken as consideration on the transfer, the ACB and the PUC must be allocated among the classes. The ACB is allocated on a sequential basis whereas the PUC is allocated on a pro rata basis based on the relative fair market values of the classes.

The elected amount ($40,000) becomes the cost of the consideration package, in total. The cost is allocated on a sequential basis; first to the debt up to its fair market value ($10,000) [ITA 85(1)(f)], next to the preferred shares up to their fair market value ($20,000) [ITA 85(1)(g)] and the remainder ($10,000) to the common shares [ITA 85(1)(h)].

The PUC of both classes of shares combined is reduced from its legal stated capital of $150,000 (preferred $20,000 + common $130,000) to $30,000 being the excess of the elected amount ($40,000) over the non-share consideration ($10,000) [ITA 85(2.1)]. The PUC of $30,000 is allocated between the preferred and common shares based on their relative fair market values. $4,000 ($20,000/$150,000 x $30,000) is allocated to the preferred shares and $26,000 ($130,000/$150,000 x $30,000) is allocated to the common shares [ITA 85(21.).]

<table>
<thead>
<tr>
<th>Susan’s consideration</th>
<th>FMV</th>
<th>ACB</th>
<th>PUC</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt</td>
<td>$10,000</td>
<td>$10,000</td>
<td>N/A</td>
</tr>
<tr>
<td>Preferred shares</td>
<td>20,000</td>
<td>20,000</td>
<td>$4,000</td>
</tr>
<tr>
<td>Common shares</td>
<td>130,000</td>
<td>10,000</td>
<td>26,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$160,000</strong></td>
<td><strong>$40,000</strong></td>
<td><strong>$30,000</strong></td>
</tr>
</tbody>
</table>
Problems

PROBLEM ONE

[ITA: 12(1)(c); 20(1)(c); 39(1)(c); 50(1)]

Shelter Tent Ltd. is a Canadian-controlled private corporation owned 50/50 by two individual shareholders. The corporation has consistently achieved annual profits of between $500,000 and $600,000.

Recently, the company has experienced a cash shortage as the result of an expansion of the tent and awning business. The bank offered some relief, but the shareholders will have to contribute additional capital to the corporation.

Although both shareholders have alternative uses for their personal capital, they are prepared to provide the funds necessary to alleviate the cash squeeze. The shareholders have approached you for advice on how they should contribute their capital to the corporation. Under its articles of incorporation, the company is permitted to issue both common shares and preferred shares. The preferred shares have a fixed non-cumulative dividend rate of 8%.

Required:

1. Identify three methods by which the shareholders can provide additional capital to the corporation.

2. Outline the tax factors that should be considered in evaluating the three alternatives.
Solution to P 12-1

1. **Alternate methods:**

   The two shareholders can provide additional capital to the corporation by one of, or a combination of, the following methods.

   (a) A shareholder loan to the corporation. The loan could be interest bearing or non-interest bearing.
   (b) In exchange for preferred shares having a fixed non-cumulative dividend of 8%.
   (c) In exchange for additional common shares.

2. **Tax factors to be considered:**

   In evaluating the three alternatives, the following tax factors should be considered.

   (a) **The return on investment** – Under the loan option, the shareholders will receive a return in the form of interest (provided that an interest rate is part of the loan terms). Interest is deductible by the corporation [ITA 20(1)(c)] and fully taxable to the shareholder [ITA 12(1)(c)]. If the corporation earns in excess of $500,000 annually, a portion of its income is subject to the higher rate of corporate tax, which may create some double taxation when after-tax profits are distributed as dividends or when the shares are sold. To the extent that interest can be paid on the shareholder loan, double taxation is avoided because corporate income (due to the interest deduction) is shifted directly to the shareholders who are taxed only once. If preference shares or common shares are issued, double taxation may occur on corporate profits, as these options provide a return in the form of dividends which are not deductible by the corporation but are taxable to the shareholder.

   (b) **Loss of the investment** - The shareholders must consider the tax implications if the company should fail and their additional investment is not recovered. In each of the three methods the loss that would occur would be a capital loss of which only one-half is allowable and can only be offset against capital gains. However, if the corporation qualifies as a small business corporation, the resulting loss may be an allowable business investment loss which, although the amount of the loss allowable is the same (1/2), can be offset against any source of income [ITA 39(1)(c)].

   While the amount of the loss available for tax purposes is the same for each method, the timing of the recognition of the loss, and therefore the timing of tax saving that will occur, are different. The loss from the loan is recognized when the debt is established to be bad, whereas the loss from either of the share methods is recognized only when the corporation is legally bankrupt, the shares are sold, or the corporation is insolvent [ITA 50(1)]. Therefore, the loan may provide a faster tax recovery which can be used by the shareholder to diminish the extent of the loss in cash flow terms (npv) or can be loaned to the company to assist with its financial problems, and perhaps reduce the risk of a complete failure.
(c) **Return of capital** - In this case it appears that the cash requirements may be temporary, and as the shareholders each have alternate uses for the funds, there is a strong possibility the additional cash provided will be returned to the shareholders when the cash squeeze is over. While all three methods allow for a return of capital without tax consequences (it is a private corporation), it is simpler to accomplish with a shareholder loan.

It appears that a shareholder loan with interest is the best option as it avoids the possibility of double taxation, speeds up the use of a loss if the investment cannot be recovered, and provides the easiest method to return the additional capital without creating any taxable income.
PROBLEM TWO

[ITA: 39(1)(a),(b),(c); 39(9); 40(1)(a)(iii); 84(3); 110.6]

Cynthia Yeung owns 10% of the common shares of Bantam Brokers Ltd. She had acquired the shares, which have a stated paid-up capital amount of $1,000, from a previous shareholder in 20X0 at a cost of $20,000. Since 20X0, Yeung has worked for the company as a senior broker earning a salary and commissions. The remaining 90% of Bantam's shares are owned by three other senior executives of the company.

Yeung has decided to leave the company and has agreed to dispose of her Bantam shares, which have a current fair market value of $60,000. A shareholders' agreement stipulates that she must sell her shares either to the other shareholders or back to the corporation for cancellation, with payment terms to be negotiated.

Currently, Bantam does not have substantial cash resources, nor does it have non-business properties that it could sell and convert into cash. Consequently, if the company is going to buy back its shares from Yeung for $60,000, deferred payment terms will have to be established. Similarly, none of the other shareholders have any cash reserves. Although each earns a high salary, all have committed their income to personal expenditures. In addition, none of them holds any other investments, and each looks to the company as his/her sole source of cash.

After a negotiation, these options are presented to Yeung:

1. Bantam will buy back her shares immediately for $60,000. Payment would involve $20,000 cash, with the balance of $40,000 paid in two annual instalments of $20,000, with interest at 8%.

2. The other shareholders will immediately purchase her shares for $60,000 under terms identical to those in option 1.

The other shareholders realize that if Yeung accepts option 2, they will have to either borrow the money from a bank to make the payments or distribute funds to themselves from the company. Even if they borrow the money, they will have to look to the company for help in repaying the principal. Bantam is a Canadian-controlled private corporation and has annual profits of approximately $100,000. Its dividends are normally classified as non-eligible. Yeung, like the other shareholders, usually pays personal tax at the rate of 45%.

Required:

1. Which option should Yeung accept? In your answer, include a comparative analysis of the options listed, and state any assumptions you feel are necessary. Yeung has already used her full capital gains deduction.

2. If you were one of the other shareholders, which option would you prefer? Explain.
Solution to P 12-2

In order to complete the problem it is necessary to make certain assumptions regarding the corporation and Cynthia. The following has been assumed:

- The corporation qualifies as a small business corporation (CCPC with all of its assets used in an active business) [ITA 248].
- The corporation is subject to a tax rate of 15% on its first $500,000 of active business income.
- Cynthia, as well as the other shareholders, is subject to a marginal tax rate on non-eligible dividends of 33% (after deducting the dividend tax credit) and 45% on the other income.
- Cynthia deals at arm’s length with the corporation and the other shareholders.

Part 1

Alternative A (share buy-back):

The buy-back of the shares results in a deemed dividend of $59,000 and a capital loss of $19,000 (calculated below). Even though payment for the share buy-back is over three years, the full dividend is taxable in the year of redemption. Normally, the capital loss is an allowable business investment loss (because the corporation is a small business corporation and Cynthia is at arm’s length) and therefore can be offset against her other sources of income which are subject to a 45% tax rate. However, because Cynthia has, in the past, used her full capital gain deduction (CGD), the ABIL status is denied and the loss is treated as a regular capital loss [ITA 39(9)]. This means that the allowable capital loss can only be deducted in the year to the extent that Cynthia has net taxable capital gains in the year. Assuming that Cynthia has sufficient net taxable capital gains to offset the allowable capital loss from this transaction, the net tax cost of this option is $15,195 as follows:

\[
\begin{align*}
\text{Dividend:} & \\
\text{Proceeds} & \quad 60,000 \\
\text{Less paid-up capital} & \quad 1,000 \\
\text{Deemed dividend [ITA 84(3)]} & \quad 59,000 \\
\text{Tax $59,000 @ 33\%} & \quad 19,470
\end{align*}
\]
Capital Loss:

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proceeds</td>
<td>$60,000</td>
</tr>
<tr>
<td>Less deemed dividend</td>
<td>$(59,000)</td>
</tr>
<tr>
<td>Adjusted proceeds [54]</td>
<td>1,000</td>
</tr>
<tr>
<td>ACB (20,000)</td>
<td></td>
</tr>
<tr>
<td>Capital loss (19,000)</td>
<td></td>
</tr>
<tr>
<td>Allowable capital loss (1/2)</td>
<td>$(9,500)</td>
</tr>
<tr>
<td>Tax saving $9,500 @ 45%</td>
<td>$(4,275)</td>
</tr>
</tbody>
</table>

Net tax cost: $15,195

Alternative B (sale to other shareholders):

The sale results only in a capital gain. Because the price of $60,000 is paid over three years (1/3 per year - $20,000) a capital gain reserve can be claimed for the deferred proceeds [ITA 40(1)(a)(iii)]. The reserve causes the tax to be paid over three years at 1/3 of the total per year.

<table>
<thead>
<tr>
<th>Year</th>
<th>Tax Cost</th>
<th>NPV</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$3,000</td>
<td>$3,000</td>
</tr>
<tr>
<td>2</td>
<td>3,000</td>
<td>2,844</td>
</tr>
<tr>
<td>3</td>
<td>3,000</td>
<td>2,695</td>
</tr>
<tr>
<td></td>
<td>$9,000</td>
<td>$8,539</td>
</tr>
</tbody>
</table>

Because the tax is payable over three years at $3,000 per year (1/3 of $9,000 = $3,000) the real tax cost should be based on a net present value basis. A pre-tax discount rate of 10% can be used which, after tax, amounts to 5.5% (10% - tax of 45% = 5.5%).

Based on the above, Cynthia should choose option B as the sale of shares results in a tax rate of 22.5% (1/2 of 45%). In comparison, the deemed dividend is taxed at a cost of 33% combined with a tax saving on the capital loss of 22.5% (1/2 of 45%).

The result would be quite different if Cynthia could use the capital gains deduction, or if the capital loss in option A could not be used in the year due to insufficient taxable capital gains.
Part 2

As both the corporation and the other shareholders are short of cash, the payment of $60,000 must come from corporate profits to be earned in the future. If the corporation buys back the shares directly, the payment will be from corporate profits that have been taxed at 15% only. Therefore, to pay off a $60,000 price requires about $70,588 of pre-tax business profits \((x - 15\%x = $60,000)\). However, under option B the corporate profits must first be paid to the remaining shareholders either as a salary (taxed at 45%) or as a dividend (33%). Therefore, under option B, to pay off a $60,000 price requires a pre-tax business profit of $105,356 \(((x - 15\%x) * 67\% = $60,000)\). This can be further demonstrated as follows (assuming dividends are paid).

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporate earnings</td>
<td>$105,356</td>
</tr>
<tr>
<td>Tax @ 15%</td>
<td>(15,804)</td>
</tr>
<tr>
<td>Available for distribution</td>
<td>89,552</td>
</tr>
<tr>
<td>Tax to remaining shareholders @ 33%</td>
<td>(29,552)</td>
</tr>
<tr>
<td>Net for payments to Cynthia</td>
<td>$60,000</td>
</tr>
</tbody>
</table>
PROBLEM THREE

[ITA: 85(1)]

Ms. Kline, a resident of Canada, is the sole shareholder of KI Inc. She plans to transfer four assets, which she owns, to KI Inc. in exchange for cash and preferred shares of KI Inc. She wishes to receive the maximum amount in cash that she can receive and still defer the recognition of income for tax purposes on the transfer of the assets. Ms. Kline and KI Inc. will jointly make a Section 85 election for each of the assets. The following is the details of the assets:

<table>
<thead>
<tr>
<th>Asset</th>
<th>FMV</th>
<th>ACB</th>
<th>UCC/CEC</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>$200,000</td>
<td>$40,000</td>
<td>N/A</td>
</tr>
<tr>
<td>Building</td>
<td>100,000</td>
<td>70,000</td>
<td>$50,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>8,000</td>
<td>30,000</td>
<td>8,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>40,000</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

**Total:** $348,000 $140,000 $58,000

Required:

1. For each of the four assets individually, state the amount that should be elected as proceeds under Section 85 of the *Income Tax Act*.

2. For each of the four assets individually, state the amount of cash and the redemption value of the preferred shares that Ms. Kline should accept as payment for the assets.
Solution to P 12-3

Part 1

In order to defer the recognition of capital gains, recapture and other income the elected amounts required are as follows:

- The elected amount for the land should be equal to the ACB of the land, $40,000. With proceeds of $40,000 the gain on the land will be deferred.

- The elected amount for the building should be equal to the UCC of the building, $50,000. With proceeds of $50,000 for tax purposes, the recapture as well as the capital gain will be deferred.

- The elected amount for the equipment should be equal to the UCC of the equipment, $8,000 which happens to also be the fair market value in this case. Capital losses are not recognized on depreciable property [ITA 39(1(b)(i)].

- The elected amount for the goodwill should be $1. This will result in income of $0.50 as the CEC is Nil. An elected amount equal to 4/3 x the CEC would be Nil which would be an invalid election as Nil is not considered to be an amount. In such a case the goodwill would be transferred at its fair market value, $40,000 [ITA 69]. To have a valid Section 85 election an amount must be elected as the proceeds. $1 is the minimum elected amount which will result in a valid election.

Part 2

The cash received should be limited to the total of the elected amounts ($40,000 + $50,000 + $8,000 + $1) = $98,001 [ITA 85(1)(b)].

The value of the shares received should equal the value of the assets minus the cash received ($348,000 - $98,001) = $249,999.

<table>
<thead>
<tr>
<th>Asset</th>
<th>Value</th>
<th>Tax Value</th>
<th>Elected Amount</th>
<th>Cash</th>
<th>Shares</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>$200,000</td>
<td>$40,000</td>
<td>$40,000</td>
<td>$40,000</td>
<td>$160,000</td>
</tr>
<tr>
<td>Building</td>
<td>100,000</td>
<td>50,000</td>
<td>50,000</td>
<td>50,000</td>
<td>50,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>8,000</td>
<td>8,000</td>
<td>8,000</td>
<td>8,000</td>
<td>0</td>
</tr>
<tr>
<td>Goodwill</td>
<td>40,000</td>
<td>0</td>
<td>1</td>
<td>1</td>
<td>39,999</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$348,000</td>
<td>$98,000</td>
<td>$98,001</td>
<td>$98,001</td>
<td>$249,999</td>
</tr>
</tbody>
</table>
PROBLEM FOUR

[ITA: 40(2)(g)(i); 53(1)(f); 85(1)(a)-(e); 251.1(1) ]

In each of the following independent situations, Mary transfers an asset to a taxable Canadian corporation owned by her and makes an election under Section 85 of the *Income Tax Act* with respect to the transfer.

<table>
<thead>
<tr>
<th>Asset transferred</th>
<th>ONE</th>
<th>TWO</th>
<th>THREE</th>
<th>FOUR</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>ACB &amp; capital cost</td>
<td>FMV</td>
<td>UCC/CEC</td>
<td>Sale price</td>
</tr>
<tr>
<td></td>
<td>$5,000</td>
<td>$8,000</td>
<td>N/A</td>
<td>$8,000</td>
</tr>
<tr>
<td></td>
<td>$100</td>
<td>$80</td>
<td>$50</td>
<td>$80</td>
</tr>
<tr>
<td></td>
<td>Nil</td>
<td>$10,000</td>
<td>Nil</td>
<td>$10,000</td>
</tr>
<tr>
<td></td>
<td>$17,000</td>
<td>$11,000</td>
<td>N/A</td>
<td>$11,000</td>
</tr>
</tbody>
</table>

**Required:**

For each of the four situations, determine the following:

a) The minimum elected amount under Section 85 of the Income Tax Act,

b) The income or loss for tax purposes to be recognized by Mary,

c) The corporation’s ACB, capital cost and UCC/CEC for the assets purchased,

d) The ACB of the shares of the corporation received by Mary, and

e) The PUC of the shares of the corporation received by Mary.
### Solution to P 12-4

<table>
<thead>
<tr>
<th></th>
<th>ONE</th>
<th>TWO</th>
<th>THREE</th>
<th>FOUR</th>
</tr>
</thead>
<tbody>
<tr>
<td>a) Minimum elected amount</td>
<td>$6,000</td>
<td>$ 50</td>
<td>$ 1</td>
<td>$11,000</td>
</tr>
<tr>
<td>b) Income</td>
<td>$ 500</td>
<td>Nil</td>
<td>$ 0.50</td>
<td>Nil *</td>
</tr>
<tr>
<td>c) Corporation:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- ACB</td>
<td>$6,000</td>
<td>$100</td>
<td>N/A</td>
<td>$17,000*</td>
</tr>
<tr>
<td>- Capital cost</td>
<td>N/A</td>
<td>$100</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>- UCC/CEC</td>
<td>N/A</td>
<td>$ 50</td>
<td>$ 0.50**</td>
<td>N/A</td>
</tr>
<tr>
<td>d) ACB of shares</td>
<td>Nil</td>
<td>$ 20</td>
<td>$ 1</td>
<td>$ 9,000</td>
</tr>
<tr>
<td>e) PUC of shares</td>
<td>Nil</td>
<td>$ 20</td>
<td>$ 1</td>
<td>$ 9,000</td>
</tr>
</tbody>
</table>

* Since Mary and the corporation she controls are affiliated persons [ITA 251.1(1)] the capital loss on the sale of the marketable securities to the corporation is a superficial loss [ITA 54] and as such is denied [ITA 40(2)(g)(i)]. The denied loss is added to the ACB of the property acquired by the corporation [ITA 53(1)(f)]. Thus, the ACB of the marketable securities in the corporation is $17,000 being the cost $11,000 + denied loss $6,000.

** On the purchase of eligible capital property for $1, the corporation will add $0.50 (i.e., ¾ x $1 – ½ x $0.50 (Mary’s income under ITA 14(1)(b)) to the CEC account [amount A of the definition of cumulative eligible capital in ITA 14(5)].
PROBLEM FIVE

[ITA: 85(1)(f), (g), (h); 85(2.1)]

Using Section 85 of the Income Tax Act, Jason Goorwah transfers non-depreciable property to a corporation at an elected value of $6,000. The property has an adjusted cost base of $6,000 and a fair market value of $17,000. As consideration he receives a note for $1,000, preferred shares with a fair market value of $2,000, and common shares with a fair market value of $14,000.

Required:

Determine the adjusted cost base (ACB) and paid-up capital (PUC) of the preferred shares and the common shares received by Jason.
Solution to P 12-5

<table>
<thead>
<tr>
<th>Consideration</th>
<th>FMV</th>
<th>ACB</th>
<th>PUC</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt</td>
<td>$1,000</td>
<td>$1,000</td>
<td>NA</td>
</tr>
<tr>
<td>Preferred shares</td>
<td>2,000</td>
<td>2,000</td>
<td>$625</td>
</tr>
<tr>
<td>Common shares</td>
<td>14,000</td>
<td>3,000</td>
<td>4,375</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$17,000</strong></td>
<td><strong>$6,000</strong></td>
<td><strong>$5,000</strong></td>
</tr>
</tbody>
</table>

The adjusted cost base (ACB) of all of the components of the consideration, combined, is $6,000 being the elected amount for the property transferred. This amount is first allocated to the non-share consideration ($1,000) and then to the share consideration – first to the preferred shares up to their fair market value ($2,000) with remainder allocated to the common shares ($3,000) [ITA 85(1)(f),(g),(h)].

The PUC of the share consideration is ground down to the tax value of the transferred asset not recovered on the transfer [ITA 85(2.1)] –

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax value of asset transferred</td>
<td>$6,000</td>
</tr>
<tr>
<td>Note taken as consideration on the transfer</td>
<td>(1,000)</td>
</tr>
<tr>
<td>PUC</td>
<td>$5,000</td>
</tr>
</tbody>
</table>

The PUC is allocated between the preferred and the common shares based on their relative fair market values.

<table>
<thead>
<tr>
<th>Share Type</th>
<th>FMV</th>
<th>PUC</th>
</tr>
</thead>
<tbody>
<tr>
<td>Preferred shares</td>
<td>$2,000</td>
<td>$625</td>
</tr>
<tr>
<td>Common shares</td>
<td>14,000</td>
<td>4,375</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$16,000</strong></td>
<td><strong>$5,000</strong></td>
</tr>
</tbody>
</table>
PROBLEM SIX

Harvey Malon has decided to incorporate his proprietorship. Certain properties of the business have a current value that is greater than their cost amount for tax purposes. These assets are as follows:

<table>
<thead>
<tr>
<th></th>
<th>Fair market Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>$ 40,000</td>
</tr>
<tr>
<td>Building</td>
<td>180,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>70,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$290,000</strong></td>
</tr>
</tbody>
</table>

The original cost of the land and building was $175,000 (land, $25,000; building, $150,000). The building currently has an undepreciated capital cost of $120,000. The goodwill was purchased from the previous owner for $50,000, and the balance in the cumulative eligible capital account is $30,000. In addition, the business has some current assets (primarily inventory), which have not appreciated in value and have a cost of $90,000. The proprietorship’s only liabilities are amounts payable to trade creditors totalling $70,000. The corporation will assume these liabilities as well as issue debt and preferred shares to Malon in exchange for the properties.

Malon is aware that a shareholder can transfer assets to a corporation and defer tax on the transfer by using a special election of the Income Tax Act. He finds this option attractive, as his personal tax rate is very high and he needs all the cash flow he can get. Within the next year or two, Malon intends to sell the land and building and acquire larger premises for the business. At this point, he is uncertain whether he will buy or lease the proposed new premises.

**Required:**

1. Assuming that Malon will sell the assets to the corporation using the elective option for tax purposes, determine the elected amounts required for tax purposes to avoid recognition of taxable income.

2. Determine (a) the maximum amount of debt, and (b) the amount of preferred shares that would be issued.

3. What would be the tax consequences to Malon if the corporation later repaid the debt and bought back the preferred shares? Would the result be different if he sold the preferred shares to a third party?

4. Prepare a brief balance sheet for the corporation after the assets are acquired, showing the accounting value for each item. How do the values of the real estate and goodwill for accounting purposes compare with their tax values to the corporation?

5. Since Malon may sell the land and building to a third party within two years, he could choose to retain ownership for two years and lease it to the corporation, rather than transfer it to the corporation and then sell it to the third party. Briefly outline the tax factors to consider when making this decision.
Solution to P 12-6

1. The elected amounts required to avoid taxable income are:

   ITA 85(1)(c.1)  Land $25,000 (ACB)
   ITA 85(1)(e)     Building 120,000 (UCC)
   ITA 85(1)(d)     Goodwill 40,000 (4/3 of CEC)

   $185,000

   Notice that the elected amount of the goodwill is $40,000. This amount becomes the selling
   price for tax purposes and 3/4 of $40,000 or $30,000 is credited to the cumulative eligible
   capital account. As the CEC account before the transfer was $30,000, the elected price of
   $40,000 will not create any taxable income.

2. The maximum non-share consideration cannot exceed the elected amounts for each asset
   transferred. Although the inventory does not require an election because its value is the same
   as its cost it is included as part of the total price.

   The relevant amounts are as follows:

<table>
<thead>
<tr>
<th>Asset</th>
<th>Elected Value</th>
<th>Elected Amount</th>
<th>Preferred Non-share</th>
<th>Preferred Shares</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>40,000</td>
<td>25,000</td>
<td>25,000</td>
<td>$15,000</td>
</tr>
<tr>
<td>Building</td>
<td>180,000</td>
<td>120,000</td>
<td>120,000</td>
<td>60,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>70,000</td>
<td>40,000</td>
<td>40,000</td>
<td>30,000</td>
</tr>
<tr>
<td></td>
<td>290,000</td>
<td>$185,000</td>
<td>185,000</td>
<td>$105,000</td>
</tr>
</tbody>
</table>

   Inventory $90,000 $NA $90,000
   $380,000 $275,000

   Liabilities assumed $70,000
   Debt issued 205,000
   $275,000

3. If, subsequent to the transfer, the corporation paid to Harvey the $205,000 owing to him there
   would be no tax consequences as the ACB of the debt is equal to $205,000.

   The preferred shares have an ACB of zero (because the maximum ACB of the consideration
   is the elected amount which has been fully allocated to the debt). Upon the buy-back of the
   shares, their paid-up capital is deemed to be zero.
The tax consequence of a buy back is as follows:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Proceeds</td>
<td>$105,000</td>
</tr>
<tr>
<td>Less Paid-up capital</td>
<td>0</td>
</tr>
<tr>
<td>Deemed dividend [ITA 84(3)]</td>
<td>$105,000</td>
</tr>
<tr>
<td>Proceeds</td>
<td>$105,000</td>
</tr>
<tr>
<td>Less deemed dividend [ITA 54]</td>
<td>(105,000 )</td>
</tr>
<tr>
<td>Adjusted Proceeds</td>
<td>0</td>
</tr>
<tr>
<td>ACB</td>
<td>0</td>
</tr>
<tr>
<td>Capital gain</td>
<td>$ 0</td>
</tr>
</tbody>
</table>

If Harvey, instead, sold the shares to a third party, he would have a capital gain of $105,000 (price of $105,000 - ACB of zero) of which $52,500 is taxable (1/2 of $105,000).

4. The balance sheet of the corporation after the acquisition (at accounting values) is presented below. It assumes the shareholder contributed cash of $100 in exchange for $100 of common shares prior to the transfer.

**Assets:**

- Cash: $100
- Inventory: 90,000
- Land: 40,000
- Building: 180,000
- Goodwill: 70,000

**Total Assets:** $380,100

**Liabilities:**

- Accounts payable: $70,000
- Due to shareholder: 205,000

**Total Liabilities:** 275,000

**Shareholders Equity:**

- Preferred shares: $105,000
- Common shares: 100

**Total Shareholders Equity:** 105,100

**Total Liabilities and Shareholders Equity:** $380,100

**Land** - Although the land has a cost of $40,000 for accounting purposes, its ACB for tax purposes is only $25,000 (the elected transfer price). If the corporation sold the land for $40,000, no accounting gain would result, however, for tax purposes a taxable capital gain of $7,500 would occur (1/2 x ($40,000-$25,000)) [ITA 85(1)(a)].

**Building** - The building has an accounting cost of $180,000 which is the basis for determining future accounting depreciation. For tax purposes, the building is deemed to have a capital cost of $150,000 (the previous owner’s original cost) and an undepreciated capital cost of $120,000. In other words, the corporation is deemed to have claimed CCA of $30,000 ($150,000 - $120,000). Therefore, if the corporation were to sell the building for $180,000, although there is no accounting income, recapture of CCA of $30,000 would occur ($150,000 - $120,000) as well as a taxable capital gain of $15,000 (1/2 of $180,000 - $150,000). If the building is not sold, the corporation can claim CCA based on the UCC of $120,000.
Goodwill - For tax purposes, three-quarters of the goodwill's elected price is added to the corporation's cumulative eligible capital account (3/4 of $40,000 = $30,000) and can be written-off at the annual rate of 7% declining balance. If the goodwill was sold by the corporation for $70,000, there would be no accounting gain. However, for tax purposes $52,500 (3/4 of $70,000) would be credited to the CEC account creating a negative balance [ITA 14(1)(b)]. To the extent the negative balance represents a recovery of the amount previously deducted from the CEC account (before and after incorporation), that amount is included in business income. Two-thirds (2/3) of any excess negative amount is also included as business income.

5. The land and building can be transferred to the corporation using the elective provisions or be retained by the shareholder and leased to the new corporation which will carry on the business. The building will be sold within two years and larger premises will be acquired. The following tax issues should be considered.

If the building is not transferred:

- To the shareholder, the building is a rental property and therefore falls within a separate CCA class.
- On the subsequent sale the shareholder will incur a recapture of CCA and a capital gain.
- As the land and building would be used in an active business by a person related to the taxpayer, the recapture and capital gain can be deferred if replacement property is acquired in the same year or within 12 months after the taxation year in which the property was sold [ITA 44(5)].

If the building is transferred:

- The future sale will create recapture of CCA and a capital gain in the corporation.
- As the land and building is used in an active business, the recapture and capital gain can be deferred if replacement property is acquired in the same year or within 12 months after the taxation year in which the property was sold [ITA 44(5)].
- If the transferred property is sold and no replacement property is acquired, the recapture of CCA is business income and may be subject to the low corporate tax rate (15%) if, in the year of sale, the small business deduction limit of $500,000 has not been reached. If some or all of the recapture is taxed at the high corporate rate then some double taxation may occur at some future time.
PROBLEM SEVEN

[ITA: 85(1); 85(5)]

Not long ago, Colson and Harmantz formed a corporation to carry on a construction business. Each owned 50% of the common shares, which were issued at a nominal cost. In addition, each shareholder sold certain of his own property to the corporation. Colson sold construction equipment to the corporation for $60,000 (its fair market value). He originally purchased the equipment for $75,000. At the time of the sale, it had an undepreciated capital cost of $40,000. For tax purposes, the corporation and Colson elected that the transfer price was $40,000. Consideration for the sale consisted of the following:

<table>
<thead>
<tr>
<th>Note payable to Colson</th>
<th>$40,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Preferred shares</td>
<td>20,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$60,000</strong></td>
</tr>
</tbody>
</table>

Two months after the incorporation, Harmantz and Colson had a dispute, which they could not resolve. Colson now has decided to leave the company. The departure agreement includes the following terms:

- Colson will buy back his old equipment from the corporation at the current fair market price of $60,000, paying in cash.
- Immediately after the equipment sale, the corporation will use its new cash of $60,000 to pay off its debt of $40,000 to Colson and buy back his preferred shares for $20,000. In addition, the corporation will buy back Colson’s common shares for a nominal cost.

Although the corporation has not begun any construction, it expects to earn a large profit in its first year if the contract bid is accepted. Some of the expected profits will be subject to a corporate tax rate of 25%. Colson has significant personal income and is subject to a 45% tax rate.

Required:

1. What are the tax consequences to both the corporation and Colson as a result of the above transactions?

2. Will double taxation occur? If it will, calculate the amount.

3. If you were Harmantz, would you have agreed to have the corporation pay Colson $60,000 for the debt and the preferred shares? Explain.

4. Assume that Colson was the sole shareholder of the corporation and had sold the equipment to the corporation in the same manner as described previously. Assume further that shortly after incorporation, the company sold the equipment to a third party for cash and discontinued its existence by paying off its debt and cancelling its shares. What amount would Colson have received? Calculate the amount of double taxation, if any. Would your calculation be different if the corporate tax rate were 15%?
Solution to P 12-7

Note: This question forces the student to examine not only the immediate consequences of using the election option but also the long-term implications that occur when the transferred property is subsequently sold and the proceeds returned to the shareholder as debt repayment or share redemption. In particular, part 4 of the problem demonstrates that the election option forces the potential income on the asset to be subject to two levels of tax in the future, and this may or may not create double taxation depending on the rate of applicable corporate tax.

1. Tax consequence to the corporation:

   Because the corporation acquired the equipment for a legal price of $60,000 but for tax purposes elected a price of $40,000, the company assumes the original capital cost of $75,000 and the undepreciated capital cost of $40,000 [ITA 85(1)(e), 85(5)]. On the assumption that the corporation has no other assets of the same class, the sale of the equipment back to Colson for $60,000 (the fair market value) will create a recapture of CCA of $20,000.

   \[
   \begin{array}{ccc}
   \text{UCC} & \$40,000 \\
   \text{Sale price} & (60,000) \\
   \text{Recapture} & (20,000) \\
   \text{Tax @ 25\%} & \$5,000
   \end{array}
   \]

   Although the corporation has not earned income at the date of the transaction, the anticipated profits before the year end will be sufficient to force a 25\% tax rate.

   It should be pointed out that if the corporation acquires new equipment before the end of the taxation year, the recapture can be avoided as a result of class pooling. However, future CCA on the new equipment is reduced accordingly. The impact of this can be calculated on a net present value basis using the formula:

   \[
   \frac{C \times T \times x \times R}{R + I}
   \]

   Assuming a 10\% discount rate the tax cost to the corporation would be only $3,333 as follows:

   \[
   \frac{20,000 \times .25 \times .20}{.20 + .10} = 3,333
   \]

   Tax consequence to Colson:

   The note ($40,000) and the preferred shares ($20,000) have a total ACB of $40,000 (the elected transfer price). As this amount is first allocated to the non-share consideration, the ACB of the note is $40,000 [ITA 85(1)(f)] and its repayment for $40,000 results in no taxable income. The shares have a cost base of zero [ITA 85(1)(g)] and, if redeemed by the corporation, are also considered to have a paid-up capital amount of zero. Therefore, the buy-back will result in a deemed dividend to Colson of $20,000 [ITA 84(3)].
Proceeds $20,000  
Paid-up capital 0  
Deemed dividend [ITA 84(3)] $20,000

Proceeds $20,000  
Less deemed dividend (20,000 )  
Adjusted proceeds 0  
ACB 0  
Capital gain $0

Colson's marginal tax rate is 45%. The approximate tax rate on eligible dividends (paid from full-rate taxable income) is 28% net of the dividend tax credit (see Chapter 10). Therefore Colson's tax is:

\[ 28\% \times \$20,000 = \$5,600 \]

2. It appears that some amount of double taxation has occurred. If Colson had sold the equipment to the corporation (or to a third party) for fair market value and did not use the election option, the total tax would have been $9,000 calculated as follows:

| Selling price $60,000  
UCC (40,000)  
Recapture $20,000  
Tax @ 45% $9,000 |

As the corporation's cost of the equipment would have been $60,000, the sale back to Colson would not result in taxable income to the corporation. In addition, the repayment of the note and the buy-back of the preference shares for $60,000 would create no future taxable income to Colson. The note would have an ACB of $40,000. The preferred shares would have a paid-up capital and ACB of $20,000.

Using the election option, the total tax is $10,600 as follows:

| Tax to corporation $5,000  
Tax to Colson $5,600  
Total $10,600 |

Therefore, the elective option combined with the buy-out terms created additional tax of $1,600. The burden of this additional tax has been shifted to Colson's partner, who remains as the shareholder of the company. (Note: this burden is reduced if the corporation acquires new equipment in the year and avoids recapture, as discussed in part 1).
3. Harmantz should not have agreed to pay Colson a total of $60,000 for the debt and preferred shares. The debt and the preferred shares are payment for the equipment which when sold by the corporation realized only $55,000 (selling price of $60,000 - $5,000 of tax). By purchasing the equipment for $60,000 and electing a lower tax value the corporation inherited the potential recapture of CCA from the previous owner. In normal circumstances this liability may not have occurred for a long period of time. However, when the buy-out was decided, Harmantz should have realized that the sale would result in tax of $5,000 and should have agreed to pay Colson only $55,000 (i.e., $40,000 debt and $15,000 for the $20,000 of preferred shares).

4. By assuming that Colson was the sole shareholder and the company's only asset was the equipment acquired from Colson under the election option, the potential impact of using the election becomes evident. The corporate balance sheet after the transfer is as follows:

<table>
<thead>
<tr>
<th>Asset:</th>
<th>$60,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equipment</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liability and Shareholder Equity:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Due to Colson</td>
<td>$40,000</td>
</tr>
<tr>
<td>Shares issued to Colson</td>
<td>20,000</td>
</tr>
</tbody>
</table>

$60,000

The sale of the equipment to a third party for $60,000 would generate no accounting profit but would incur recapture of CCA of $20,000 resulting in corporate tax of $5,000 ($20,000 x 25%). Therefore after the tax is paid, the company has only $55,000 in cash to repay the debt and retire the shares as follows:

<table>
<thead>
<tr>
<th>Debt</th>
<th>$40,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shares</td>
<td>15,000</td>
</tr>
</tbody>
</table>

$55,000

The shares have a cost base of zero and a paid-up capital amount of zero. Therefore, the redemption of shares results in a deemed dividend of $15,000 causing Colson to pay tax of $4,200 (28% x $15,000).

Total tax paid:

<table>
<thead>
<tr>
<th>Corporation</th>
<th>$5,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shareholder (Colson)</td>
<td>4,200</td>
</tr>
</tbody>
</table>

$9,200

If Colson had not transferred the equipment to the company but had sold it directly to the third party, the tax would have been only $9,000 (45% of $20,000). Therefore, double tax of $200 occurred as a result of the election.
If the rate had been 15%, a small tax savings would have occurred as shown below.

Corporation:
- Cash from sale of equipment $60,000
- Less tax
  - 15% of $20,000 (3,000)
  - Net cash 57,000
- Less
  - Repayment of debt (40,000)
  - Redemption of shares ($57,000 - $40,000) (17,000)
- Total tax: $ 0

Total tax:
- Corporation 3,000
- Shareholder (Colson)
  - 33% x $17,000 (non-eligible dividend) 5,610
- Total tax $ 8,610

Normal tax $9,000

Because the corporate tax rate is only 15% no double taxation occurs (in fact there is a $390 tax savings ($9,000 - $8,610)). The dividend tax credit is more than sufficient to offset the corporate taxes paid on the recapture of CCA.
PROBLEM EIGHT

[ITA:  13(7)(e)(iii); 13(21.2); 14(1)(b); 14(5)(b); 22(1); 40(2)(g)(i); 53(1)(f); 54; 69; 85(1); 85(2.1); 85(1)(b), (f), (g); 85(5); (251.1)

Dan Dash has decided to incorporate his retailing business. On July 1st he plans to transfer the assets of the business to Dash Inc., a corporation owned wholly by him, in exchange for a note of $535,000, being the fair market value of the assets.

The assets of the retailing business are as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>FMV</th>
<th>COST</th>
<th>UCC/CEC</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts receivable</td>
<td>$5,000</td>
<td>$8,000</td>
<td></td>
</tr>
<tr>
<td>Inventory</td>
<td>200,000</td>
<td>120,000</td>
<td></td>
</tr>
<tr>
<td>Land</td>
<td>60,000</td>
<td>20,000</td>
<td></td>
</tr>
<tr>
<td>Building</td>
<td>180,000</td>
<td>160,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Class 8 Equipment</td>
<td>50,000</td>
<td>100,000</td>
<td>70,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>40,000</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Total</td>
<td>$535,000</td>
<td>$408,000</td>
<td>$170,000</td>
</tr>
</tbody>
</table>

Dan also plans to transfer his shares of Grape Expectations, a publicly-traded company, to Dash Inc. He purchased the shares of Grape Expectations two years ago for $60,000. He plans to transfer them to Dash Inc. for $50,000, the estimated fair market value.

Required:

Prepare a memo for Dan outlining the tax implications of his plans and provide detailed recommendations as to how he can accomplish his goals in a more tax effective manner.
Solution to P 12-8

Income from sale of assets for debt:

If Dan transfers the business assets to a corporation for debt as he plans, he will incur taxable capital gains of $30,000 and income of $160,000 as outlined below.

<table>
<thead>
<tr>
<th>Selling Price</th>
<th>FMV</th>
<th>Tax Value</th>
<th>Business Income</th>
<th>Taxable Capital gain</th>
<th>Note</th>
</tr>
</thead>
<tbody>
<tr>
<td>Acc. Rec.</td>
<td>$5,000</td>
<td>$8,000</td>
<td>$0 (1)</td>
<td>$0</td>
<td></td>
</tr>
<tr>
<td>Inventory</td>
<td>200,000</td>
<td>120,000</td>
<td>$80,000</td>
<td>20,000</td>
<td></td>
</tr>
<tr>
<td>Land</td>
<td>60,000</td>
<td>20,000</td>
<td></td>
<td>20,000</td>
<td></td>
</tr>
<tr>
<td>Building</td>
<td>180,000</td>
<td>100,000</td>
<td>60,000</td>
<td>10,000</td>
<td></td>
</tr>
<tr>
<td>Equip</td>
<td>50,000</td>
<td>70,000</td>
<td></td>
<td>0</td>
<td>(2)</td>
</tr>
<tr>
<td>Goodwill</td>
<td>40,000</td>
<td>0</td>
<td>20,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$535,000</strong></td>
<td><strong>$318,000</strong></td>
<td><strong>$160,000</strong></td>
<td><strong>$30,000</strong></td>
<td></td>
</tr>
</tbody>
</table>

Notes:

1) Accounts receivable are considered to be capital property. The capital loss of $3,000 is denied [ITA 40(2)(g)(i)] as a superficial loss [ITA 54] and added to the cost of the accounts receivable to the corporation [ITA 53(1)(f)]. Since the corporation is controlled by Dan, the corporation is an affiliated person [ITA 251.1].

2) The terminal loss of $20,000 is denied because Dan has transferred the depreciable capital property to an affiliated person [ITA 13(21.2)]. The denied loss is treated as the capital cost of a depreciable property to Dan in the class from which the property was disposed. CCA may be claimed by Dan on the $20,000 balance. Any portion of the denied loss not claimed as CCA may be recognized as a terminal loss by Dan, if he has no other assets in the class, at the time that the equipment is no longer owned by an affiliated person for a 30-day period.

The cost of the property to the corporation for tax purposes is as follows.

<table>
<thead>
<tr>
<th>Capital cost</th>
<th>UCC/CEC</th>
<th>ACB</th>
<th>Other Tax Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Acc. Rec.</td>
<td>$8,000 (1)</td>
<td></td>
<td>$200,000</td>
</tr>
<tr>
<td>Inventory</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Land</td>
<td></td>
<td>60,000</td>
<td></td>
</tr>
<tr>
<td>Building</td>
<td>$170,000 (2)</td>
<td>$170,000 (2)</td>
<td>180,000</td>
</tr>
<tr>
<td>Equip</td>
<td>100,000 (3)</td>
<td>50,000</td>
<td></td>
</tr>
<tr>
<td>Goodwill</td>
<td></td>
<td>20,000 (4)</td>
<td></td>
</tr>
</tbody>
</table>
Notes:
(1) The ACB of the Accounts Receivable is computed as purchase price $5,000 + capital loss denied to Dan $3,000 = $8,000 [ITA 53(1)(f)].

(2) Because the building is a depreciable property which has been acquired from a non-arm’s length person (Dan) at a price higher than Dan’s cost, the capital cost of the building for CCA and future recapture purposes is deemed to be the aggregate of $160,000 (capital cost to Dan) + $10,000 (Dan’s taxable capital gain) = $170,000 [ITA 13(7)(e)(i)].

(3) Because the equipment is a depreciable property which has been acquired from a non-arm’s length person (Dan) at a price lower than Dan’s cost, the capital cost of the equipment for future recapture purposes is deemed to be Dan’s cost, $100,000 [ITA 13(7)(e)(iii)].

(4) On a purchase of eligible capital property for $40,000, the corporation adds $20,000 (i.e., \( \frac{3}{4} \times 40,000 - \frac{1}{2} \times 20,000 \) (Dan’s income under ITA 14(1)(b))) to its CEC account [amount A of the definition of cumulative eligible capital in ITA 14(5)(b)].

A More Tax Effective Manner:

For the Equipment there is not a more tax-effective manner. For the other assets Dan should use election provisions available in the *Income Tax Act*, i.e., Section 22 and Section 85.

Section 22 election on the Accounts Receivable

A Section 22 election is a joint election made by the seller and the purchaser. In order to make the election Dan must be selling all or substantially all the assets used in a business, including the receivables, to a purchaser who plans to carry on the business. As these conditions are met, a Section 22 election can be used.

Under Section 22, Dan will get a $3,000 business loss. The corporation must include the $3,000 in its income and will be allowed to claim a reserve for doubtful accounts [ITA 20(1)(l)] and to write off bad debts [ITA 20(1)(p)] against business income as appropriate at its year end. Without a Section 22 election the corporation would not be allowed a reserve or a bad debt write-off against these receivables. Instead, collection of an account for less than its cost to the corporation would result in a capital loss to the corporation.

Dan would still transfer the receivables to the corporation for a note equal to the FMV of the receivables. However, for tax purposes a Section 22 election would be made.
Section 85 election to defer recognition of recapture and capital gains on other assets -

A section 85 election is a joint election made by the seller and the purchaser. In order to use section 85 for the other assets, Dan is going to have to change the consideration received for the other assets from all debt to a combination of shares and debt [ITA 85(1)].

<table>
<thead>
<tr>
<th>Asset</th>
<th>Value</th>
<th>Tax Value</th>
<th>Elected Amount</th>
<th>--Consideration--</th>
<th>Debt</th>
<th>Shares</th>
<th>Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory</td>
<td>200,000</td>
<td>120,000</td>
<td>$120,000</td>
<td>$120,000</td>
<td>$80,000</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Land</td>
<td>60,000</td>
<td>20,000</td>
<td>20,000</td>
<td>20,000</td>
<td>40,000</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Building</td>
<td>180,000</td>
<td>100,000</td>
<td>100,000</td>
<td>100,000</td>
<td>80,000</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Goodwill</td>
<td>40,000</td>
<td>0</td>
<td>1</td>
<td>0</td>
<td>40,000</td>
<td>0</td>
<td>0.50</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$480,000</td>
<td>$240,000</td>
<td>$240,000</td>
<td>$240,000</td>
<td>$240,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The total of the debt and share consideration equals the fair market value of the assets transferred to the corporation. In each case the debt is limited to the Section 85 elected amount [ITA 85(1)(b)]. For the goodwill, $1 of debt and $39,999 of shares could have been taken as consideration with the same resulting income for tax purposes.

The cost of the property to the corporation for tax purposes after the elections under Section 22 and Section 85 is as follows.

<table>
<thead>
<tr>
<th>Capital cost</th>
<th>UCC/CEC</th>
<th>ACB</th>
<th>Other Tax Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Acc. Rec. Inventory</td>
<td>$8,000 (1)</td>
<td></td>
<td>$120,000 (2)</td>
</tr>
<tr>
<td>Land</td>
<td>20,000 (2)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Building</td>
<td>$160,000 (3)</td>
<td>$100,000 (2)</td>
<td>160,000</td>
</tr>
<tr>
<td>Equip</td>
<td>100,000 (4)</td>
<td>50,000</td>
<td></td>
</tr>
<tr>
<td>Goodwill</td>
<td></td>
<td>0.50 (5)</td>
<td></td>
</tr>
</tbody>
</table>

Notes:
(1) Face value.
(2) Elected amount [ITA 85(1)].
(3) Because the building is a depreciable property which has been acquired under a Section 85 election at a price lower than Dan’s cost, the capital cost of the building for future recapture purposes is deemed to be Dan’s cost, $160,000 [ITA 85(5)].
(4) Because the equipment is a depreciable property which has been acquired from a non-arm’s length person (Dan) at a price lower than Dan’s cost, the capital cost of the equipment for future recapture purposes is deemed to be Dan’s cost, $100,000 [ITA 13(7)(e)(iii)].
(5) On a purchase of eligible capital property at an elected amount of $1, the corporation would add $0.50 (i.e., ¾ x $1 – ½ x $0.50 (Dan’s income under ITA 14(1)(b))) to its CEC account [amount A of the definition of cumulative eligible capital in ITA 14(5)(b)].
The ACB of the share consideration received on the section 85 transfer is $1, computed as follows [ITA 85(1)(f) & (g)]:

<table>
<thead>
<tr>
<th>Elected amount</th>
<th>$240,001</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less: allocation to debt</td>
<td>(240,000)</td>
</tr>
<tr>
<td>Allocation to shares</td>
<td>$1</td>
</tr>
</tbody>
</table>

The PUC of the share consideration received is $1 [ITA 85(2.1)]. The PUC of the shares reflects the tax-paid cost of the assets transferred to the corporation that has not or will not be recovered tax-free in non-share consideration. In this case all of the tax-paid cost of the assets was recovered by tax-free debt. The $1 of PUC represents the $1 elected as proceeds in excess of the tax-paid cost of the goodwill.

<table>
<thead>
<tr>
<th>Dan’s consideration:</th>
<th>FMV</th>
<th>ACB</th>
<th>PUC</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt</td>
<td>$240,000</td>
<td>$240,000</td>
<td>NA</td>
</tr>
<tr>
<td>Shares</td>
<td>240,000</td>
<td>1</td>
<td>$1</td>
</tr>
<tr>
<td>$480,000</td>
<td>$240,001</td>
<td>$1</td>
<td></td>
</tr>
</tbody>
</table>

Grape Expectations

If Dan transfers his shares of Grape Expectations, a public company, to Dash Inc., the $10,000 capital loss ($50,000 – $60,000) will be denied to Dan (superficial loss) [ITA 40(2)(g)] and will increase the ACB of the Grape Expectations shares now held by Dash Inc. to $60,000 ($50,000 + $10,000) [ITA 53(1)(f)].

The Grape Expectations shares are currently worth almost 10% value of the assets in Dash Inc. If Dan transfers these shares to Dash Inc. and they increase in value, Dan runs the risk of Dash Inc ceasing to be a Small Business Corporation (not meeting the 90% test). Dan should not transfer these shares to Dash Inc.
CHAPTER 13
THE CANADIAN-CONTROLLED PRIVATE CORPORATION

Review Questions

1. Explain why a Canadian corporation whose voting share capital is owned 50% by Canadian residents and 50% by non-residents is classified as a Canadian-controlled private corporation.

2. Canadian-controlled private corporations differ from public corporations in the rate of tax, the extent of double taxation, and the degree of secondary relationships with shareholders. Briefly describe these differences.

3. “A business that derives its income from selling personal services (plumbing repairs, for example) cannot be viewed as earning active business income.” Is this statement true? Explain. How is a personal services business different from an active business?

4. Why may a Canadian-controlled private corporation that earns business income of $100,000 in year 1 and $500,000 in year 2 (total: $600,000) pay less tax than a corporation earning $50,000 in year 1 and $550,000 in year 2 (total: $600,000)?

5. In question 4, what might the latter corporation be able to do to ensure that it pays the same amount of tax as the first corporation? If these options are, in fact, available, what other factors must be considered before a decision is made to take such actions?

6. “The use of the small-business deduction by a Canadian-controlled private corporation does not result in a tax saving; rather, it creates a tax deferral.” Explain.

7. Interest income and/or rental income earned by one Canadian-controlled private corporation may be treated as specified investment business income. At the same time, income from the same source(s) earned by another Canadian-controlled private corporation may be treated as active business income. Why is this? And to what extent will the rate of tax applied to that income be different for the two corporations?

8. Identify and briefly explain the mechanism that is used to reduce the incidence of double taxation when specified investment business income is distributed by a Canadian-controlled private corporation to its shareholders.

9. Does double taxation occur when a Canadian-controlled private corporation earns capital gains and distributes those gains as dividends to individual shareholders? Explain.

10. “An investor can achieve a tax deferral on portfolio dividends received from public corporation shares if those shares are owned by his or her private corporation.” Is this statement true? Explain.

11. There are several advantages to deferring tax by utilizing the small-business deduction. Briefly state two of them.
12. A Canadian-controlled private corporation can obtain a tax deferral from the small-business deduction. Will the corporation’s owner always benefit from investing the extra cash flow that results, regardless of the type of return that may be received from the investment? Explain.


14. Why may it be worthwhile for a corporation to pay an additional salary or bonus to its shareholder/manager, even though he or she does not require additional funds?

15. Is it possible for a shareholder to obtain personal use of corporate funds without first declaring a dividend or salary? Explain.

16. Individual A is about to acquire 30% of the shares of a new corporation (a Canadian-controlled private corporation) that will carry on an active business. The remaining 70% of the shares will be owned by X Corporation, a company that also owns an active business. What concern should individual A have regarding the tax treatment of the new corporation’s income?
Solutions to Review Questions

R13-1. A Canadian-controlled private corporation is defined as a Canadian private corporation that is not controlled directly or indirectly, in any manner whatever, by one or more non-residents or by one or more public corporations. In this particular case, even though the corporation is not actually controlled by Canadians (50%) it is also not controlled by non-residents (50%). Therefore, by definition, the corporation is a Canadian-controlled private corporation [ITA 125(7)].

R13-2. Basic differences between public corporations and Canadian-controlled private corporations:

- **Rates of Tax (2012)** - The rates of tax applicable to a public corporation and a CCPC differ in several ways. In a CCPC the first $500,000 of annual active business income is eligible for the small business deduction [ITA 125(1)] of 17% reducing federal taxes (after the 10% abatement) to 11%. In most provinces, the provincial rate is also reduced for this income. A CCPC pays an additional 6 2/3% refundable tax on its investment income [ITA 123.3] and is entitled to a refund of Part I tax equal to 26 2/3% of its investment income. As well, dividends from non-connected corporations are subject to a 33 1/3% Part IV tax [ITA 186(1)] which is not the case for public corporations.

- **Double Taxation** – The Canadian tax system is intended to be integrated; the combined tax rate - corporate plus shareholder tax on the dividend distribution - approximates the individual shareholders’ personal rate of tax. This is achieved by the dividend gross-up and tax credit. As well for CCPCs integration tools include the small business deduction on active business income, the refund mechanism on property income and taxable capital gains [ITA 129(1)], and the special tax-free dividend distribution on certain non-taxable income such as one-half of capital gains [ITA 83(2)].

In some cases the integration is not perfect and results in an overall tax cost or tax savings. Where a tax cost occurs, this is referred to as double taxation. At the high corporate rate (25%) some double taxation occurs. This rate applies to all income earned by a public corporation and business income over $500,000 earned annually by a CCPC.

- **Secondary Relationship** - A secondary relationship exists when a shareholder also acts in another capacity with the corporation such as a creditor lending funds to the corporation, a lesser leasing property to the corporation, or as an employee of the corporation. Such relationships are common in a CCPC because the number of shareholders is usually small and the affairs of the corporation and the shareholders are closely associated. In a public corporation, there are a large number of shareholders who do not participate in the management of the corporation and, therefore, secondary relationships are rare.

R13-3. The statement is not true. Active business income is defined as any business carried on by the corporation other than a specified investment business or a personal service business. While the definition excludes a personal service business it does not mean income from selling services is excluded. The term personal service business has a special and narrow definition and relates to providing services in a particular manner (i.e., where there is an employer/employee relationship between the entity receiving the service and the individual shareholder of the corporation that is providing the service). As this type of relationship is not common, it can be said that corporate income derived from selling services (e.g., consulting services) is normally considered to be active business income eligible for the small business deduction [ITA 125(7)].
R13-4. The corporation that earns $100,000 in year 1 and $500,000 in year 2 has all of its income ($100,000 + $500,000 = $600,000) eligible for the small business deduction because in both years the income does not exceed the annual $500,000 limit. The corporation will pay less tax than the other corporation which also earns $600,000, but in year 2 has income in excess of $500,000. This corporation will receive the small business deduction on $50,000 in year 1 and $500,000 in year 2 (total $550,000) leaving $50,000 to be taxed at a higher corporate rate. This major difference in tax cost results from the imposition of an annual limit, which means that not only is the amount of income earned important but also when that income is earned.

R13-5. In question 4 above, the second corporation could take steps to increase the income in the first year and reduce the income of the second year. This would qualify more of the total income for the small business deduction. These steps do not change the real income of the entity but change the time period in which they are recognized. For example, the corporation could choose not to claim a reserve for doubtful accounts in year 1 but recognize the deduction in year 2. Similarly, owners’ salaries could be reduced in year 1 and increased in year 2.

While such actions reduce the rate of tax payable, it also speeds up the timing of tax. In other words, the total tax for the two years is less but more tax is payable in the first year than would otherwise be payable. Therefore, the impact on cash flow must also be considered before this decision is made.

R13-6. The use of the small business deduction results in a corporate tax rate of approximately 15%. This rate is substantially lower than the top marginal rate of tax that an individual would pay if the business income was earned by a proprietorship (or partnership) rather than a corporation. However, when the corporate structure is used, the after-tax income of the corporation is subject to a second level of tax when it is paid to the shareholder as a dividend or, if not paid as a dividend, when the shares are sold and a capital gain occurs. This second level of tax, although deferred, normally will eliminate most of the tax saving achieved from the use of the small business deduction. Consequently, the small business deduction is useful if the corporate earnings are retained in the corporation; its benefit is a deferral and not permanent.

R13-7. A CCPC has specified business investment income if it earns income from property (interest, rents, royalties) other than dividends from Canadian corporations. Property income is achieved from these sources when the return on investment is earned with little attention or labour of the owner; otherwise it is business income. For a CCPC, such income is arbitrarily classified as active business income if the corporation employs more than five full-time employees who work to generate that income. Therefore, based on this arbitrary factor one CCPC may have active business income and another CCPC may have specified business investment income [ITA 125(7)].

When classified as active business income, the income is eligible for the small business deduction resulting in a tax rate of 15% provided that it is within the $500,000 annual limit. Active business income in excess of the $500,000 annual limit is subject to the higher corporate rate (25%). If the income is classified as specified business investment income, it is subject to the highest rate of corporate tax (44 2/3%) but is eligible for a partial refund when that income is distributed to the shareholders as dividends [ITA 129(3)].

R13-8. Specified business investment income is taxed in a CCPC at the highest corporate rate
(44 2/3%). In spite of this high rate, the element of double taxation is avoided by a refund mechanism [ITA 129(3)]. The potential refund is 26 2/3% of specified business investment income earned and the refund is paid to the corporation when a dividend distribution is made to the shareholder. Although the corporate tax rate may be as high as 44 2/3% when the income is earned, this amount is reduced by 26 2/3% to 18% when distributed. The combination of the refund plus the dividend tax credit for the shareholder eliminates almost, if not all, of the double taxation.

R13-9. Double taxation generally does not occur when a CCPC earns a capital gain. One-half of the capital gain is taxable at the high corporate rate of 44 2/3%. However, of this tax, an amount equal to 26 2/3% of the taxable gain is refunded to the corporation when the gain is distributed as a taxable dividend to the shareholder [ITA 129(3)]. This reduction of corporate tax plus the dividend tax credit avoids double taxation. One-half of the capital gain is not taxable. This tax-free portion of the gain can be distributed as a tax-free capital dividend [ITA 83(2), 89(1)]. The refund mechanism plus the tax-free dividend are designed specifically to avoid double taxation for a CCPC on this type of income.

R13-10. Dividends received by a CCPC are not subject to normal corporate rates of tax because the dividends are excluded from taxable income. However, portfolio dividends (from public corporations) and certain dividends from Canadian private companies are subject to a special Part IV tax of 33 1/3% [ITA 186(1)]. This tax is fully refundable to the corporation when the dividend income is distributed to the shareholder. Once distributed to an individual shareholder, the dividend will be taxed in the ordinary manner.

If the portfolio dividend was a non-eligible dividend and was received directly by an individual in the top tax bracket, the rate of tax would be approximately 33%. Therefore, earning portfolio dividends in a CCPC normally does not result in a tax deferral. (Depending on the province, actual rates in 2012 on non-eligible dividends vary from a low of 28% in Alberta to a high of 41% in Prince Edward Island).

R13-11. The tax deferral from the small business deduction results in two basic advantages.

- The increased cash flow from the lower tax rate (compared to the personal tax rate) can be reinvested in business expansion or passive investments resulting in greater long-term return on investments.
- The increased cash flow, especially at the early stages of a new business, reduces the risk of business failure by providing greater liquidity for responding to changing business needs.

R13-12 The tax advantage from incorporating a proprietorship business results from the reduced tax rate on active business income that is subject to the small business deduction. This tax reduction is only a deferral as ultimately the shareholder must realize their investment through dividend distribution and/or a disposal of the shares. The increased cash flow in the corporation, when reinvested, will provide returns to the corporation that are subject to tax. If those additional returns are also subject to the small business deduction or are specified investment business income (subject to the high corporate tax rate combined with a refund when distributed), no double taxation on those returns will occur. However, when the returns from investing the tax deferrals from the small business deduction earn active business income subject to the high corporate tax rate, some double taxation on those returns may occur at some future time.
It is important to recognize that the additional cash flow provided from the small business deduction may be critical to the success of the business and the expansion opportunities that it can participate in.

R13-13. The incorporation of investment income (other than certain dividends) does not provide a substantial advantage. In a CCPC investment income such as interest and rents, as well as taxable capital gains, are subject to the highest corporate tax rate (44 2/3%) which, in many provinces, is higher than the top individual tax rate. Therefore, incorporation does not provide a tax deferral.

Investment income in the form of dividends from Canadian public corporations and non-connected private corporations are subject to a special refundable tax of 33 1/3% (Part IV tax) when received by a Private corporation. The rate is about the same as the top marginal personal tax rate on dividends. Therefore, incorporating this income provides no tax deferral. Dividends received by a CCPC from a connected corporation are normally not subject to Part IV tax and a substantial tax deferral will occur [ITA 186(1)].

One disadvantage to incorporating investments should be noted. If an investment in shares of a qualified small business corporation is made through another corporation, any gain on the subsequent sale of those shares will not be available for the capital gains deduction since only individuals can claim a capital gains deduction [ITA 110.6].

R13-14 It may be advantageous for a corporation to pay an additional salary or bonus to the manager/shareholder in situations where the corporation has earned active business income that is not subject to the small business deduction. Such income is subject to the high corporate tax rate (25% in some provinces on income over $500,000) and is subject to further taxation when distributed as dividends to the shareholder at some future time. The result is some double taxation. The payment of an additional salary reduces the amount of corporate income by shifting it directly to the shareholder. Although the shareholder’s tax rate is perhaps higher than the corporate rate, the double tax is avoided.

When the shareholder does not need the funds, the additional salary or bonus can be loaned back to the corporation (the bonus amount minus personal tax). However, in this case the decision is difficult. The corporate rate of 25% is lower than the top personal tax rate but still results in some double taxation at some future time. The combined corporate and personal tax on the dividend distribution is approximately 46%. Therefore, if the shareholder does not need the funds immediately, a decision to leave the funds in the corporation to gain a 20% tax deferral (45% personal rate v 25% corporate rate) must be weighed against the impact of the small amount of double taxation at some future time. It should be recognized that the payment of an additional salary or bonus must pass the test of reasonableness before it can be deducted from corporate income [ITA 67].

R13-15. Under certain circumstances, a shareholder may be able to secure temporary use of corporate funds without the corporation declaring taxable dividends or paying salaries. If the shareholder is also an employee or officer of the corporation, the corporation may loan funds to the shareholder for acquiring a personal residence, for acquiring treasury shares of the corporation, or for acquiring an automobile to be used in performing employment duties. The loan will have no tax consequences to the shareholder provided that reasonable repayment terms are made and the loan is received because of employment and not because of someone’s shareholding [ITA 15(2.4)]. However, there
will be an imputed interest benefit included in the employee’s employment income if the loan is interest-free or at a low interest rate [ITA 80.4(1) & (3)].

Loans made to shareholders for any other purpose must be repaid within one year from the end of the taxation year of the corporation in which the loan was made. Otherwise, the amount of the loan will be considered as income to the shareholder in the year received [ITA 15(2.6)]. If this occurs, a subsequent repayment of the loan is permitted as a deduction from the shareholder’s income in the year of repayment [ITA 20(1)(j)].

R13-16. Because 70% of the new corporation's shares are owned by X Corporation, the two corporations are associated [ITA 256(1)(a)]. X Corporation controls the new corporation. Consequently, the $500,000 small business deduction limit must be shared between the two corporations [ITA 125(3)]. As X Corporation also carries on an active business, it would be to X Corporation’s advantage to use the full $500,000 limit and not share any of it with the new corporation that is owned 33% by individual A. As a minority shareholder of the new corporation, individual A should be concerned about not having the use of the small business deduction in the new corporation. This issue could be resolved by a shareholders’ agreement that establishes the allocation of the $500,000 annual limit for future years [256(1), 125(3)].
Key Concept Questions

QUESTION ONE

Determine the type of business income being earned by each of the following Canadian-controlled private corporations. Income tax reference: ITA 125(7), 129(6).

a) Corporation A earns interest and dividends from numerous Canadian corporations. Corporation A employs three full-time employees.

b) Corporation B earns rental income from leasing automobiles.

c) Corporation C carries on a wholesaling business. In the current year Corporation C earned interest income on overdue accounts receivable in addition to income from the wholesaling business.

d) Corporation D earns interest income from numerous sources. Corporation D employs 10 full-time employees.

e) Corporation E earns consulting income from services provided to X Ltd. Eddy is the sole shareholder and the only employee of E Ltd. Eddy was previously employed by X Ltd. as VP operations.

f) Corporation F provides consulting services to several clients. Fred is the sole shareholder and only employee of Corporation F.

g) Corporation G earns interest income on a loan to an associated corporation that carries on an active business.

The interest was deducted in computing the active business income of the associated corporation.

QUESTION TWO

Can Corp., a Canadian-controlled private corporation, has net income and taxable income of $100,000 for the current year. The income is specified investment income. Determine the federal Part I tax payable. Income tax reference: ITA 123(1), 124(1), 123.3.

QUESTION THREE

A Canadian private corporation incurred the following transactions in previous years:

- In 1996, sold a capital asset that resulted in a capital gain of $10,000.
- In 2003, sold a capital asset that resulted in a capital loss of $4,000.
- In 2004, paid a capital dividend of $1,000.
- In 2006, eligible capital property was purchased for $20,000. A CECA deduction of $1,050 was claimed on the corporate tax return.
- In 2007, the eligible capital property was sold for $28,000.
- In 2008, received life insurance proceeds of $50,000. The policy had an adjusted cost base of $10,000.

In the current year, a capital dividend of $15,000 was received.
Determine the current balance in the capital dividend account based on the above information. *Income tax reference: ITA 89(1).*

**QUESTION FOUR**

Black Ltd., a Canadian private corporation, owns 40% of the voting shares of White Ltd. In the current year, White paid a dividend of $60,000, which triggered a dividend refund of $20,000 to White. Black also received dividends of $40,000 from its wholly-owned subsidiary, Red Ltd., and dividends of $30,000 from sundry Canadian public corporations in which Black owns less than 1% of the issued shares. Red carries on an active business and, thus, did not receive a dividend refund.

Determine the refundable Part IV tax payable by Black Ltd. for the current year. *Income tax reference: ITA 186(1), (2), (4).*

**QUESTION FIVE**

On March 1, 20X7, Martin received an interest-free loan from his employer, X Ltd., a private corporation, owned by his wife. Martin used the loan to purchase the condominium in which he lives. A loan agreement was signed by Martin agreeing to repay the loan in full after three years. Such a loan is not available to other employees. X Ltd. has a June 30 year end.

Determine the tax implications of the loan for Martin. *Income tax reference: ITA 15(2), (2.1), (2.4), (2.6), 20(1)(j), 80.4(3).*

**QUESTION SIX**

Howard owns 2% of the shares of Y Ltd. He is also employed by Y in a middle management position. On August 1, 20X7, Howard received a loan from Y that he used to repay personal debts. Howard signed a loan agreement, agreeing to pay interest on the loan at the bank prime rate in effect on August 1, 20X7 and to repay the loan over three years by monthly payroll deductions. Similar loans have been made in the past to mid-level management employees. Y has a December 31 year end.

Determine the tax implications of the loan for Howard. *Income tax reference: ITA 15(2), (2.4), (2.6), 80.4(3).*
QUESTION SEVEN

Consider each of the following unrelated situations.

1) Sally owns 80% of the issued share of Salt Ltd. and 20% of the issued shares of Pepper Ltd. Her friend owns the remaining 20% of Salt Ltd. and 80% of Pepper Ltd.

2) Bob owns 70% of the issued shares of B Ltd. that in turn owns 40% of the shares of X Ltd. Bob’s father owns the remaining 60% of the shares of X Ltd.

3) Glen and his brother each own 50% of the shares of A Ltd. Glen’s son owns 50% of the shares of B Ltd. The remaining shares of B Ltd. are owned equally by Glen and his father.

4) Wayne owns 100% of the share of W Ltd. His son, Stephen, owns 100% of the common shares of S Ltd. Wayne owns 100% of the preference shares of S Ltd. The preferred shares are non-voting, have a fixed dividend rate (4%), have an issue price of $1,000 per share and are redeemable at $1,000 per share. The prescribed rate was 5% when the shares were issued.

For each situation, determine whether the two corporations are associated and if so, state the paragraph in ITA 256(1) which makes them associated. *Income tax reference: ITA 256(1),(1.1),(1.2).*

QUESTION EIGHT

TV Ltd. is a Canadian-controlled private corporation. The taxable income for its current year has been correctly calculated below.

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Manufacturing &amp; processing profits</td>
<td>$440,000</td>
</tr>
<tr>
<td>Taxable capital gains</td>
<td>100,000</td>
</tr>
<tr>
<td>Taxable dividends from Canadian public corporations</td>
<td>24,000</td>
</tr>
<tr>
<td>Interest on five-year bonds</td>
<td>10,000</td>
</tr>
<tr>
<td>Net income for tax purposes</td>
<td>574,000</td>
</tr>
<tr>
<td>Dividends</td>
<td>(24,000)</td>
</tr>
<tr>
<td>Net capital losses</td>
<td>(30,000)</td>
</tr>
<tr>
<td>Non-capital losses</td>
<td>(20,000)</td>
</tr>
<tr>
<td>Taxable income</td>
<td><strong>$500,000</strong></td>
</tr>
</tbody>
</table>

TV Ltd and Nano Ltd. are associated corporations. For the current year, Nano Ltd. claimed the small-business deduction on $120,000 of its active business income. The taxable capital of the two corporations, combined, is below $10,000,000.

Determine the small-business deduction for TV Ltd. *Income tax reference: ITA 125(1), (2), (3).*
QUESTION NINE

Using the information provided in Question Eight, determine TV Ltd.'s refundable tax on investment income. *Income tax reference: ITA 123.3, 129(4).*

QUESTION TEN

Using the information provided in Question Eight, determine the manufacturing and processing deduction for TV Ltd. Assume that Canadian manufacturing and processing profits, $440,000, have been calculated in accordance with the prescribed rules. *Income tax reference: ITA 125.1(1).*

QUESTION ELEVEN

Using the information provided in Question Eight, determine TV Ltd.'s general rate reduction. *Income tax reference: ITA 123.4(1).*

QUESTION TWELVE

TV Ltd. has Part I tax payable for the current year of $68,133. TV Ltd. had a balance in its refundable dividend tax on hand (RDTOH) account at the end of the previous year of $27,000. TV Ltd. calculated a dividend refund of $6,000 for the previous year, based on dividends paid in the previous year. Using the information provided in Question Eight, determine TV Ltd.'s RDTOH balance at the end of the current year. *Income tax reference: ITA 129(3), 186(1).*

QUESTION THIRTEEN

Assume TV Ltd. has a RDTOH balance of $50,333 at the end of the current year, and that taxable dividends of $90,000 and tax-free capital dividends of $30,000 were paid in the current year. *Income tax reference: ITA 129(3).*

Determine the dividend refund for the current year.

QUESTION FOURTEEN

EX Ltd. is a Canadian-controlled private corporation operating a retail business in Canada. For the current year EX Ltd. has net income of $662,000 and taxable income of $600,000. Included in net income are taxable capital gains of $46,000 and interest from Canadian sources of $30,000 as well as $42,000 of dividends from Canadian public companies. Net capital losses of $20,000 were deducted in computing taxable income. EX Ltd. is claiming a small-business deduction of $85,000 ($500,000 x 17%), which reduces the Part I tax payable to $204,433. The RDTOH balance at the end of the previous year was $12,000. During the current year taxable dividends of $27,000 were paid. Dividends were not paid in the previous year.
Determine the dividend refund for EX Ltd. for the current year. *Income tax reference: ITA 129(1), (3), (4), 186(1).*

**QUESTION FIFTEEN**

Ready Ltd is a Canadian-controlled private corporation operating a retail business in Ontario. Ready Ltd is not associated with any other corporation and its taxable capital is under $10,000,000. For its current year ended, its records showed the following amounts:

- Income from retail business $600,000
- Interest income 10,000
- Eligible dividend received from a Canadian company 40,000
- Net income 650,000
- Dividend (40,000)
- Taxable income $610,000

Ready Ltd. has not paid any dividends in the last few years. Ready Ltd. had a general rate income pool (GRIP) account balance of $50,000 at the end of the previous year.

Determine the GRIP account balance at the end of the current year. *Income tax reference: ITA 89(1) – definition of GRIP.*

**QUESTION SIXTEEN**

Hitech Ltd., a Canadian-controlled private corporation, spent $1,000,000 in current expenditures for scientific research and experimental development (SR&ED), as well as $500,000 in capital expenditures for SR&ED in the current year. Hitech Ltd. is not associated with any other corporation. Its taxable income for the previous year was $120,000 which resulted in federal tax payable of $13,200. There was no tax payable for the two years before that. The taxable capital is well below $10,000,000. Taxable income for the current year is $100,000. *Income tax reference: ITA 127(5),(9),(10.1), (10.2), 127.1, 12(1)(t).*

Determine the following:

a) The investment tax credit earned by Hitech Ltd.

b) The cash refund available due to the investment tax credit, and

c) The investment tax credit available for carry over.
Solutions to Key Concept Questions

KC 13-1

[ITA: 125(7), 129(6) – Types of Business income]

There are three possible types of business income:

1) Active business income (ABI) – any business carried on by the corporation other than a specified investment business (SIB) or a personal services business (PSB).

2) SIB – a business whose principal purpose is to earn income from property, unless more than 5 full-time employees are employed in the business throughout the year.

3) PSB – a business that provides services, when the person providing the services is a specified shareholder of the corporation, and the relationship between the person providing the services and the entity receiving the services is of an employment nature. Two exceptions are made to the definition of PSB:
   - More than 5 full-time employees are employed in the business throughout the year, or
   - The services are provided to an associated corporation.

Specified shareholder means someone who alone, or together with related persons, owns at least 10% of the issued shares of any class of the corporation or a related corporation [ITA 248(1)].

a) Corporation A earns SIB.
b) Corporation B earns ABI.
c) Corporation C earns ABI. The interest on the overdue accounts receivable is income from an active business because it is pertaining to or incidental to the wholesaling business.
d) Corporation D earns ABI. It is not SIB because more than 5 full-time employees are employed in the business throughout the year.
e) Corporation E earns PSB if an employer/employee relationship exists between Eddy and X Ltd.
f) Corporation F earns ABI. It is not PSB as the employer/employee relationship (between Fred and the several clients) is absent.
g) Corporation G earns ABI. The interest is deemed to be ABI because it is deductible in computing the ABI of an associated corporation [ITA 129(6)].

KC 13-2

[ITA: 123(1), 124(1), 123.3 – Federal tax calculation - SIB]

\[
\begin{align*}
\text{ITA 123(1) Basic federal tax} & \quad \text{-} \quad \$100,000 \times 38\% \quad \text{\$38,000} \\
\text{ITA 124(1) Federal abatement} & \quad \text{-} \quad \$100,000 \times 10\% \quad \text{(10,000)} \\
\text{ITA 123.3 Refundable tax on CCPC investment income} & \quad \text{-} \quad \$100,000 \times 6 2/3\% \quad \text{6,667} \\
\text{Federal tax} & \quad \text{-} \quad \text{\$34,667} 
\end{align*}
\]
KC 13-3

[ITA: 89(1) – Capital dividend account]

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>ITA 89(1)(a) – Non-taxable portion of capital gains ($10,000 x ¼)</td>
<td>$ 2,500</td>
</tr>
<tr>
<td>– Non-allowable portion of capital losses ($4,000 x ½)</td>
<td>(2,000)</td>
</tr>
<tr>
<td>ITA 89(1)(b) – Capital dividends received</td>
<td>15,000</td>
</tr>
<tr>
<td>ITA 89(1)(c.1) – Non-taxable portion of gains on eligible capital property</td>
<td>4,000</td>
</tr>
<tr>
<td>($28,000 - $20,000) x ½</td>
<td></td>
</tr>
<tr>
<td>ITA 89(1)(d) – Life insurance proceeds $50,000 – ACB $10,000</td>
<td>40,000</td>
</tr>
<tr>
<td>Less – Capital dividends paid</td>
<td>(1,000)</td>
</tr>
<tr>
<td>Capital dividend account balance</td>
<td>$58,500</td>
</tr>
</tbody>
</table>

* The capital gains inclusion rate in 1996 was ¾.

KC 13-4

[ITA: 186(1),(2),(4) – Part IV tax]

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividends received from Non-connected corporations $30,000 x 1/3</td>
<td>$10,000</td>
</tr>
<tr>
<td>Dividends received from connected corporations:</td>
<td></td>
</tr>
<tr>
<td>• White Ltd. - 40% of White Ltd.’s dividend refund $20,000</td>
<td>8,000</td>
</tr>
<tr>
<td>• Red Ltd. - 100% of Red Ltd.’s dividend refund $0</td>
<td>0</td>
</tr>
<tr>
<td>Part IV tax</td>
<td>$18,000</td>
</tr>
</tbody>
</table>

KC 13-5

[ITA: 15(2),(2.1),(2.4),(2.6), 20(1)(j), 80.4(3) – Shareholder loan]

Since a similar loan is not available to other employees, Martin is considered to receive the loan because of his wife’s shareholding. If the loan is not repaid by June 30, 20X8, the loan will be included in Martin’s income for tax purposes for 20X7, the year he received the loan [ITA 15(2), (2.6)]. Even though the loan is used to buy a condominium to live in, it is not an exempt loan, since the loan was received because of his wife’s shareholding and not because of employment [ITA 15(2.4)(e)]. Since the loan is included in income, there is no imputed interest benefit [ITA 80.4(3)(b)]. If the loan is included in Martin’s income in 20X7, then Martin can deduct the loan repayment in the year the loan is repaid [ITA 20(1)(j)].

KC 13-6

[ITA: 15(2),(2.4), 80.4(3) – Shareholder loans]

Since Howard is a shareholder of Y Ltd., the shareholder loan rules must be considered. The loan is an excluded loan and will not be included in Howard’s income even if it is not repaid by December 31, 20X8. Howard is not a specified employee of Y Ltd., he received the loan because of his employment, and bone fide arrangements were made for repayment of the loan within a reasonable time [ITA 15(2.4)]. A specified employee is someone, who alone or together with related persons, owns 10% or more of any class of shares of the corporation [ITA 80.4(3)(b)].
248(1)]. Howard owns only 2%. Since the loan is not a low-interest loan or an interest-free loan, there is no imputed interest benefit [ITA 80.4(3)(a)].

**KC 13-7**

[ITA: 256(1), (1.1), (1.2) - Associated corporations]

1) Salt Ltd. and Pepper Ltd. are associated corporations [ITA 256(1)(b)]. They are controlled by the same group, Sally and her friend. ITA 256(1.2) clarifies that a shareholder need own only one share to be included in the group; and that a corporation may be controlled by a person or group of persons notwithstanding that the corporation is also controlled by another person or group of persons.

2) B Ltd. and X Ltd. are associated corporations [ITA 256(1)(c)]. Bob controls B Ltd. and he is related to his father, who controls X Ltd. Although Bob does not own any shares of X Ltd. directly, he is deemed to own 28% of X Ltd. (70% x 40%) by the look-through rules in 256(1.2)(d). Thus, the 25% cross ownership requirement is met.

3) Since neither corporation is controlled by one person, the only possible provision under which A Ltd. and B Ltd. could be associated is 256(1)(e). Both corporations are owned by a related group and Glen owns 25% of the issued shares of a class of both corporations. But the two corporations are not associated. To be associated each of the members of each related group must be related to all of the members of the other related group. Since Glen’s son and his brother (nephew and uncle) are not related, the two corporations are not associated.

4) W Ltd. and S Ltd. are not associated. For the corporations to be associated, Wayne would have to own at least 25% of the issued shares of any class of S Ltd. (other than a specified class) or Stephen would have to own 25% of the issued shares of any class (other than a specified class) of W Ltd. The preferred shares of S Ltd. are shares of a specified class [ITA 256(1.1)], therefore, the 25% cross ownership test is not met.

In general terms, shares of a specified class are non-voting, preferred shares that have a fixed dividend rate and redemption amount. The dividend rate cannot exceed the prescribed interest rate at the issue date of the shares and the redemption amount cannot exceed the issue amount.

**KC 13-8**

[ITA: 125(1),(2),(3) – Small business deduction]

Before the small business deduction can be calculated, the active business income and the annual business limit must be determined.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net income for tax purposes</td>
<td>$574,000</td>
</tr>
<tr>
<td>Less: Interest income</td>
<td>(10,000)</td>
</tr>
<tr>
<td>Dividends from taxable Canadian corporations</td>
<td>(24,000)</td>
</tr>
<tr>
<td>Net taxable capital gains</td>
<td>(100,000)</td>
</tr>
<tr>
<td>Active business income</td>
<td>$440,000</td>
</tr>
</tbody>
</table>
Business limit [ITA 125(2)] $500,000
Less amount claimed by associated corporation [ITA 125(3)] (120,000)
Business limit available to TV Ltd. $380,000

The Small business deduction is $64,600, calculated as follows:

Least of:
Active business income $440,000
Taxable income $500,000
Business limit $380,000

Least amount $380,000 x 17% $64,600

KC 13-9

[ITA: 123.3, 129(4) – Refundable tax on CCPCs Investment income]

The 6 2/3% refundable tax applies to the CCPC’s aggregate investment income which is calculated as follows [ITA 129(4)]:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net taxable capital gains</td>
<td>$100,000</td>
</tr>
<tr>
<td>Income from property (interest)</td>
<td>10,000</td>
</tr>
<tr>
<td>Investment income</td>
<td>110,000</td>
</tr>
<tr>
<td>Net capital losses</td>
<td>(30,000)</td>
</tr>
<tr>
<td>Aggregate investment income</td>
<td>$ 80,000</td>
</tr>
</tbody>
</table>

The refundable tax is $5,333, as follows [ITA 123.3]:

The lesser of:

a) Aggregate Investment income $80,000
b) Taxable income ($500,000) minus income subject to the small business deduction ($380,000) [KC 13-8] $120,000

Lesser amount $80,000 x 6 2/3 % 5,333
**KC 13-10**

[ITA: 125.1(1) – SBD and M&P deduction]

The M&P deduction applies only to the M&P profits that are not subject to the small business deduction. The small business deduction (SBD) was claimed on $380,000 of active business income (See solution to KC 13-8).

The M&P deduction is calculated as follows [ITA 125.1(1)]:

The least of:

a) M&P profits $440,000
   Less Income subject to the SBD (380,000) $60,000

b) Taxable income $500,000
   Less: Income subject to the SBD (380,000)
   Aggregate investment income (KC 13-9) (80,000) $40,000

Least amount $40,000 x 13% (2012) * $5,200

* 13% in 2012; 11.5% in 2011

**KC 13-11**

[ITA: 123.4 – General Rate Reduction]

The general rate reduction (13% in 2012, 11.5% in 2011) applies to the corporation’s taxable income other than income eligible for the M&P and SBD deductions, resource income, and investment income earned by CCPCs. TV Ltd. claimed the M&P deduction on income of $40,000 (See solution to KC 13-10); claimed the SBD deduction on income of $380,000 (See solution to KC 13-8); and has aggregate investment income of $80,000 (See solution to KC 13-9). Taxable income eligible for the general rate reduction is calculated as follows [ITA 123.4 - part (b) of the definition of “full rate taxable income”]

\[
\begin{align*}
\text{Taxable income} & \quad \text{$500,000} \\
& \quad \text{Less: Income eligible for the M&P deduction} \quad (40,000) \\
& \quad \text{Income eligible for the SBD deduction} \quad (380,000) \\
& \quad \text{Aggregate Investment income (calculated in KC 13-9)} \quad (80,000) \\
& \quad \text{Income eligible for the general rate reduction} \quad \text{Nil}
\end{align*}
\]
KC 13-12

[ITA: 129(3), 186(1) – RDTOH]

**ITA**

129(3)(c) RDTOH at end of previous year $27,000  
129(3)(d) Dividend refund for previous year (6,000)  
129(3)(b) Add: Part IV tax payable ($24,000 x 1/3) 21,000  
129(3)(a) CCPC Refundable Part I - Least of:  
   (i) 26 2/3% x aggregate investment income $21,333  
   (ii) 26 2/3% x (taxable income ($500,000) – income subject to SBD ($380,000)) $32,000  
   (iii) Part I tax $68,133 21,333  

RDTOH at end of current year $50,333  

(See solutions for KC 13-8 and KC 13-9 for the calculation of income subject to the SBD and aggregate investment income.)

KC 13-13

[ITA: 129(1) – Dividend Refund]

The dividend refund for the current year is $30,000 calculated as follows [ITA 129(1)(a)]:

The lesser of:  
   (i) 1/3 x taxable dividends paid in the year ($90,000) $30,000  
   (ii) RDTOH balance at end of current year $50,333  

KC 13-14

[ITA: 129(1),(3),(4), 186(1) - RDTOH and Dividend Refund]

The dividend refund for EX Ltd. for the current year is $9,000 calculated as follows [ITA 129(1)(a)]:

The lesser of:  
   (i) 1/3 x taxable dividends paid in the year ($27,000) $9,000  
   (ii) RDTOH balance at end of current year $40,933
The RDTOH at the end of the current year is calculated as follows [ITA 129(3)]

129(3)(c)  RDTOH at end of previous year  $12,000
129(3)(d)  Dividend refund for previous year  (0)

Add:  129(3)(b)  Part IV tax payable ($42,000 x 1/3)  14,000
129(3)(a) CCPC Refundable Part I Tax - Least of:
   (i)  26 2/3% x aggregate investment income ($56,000)  $14,933
   (ii) 26 2/3% x (taxable income $600,000 – income subject to SBD $500,000)  $26,667
   (iii) Part I tax  204,433

RDTOH at end of current year  $40,933

Aggregate investment income is $56,000 (net taxable capital gains $46,000 + interest income $30,000 – net capital losses $20,000) [ITA 129(4)].

KC 13-15

[ITA: 89(1) – GRIP]

GRIP end of previous year  $ 50,000
Add:
   72% of:
     Taxable income  $610,000
     Less:
       Income subject to the small business deduction  (500,000)
       Aggregate investment income  (10,000)
     $100,000
   72% x $100,000  72,000
   Eligible dividends received  40,000

Deduct:  Eligible dividends paid in the preceding year  0
   69% of current year’s losses carried back to a previous year’s full rate taxable income  0

GRIP end of current year  $162,000

Notes:

(1) 72% in 2012, 70% in 2011.

(2) A CCPC may designate a dividend as an eligible dividend as long as it has sufficient GRIP at the end of the year. If the eligible dividend exceeds the GRIP balance, the excess will be subject to a 20% Part III.1 tax.
The investment tax credit (ITC) enhanced rate of 35% applies to the first $3 million of annual SR&ED expenditures incurred by a CCPC [ITA 127(10.1)]. The 35% rate is gradually reduced to the standard 20% rate when the corporation’s taxable income of the previous taxation year is between $500,000 and $700,000 and when taxable capital is between $10 million and $50 million [ITA 127(10.2)]. Since Hitech’s taxable income in the preceding year did not exceed $500,000 and its taxable capital is less than $10 million, the 35% ITC rate applies to all of Hitech’s SR&ED expenditures. Therefore, the ITC earned by Hitech Ltd. in the current year is $525,000 ($1,500,000 x 35%).

Note: A corporation’s 3 million maximum expenditure limit decreases by $10 for each dollar of taxable income over $500,000 in the preceding taxation year. The amount is further reduced by 43 for every $40 in taxable capital in excess of $10 million [ITA 127(10.2)].

Hitech’s federal tax payable before applying the ITC is $12,100 being taxable income of $110,000 x 11% (38% - 10% - 17% = 11%). $12,100 of the $525,000 ITC will be used to reduce the federal tax payable to Nil; the remaining $512,900 can be carried back three years and forward 20 years to reduce taxes in those years [ITA 127(9) - definition of Investment tax credit]. $13,200 of ITC’s will be carried back to the previous year to recover $13,200 in federal tax paid. Hitech can claim and receive a cash refund for the excess ITC. The amount of the refund available varies depending on the nature of the SR&ED expenditures. The 35% ITC on current expenditures is 100% refundable. However, only 40% of the ITC that was created from expenditures of a capital nature is refundable [ITA127.1].

<table>
<thead>
<tr>
<th>Expenditure</th>
<th>ITC</th>
<th>Applied To current year</th>
<th>Carried Back</th>
<th>Refund Available</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current</td>
<td>$1,000,000</td>
<td>$350,000</td>
<td>$(0)</td>
<td>$(0)</td>
</tr>
<tr>
<td>Capital</td>
<td>$500,000</td>
<td>$175,000</td>
<td>$(12,100)</td>
<td>$(13,200)</td>
</tr>
<tr>
<td></td>
<td>$1,500,000</td>
<td>$525,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

If Hitech claims a refund of $409,880, there will be no ITC’s left to carry forward. Hitech should consider not claiming a refund of the ITC generated by the capital expenditures since only 40% is refundable. This would leave $149,700 ($175,000 - $12,100 - $13,200) of ITC’s available to carry forward and reduce federal tax in any of the following 20 years.
Problems

PROBLEM ONE

[ITA: 110.6; 125(1), (3), (7); 256(1)(b)]

John Basler is employed in the transportation industry and earns a substantial salary. His personal marginal tax rate is 45% (federal and provincial). He also owns 100% of the shares of Truck Ltd. The corporation is a 20% partner in a small trucking business. In 20X1, the partnership earned a net profit of $80,000.

Basler intends to do some consulting work starting in 20X2 while continuing in his present employment. A small trucking company has requested that he provide advice on how to set up a proper accounting system. He would be paid on a fee-for-service basis. The contract, if he accepts it, would likely last for two years and earn him $20,000 per year. It would also use up his entire available consulting time. In the future, he may accept two or three smaller contracts a year.

Basler has requested advice on whether he should incorporate his proposed consulting activities. He has indicated that he will not require the income for personal use and intends to invest the after-tax profits.

Required:

1. What are the tax benefits, if any, to Basler if he incorporates his consulting activities? Provide any appropriate calculations.

2. Would your answer change if Basler required all of the income for personal use? Show calculations.

3. Should Basler incorporate a separate company or simply use his existing company?
Solution to P 13-1

1. If Basler earns the consulting income as a proprietor, the income will be taxed at his personal tax rate of 45%. Over the two year period relating to the consulting contract his after-tax profits available for investment purposes are calculated below:

<table>
<thead>
<tr>
<th>Income</th>
<th>Less tax 45% x $40,000</th>
<th>After-tax profits for investment</th>
</tr>
</thead>
<tbody>
<tr>
<td>$20,000 x 2</td>
<td>$18,000</td>
<td>$22,000</td>
</tr>
</tbody>
</table>

If the consulting income is earned by his corporation, it qualifies as active business income and is eligible for the small business deduction (federal) as well as a reduced rate of provincial tax. The rate of provincial tax varies by province. For example, in 2012 the Ontario rate is 4.5%, New Brunswick is 5%, Nova Scotia, Newfoundland and Labrador is 4%, Alberta is 3.0% while the British Columbia rate is only 0.62 and Manitoba 0%.

Based on the limited information provided, it is unlikely, but possible, that the consulting income may be classified as personal service business income [ITA 125(7)]. This would occur if there was an indirect employer/employee relationship between the entity receiving the service and Basler who is the only shareholder of a corporation providing the service. Although the contract is to one entity, and for an extended time period (two years), there is no indication that such a relationship exists. If the income was personal service business income, the small business deduction would not be available, nor would the reduced provincial rate of tax.

Assuming that the provincial tax rate is 4%, the combined federal and provincial tax rate on the consulting income is 15% as follows:

| ITA 123(1) Federal rate | 38% |
| ITA 124(1) Less abatement | (10%) |
| ITA 125(1) Small business deduction | (17%) |

Federal tax       11%  
Provincial tax     4%  
Total rate of tax  15%

The after-tax funds available if the income is incorporated are:

| Income $20,000 x 2 | $40,000 |
| Less tax (15% x $40,000) | (6,000)  |
| After tax profits for investment | $34,000 |

Over the two year period, incorporation will provide increased after-tax profits of $12,000 ($34,000 - $22,000) which can be used to acquire investments. Basler's existing corporation, Truck Ltd., currently earns active business income from its share of partnership profits. The corporation's share of partnership profits is $16,000 (20% of $80,000) and, therefore, the consulting income would be well within the $500,000 small business deduction limit. However, Basler should be aware that if the partnership profits should increase substantially, the benefit of the low rate of tax on the consulting income may be limited.
2. If Basler needed all of the consulting income for personal use, there may be a small advantage from incorporation. The corporate profits would be paid to Basler as a salary or passed through as a dividend.

If the profits were paid as a salary, corporate profits and tax would be zero but Basler would incur 45% tax on the salary of $20,000 for each of the two years (total tax 45% x $40,000 = $18,000) which is the same as if the income had been earned directly by him as a proprietor.

If income is passed through as a dividend, Basler will pay tax on the dividend at a rate of approximately 33% (45% minus the dividend tax credit effect). The combined tax would then be:

Corporate profits $40,000
Less corporate tax (15%) (6,000)
Available for dividend $34,000

Tax on dividend (non-eligible):
33% x $34,000 $11,220

Total tax:
Corporation $6,000
Individual 11,220
$17,220

In this case there is a tax savings of $780 ($18,000 - $17,220).

3. Whether Basler incorporates a second corporation to carry on the consulting business or uses the existing company will not affect his ability to use the small business deduction. If a separate corporation is used, it will be associated with the existing company (Truck Ltd.) [ITA 256(1)(b)] and must share the $500,000 annual small business deduction limit [ITA 125(3)]. However, as the two companies would earn less than $500,000 in total, the small business deduction is not affected.

Basler should, however, anticipate possible future transactions. For example, he may want to dispose of his partnership investment in the trucking business, but it is unlikely that he will be in a position to sell the consulting business. Therefore, combining the two activities in one corporation would make it difficult to sell the shares of Basler Ltd. because the corporation will include both businesses plus investments created from the consulting practice excess cash flows. Therefore, Truck Ltd. would have to sell the partnership interest. In addition, the inclusion of the passive investments in Truck Ltd. may disqualify the corporation from being a small business corporation because all or substantially all of its assets are not used in an active business. Consequently, Basler would not be entitled to the capital gains deduction which is available on the sale of shares of a qualified small business corporation (QSBC) [ITA 110.6(1)].
PROBLEM TWO

[ITA: 83(2); 85(1); 89(1); 110.6; 123(1); 123.2; 123.3; 124(1); 129(1), (3); 186(1)]

Ruth Delaney owns all of the common shares of Delaney Fast Food Services Ltd. In addition, she has several investments that generate reasonable annual cash returns, as follows:

<table>
<thead>
<tr>
<th>Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporate bonds</td>
</tr>
<tr>
<td>Land and building</td>
</tr>
<tr>
<td>Shares of public corporations</td>
</tr>
</tbody>
</table>

Income

- Corporate bonds: $5,000
- Land and building: $10,000
- Shares of public corporations: $8,000

The property has the following relevant values:

<table>
<thead>
<tr>
<th>Cost</th>
<th>UCC</th>
<th>Fair market Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>$30,000</td>
<td>$50,000</td>
</tr>
<tr>
<td>Building</td>
<td>70,000</td>
<td>95,000</td>
</tr>
<tr>
<td>Shares</td>
<td>75,000</td>
<td>105,000</td>
</tr>
<tr>
<td>Corporate bonds</td>
<td>40,000</td>
<td>42,000</td>
</tr>
</tbody>
</table>

Delaney has expressed an interest in using a corporation to hold her investments and has sought your advice. She has suggested that the investments could be transferred to Delaney Fast Food Services, which operates three restaurants.

Delaney’s marginal tax rate is 46% (federal and provincial) on regular income, 28% on eligible dividends and 33% on non-eligible dividends. The provincial corporate tax rate in her province is 10%. To date she has not used any of her lifetime capital gain deduction.

**Required:**

1. Advise Delaney on the benefits, if any, of incorporating her investment income. Show sample calculations. Your answer should be specific with respect to (a) interest and rents, (b) capital gains, and (c) dividends.

2. Discuss the implications of Delaney’s suggestion regarding transferring the investments to her active business corporation.

3. Assuming that she decides to incorporate the investments, outline a plan that will enable the investments to be transferred to the corporation without tax consequences.
Solution to P 13-2

1. Before determining the tax impact of incorporating the investments, it is important to establish the marginal tax rates for the individual and the corporation for the various types of income.

Corporate tax rate on interest, rents, and taxable portion of capital gains:

- Federal rate [ITA 123(1)] 38%
- Less abatement [ITA 124(1)] (10)%
- Refundable tax [ITA 123.3] 6 2/3%
- Provincial tax [given] 10%

Corporate tax rate on dividends from public corporation:

- Fully refundable Part IV tax [ITA 186(1)] 33 1/3%

Individual tax rate on interest, rents and taxable capital gains [given] 46%

Individual tax rate on non-eligible dividends [given] 33%

Based on Delaney’s current income, the annual tax advantage of incorporating the investment is as follows:

<table>
<thead>
<tr>
<th></th>
<th>As an Individual</th>
<th>As a Corporation</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest and rents:</td>
<td>$6,900</td>
<td>$6,700</td>
<td>$200</td>
</tr>
<tr>
<td>$5,000+$10,000=$15,000</td>
<td>(Individual $15,000 x 46%)</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>(Corporation $15,000 x 44 2/3%)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dividends ($8,000):</td>
<td>2,640</td>
<td>2,667</td>
<td>(27)</td>
</tr>
<tr>
<td></td>
<td>(Individual $8,000 x 33%)</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>(Corporation $8,000 x 33 1/3%)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Annual tax decrease by incorporation</td>
<td></td>
<td>$173</td>
<td></td>
</tr>
<tr>
<td>Capital Gains (none at this time):</td>
<td>23.00%</td>
<td>22.33%</td>
<td>0.67%</td>
</tr>
<tr>
<td>Individual (1/2)(46%)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Corporation (1/2)(44 2/3%)</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The above indicates that incorporation will decrease taxes on interest and rents by 1.33% and on capital gains by 0.67%. Tax on the dividend income will increase by 0.34% but this tax is fully refundable. Therefore, there appears to be a benefit to earning the income in a corporation.

Delaney should be informed that if the investment returns are distributed as dividends from the corporation, there will be a small tax savings (1%). A portion of the taxes on
interest, rents and capital gains are refunded to the corporation and all of the 33 1/3% Part IV tax on dividends is refunded to the corporation [ITA 129(1), (3)]. In addition, the tax-free portion of any capital gains can be paid out as a tax-free capital dividend [ITA 83(2), 89(1)]. With respect to the interest and rents, the total tax on distribution amounts to 45% as follows:

<table>
<thead>
<tr>
<th></th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest and rental income (assumed)</td>
<td>$1,000</td>
</tr>
<tr>
<td>Corporate tax 44 2/3%</td>
<td>(447)</td>
</tr>
<tr>
<td>Add refund potential 26 2/3% of $1,000</td>
<td>267</td>
</tr>
<tr>
<td>Available for dividend</td>
<td>820</td>
</tr>
<tr>
<td>Tax on dividend 33% of $820</td>
<td>(271)</td>
</tr>
<tr>
<td>Total tax: Corporation ($447 - $267)</td>
<td>$180</td>
</tr>
<tr>
<td>Shareholder</td>
<td>271</td>
</tr>
<tr>
<td></td>
<td>$451</td>
</tr>
<tr>
<td></td>
<td>45%</td>
</tr>
</tbody>
</table>

The above indicates that a small amount of tax savings will occur upon distribution. Total tax is 45% whereas Delaney’s tax rate is 46%.

2. If Delaney transfers her investments to her active business corporation it may cause the corporation not to be classified as a small business corporation, with the consequence that a subsequent sale of the shares of Delaney Fast Foods Ltd. would not qualify for the capital gains deduction. To qualify for the deduction, the corporation must be a qualified small business corporation which requires, among other things, that all or substantially all of its assets be used in an active business at the time of sale [ITA 110.6].

3. To avoid tax on the transfer of the investments to a corporation, Delaney could elect a transfer price for tax purposes equal to the properties' cost amounts as described in Chapter 12. The cost amounts for the land, shares, and bond is their adjusted cost base and for the building it is the undepreciated capital cost. The elected amounts and consideration are as follows: [ITA 85(1)].

<table>
<thead>
<tr>
<th>Asset</th>
<th>Values</th>
<th>Tax Values</th>
<th>Elected Amount</th>
<th>-- Consideration --</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>$50,000</td>
<td>$30,000</td>
<td>$30,000</td>
<td>$30,000 $20,000</td>
</tr>
<tr>
<td>Building</td>
<td>$95,000</td>
<td>$50,000</td>
<td>$50,000</td>
<td>$50,000 45,000</td>
</tr>
<tr>
<td>Shares</td>
<td>$105,000</td>
<td>$75,000</td>
<td>$75,000</td>
<td>$75,000 30,000</td>
</tr>
<tr>
<td>Bonds</td>
<td>$42,000</td>
<td>$40,000</td>
<td>$40,000</td>
<td>$40,000 2,000</td>
</tr>
<tr>
<td></td>
<td>$292,000</td>
<td>$195,000</td>
<td>$195,000</td>
<td>$195,000 $97,000</td>
</tr>
</tbody>
</table>

In the event that the corporation subsequently sells the above assets, the corporation will incur capital gains and recapture of capital cost allowance similar to what would have occurred if the property was sold by Delaney at FMV.
PROBLEM THREE

[ITA: 186(1), (2), (4)]

Investco Ltd., a private corporation, received dividend income from taxable Canadian corporations during its year ended December 31, 20X6, as follows:

Portfolio dividends from public corporations $60,000
Dividends from Subsidiary 30,000

$90,000

Investco Ltd. owns 80% of the issued shares of Subsidiary. Subsidiary’s dividend refund for its year ended December 31, 20X6 was $4,000.

Required:

Calculate the Part IV tax payable by Investco Ltd. for its year ended December 31, 20X6
Solution to P 13-3

The Part IV tax payable by Investco Ltd. is $23,200, computed as follows [ITA 186(1)]:

Dividends received from non-connected corporations $60,000 x 1/3 = $20,000

Dividends received from connected corporations –
Dividend refund received by Subsidiary $4,000 x 80% ownership = 3,200

Part IV Tax $23,200

Subsidiary is connected with Investco Ltd. as shares of Subsidiary representing more than 10% of the votes and fair market value are owned by Investco Ltd. [ITA 186(4)].
PROBLEM FOUR

[ITA: 123(1); 123.3; 124(1); 129(1), (3); 186(1), (2), (4)]

Canco Ltd. is a Canadian-controlled private corporation. For its fiscal year ended December 31, 20X6, Canco Ltd. had income of $100,000, comprised as follows:

- Interest income $20,000
- Taxable capital gains 30,000
- Taxable dividends received from
  - A Ltd. 40,000
  - B Ltd. 10,000

During the same year Canco Ltd. paid taxable dividends of $16,000 and capital dividends of $4,000. Canco Ltd. owns 40% of the issued shares of A Ltd. and 5% of the issued shares of B Ltd. A Ltd. received a dividend refund of $20,000 and B Ltd. received a dividend refund of $8,000 as a result of paying dividends during their respective taxation years ended December 31, 20X6.

Required:

Determine the dividend refund for Canco Ltd. for its 20X6 taxation year. Assume the balance in its RDTOH account at January 1, 20X6 was Nil.
Solution to P 13-4

ITA 129(1) Dividend Refund

The dividend refund is $5,333 computed as follows:
Lesser of:
(a) 1/3 x taxable dividends paid in 20X6 $16,000 = $5,333
(b) RDTOH balance $24,666

ITA 129(3) RDTOH

129(3)(c) RDTOH balance at end of 20X5 $0
(d) Dividend refund for 20X5 $0
(a) Refundable Part I tax $13,333
(b) Part IV tax $11,333
$24,666

ITA 129(3) Refundable Part I tax

The least of:
(i) Aggregate investment income [ITA 129(4)]:
   Interest $20,000
   Taxable capital gains 30,000
   Net capital loss claimed (0)
   $50,000 x 26 2/3% = $13,333
(ii) Taxable income:
   Net income $100,000
   Dividends from taxable Canadian corps [ITA 112(1)] (50,000)
   $ 50,000 x 26 2/3% = $13,333
(iii) Part I tax payable:
   Federal tax 38% x $50,000 [ITA 123(1)] $19,000
   Less abatement 10% x $50,000 [ITA 124(1)] (5,000)
   14,000
   Plus Refundable tax on investment income
   6 2/3 % x $50,000 [ITA 123.3] $3,333
   $17,333
ITA 186(1) Part IV tax
Dividends received from non-connected corporations  $10,000 \times \frac{1}{3} = \$3,333

Dividends received from connected corporations –
Dividend refund received by A Ltd. $20,000 \times 40\% \text{ ownership} = 8,000

Part IV Tax \hfill \$11,333

A Ltd. is connected with Canco Ltd. as shares of A Ltd. representing more than 10\% of the votes and fair market value are owned by Canco Ltd. [ITA 186(4)].
PROBLEM FIVE

[ITA: 129(1), (3); 186(1)]

Wrap Ltd. is a Canadian-controlled private corporation. At the end of 20X5, Wrap had the following tax account balances:

- Non-capital losses: $8,000
- Net capital losses (incurred in 20X3): $2,000
- RDTOH: $7,000
- Dividend Refund: $1,000
- CDA: $12,000

For the current year, 20X6, net income for tax purposes is $261,000. Included in this amount is the following:

- Income from an active business carried on in Canada: $200,000
- Taxable capital gain: $6,000
- Dividends from Canadian public companies: $15,000
- Canadian bond interest: $30,000
- Foreign bond interest: $10,000

The following is a summary of other information for Wrap Ltd. for the 20X6 year:

- Taxable income: $236,000
- Capital dividend paid: $12,000
- Taxable dividend paid: $75,000
- Small Business Deduction: $34,000
- Foreign tax credit—non business income: $1,000
- Total Federal Part I tax payable: $39,123

Required:

Determine the dividend refund for 20X6. Would the dividend refund change if Wrap Ltd. was not a CCPC but instead was a Private corporation or a Public corporation?
Solution to P 13-5

ITA 129(1) Dividend Refund

The dividend refund is $19,859 computed as follows:
Lesser of:
   (i) 1/3 x taxable dividends paid in 20X6 $75,000 = $25,000
   (ii) RDTOH balance $19,859

ITA 129(3) RDTOH

129(3)(c) RDTOH balance at end of 20X5 $ 7,000
   (d) Dividend refund for 20X5 (1,000)
   (a) Refundable Part I tax 6,000
   (b) Part IV tax 8,859
   (a) Refundable Part I tax 5,000
   (b) Part IV tax $19,859

ITA 129(3) Refundable Part I tax

The least of:
(i) Aggregate investment income [ITA 129(4)]:
   - Interest $40,000
   - Taxable capital gains 6,000
   - Net capital losses (2,000)
   $44,000 x 26 2/3% = $11,733

   Less excess of foreign non-business tax credit ($1,000)
   Over 9 1/3% of the foreign investment income ($933) (67)
   $11,666

(ii) Taxable income $236,000
   - Income subject to Small Business Deduction (200,000)
   - 25/9 x ITA 126(1) foreign tax credit (2,778)
   $ 33,222 x 26 2/3% = $ 8,859

(iii) Part I tax payable $39,123

ITA 186(1) Part IV tax

Dividends received from non-connected corporations $15,000 x 1/3 = $5,000
If Wrap Ltd. was a Private corporation, but not a CCPC, then the Refundable portion of Part I tax would not apply. Refundable Part I applies to CCPCs only. The dividend refund would be $11,000 (equal to the RDTOH balance).

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>129(3)(c) RDTOH balance at end of 20X5</td>
<td>$7,000</td>
</tr>
<tr>
<td>(d) Dividend refund for 20X5</td>
<td>(1,000)</td>
</tr>
<tr>
<td>(a) Refundable Part I tax</td>
<td>0</td>
</tr>
<tr>
<td>(b) Part IV tax</td>
<td>5,000</td>
</tr>
<tr>
<td></td>
<td><strong>$11,000</strong></td>
</tr>
</tbody>
</table>

If Wrap Ltd. was a Public company the dividend refund would be Nil. Only Private corporations are entitled to receive dividend refunds.
PROBLEM SIX

[ITA: 112(1); 123(1); 123.2; 123.3; 124(1); 125(1), (3); 129(1), (3); 186(1), (2), (4)]

Quality Quo is a Canadian-controlled private corporation, (CCPC), carrying on business in Canada. For its year ended December 31, 20X6 Quality Quo earned income from the following sources:

- Active Business income
- Gain on sale of asset used in the active business
- Dividends from taxable Canadian corporations

Quality Quo is associated with one corporation, Pear Inc. Pear Inc. was allocated a Business Limit of $160,000 for 20X6. The taxable capital of the two corporations, Quality Quo and Pear Inc., combined is less than $10,000,000.

Required:

Describe in detail how each source of income is taxed federally.
Solution to P 13-6

The answer to this question uses 2012 federal tax rates.

Active Business Income (ABI):

ABI eligible for the Small Business deduction, (“SBD”) is taxed at a federal rate of 11%.

<table>
<thead>
<tr>
<th>Federal rate [ITA 123(1)]</th>
<th>38%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Abatement [ITA 124(1)]</td>
<td>(10)%</td>
</tr>
<tr>
<td>Small Business deduction [ITA 125(1)]</td>
<td>(17)%</td>
</tr>
<tr>
<td></td>
<td>11%</td>
</tr>
</tbody>
</table>

A maximum of $500,000 annually of ABI earned by associated corporations qualifies for the SBD [ITA 125(1), (3)]. Since Pear Inc. was allocated $160,000 of the business limit for 20X6, $340,000 of ABI earned by Quality Quo is the maximum amount that will qualify for the SBD and, thus, be taxed at 11% federal rate. The remainder of the ABI earned by Quality Quo in 20X6 will be taxed at a federal rate of 15%.

Gain on sale of assets used in the active business:

The gain would be a capital gain for tax purposes and as such 1/2 of the capital gain is included in investment income.

Investment income is taxed at the highest corporate rate 28% + 6.67% refundable tax [ITA 123.3] for a total federal rate of 34.67%.

26 2/3% of the investment income is added to a memo account called “Refundable Dividend Tax On Hand” (RDTOH) and is refunded to Quality Quo in the year dividends are paid to the shareholders. The refund rate is $1 refund for each $3 taxable dividend paid [ITA 129(1)].

Dividends from taxable Canadian corporations:

These dividends are excluded from taxable income for the purposes of computing Part I tax [ITA 112(1)]. They are subject to Part IV tax instead [ITA 186(1)].

The calculation of the Part IV tax depends on whether the paying corporation and the receiving corporation are connected corporations. Where the receiving corporation, together with related persons, owns greater than 50% of the voting shares of the paying corporation, the corporations are connected. Alternatively, where the receiving corporation owns more than 10% of the voting issued shares of the paying corporation and these shares represent more than 10% of the fair market value of the paying corporation, the corporations are connected [ITA 186(2) & (4)].

For dividends received from non-connected corporations, the Part IV tax is equal to 1/3 of the dividends received [ITA 186(1)(b)].

For dividends received from connected corporations, the Part IV tax is equal to Quality Quo’s share of the dividend refund received by the paying corporation [ITA 186(1)(a)].

Part IV tax is fully refundable. Part IV tax payable for the year increases the RDTOH [ITA 129(3)(b)].
PROBLEM SEVEN

[ITA: 18(1)(a); 67]

Pembroke Realtors Ltd. is a closely held Canadian-controlled private corporation. At the end of 20X2, during which it earned an unusually high profit, the corporation paid additional salaries of $200,000 to its officers, who are also the shareholders. The salaries were paid in proportion to each shareholder’s holdings in the corporation.

After reviewing the transaction, the CRA proposed to disallow $60,000 of the $200,000 salaries as an expense for tax purposes.

Required:

1. On what basis may the CRA justify such a proposal?

2. If the $60,000 is properly disallowed, what impact will it have on the shareholders who received the salary? Explain.
Solution to P 13-7

1. CRA may justify their proposal to deny the deduction of a portion of the salaries ($60,000) awarded to the corporation's shareholders on the following basis:

   • In order to be deductible, the salaries must be reasonable in the circumstances [ITA 67]. Therefore, if the salaries are excessive in relation to the work performed the deduction may be denied.

   • The general rules for determining income from business require that, to be deductible, an expense must be incurred for the purpose of earning income [ITA 18(1)(a)]. If services were not performed for the additional salary, the deduction may be denied.

   In this particular case, it appears that the additional salaries were paid to reduce corporate income that would otherwise be subject to the high corporate tax rate. The question of reasonableness in such situations is difficult to assess. CRA's assessing practice, in this regard, appears to be extremely lenient provided that the additional salaries are paid to shareholders who are active in the management of the business. In this particular case, the denial of only a portion of the salaries may indicate that one of the shareholders was not active or was active only in a minor way.

2. If the $60,000 salary is disallowed to the corporation, it does not change the fact that a shareholder was awarded the salary. Consequently, both the shareholder and the corporation will be taxable on an additional $60,000 of income. If the corporation's tax rate is 25% and the shareholder's rate is 45%, extreme double taxation occurs.

   Actual income                      $60,000
   Tax - corporation 25% x $60,000     $15,000
   - individual 45% x $60,000         27,000
   Effective tax rate                70%
PROBLEM EIGHT

[ITA: 44(1), (5); 73(1); 74.1(1); 123.3; 129(1), (3); 186(1); 125(1), (3), (7); 125.1(1); 129(6); 251(2)(c); 256(1)(a), (b)]

Joe Crum is a restaurant consultant and also owns two restaurants. His corporate structure and activities are outlined below.

_Crum Restaurants Ltd._

- Owned 100% by Crum.
- Owns and operates Crum Slow Foods.
- Provides consulting services to a large number of small restaurants.
- Provides managerial and administrative services to Hamburger Joint Ltd., a company owned 15% by Joe Crum.
- 20X1 income is as follows:

<table>
<thead>
<tr>
<th>Income Source</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consulting services</td>
<td>$10,000</td>
</tr>
<tr>
<td>Managerial services (Hamburger Ltd.)</td>
<td>35,000</td>
</tr>
<tr>
<td>Crum Slow Foods</td>
<td>60,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$105,000</strong></td>
</tr>
</tbody>
</table>

_Pecky’s Restaurant Ltd._

- Owned 100% by Crum Restaurants Ltd.
- Owns and operates Pecky’s Coffee Shop.
- 20X1 income is $440,000.

_Real Co. Ltd._

- Owned 51% by Crum and 49% by his wife.
- Owns several commercial and residential real estate properties, including the building occupied by Pecky’s.
- 20X1 income is as follows:

<table>
<thead>
<tr>
<th>Income Source</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rents</td>
<td></td>
</tr>
<tr>
<td>Outside parties</td>
<td>$40,000</td>
</tr>
<tr>
<td>Pecky’s Coffee Shop</td>
<td>10,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$50,000</strong></td>
</tr>
</tbody>
</table>

Required:

1. Diagram the organization structure of Crum’s financial activities.
2. Describe the type of income each entity earns, and explain the related tax treatment.
3. Identify any problems that the existing structure may present, and suggest changes that you feel would be appropriate. If you are suggesting structural changes, briefly explain how they would be accomplished.
Solution to P 13-8

1. Organization structure:

<table>
<thead>
<tr>
<th>Mr. Crum</th>
<th>Mrs. Crum</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

2. Crum Restaurants Ltd. - The profits from the consulting services to a large number of small restaurants and the restaurant profits from Crum Slow Foods are definitely active business income. It is not clear whether the managerial service income of $35,000 is active business income or personal service business income. The managerial service is different from the consulting services and it is important to determine if an indirect relationship between Mr. Crum and Hamburger Joint Ltd. is similar to an employer/employee relationship. As there is no evidence to support this relationship, it is likely that the managerial service income is also active business income [ITA 125(7)].

The active business income is subject to a corporate tax rate of approximately 15% on the first $500,000 of annual active business income. Business income in excess of $500,000 is subject to the high rate of corporate tax of 25%. A portion of the restaurant profits may be classified as manufacturing and processing income and, to the extent that this income is not subject to the small business deduction, a federal tax reduction (13% in 2012, 11.5% in 2011) and a possible provincial/territorial reduction occur. Converting raw food into cooked meals is a processing activity [ITA 125.1(1)]. Business income not subject to the small business deduction or the manufacturing and processing deduction will receive the general tax reduction (13% in 2012, 11.5% in 2011).

Pecky’s Restaurant Ltd. - Profit from the coffee shop is active business income and taxed in the manner described above. However, Pecky’s Restaurant Ltd. and Crum Restaurant Ltd. are associated [ITA 256(1)(a)] since one corporation controls the other and, therefore, must share the $500,000 small business deduction limit [ITA 125(3)]. As the combined profits of the two corporations are currently $545,000 ($105,000 + $440,000), $45,000 is subject to the higher corporate tax rate of 25%. 

Diagram:

```
  Hamburger Joint  | Crum Restaurants  | Real Co. 
   100%          | 100%          | 51%    
     Pecky’s Restaurant  |               |        
```

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Solutions Manual Chapter Thirteen
Real Co. Ltd. - This corporation earns rental income from third parties as well as rental income from Pecky's Restaurant Ltd. With respect to the rental income from outside parties ($40,000), this income is classified as specified business investment income [ITA 125(7)]. It is, therefore, taxed at the high corporate rate of 44 2/3% but is entitled to a refund of 26 2/3% of rental income when it is distributed as a dividend to the shareholders [ITA 129(1) & (3)].

Normally, the rental income from Pecky's Restaurant Ltd. ($10,000) would also be specified business investment income. However, Real Co. and Pecky's are associated corporations [ITA 256(1)(b)] since both corporations are controlled by Mr. Crum. Because they are associated and the rent is deductible from Pecky's active business income, the rent is deemed to be active business income to the recipient associated corporation (Real Co.) [ITA 129(6)]. This increases the overall active business income of the associated corporations to $555,000 ($105,000 + $440,000 + $10,000) and, therefore, increases the amount of income subject to the higher rate of tax. Consequently, the $10,000 of rental income from Pecky's will not be eligible for refundable tax treatment as is the other $40,000 of rental income.

3. The following problems exist:

   a) The combined active business income is in excess of $500,000 creating a potential for double taxation. However, the corporate business income above $500,000 is taxed at 25% and is lower than the shareholder’s personal marginal tax rate. Therefore, while some amount of double taxation may occur sometime in the future, it may not be worth paying additional salaries or bonuses (reducing income to the $500,000 level) to avoid that potential double tax in the future. Part of this problem could also be solved by disassociating Real Co. This would cause the rental income from Pecky’s to be specified business investment income (no double taxation). To disassociate, Mr. Crum would have to reduce his shareholding in Real Co. to below 25% [ITA 256(1)(c)]. This could be done by simply selling his shares to Mrs. Crum. Such a sale, between spouses, is deemed to occur at the cost base of the shares [ITA 73(1)] (see Chapter 8) and consequently no tax would result on the transfer. All future dividends on the transferred shares would be attributed to Mr. Crum for tax purposes [ITA 74.1(1)].

   (b) Holding the real estate occupied by Pecky’s Restaurant in a separate family corporation may create a problem in the future. Because the property earns rental income, the building is classified as rental property for CCA purposes. Assuming that its cost is greater than $50,000 it sits within a separate CCA pool. Therefore, if the building is ever sold, a recapture of CCA and a capital gain would likely occur. If the property was owned by Pecky’s Restaurant Ltd. it would not be a rental property. If it is desirable to have the building owned by Pecky’s Restaurant Ltd., this change in structure can be accomplished by transferring the property from Real Co. to Pecky’s using the election option to avoid tax on the sale [ITA 85].

If the building is ever sold with the intention of acquiring larger premises for the coffee shop, the capital gain and recapture could be deferred by electing under the replacement property rules [ITA 44(1)]. The property will qualify for the deferral whether it is owned by Real Co or Pecky’s Restaurant as the two corporations are related [ITA 44(5), 251(2)(c)(i)].
PROBLEM NINE

[ITA: 15(2.4); 80.4(1); 125(1), (3); 256(1)(a)]

CKG Ltd. is a Canadian-controlled private corporation owned equally by Mr. and Mrs. Ducharme. The company has been profitable for several years, largely because of the efforts of the Ducharmes, who both participate actively in the management of the business.

The current year’s business profit, before taxes, is expected to be $540,000. This is a record high for the company and is $50,000 higher than in the previous year. Over the past two years, the company has built up substantial cash reserves. The Ducharmes are considering using the funds as follows:

A competitor wants to sell out and has offered to sell its shares to CKG for $500,000.

The following summary of the competitor’s most recent operating results was provided to the Ducharmes:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$850,000</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>378,000</td>
</tr>
<tr>
<td>Gross profit</td>
<td>472,000</td>
</tr>
<tr>
<td>Operating expenses</td>
<td>370,000</td>
</tr>
<tr>
<td>Income</td>
<td>102,000</td>
</tr>
<tr>
<td>Income taxes</td>
<td>(15,300)</td>
</tr>
<tr>
<td>Net income</td>
<td>$ 86,700</td>
</tr>
</tbody>
</table>

• The Ducharmes recently agreed to purchase a large new personal residence, which they will take possession of in two months. They have not yet sold their existing home, but when they do, they will need an additional $100,000 to complete the purchase. The Ducharmes feel that CKG has sufficient resources to fund both of the above transactions. They are particularly interested in purchasing the competitor’s business and feel that the purchase price of $500,000 is reasonable, as it will provide an after-tax return on investment of 17% ($86,000 ÷ $500,000).

Both Ducharmes are paid an annual salary of $130,000.

**Required:**

1. Comment on the purchase of the competitor's business by CKG.

2. What methods should CKG use to provide funds to the Ducharmes so that they can meet their cash needs in acquiring their new home? Explain.
Solution to P 13-9

1. The Ducharmes have indicated that the purchase of the shares of the competitors business by CKG Ltd. is attractive because it will provide a return on investment of 17% after-tax ($86,700/$500,000 = 17%). However, the competitor's income taxes are $15,300 on pre-tax profits of $102,000 (15%). This means that the competitor corporation is claiming the small business deduction on its income. If the shares are purchased, the competitor corporation and CKG Ltd. will be associated [ITA 256(1)(a)] since CKG Ltd. will control the competitor corporation. Consequently, the $500,000 annual business limit for the small business deduction must be shared by the two corporations. As CKG's profits are already $540,000, the acquired profits of $102,000 will be subject to the higher corporate tax rate (25%). Therefore, the return on investment would be only 15% calculated as follows:

<table>
<thead>
<tr>
<th>Income</th>
<th>$102,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less tax:</td>
<td></td>
</tr>
<tr>
<td>25% x $102,000</td>
<td>(25,500)</td>
</tr>
<tr>
<td>After-tax profits</td>
<td>$ 76,500</td>
</tr>
</tbody>
</table>

Return on investment: $76,500/$500,000 = 15%

The value of the competitor's business is less to the Ducharmes (because of their other business income) than it would be to a different buyer who did not have other business income and would pay the lower rate of corporate tax.

2. The Ducharmes require $100,000 from CKG Ltd. to fund the purchase of a new home. This can be achieved with the minimum amount of tax as follows:

- Because CKG Ltd. has earned pre-tax profits of $540,000, which is $40,000 in excess of the small business deduction limit, it would be prudent to pay additional salary or bonus to Mr. and Mrs. Ducharme totalling $40,000. This eliminates the potential for double taxation. Assuming the Ducharme's tax rate is 45%, this provides them with cash of $22,000 ($40,000 - tax @ 45% = $22,000). As both are active in the business, the reasonableness of such a bonus is not an issue.

- The remaining funds of $78,000 ($100,000 - $22,000) can be loaned to the Ducharmes without tax consequences provided reasonable terms of repayment are made and it can be reasonably demonstrated that the loan was made because of the person's employment and not the shareholdings [ITA 15(2.4)]. Effectively, this provides the shareholders with corporate funds that have been taxed at approximately 15% by avoiding the tax on a dividend distribution. If the shareholders do not pay interest on the loan, a taxable benefit equal to a prescribed rate will accrue to them [ITA 80.4(1), (3)]. Although the loan may have repayment terms extended over a long period (for example, 25 years is not unreasonable for a house loan) it is likely that the loan can be repaid in the next couple of years if profit levels remain high and an annual bonus. The after-tax bonus amounts can be used as a loan repayment.
PROBLEM TEN

[ITA: 18(1)(a); 9(1); 20(1)(l); 38(a); 83(2); 110.1; 110.6; 112(1); 123(1); 123.2; 123.3; 124(1); 125(1), (2); 129(4); 186(1)]

Carol Stoller is the president and sole shareholder of Modern Floors Ltd., a Canadian-controlled private corporation based in your province. It is one month before the company’s year end, and Stoller is reviewing the company’s financial information. The operating results, to date, are good, and her accountant has projected the following results to the end of the fiscal year:

<table>
<thead>
<tr>
<th>Sales</th>
<th>$1,400,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of sales</td>
<td>740,000</td>
</tr>
<tr>
<td>Gross profit</td>
<td>660,000</td>
</tr>
</tbody>
</table>

Expenses:
- Salaries and wages                        $100,000
- Rent and utilities                        19,000
- Amortization                              8,000
- Travel and delivery                       17,000
- Insurance                                 3,000
- Reserve for doubtful debts                22,000
- Advertising                               15,000
- Charitable donations                      5,000
- Other                                     6,000

Operating income                           465,000

Other income:
- Interest on bonds                         15,000
- Dividends from taxable Canadian public corporations 8,000
- Capital gain on the sale of securities    40,000

Net income before tax                      $ 528,000

In preparing the year-end projection, the accountant determined the ending inventory based on an estimated value at the lower of cost or market (which is $20,000 lower than the estimate of the inventories cost). Amortization is equal to CCA for tax purposes.

Stoller has noticed that the financial statement does not provide an estimate of the company’s tax liability and has asked her accountant to provide this. Also, the following two developments have taken place that may affect the company’s tax position as well as Stoller’s personal tax position:

- Modern Floors has signed a long-term contract to supply products to a large national chain organization. The contract will begin early in the new year. Operating profits for next year will increase by approximately $180,000.

- Stoller has decided to sell 30% of her common shares in the company to a senior manager for $400,000. She originally purchased the entire share capital of the company seven years ago for $100,000.

While Stoller is pleased with these developments, she is also concerned about their tax consequences. She understands that corporate tax rates increase when a certain level of income is reached. Stoller has never sold any capital property before but is aware that a friend

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of hers recently sold the shares of his corporation and was entitled to claim a capital gain deduction of $750,000. Stoller now asks you to address these issues and explain what steps, if any, she can take to minimize the overall tax impact on the company and on herself.

Stoller’s personal marginal tax rate is 45%.

**Required:**

1. For the current taxation year, determine the following for Modern Floors: (a) net income for tax purposes; (b) taxable income; and (c) federal and provincial tax payable.

2. Explain to Stoller the tax impact of the projected higher corporate profits for next year.

3. Identify any actions which the corporation can take this year or next year that will be advantageous for the corporation and/or Stoller.

4. Describe the tax consequences to Stoller arising from the proposed sale of shares. What steps, if any, can she take to minimize any potential tax on the sale?
Solution to P 13-10

The solution uses 2012 federal tax rates.

1. Net income per financial statement $528,000
   Add (deduct)
   Charitable donations 5,000
   Gain on sale of securities (40,000)
   Taxable capital gain on securities (1/2 of $40,000) 20,000
   Net income for tax purposes 513,000
   Donations (5,000)
   Canadian dividends (8,000)

   Taxable income $500,000

For purposes of calculating the small business deduction, the active business income is $470,000 as follows:

   Net income for tax purposes $513,000
   Less: dividends (8,000)
       taxable capital gain (20,000)
       interest income (15,000)

   $470,000

Calculation of tax (assuming a provincial rate of 4% for eligible small business income and 10% on other)

   Federal
   38% of $500,000 [ITA 123(1)] $190,000
   Less: abatement (10% of $500,000) [ITA 124(1)] (50,000)

   140,000

   Refundable tax - 6 2/3% x lesser of: [ITA 123.3]
   Aggregate investment income $35,000
   (interest $15,000 + TCG $20,000)
   TI ($500,000) minus income subject
   to the small business deduction ($470,000) $30,000
   6 2/3% x $30,000 2,000

   Small business deduction (17% x $470,000) [ITA 125(1)] (79,900)

   General tax reduction 13% ($500,000 - $470,000 - $35,000) (0)

   62,100

   Provincial
   4% $470,000 $18,800
   10% 30,000 3,000

   $500,000 21,800

   $83,900

   Fully refundable part IV tax on
   Dividends $8,000 x 1/3 [ITA 186(1)] $2,667
2. The expected additional profits for next year from the new contract will increase the corporation’s active business income from $470,000 to $650,000. This is $150,000 in excess of the annual small business deduction limit of $500,000 [ITA 125(2)]. This excess will not be subject to the small business deduction and will also not receive the lower provincial tax rate of 4%. The income will be subject to the following tax rates:

1st $500,000 (business income up to $500,000) 15%
   [38% - 10% - 17% + 4% provincial]

Next $150,000 of business income 25%
   [38% - 10% – 13% (general tax reduction)* + 10% (provincial)]

* 13% in 2012, 11.5% in 2011)

The additional income over the small business deduction limit will be subject to some double taxation if dividends are declared in the future or if the shares of the corporation are sold resulting in a taxable capital gain.

3. As a result of the current year’s estimate of income and the projected profits for next year, two events will cause increased tax costs. First of all, the current year’s business income is $470,000 and, therefore, does not use $30,000 of potential small business deduction income ($500,000 - $370,000) while next year the business income will be in excess of $500,000 and taxed at the higher rate. Secondly, income in the second year over $500,000 is subject to some double taxation if distributed as a dividend in the future.

In order to use up the full small business deduction this year (knowing that next year's income is over the limit), the corporation can take steps to recognize more taxable income in the current year and reduce the taxable income the following year. One item in particular is evident. The financial statement indicates a reserve for doubtful accounts of $22,000. This reserve does not have to be claimed, which will increase profits by a further $22,000 this year and reduce profits by a corresponding reduction the following year [ITA 20(1)(l)]. This means that $22,000 of income will be taxed this year at the low rate rather than next year at 25%. It is not known if the owner/manager has taken her salary in the current year. If possible, she should reduce or eliminate her salary for the remaining part of the fiscal year and extract her required funds by either a dividend or a temporary loan.

To the extent that next year's profits still exceed $500,000, the company should consider paying Carol an additional salary or bonus which shifts the corporate income directly to Carol to be taxed only once rather than twice if it was taxed in the corporation and later distributed as a dividend. This avoids the potential for double taxation. This should be done if Carol needs additional funds.

However, if she does not need additional funds it may not be prudent to pay additional salaries on these amounts as the salary is taxed at 45% and avoids immediate corporate tax of only 25%. Thus, there is a significant deferral while the after-corporate-tax income remains in the corporation. She must consider when additional funds may be needed and take into account the time value of money.
4. If Carol sells 30% of her common shares to the senior manager, she will incur a taxable capital gain of $185,000 [$400,000 - (30% x $100,000) = $370,000 x 1/2]. As she has never sold any capital property before, she will be entitled to claim the capital gain deduction of $375,000 (1/2 of $750,000) if the corporation is a qualified small business corporation (QSBC) [ITA 110.6]. Sufficient information is not provided to determine this, but, the income statement shows interest income of $15,000 from bonds, and $8,000 of dividends from shares of public corporations. This means that the corporation has some non-business assets. One of the tests to qualify as a QSBC is that all or substantially all of the corporation’s assets must be used in an active business at the time of sale. Generally, CRA has interpreted substantially all to mean 90%. The amount of the capital gain that would be taxable is either $185,000 or nil depending on the corporation’s status.

During the current year, the corporation earned a capital gain of $40,000 ($20,000 taxable). The non-taxable portion of this gain ($20,000) can be paid out to Carol as a special tax-free capital dividend [ITA 83(2)]. This should be done before the share sale, as the payment of the tax-free dividend will reduce the value of all the shares by $20,000 of which $6,000 (30%) applies to the shares that will be sold. This reduces the capital gain on the proposed sale by $6,000 which, although it is a small amount, still reduces the tax on the sale or reduces the amount of the capital gains deduction that will be used up.

There are a number of elective options and reorganization techniques that can be used to transfer 30% of the shares to the manager. However, these techniques are not reviewed until Chapters 14 and 18 and in most cases defer taxes but do not necessarily minimize the tax. This section of the problem can be reexamined again after reviewing Chapters 14 and 18.
PROBLEM ELEVEN

[ITA: 123(1); 123.2; 123.3; 124(1); 125(1); 125.1(1); 129(1), (3); 256(1)(a); 186(1), (4)]

Cinder and PQ are associated [ITA 256(1)(a)] and connected [ITA 186(4)] for tax purposes.

Cinder Inc. is a Canadian-controlled private corporation based in your province. The company operates a wholesale business. The following information is provided for its year ended May 31, 20X5:

1. Net income for tax purposes is $212,000. Included in this amount is the following:
   - Interest income from bonds $10,000
   - Interest income on overdue trade accounts receivable 1,000
   - Taxable capital gain on sale of land 14,000
   - Dividends from Canadian public corporations 12,000
   - Dividends from PQ Ltd. (see item 2 below) 6,000

2. PQ Ltd. is a Canadian-controlled private corporation. Cinder owns 60% of its common voting shares. In 20X5, PQ claimed the small-business deduction on $320,000 of its active business income. PQ paid a dividend of $10,000, of which Cinder’s share is $6,000 (60%). As a result of the dividend, PQ received a dividend refund of $1,000.

3. Cinder made contributions of $4,000 to registered charities. These amounts have been correctly adjusted for in computing net income for tax purposes.

4. At the end of 20X4, Cinder had the following tax account balances:
   - Non-capital losses $5,000
   - Refundable dividend tax on hand 2,000

5. On May 31, 20X5, Cinder paid a dividend of $20,000 to its shareholders.

Required:

Determine Cinder’s federal income tax payable for the 20X5 taxation year.
Solution to P 13-11

Solution uses 2012 federal tax rates.

Taxable income:
Net income for tax purposes $212,000
less:
  Charitable donations [ITA 110.1] (4,000)
  Non-capital losses [ITA 111(1)(a)] (5,000)
  Dividends from Canadian corporations [ITA 112(1)]
    ($12,000 + $6,000) (18,000)
  Taxable income $185,000

Active business income:
Net income for tax purposes $212,000
less:
  Interest income from bonds (10,000)
  Dividends (18,000)
  Taxable capital gain (14,000)
  Active business income $170,000

Note: The interest on trade accounts receivable is active business income.

Part I tax:
Federal 38% x $185,000 [ITA 123(1)] $70,300
Abatement 10% x $185,000 [ITA 124(1)] (18,500)
Refundable tax - 6 2/3% x least of: [ITA 123.3]
  Aggregate Investment income - $24,000 (bond interest $10,000 + taxable capital gain $14,000)
  Taxable income ($185,000) - amount subject to the small business deduction ($170,000) = $15,000
  6 2/3% x $15,000 1,000
Small business deduction – 17% x least of: [ITA 125(1)]
  Active business income $170,000
  Taxable income $185,000
  Annual limit $180,000 ($500,000 – amount claimed by PQ $320,000)
  17% x $170,000 (28,900)
General tax reduction (TI $185,000 – All $24,000 – SBD income $170,000 – M&P income $0) x 13% (0)
Federal Part I tax $23,900
Part IV tax: [ITA 186(1)]
From non-connected corporations
\[ \frac{1}{3} \times 12,000 \] $4,000
From connected corporation [ITA 186(4)]
\[ 0.60 \times 1,000 \] 600
\[ \text{Total} \] $4,600

RDTOH \ [ITA 129(3)]
RDTOH at the end of previous year $2,000
Dividend refund for previous year (0)
Part IV tax 2,000
Refundable portion of Part I tax - least of:
(i) \[ 0.2667 \times 24,000 \text{ aggregate investment income} = 6,400 \]
(ii) \[ 0.2667 \times 15,000 \text{ (taxable income $185,000 - amount subject to small business deduction $170,000)} = 4,000 \]
(iii) Part I tax $23,900
\[ \text{Least of} \] $4,000
\[ \text{Dividend refund – least of: [ITA 129(1)]} \]
• \[ \frac{1}{3} \times 20,000 \text{ (dividend paid)} = 6,667 \]
• \[ \text{RDTOH} = 10,600 \]
\[ \text{Least of} \] $6,667
Net federal tax ($23,900 + $4,600 - $6,667) $21,833
PROBLEM TWELVE

[ITA: 9(1); 12(3); 18(1)(a), (b), (e), (h), (l); 19.1; 20(1)(a), (b), (aa), (cc); 20(16); 39(1)(c); 50(1); 67.1; 110.1; 112(1); 123(1); 123.2; 123.3; 124(1); 125(1); 125.1; 129(1), (3); 186(1), (4); 256(1)(a); Reg. 1100(1), (2)]

TR Ltd. is a Canadian-controlled private corporation operating a franchised retail and mail-order business in Vancouver. Denver Chan, the company’s president, owns 100% of the corporation’s share capital. The corporation was created on December 1, 20X5. For the year ended November 30, 20X6, TR Ltd.’s financial statement reported income before income taxes of $126,000.

You have been retained to help prepare the company’s first tax return and to advise on other tax-related matters. Financial information relating to the 20X6 taxation year and to the corporation’s financial statement is summarized below.

TR Ltd.
Selected Financial Information

1. The following properties were purchased for the new business:

<table>
<thead>
<tr>
<th>Property</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Franchise</td>
<td>$40,000</td>
</tr>
<tr>
<td>Land</td>
<td>30,000</td>
</tr>
<tr>
<td>Building</td>
<td>270,000</td>
</tr>
<tr>
<td>Delivery truck</td>
<td>40,000</td>
</tr>
</tbody>
</table>

The franchise, purchased on December 1, 20X5, permits the corporation to operate under the TR name for a period of 15 years. A renewable period of another 15 years is available, subject to satisfactory performance.

The land cost of $30,000 consists of the purchase price of $20,000, $7,000 for permanent landscaping, and $3,000 for water and sewer connections. The building was constructed after March 18, 2007.

On October, 15, 20X6, the truck was involved in an accident. The damage was not repairable, and TR immediately signed an agreement with the insurance company to settle the claim for $31,000. The cash was received on December 10, 20X6. Another truck was obtained under a lease arrangement. Amortization expense of $28,000 has been deducted from income.

2. Legal expense includes the following costs:

<table>
<thead>
<tr>
<th>Expense</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Preparing annual corporate minutes</td>
<td>300</td>
</tr>
<tr>
<td>Incorporation costs for TR Ltd.</td>
<td>1,500</td>
</tr>
<tr>
<td>Negotiation of franchise agreement</td>
<td>2,000</td>
</tr>
</tbody>
</table>

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3. Repairs and maintenance expense includes the following items:

- Paving the parking lot $8,000
- Cleaning and supplies 1,400
- Replacing a broken window 1,000
- Small tools costing less than $500 1,200

4. Advertising expense includes a cost of $7,000 to acquire a permanent mailing list for the mail-order business. The list has an expected life of six years. Other advertising items are listed below.

- Cost of making a television commercial $25,000
- Travel costs for Chan to attend a franchiser convention. Chan’s spouse travelled with him and attended a social function (her expenses were $1,500) 3,000
- Charitable donations 2,000
- Meals and beverage costs for entertaining suppliers 1,800
- Costs of leasing and maintaining a pleasure boat to entertain suppliers and employees 2,600
- Television advertising
  - Vancouver station 11,000
  - Seattle station directed at the Vancouver market 6,000

5. A contingent reserve for possible defective products of $5,000 was recorded as a charge against cost of sales. During the year, $3,000 of products were returned.

6. On May 31, 20X6, TR invested $40,000 in a one-year bank certificate earning annual interest of 7%. TR intends to recognize the interest revenue upon receipt at its one-year anniversary date.

7. Interest expense includes $14,000 on the building mortgage and $700 from a temporary bank loan of $12,000. The bank loan funds were, in turn, loaned, without interest, to Y Ltd., a corporation owned by Chan’s brother. Y Ltd. used all of its assets to operate an active business but declared bankruptcy in November 20X6.

8. TR is planning to sell a new product in 20X7—a bracelet with a charm depicting a popular cartoon character. The bracelet and charm will be ordered from separate suppliers, and TR’s staff will assemble the two pieces and package them in a specially designed box.

9. Shortly after incorporation, TR acquired 46% of the voting common shares of Q Ltd., a Canadian-controlled private corporation that supplies certain products to TR and other retailers. On October 31, 20X6, TR received a dividend of $15,000 from Q Ltd. At the time, Q Ltd. had an RDTOH account of $2,000. An opportunity exists for TR to purchase an additional 5% of the voting common shares of Q Ltd. early in 20X7. A decision will be made in January 20X7.

10. On November 30, 20X6, TR declared and paid a taxable dividend of $40,000.
Required:


2. Based on your answer to 1, calculate TR’s minimum Part I and Part IV federal income tax for the 20X6 taxation year.

3. Briefly describe the tax consequences, if any, if TR Ltd. purchases the additional 5% of the shares of Q Ltd. in January 20X7.

4. Advise TR Ltd. on the tax implications, if any, of selling its new charm bracelet in the 20X7 year.
Solution to P 13-12

Part 1
Income for tax purposes and taxable income:

- Income per financial statement [ITA 9(1)] $126,000
- Amortization [ITA 18(1)(b)] 28,000
- CCA (note 1) (24,920)
- Terminal loss - truck, class 10 (note 2) (9,000)
- CEC deduction (note 3) (446)
- Landscaping of grounds [ITA 20(1)(aa)] (7,000)
- Sewer and water connection [ITA 20(1)(cc)] (3,000)
- Incorporation costs [ITA 18(1)(b)] 1,500
- Negotiating franchise agreement [ITA 18(1)(b)] 2,000
- Paving parking lot [ITA 18(1)(b)] 8,000
- Small tools [ITA 18(1)(b)] 1,200
- Mailing list [ITA 18(1)(b)] 7,000
- Travel costs, spouse [ITA 18(1)(h)] 1,500
- Charitable donations [ITA 18(1)(a)] 2,000
- Meals and beverages – 50%(1,800) [ITA 67.1] 900
- Television commercial [ITA 18(1)(b)] 25,000
- Foreign television advertising [ITA 19.1] 6,000
- Yacht maintenance [ITA 18(1)(l)] 2,600
- Reserve ($5,000 - $3,000) [ITA 18(1)(e)] 2,000
- Accrued interest - 7%($40,000)(183/365) [ITA 12(3)] 1,403
- Interest expense - not for the purpose of earning income [ITA 18(1)(a)] 700
- ABIL (note 4) (0)

Income for tax purposes 171,437

Deduct:
- Taxable Canadian dividends [ITA 112(1)] (15,000)
- Donations [ITA 110.1] (2,000)

Taxable income $154,437

Note 1: Capital Cost Allowance: [ITA 20(1)(a), Reg 1100(1), (2)]
- Class 1 - building $270,000(6%)(½) = $8,100
- Class 12 - TV commercial $25,000(100%)(½) + small tools $1,200(100%)(no ½ rule on small tools) = $13,700
- Class 14 - franchise $42,000 (40,000 + 2,000)/15 years = $2,800 (no one-half rule)
- Class 17 - paving $8,000(8%)(½) = $320

Total CCA $24,920 ($8,100 + $13,700 + $2,800 + $320)
Note 2: Terminal loss:
Class 10 – truck $40,000 - $31,000 = $9,000 [ITA 20(16)]

Note 3: CEC deduction: [ITA 20(1)(b)]
Incorporation costs - ¾($1,500) $1,125
Mailing list - ¾($7,000) 5,250
$6,375
Deduction - 7% x $6,375 = $446

Note 4: TR Ltd. Loaned $12,000 to Y Ltd., a related corporation, without interest. Y Ltd. declared bankruptcy. Therefore, there is a disposition of the loan [ITA 50(1)(a)]. Since the loan did not bear interest, TR Ltd. cannot recognize the loss on the disposition of the loan [ITA 40(2)(g)(ii)]. If interest had been charged on the loan, the loss would be a capital loss but not a business investment loss. Although Y Ltd. is a small business corporation, the loss is not a business investment loss since the taxpayer, TR Ltd., is a corporation and TR Ltd. and Y Ltd. are related [ITA 39(1)(c)(iv)].

Part 2

Active Business Income:
Income for tax purposes $171,437
Dividend income (15,000)
Interest income (1,403)
$155,034

Calculation of Part I (2012 rates) and Part IV tax:
Part I Tax
Federal 38% x $154,437 [ITA 123(1)] $58,686
Abatement 10% x $154,437 [ITA 124(1)] (15,444)
43,242

Small Business Deduction – 17% x lesser of: [ITA 125(1)]
• ABI - $155,034
• TI - $154,437
• Annual limit - $500,000
17% x $154,437 (26,254)

Refundable tax – 6 2/3% x lesser of: [ITA 123.3]
• Aggregate Investment income - $1,403 (interest)
• TI $154,437 - SBD income $154,437 = 0
0
$16,988
Part IV Tax [ITA 186(1), (4)]
Dividend from connected corporation – Q Ltd.
46% (percentage ownership) x $2,000 dividend refund $920

RDTOH [ITA 129(3)]
RDTOH at end of previous year $ 0
Part IV tax 920
Refundable portion of Part I tax - least of:
  • 26 2/3% (TI $154,437 - SBD income $154,437) = $0
  • 26 2/3% (Aggregate investment income $1,403) = $374
  • Part I tax $16,988
    Least of $0 0
    $920

Dividend Refund: [ITA 129(1)]
Lesser of
  • RDTOH = $920, or
  • 1/3 x $40,000 (dividend paid) = $13,333
    Least of $920

Part 3
If TR purchases another 5% of Q Ltd. shares, it will own a controlling interest (46% + 5% = 51%) and the two corporations will be associated for tax purposes [ITA 256(1)(a)]. Consequently, TR and Q must share the annual business limit for the small business deduction ($500,000).

Part 4
The process of combining the bracelet and the charm to sell as a new product is a manufacturing and processing activity. As a result, TR will be entitled to claim a M&P deduction (13% in 2012, 11.5% in 2011) on the M&P profits that are not subject to the small business deduction [ITA 125.1(1)]. Because the small business deduction or the M&P deduction will be claimed, this income will not be subject to the general tax reduction. There may be a provincial tax rate reduction for the M&P income.
PROBLEM THIRTEEN

[ITA: 186(2), (4); 251(2), (3), (4), (5), (6); 251.1(1); 256(1)(d)]

Dave owns 100% of the issued shares of D Ltd. His wife, Mary, owns 100% of the issued shares of M Ltd. D Ltd. owns 48% of the shares of X Ltd. while M Ltd. own only 5% of the shares of X Ltd. The remaining 47% of the shares are owned by strangers.

Dave and Mary have a 32-year-old son, Sam. He owns 100% of the issued shares of S Ltd. Sam's cousin, Ben, and S Ltd. each own 50% of the issued shares of Y Ltd. All of the corporations are Canadian-controlled private corporations and all of the issued shares are common shares.

Required:

(a) Which of the individuals and/or corporations are related persons, as defined in the Income Tax Act?

(b) Which of the corporations are associated corporations, as defined in the Income Tax Act?

(c) Which of the corporations are connected corporations, as defined in the Income Tax Act?

(d) Which of the individuals and/or corporations are affiliated persons, as defined in the Income Tax Act?
Solution to P 13-13

(a) Related

Individuals [ITA 251(2)(a)]:
Dave and Mary are related by marriage
Dave and Sam are related by blood
Mary and Sam are related by blood
None of Dave, Mary, or Sam is related to Ben, (Sam’s cousin).

Individuals & Corporations [ITA 251(2)(b)]:
Dave is related to D Ltd., M Ltd., X Ltd., and S Ltd.
Mary is related to D Ltd., M Ltd., X Ltd., and S Ltd.
Sam is related to D Ltd., M Ltd., X Ltd., and S Ltd.
None of Dave, Mary, or Sam is related to Y Ltd.

Corporations [ITA 251(2)(c)]:
D Ltd. and M Ltd. are related corporations.  Dave who controls D Ltd. is related to Mary who controls M Ltd.
D Ltd. and S Ltd. are related corporations.  Dave who controls D Ltd. is related to Sam who controls S Ltd.
M Ltd. and S Ltd. are related corporations.  Mary who controls M Ltd. is related to Sam who controls S Ltd.
D Ltd. and X Ltd. are related corporations.  Dave controls X Ltd. and he is related to each member of the related group of D Ltd. and M Ltd. which controls X Ltd.
M Ltd. and X Ltd. are related corporations.  Mary controls M Ltd. and she is related to each member of the related group of D Ltd. and M Ltd. which controls X Ltd.
S Ltd. and X Ltd. are related corporations.  Sam controls S Ltd. and he is related to each member of the related group of D Ltd. and M Ltd. which controls X Ltd.

(b) Associated

D Ltd. and X Ltd. are associated by ITA 256(1)(d).  D Ltd. is controlled by Dave who is related to the group of persons that control X Ltd., being D Ltd. and M Ltd., and Dave is deemed to own 48% of the common shares of X Ltd.

No other corporations are associated.

(c) Connected

S Ltd. is connected with Y Ltd. as S Ltd. owns greater than 10% of the issued shares of Y Ltd. representing greater than 10% of the votes and fair market value [ITA 186(4)(b)].

D Ltd. is connected with X Ltd. as D Ltd. owns greater than 10% of the issued shares of X Ltd. representing greater than 10% of the votes and fair market value [ITA 186(4)(b)].

M Ltd. is connected with X Ltd. as greater than 50% of the issued shares of X Ltd. belong to M Ltd. and a related person, D Ltd. (48% + 5% = 53%) [ITA 186(2), (4)(a)].
(d) **Affiliated**

**Individuals [ITA 251.1(1)(a)]:**
Dave and Mary are affiliated persons as Mary is Dave’s spouse.

**Individuals & Corporations [ITA 251.1(1)(b)]:**
Dave and D Ltd. are affiliated persons as Dave controls D Ltd.
Mary and M Ltd. are affiliated persons as Mary controls M Ltd.
Sam and S Ltd. are affiliated persons as Sam controls S Ltd.
Dave and Mary and X Ltd. are affiliated persons as X Ltd. is controlled by the affiliated group of Dave and Mary.
Dave and M Ltd. are affiliated persons as Dave is the spouse of Mary who controls M Ltd.
Mary and D Ltd. are affiliated persons as Mary is the spouse of Dave who controls D Ltd.

**Corporations [ITA 251.1(1)(c)]:**
D Ltd. and M Ltd. are affiliated persons. D Ltd. is controlled by Dave and M Ltd. is controlled by Mary and Dave and Mary are affiliated persons.
D Ltd. and X Ltd. are affiliated persons. D Ltd. is controlled by Dave; X Ltd. is controlled by D Ltd. and M Ltd. which are both affiliated with Dave.
M Ltd. and X Ltd. are affiliated persons. M Ltd. is controlled by Mary; X Ltd. is controlled by D Ltd. and M Ltd. which are both affiliated with Mary.
PROBLEM FOURTEEN

[ITA: 256]

Each of the following cases is independent.

1. Edward and Kris are unrelated individuals. Edward owns 80% of the issued shares of E Ltd. and 25% of the issued shares of Pro Ltd. Kris owns 20% of the issued shares of E Ltd. and 75% of the issued shares of Pro Ltd.

2. Jeremy owns 100% of the issued shares of J Ltd. which in turn owns 55% of the issued shares of K Ltd.

3. Al and Kevin are brothers. Al owns 100% of the issued shares of A Ltd. and 25% of the issued shares of K Ltd. The remaining shares of K Ltd. are owned by Kevin.

4. Robert and Raymond are brothers. They each own 50% of the issued shares of Barone Ltd. Raymond and his wife, Debra, each own 50% of the issued shares of Tee Ltd.

5. Kim and Kristin are cousins. They each own 35% of the issued shares of K Ltd. Their grandmother, Anna owns 100% of the issued shares of A Ltd. and the remaining 33% of the issued shares of K Ltd.

6. Clarence owns 100% of the issued shares of C Ltd. His two sons, Robert and Raymond, each own 50% of the issued common shares of R Ltd. Clarence helped finance R Ltd. by purchasing preference shares of R Ltd. The preference shares were issued to Clarence for $100,000 and are redeemable for the same amount. The preference shares are non-voting and have a non-cumulative dividend fixed at 3%, the prescribed rate in effect at the time the shares were issued. Clarence is the only owner of preference shares.

Required:

Determine which of the above corporations are associated. Support your answer with a reference from Section 256 of the Income Tax Act.
Solution to P 13-14

1. E Ltd. and Pro Ltd. are associated because they are controlled by the same group of persons, namely, Edward and Kris [ITA 256(1)(b)]. Edward and Kris may be considered as a group controlling E Ltd. and Pro Ltd., even though Edward controls E Ltd. on his own and Kris controls Pro Ltd. on her own also [ITA 256(1.2)(b)(i) and (ii)].

2. J Ltd. and K Ltd. are associated because J Ltd. controls K Ltd [ITA 256(1)(a)]. They are also associated by ITA 256(1)(b) as both corporations are controlled by the same person, Jeremy.

3. A Ltd. and K Ltd. are associated because each company is controlled by one person and the person who controls A Ltd. is related [ITA 251(6)(a)] to the person who controls K Ltd. and that person owns not less than 25% of the shares, other than of a specified class, of each corporation [ITA 256(1)(c)].

4. Barone Ltd. and Tee Ltd. are associated [ITA 256(1)(e)]. Both corporations are controlled by a related group. Each member of one of the related groups is related to all members of the other related group. Raymond is a member of both related groups and he owns 25% or more of the issued shares (of any class, other than a specified class) of both corporations.

5. A Ltd. and K Ltd. are associated because A Ltd. is controlled by one person, Anna, and she is related to each member of a group of persons (Kim and Kristin (granddaughters)) that control K Ltd. Anna owns not less than 25% of the issued shares (of any class, other than of a specified class) of K Ltd. [ITA 256(1)(d)].

6. C Ltd. and R Ltd. are not associated. C Ltd. is controlled by one person, Clarence and he is related to each member of a group that controls R Ltd., his sons, Robert and Raymond. However the preferred shares of R Ltd. owned by Clarence are shares of a specified class [ITA 256(1.1)]. Therefore, the preferred shares do not count towards the 25% ownership required for the corporations to be associated. Thus, the two corporations are not associated [ITA 256(1)(d)].
PROBLEM FIFTEEN

[ITA: 251(2),(4),(6); 252; 256(1), (1.2)(c) & (d), (1.3), (2) and (5.1)]

Each of the following six situations is independent. Assume all individuals are over the age of 18 unless otherwise noted.

1. Susan owns 100% of her holding company, Susan Inc., which owns 43% of the issued common shares of Sumi Inc. Mike owns 8% of Sumi and Agnes, an unrelated individual, owns the remaining 49% of Sumi. Susan and Mike are siblings.

2. Vicki owns 75% of the common shares of Vicki Inc. with the other 25% being owned by an unrelated individual. Marc owns 55% of Marc Inc. with the other 45% of the common shares owned by Vicki Inc. Vicki is Marc's mother.

3. Matt, Bill and Marg are brothers and sister. Each owns 1/3 of the shares of Sibling Inc. Carol and Matt are married to each other and each owns 50% of the shares of Spouses Inc.

4. Connie owns 100% of the common shares of Connie Inc. Aileen owns 100% of the common shares of Aileen Inc. with a current value of $350,000. Connie, who is Aileen's husband's grandmother, lent $190,000 to Aileen Inc. in June, 1998. The loan bears interest at the current bank rate plus 1/2% and is due on demand.

5. Andrew and Cheryl are first cousins and each owns 50% of the common shares of Breton Inc. The value of a 50% shareholding of Breton Inc. is $45,000. Arch owns 100% of the common shares of Arch Inc. Arch is Andrew's and Cheryl's grandfather and owns the one and only non-voting redeemable preference share in Breton Inc. which was issued for $50,000 in March 1995. The preferred share is redeemable at $100,000. (The preference share is not a share of a specified class as defined in ITA 256(1.1)). At all relevant times during the company's taxation year the value of the preference share was $100,000 and the value of all the Breton Inc. common shares was $90,000.

6. Jeff and Valerie are spouses who each own 100% of their respective companies, Jeff Inc. and Valerie Inc. Chelsea Inc. is 100% owned by Chelsea. Chelsea is Jeff's and Valerie's 16 year-old daughter.

Required:

In each of situations outline the reasons why any of the corporations are associated. Support your answer with references from the Income Tax Act. Assume that there is no indirect influence which, if exercised, could result in de facto control except in situation 4. Also, assume the anti-avoidance provision in ITA 256(2.1) would not apply to otherwise deem the corporations to be associated.
Solution to P 13-15

General Assumption

If individuals are related, they are related by ITA 251(2)(a). The references used in the solution support the relationship under that paragraph.

Situation 1

- Susan Inc. and Sumi Inc. are associated [ITA 256(1)(d)]
- Susan controls Susan Inc.,
- Susan is related to each member of the group of Susan and Mike that controls Sumi Inc., i.e., 43% + 8% (Susan is considered to be related to herself as a shareholder in each of the corporations [ITA 256(1.5)]) and is deemed to own 43% (100% of 43%) of Sumi Inc. [ITA 256(1.2)(d)] and
- In respect of each corporation Susan owns at least 25% of the shares of any class, (100% of Susan Inc. and 43% of Sumi Inc.).

Situation 2

Vicki is deemed to own 33.75% (75% of 45%) of the shares of Marc Inc. [ITA 256(1.2)(d)].

Vicki Inc. is associated with Marc Inc [ITA 256(1)(c)].

- each corporation is controlled by one person (Marc controls Marc Inc. and Vicki controls Vicki Inc.),
- the person who controls one company is related to the person who controls the other company (Vicki and Marc are related), and
- in respect of each corporation one person, Vicki, owns at least 25% of the shares of any class (i.e., 75% of Vicki Inc. and 33.75% of Marc Inc.).

The corporations are also associated by ITA 256(1)(d).

- Vicki controls Vicki Inc.
- Vicki and Marc are a group that controls Marc Inc. because they each own shares in the corporation [ITA 256(1.2)(a)].
- The group is considered to control Marc Inc. even though it is controlled by one member of the group [ITA 256(1.2)(b)].
- Vicki is related to each member of the group of Vicki and Marc that controls Marc Inc.
- In respect of each corporation Vicki owns at least 25% of the shares of any class, (75% of Vicki Inc. and 33.75% of Marc Inc.)
Situation 3

Carol and Matt constitute a group that controls Spouses Inc.

Any two of Matt, Bill and Marg constitute a group that controls Sibling Inc. All three of them also constitute a group that controls Sibling Inc.

Matt, Bill and Marg are related because they are siblings.

Carol and Matt are related by marriage [ITA 251(6)(b)].

Carol is related to Bill and Marg because they are brother-in-law / sister-in-law [ITA 251(6)(b) or ITA 252(2)(b)(i) and (c)(i)].

Spouses Inc. and Sibling Inc. are associated [ITA 256(1)(e)].

- Each corporation is controlled by a related group [ITA 251(4)].
  - Spouses Inc. is controlled by the related group of Carol and Matt.
  - Sibling Inc. is controlled by the related group of Matt and either Bill and/or Marg.
- Each member of one related group is related to each member of the other related group, and
- One or more persons who are members of both related groups, Matt, owns at least 25% of the shares of each corporation.
  - It is sufficient for one person of the related group to own at least 25% of the shares in each corporation in order to satisfy the cross-ownership test.

Situation 4

Connie and Aileen are related since Connie is Aileen's grandmother-in-law [ITA 251(6)(a) and ITA 252(2)(d) or by ITA 251(6)(b)].

Where the phase “controlled, directly or indirectly in any manner whatever” is used in the Act, it refers to de facto control, or control in fact [ITA 256(5.1)].

- Other places in the Act refer only to control and this generally means de jure or legal control.

Connie may be in a position to control Aileen Inc. by virtue of the $190,000 loan.

- If the financing provided by Connie is critical to the company and if Aileen is unable to replace it elsewhere, then Connie would have de facto control since she could cripple the company by demanding repayment of the loan [ITA 256(5.1)]. In which case the companies are associated [ITA 256(1)(b)].
• If Aileen is able to replace this financing, then Connie probably does not have undue influence and would not be considered to control the company. In which case the companies are not associated because there is no cross-ownership [ITA 256(1)(c)].

Situation 5

Arch is related to Andrew and Cheryl since they are his grandchildren. [ITA 251(6)(a)]

Andrew and Cheryl are not related since there is no provision that considers cousins to be related.

Arch’s ownership of shares of Breton Inc., representing, at any time in the year, more than 50% of the fair market value of all shares issued by the company, deems him to control Breton Inc. [ITA 256(1.2)(c)(i)]

Breton Inc. and Arch Inc. are associated for two reasons.

• First, Breton Inc. and Arch Inc. are associated because they are both controlled by Arch [ITA 256(1)(b)].

• Second, Arch Inc. and Breton Inc. are associated, since Arch who controls Arch Inc. is related to each member of the group of Andrew and Cheryl that controls Breton Inc. and Arch owns 100% of the class of preferred shares (which are not shares of a specified class) in Breton Inc. [ITA 256(1)(d)]
  o There is no requirement that the group controlling Breton Inc. be related, only that the person controlling the other company be related to each member of the group.

Situation 6

Each of Jeff and Valerie is deemed, for purposes of the association rules, to own 100% of the shares of Chelsea Inc. owned by Chelsea, since she is under the age of 18 [ITA 256(1.3)].

• If Chelsea managed the business without a significant degree of influence by a parent, the parents would not be deemed to own the shares [ITA 256(1.3)].

• Jeff, Valerie, and Chelsea each control Chelsea Inc., at the same time, since each one owns, or is deemed to own, 100% of the common shares of the company [ITA 256(1.2)(c)(ii)].

Jeff Inc. and Chelsea Inc. are associated since each company is deemed to be controlled by Jeff [ITA 256(1)(b)].

Similarly Valerie Inc. and Chelsea Inc. are associated since they are both deemed to be controlled by Valerie.

Jeff Inc. and Valerie Inc. are associated since each is associated with Chelsea Inc. [ITA 256(2)].
Note that without the existence of Chelsea Inc., Valerie Inc. and Jeff Inc. would not be associated.

- Chelsea Inc. may elect in prescribed form not to be associated with any other company for a particular year [ITA 256(2)].
- The effect of this election would be that Jeff Inc. and Valerie Inc. would not be associated.
- If this election is made, then Chelsea Inc.’s annual business limit for the purposes of the small business deduction is deemed to be nil.
PROBLEM SIXTEEN

[ITA: 8(1)(j); 15(2),(2.4),(2.6),(9); 20(1)(j); 80.4(1),(2),(3),(4); 80.5]

Each of the following three situations is independent.

1. Len is an employee and the sole shareholder of Laser Ltd. On July 1, 20X6 Len entered into a loan agreement with Laser Ltd. wherein Laser Ltd. agreed to loan $30,000 at 3% interest to Len to enable him to purchase a car to be used in carrying out his duties of employment. The loan is to be repaid in full at the end of three years. The interest is to be paid annually. Although Laser Ltd. has sixty-five employees, Laser Ltd. has never made a car loan to any other employee. Laser Ltd. has a June 30 year end.

2. Karen is a shareholder and key employee of X Ltd., a CCPC with a November 30, fiscal year end. Karen’s daughter, age 19, a full-time student at the University of Toronto, received an interest-free loan of $10,000 from X Ltd. on December 31, 20X6 to pay her tuition. The loan is repayable in full in 20X9, one year after she graduates.

3. Wayne Fry is a 60% shareholder and president of Attack Ltd., a Canadian-controlled private corporation with a November 30th year end. On March 1, 20X6, Wayne received a $300,000 loan from Attack Ltd. to assist him with the purchase of a new home, located 10 km from his previous home. The loan is repayable over five years in equal instalments of principal payable on the anniversary date. The loan has an interest rate of 1% per annum. The interest is payable monthly.

Required:

What are the tax implications for the individuals receiving the loans? Assume the prescribed rates of interest were as follows:

<table>
<thead>
<tr>
<th>Period</th>
<th>20X6</th>
<th>20X7</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jan – Mar</td>
<td>3%</td>
<td>5%</td>
</tr>
<tr>
<td>Apr – June</td>
<td>3%</td>
<td>5%</td>
</tr>
<tr>
<td>July – Sept</td>
<td>4%</td>
<td>5%</td>
</tr>
<tr>
<td>Oct – Dec</td>
<td>4%</td>
<td>5%</td>
</tr>
</tbody>
</table>
Solution to P 13-16

1. The $30,000 car loan will be included in Len’s income in 20X6, the year of receipt [ITA 15(2)] and Len will be able to deduct the loan repayment in 20X9. The car loan does not meet the tests for exclusion under ITA 15(2.4) as the loan was not received because of employment. The CRA’s administrative position is that if similar loans are not available to employees who are not shareholders, the loan is received because of shareholding. Len can avoid the inclusion by repaying the loan by June 30, 20X8 [ITA 15(2.6)].

If the loan is included in Len’s income, there will not be an imputed interest benefit [ITA 80.4(3)(b)]. If the loan is not included in Len’s income he will have an imputed interest benefit calculated at the prescribed rate in effect for the period in the year during which the loan is outstanding included as income from property [ITA 15(9)] in his income for tax purposes. The imputed interest benefit is reduced by the 3% interest paid by Len, provided it is paid by 30 days after the end of the calendar year [ITA 80.4(2)]. The imputed interest benefit is deemed to be interest paid [ITA 80.5].

Len is entitled to deduct the interest paid on the car loan prorated for his employment use [ITA 8(1)(j)].

2. The $10,000 interest-free tuition loan is included in the daughter’s income as income from property for 20X6, the year she received the loan [ITA 15(2),(9)]. She can claim a deduction in 20X9 when she repays the loan [ITA 20(1)(j)]. Since the loan is included in income, there is no imputed interest benefit [ITA 80.4(3)(b)].

3. If Wayne received the $300,000 home purchase loan by virtue of being a shareholder, and it is not repaid by November 30, 20X7, the entire $300,000 loan will be included in his income for 20X6 as income from property [ITA 15(2)]. If the loan is included in his income, he will be able to deduct the repayments he makes in each of the following five years [ITA 20(1)(j)].

If Wayne received the loan by virtue of being an employee, the loan is not included in his income even if it is not repaid by November 30, 20X6 [ITA 15(2.4)]. The loan meets the following conditions for exclusion:
- the loan is made to an employee to assist the employee to acquire a home,
- the employee received the loan because of his employment
- at the time the loan was made, bona fide arrangements were made for repayment of the loan within a reasonable time.

Since the loan is not included in income, Wayne will have an imputed interest benefit included in his income for the five years the loan, or any portion thereof, remains outstanding. For the five years the imputed interest benefit will be calculated using the lower of the prescribed rate for each quarter and the prescribed rate in affect at March 1, 20X6 when the loan was received [ITA 80.4(4)]. The imputed interest benefit will be reduced by the 1% interest paid, provided it is paid each year by January 30th of the following year [ITA 80.4(1)].

A benefit is considered conferred qua employee if it can be considered part of a reasonable employee remuneration package (a one-employee corporation can qualify [doc 2008-0270201E5]).
CASES

Hockey Facilities

[ITA: 85(1); 121; 125(1); 125.1; 256]

Don Cameron operates Hockey Facilities as a sole proprietorship. The operations consist of two retail outlets that sell all types of hockey equipment, as well as a separate manufacturing facility that manufactures the famous Slap Shot hockey stick. Financial information for the most recent 12-month period is outlined in Exhibits I and II on the following pages. In addition to the income derived from Hockey Facilities, Cameron has substantial investments that generate high returns. The investment income by itself has put Cameron in the top marginal tax bracket of 45%. That income consists of dividends from shares of public corporations and interest on bonds.

As the proprietor, Cameron draws funds from Hockey Facilities to pay his personal expenses and income taxes. He usually requires $40,000 annually for living expenses exclusive of any income taxes. You have recently met with Cameron to discuss the possibility of incorporating Hockey Facilities’ business operations. At the meeting, Cameron provided you with the following additional information:

1. Expected profits from Hockey Facilities are as follows:
   
<table>
<thead>
<tr>
<th>Year</th>
<th>Profit</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X2</td>
<td>$475,000</td>
</tr>
<tr>
<td>20X3</td>
<td>520,000</td>
</tr>
<tr>
<td>20X4</td>
<td>570,000</td>
</tr>
</tbody>
</table>

2. The assets described in the attached balance sheet have the following current fair market values:

<table>
<thead>
<tr>
<th>Asset</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current assets</td>
<td>$300,000</td>
</tr>
<tr>
<td>Land</td>
<td>150,000</td>
</tr>
<tr>
<td>Buildings</td>
<td>400,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>100,000</td>
</tr>
<tr>
<td>Licence</td>
<td>120,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>200,000</td>
</tr>
</tbody>
</table>

3. The undepreciated capital cost of depreciable property at December 31, 20X1, after current capital cost allowance, is as follows:

<table>
<thead>
<tr>
<th>Asset</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Buildings</td>
<td>$240,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>90,000</td>
</tr>
<tr>
<td>Licence</td>
<td>70,000</td>
</tr>
</tbody>
</table>

4. The cumulative eligible capital account at December 31, 20X1, amounted to $22,000 after the 20X1 deduction.
5. The financial statements include amortization at an amount equal to the available capital cost allowance.

6. Cameron does not have a detailed breakdown of manufacturing profits and retail profits, although he estimates the retail profits to be $100,000.

You have asked Cameron to provide you with a list of manufacturing assets and manufacturing labour, but to date, he has not provided this information, as he has been tied up arranging for a contractor to build his new home.

Cameron is confused about how a corporate structure would be worthwhile and is concerned that, according to what he had heard, double taxation might result in certain circumstances.

Cameron’s son Eric is 23 years old and is actively involved in the business, earning a salary of $20,000 annually. Eric has spent most of his time at the manufacturing plant but intends to become involved in the retail operations as well. Cameron looks at the manufacturing activity as a separate business from the retail operation.

The meeting ended with you agreeing to provide a report to Cameron on the issues discussed.

**Required:**

Prepare the report, together with any supporting calculations and analyses you feel are necessary.
EXHIBIT I
HOCKEY FACILITIES
Balance Sheet
December 31, 20X1

Assets

Current assets $300,000
Fixed assets (at cost):
   Land $100,000
   Buildings 300,000
   Equipment 200,000
   600,000
   Accumulated amortization (220,000) 380,000
   Slap Shot manufacturer's licence (at cost) 80,000
   Goodwill, at cost 60,000
   $820,000

Liabilities and Equity

Liabilities $600,000
Proprietor's equity 220,000
$820,000

EXHIBIT II
HOCKEY FACILITIES
Statement of Income
Year Ended December 31, 20X1

Sales (retail and manufacturing) $1,600,000
Cost of sales:
   Opening inventory $ 300,000
   Purchases and manufacturing costs 800,000
   1,100,000
   Closing inventory 200,000
   Gross profit 700,000
   General administrative and selling expenses 250,000
   Net income $ 450,000
CASE SOLUTION

Hockey Facilities

The report to Cameron should include a review of the following issues:

- Tax benefits of incorporation.
- Is his fear of double taxation justified?
- How can the proprietorship be transferred to the corporation?
- Possible separation of the manufacturing and retail entities.
- Potential transfer of all or a part of the business to his son.

Note: Actual marginal tax rates for a specific province can be substituted.

Benefits of Incorporation

The primary benefit of incorporation is the ability to utilize the small business deduction on active business profits. This benefit, however, is valuable to the extent that the income is retained in the corporation for expansion purposes or for other investments. It is necessary to determine the amount that Cameron will be required to withdraw from the corporation to meet his personal needs.

Currently, Cameron requires $40,000 for personal expenses exclusive of income taxes. After incorporation, Cameron will have to receive a taxable salary to meet these needs. Because of his other income, his personal tax rate is 45%. Therefore, a salary of approximately $73,000 will be necessary.

\[
x - .45x = 40,000 \\
x = 72,727
\]

With this salary, the expected profits after incorporation will be:

<table>
<thead>
<tr>
<th></th>
<th>20X2</th>
<th>20X3</th>
<th>20X4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Projected profits</td>
<td>$475,000</td>
<td>$520,000</td>
<td>$570,000</td>
</tr>
<tr>
<td>Less salary</td>
<td>(73,000)</td>
<td>(73,000)</td>
<td>(73,000)</td>
</tr>
<tr>
<td></td>
<td>$402,000</td>
<td>$447,000</td>
<td>$497,000</td>
</tr>
</tbody>
</table>

Over the next three years, all profits are eligible for the small business deduction because they are less than $500,000 annually. An M & P deduction will not be available as there are no M & P profits in excess of $500,000.

Assuming that the tax rate on the corporate income will be 15%, the proprietorship and corporate structure can be compared on the basis of after-tax cash flow available for reinvestment.
As a proprietorship:

<table>
<thead>
<tr>
<th>Year</th>
<th>Income</th>
<th>Tax @ 45%</th>
<th>Cash for personal needs</th>
<th>Profit for reinvestment</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X2</td>
<td>$475,000</td>
<td>(213,750)</td>
<td>(40,000)</td>
<td>$221,250</td>
</tr>
<tr>
<td>20X3</td>
<td>$520,000</td>
<td>(234,000)</td>
<td>(40,000)</td>
<td>$246,000</td>
</tr>
<tr>
<td>20X4</td>
<td>$570,000</td>
<td>(256,500)</td>
<td>(40,000)</td>
<td>$273,500</td>
</tr>
<tr>
<td>Total</td>
<td>$1,565,000</td>
<td>(704,250)</td>
<td>(120,000)</td>
<td>$740,750</td>
</tr>
</tbody>
</table>

As a corporation:

<table>
<thead>
<tr>
<th>Year</th>
<th>Income after salary</th>
<th>Tax @ 15%</th>
<th>Profit for reinvestment</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X2</td>
<td>$402,000</td>
<td>(60,300)</td>
<td>$341,700</td>
</tr>
<tr>
<td>20X3</td>
<td>$447,000</td>
<td>(67,050)</td>
<td>$379,950</td>
</tr>
<tr>
<td>20X4</td>
<td>$497,000</td>
<td>(74,550)</td>
<td>$422,450</td>
</tr>
<tr>
<td>Total</td>
<td>$1,346,000</td>
<td>(201,900)</td>
<td>$1,144,100</td>
</tr>
</tbody>
</table>

Therefore, in the first three years of incorporation, additional cash flow of $403,350 ($1,144,100 - $740,750) will be available. This additional cash flow is valuable to Cameron as it can be used in three basic ways:

1. It can be used to expand or improve the business operation, thereby enhancing its competitive position and potential growth.

2. The funds can simply be invested in short term or long term passive investments, which provide a return on funds that would otherwise have been paid in income taxes.

3. Some of the funds can be loaned to Cameron for the funding of his proposed new home. The loan will not be included in Cameron's income provided that the loan is repaid within one year after the corporation year end in which the loan is made [ITA 15(2.6)]. It does not meet the exception for a housing loan if similar loans are not available to other employees who are not a shareholder or related to a shareholder. I assume this to be the case which means the CRA would consider Cameron to have received the loan because of his shareholding and not because of his employment [ITA 15(2.4)]. Therefore, Cameron will have immediate access to business profits that have been taxed at 15% rather than the pre-incorporation rate of 45%. Cameron will pay tax on an imputed interest benefit if the interest rate on the loan is below market value.

In addition to the above, some immediate benefits may result because Cameron can be an employee of his own corporation (not possible as a proprietorship). The corporation can provide certain tax-free benefits. Also, the corporation structure provides greater flexibility for transferring ownership to family members (see below).
Double Taxation

Cameron's concern of double taxation is unfounded. Although corporate income is taxed a second time when dividends are distributed, the dividend tax credit is sufficient to offset the corporate taxes on the first $500,000 of annual business income. For example, if the 20X2 after-tax corporate profits of $341,700 (see above) were distributed as a dividend the personal tax would be $112,761 (33% of $341,700 - being the approximate tax rate on dividends net of the dividend tax credit for an individual in a 45% tax bracket). Therefore, after distributing the full 20X2 pre-tax profits of $475,000, Cameron would incur total tax of $205,911 as follows:

| Corporate tax | $60,300 |
| Personal tax: | |
| On salary of $73,000 @ 45% | 32,850 |
| On dividend of $341,700 @ 33% | 112,761 |
| **Total** | **$205,911** |

This compares with total taxes paid under the proprietorship structure of $213,750 ($475,000 @ 45%) which is higher.

If, in the future, business income exceeds $500,000 annually, that income may be subject to some double taxation because the corporate rate will increase to 25% on business income above $500,000 causing the combined corporate tax plus tax on the dividend distribution to be approximately 46%. For example:

| Corporate tax on $100 of income | $25 |
| Tax on eligible dividend | |
| $100 - $25 = $75 @ 28% | 21 |
| **Total tax** | **$46** |

However, the double tax effect can be avoided by reducing corporate income subject to the highest corporate rate (25%) by increasing the annual salary paid to Cameron. This is possible as Cameron is active in the business and is the sole shareholder. However, Cameron must weigh the advantage of a 20% deferral (45% personal rate – 25% corporate rate) against the possibility of a future double tax of 1% (46% - 45%).

In addition, no double taxation will occur on any investment income (e.g., interest) earned in the corporation from investing the increased cash flow. Although such income would be taxed at a high corporate rate of 44 2/3%, a subsequent tax refund equal to 26 2/3% of the investment income occurs upon payment of a dividend to the shareholders. This will eliminate the potential for double tax.

Incorporation of the Proprietorship:
To incorporate the proprietorship, all or some of the business assets must be sold to a newly created corporation. As Cameron will not deal at arm's length with the corporation, assets are deemed to have been sold to the corporation at their market value which will create taxable income. The potential tax on a fair market value transfer is as follows:
Taxable Income

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Land ($150,000 - $100,000 = $50,000 x 1/2)</td>
<td>$25,000</td>
</tr>
<tr>
<td>Building:</td>
<td></td>
</tr>
<tr>
<td>($400,000 - $300,000 = $100,000 x 1/2)</td>
<td>50,000</td>
</tr>
<tr>
<td>($400,000 - $240,000)</td>
<td>60,000</td>
</tr>
<tr>
<td>Equipment ($100,000 - $90,000)</td>
<td>10,000</td>
</tr>
<tr>
<td>License:</td>
<td></td>
</tr>
<tr>
<td>($120,000 - $80,000 = $40,000 x 1/2)</td>
<td>20,000</td>
</tr>
<tr>
<td>($80,000 - $70,000)</td>
<td>10,000</td>
</tr>
<tr>
<td>Goodwill – (Note)</td>
<td>93,000</td>
</tr>
<tr>
<td>Total</td>
<td>$268,000</td>
</tr>
</tbody>
</table>

Tax @ 45% $120,600

Note:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>CEC balance</td>
<td>$22,000</td>
</tr>
<tr>
<td>Sale proceeds – ¾ ($200,000)</td>
<td>(150,000)</td>
</tr>
<tr>
<td>Negative balance</td>
<td>$(128,000)</td>
</tr>
</tbody>
</table>

Taxable portion:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Recovery of previous deductions</td>
<td>$23,000</td>
</tr>
<tr>
<td>($45,000* - $22,000)</td>
<td></td>
</tr>
<tr>
<td>Excess–2/3($128,000 - $23,000)</td>
<td>70,000</td>
</tr>
<tr>
<td></td>
<td>93,000</td>
</tr>
</tbody>
</table>

* the original cost of the goodwill was $60,000 and, therefore, $45,000 (3/4 x $60,000) was originally added to the CEC account.

The cost of the assets to the corporation will be higher than Cameron’s costs and, therefore, a portion of the immediate tax cost may ultimately be recovered through increased CCA against future income. However, this recovery would be long-term and clearly a potential tax liability of $120,600 is undesirable.

The potential tax on the transfer can be avoided or reduced in one of two ways. First of all, Cameron could retain ownership of some of the assets and lease them to the corporation. For example, the land, buildings and equipment could be used by the corporation in exchange for rents. As well, Cameron could retain ownership of the licence in exchange for a royalty. While this would reduce the tax liability, it creates new problems. The payment of rents and royalties will reduce the corporate income and, therefore, the use of the small business deduction is diminished, eliminating part of the available tax deferral.

Alternatively, the assets could be transferred to the corporation using the elective option, which permits a transfer price for tax purposes at the assets’ cost amounts even though the legal price is at fair market value. This alternative appears to be the most attractive in this particular case.
Separation of Manufacturing and Retailing:

Because the retailing and manufacturing businesses are so different and Cameron regards them as separate businesses there may be compelling business and administrative reasons for organizing two corporations— one for each activity. However, at the present time and based on the three year projection there are no significant tax reasons for doing so.

The federal tax rate reduction (13% in 2012, 11.5% in 2011) plus various provincial rate reductions apply only to M & P profits not subject to the small business deduction. Therefore, based on the profit projections for the next three years (after deducting Cameron's required salary of $73,000) all income is subject to the small business deduction and the M&P deduction is not applicable.

If profits improve beyond what is expected, a slightly different result occurs. For example, assume the retail profits are $500,000 and the M & P profits are $100,000 for a total of $600,000. In a combined structure only $500,000 of the profits are eligible for the small business rate. However, the rules require that the manufacturing profits are first designated as the income eligible for the small business deduction [ITA 125.1(a)]. This means that the $100,000 of M & P profits get the small business deduction and no M & P deduction is available. In other words, it is the retailing profit that constitutes the high rate income. The outcome is that the benefit of the provincial rate reduction (if any) is lost. If two corporations were used they would be associated and must share the $500,000 SBD limit in any manner designated [125(3)]. Consequently, Cameron could designate the $500,000 to the retailing corporation, leaving none of it for the manufacturing corporation. Therefore, as a separate corporation, the entire M&P profit of $100,000 would not be eligible for the SBD and the federal and provincial/territorial M&P deductions would apply. (Remember that the general tax reduction applies to business income not eligible for the small business deduction or the M&P deduction).

While, in the above example, a separate corporation achieves the use of the M&P deduction it still may not be desirable. The deduction does not reduce the federal tax rate. (The provincial rate may be reduced depending on the province or territory). The 25% corporate rate is better than Cameron's personal tax rate of 45%, but it means that double taxation may occur at some future time when dividends are distributed.

For example -

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporate tax on $100</td>
<td>$25</td>
</tr>
<tr>
<td>Personal tax on dividend –Eligible</td>
<td></td>
</tr>
<tr>
<td>$100 - $25 = $75 x 28%</td>
<td>$21</td>
</tr>
<tr>
<td>Total tax</td>
<td>$46</td>
</tr>
</tbody>
</table>

The question arises: Is it better to eliminate the corporate income by paying a salary which will be taxed at 45% now or not pay a salary creating corporate tax of 25% now in exchange for some double tax later? Since the double taxation is minimal (1%) the deferral is probably preferable. The answer depends upon the need for immediate cash flow and the timing of potential dividend distributions.
Transfer of Ownership

Because Cameron’s son is actively involved in the business students analyzing the case usually raise the question of the son’s potential ownership. The corporate structure provides a number of options for transferring an ownership interest to the son and most of these are not discussed until Chapter 18. At this stage however, two possible items can be discussed.

The first deals with a future transfer of ownership. After incorporation, the company will be a qualified small business corporation (QSBC), which means that Cameron can sell shares to the son and be eligible for the capital gains deduction. However, this status may change if the expanded cash flow from the small business tax rate is invested in non-business assets. This opportunity was not available under the proprietorship structure.

The second item is more difficult and needs to be brought out through a class discussion. The son could obtain an equity interest at the time of incorporation. For example, if Cameron transfers the assets to a new corporation for a fair market value legal price but elects the assets' cost amount for tax purposes, he could be paid in the form of debt plus non-participating preferred shares. For example, the fair market value and the elected values would be as follows:

<table>
<thead>
<tr>
<th>Asset</th>
<th>Tax Value</th>
<th>Elected Price</th>
<th>Consideration</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Value</td>
<td></td>
<td>Debt</td>
</tr>
<tr>
<td>Current assets</td>
<td>$300,000</td>
<td>$300,000</td>
<td>$300,000</td>
</tr>
<tr>
<td>Land</td>
<td>150,000</td>
<td>100,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Buildings</td>
<td>400,000</td>
<td>240,000</td>
<td>240,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>100,000</td>
<td>90,000</td>
<td>90,000</td>
</tr>
<tr>
<td>Licence</td>
<td>120,000</td>
<td>70,000</td>
<td>70,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>200,000</td>
<td>29,333</td>
<td>29,333</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>$829,333</td>
</tr>
<tr>
<td></td>
<td>$1,270,000</td>
<td>$829,333</td>
<td>$829,000</td>
</tr>
</tbody>
</table>

The price and payment terms would be:

Price

$1,270,000

Payment:

Non-share --assumption of liabilities $ 600,000

--owing to Cameron 229,000

Preferred shares 829,000

$1,270,000

Notice that at this stage, the full value of the entity is tied up in the shareholder loan and the preferred shares. This means that the value of the common shares is nominal. Therefore, immediately after incorporation, the son could acquire some common shares directly from the corporation. This would permit the son to share in any increase in the business value over and above its existing value.
CASE TWO

Eastern Smallwares Ltd. and Byron Ltd.

Sheila Stekylo is the sole shareholder of Eastern Smallwares Ltd., a Canadian-controlled private corporation based in southwestern Ontario. The company wholesales small wares to retail variety stores in eastern Canada. Two years ago, ESL purchased 40% of the common shares of Byron Products Ltd., a company in a similar line of business but operating in western Canada. The remaining 60% of BPL’s shares are owned by Ranjit Dhillon.

Dhillon is actively involved in managing BPL’s operations. It is two months before ESL’s year end and Stekylo has completed a review of the company’s financial information. ESL’s operating results, to date, are good. The company’s internal accountant has prepared projections to the end of the year (see Exhibit I). Stekylo notices that the projections do not include an estimate of the current year’s taxes and tells her internal accountant the following:

“We need an estimate of the current year’s tax cost for ESL so we can properly plan our cash flows. Also, there are a lot of planned activities that you and I have discussed that are going to have tax consequences and may require some planning...Also, some changes are happening at BPL. For example, BPL has taken out a $200,000 life insurance policy on both me and Dhillon as part of the buy/sell agreement, and I have no idea what the tax implications are if BPL collects on that insurance. And Dhillon is talking about acquiring a separate business in his own name. Prepare as much information as you can, and send it over to our accountants at Carlson and Kominsky (C&K). Have them estimate this year's tax cost for ESL, and then have them explain to us the tax implications of the various planned events and make any planning suggestions.”

As a member of C&K, you have been assigned to report to Stekylo. You intend to prepare a preliminary draft report for review based on the information provided in Exhibits I, II, and III. Your report will include an estimate of ESL’s net income for tax purposes, taxable income, and tax cost for the current year.

Required:

Prepare the preliminary draft report for Stekylo.
EXHIBIT I
EASTERN SMALLWARES LTD.
Projected Year-End Statement of Income
with Supplementary Notes

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$1,333,000</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>690,000</td>
</tr>
<tr>
<td>Gross profit</td>
<td>643,000</td>
</tr>
<tr>
<td>Expenses:</td>
<td></td>
</tr>
<tr>
<td>Salaries and wages</td>
<td>$320,000</td>
</tr>
<tr>
<td>Rent and utilities</td>
<td>24,000</td>
</tr>
<tr>
<td>Repairs and maintenance</td>
<td>23,000</td>
</tr>
<tr>
<td>Amortization</td>
<td>8,000</td>
</tr>
<tr>
<td>Travel and delivery</td>
<td>17,000</td>
</tr>
<tr>
<td>Interest</td>
<td>26,000</td>
</tr>
<tr>
<td>Insurance</td>
<td>7,000</td>
</tr>
<tr>
<td>Reserve for doubtful debts</td>
<td>37,000</td>
</tr>
<tr>
<td>Advertising</td>
<td>11,000</td>
</tr>
<tr>
<td>Charitable donations</td>
<td>5,000</td>
</tr>
<tr>
<td>Legal and accounting</td>
<td>20,000</td>
</tr>
<tr>
<td>Other</td>
<td>15,000</td>
</tr>
<tr>
<td>Income from operations</td>
<td>130,000</td>
</tr>
<tr>
<td>Other income:</td>
<td></td>
</tr>
<tr>
<td>Interest on bonds</td>
<td>35,000</td>
</tr>
<tr>
<td>Dividends from taxable Canadian public corporations</td>
<td>8,000</td>
</tr>
<tr>
<td>Gain on sale of marketable securities</td>
<td>40,000</td>
</tr>
<tr>
<td>Net gain on land sales</td>
<td>15,000</td>
</tr>
<tr>
<td>Net income before tax</td>
<td>$228,000</td>
</tr>
</tbody>
</table>

Supplementary Notes:

1. The insurance expense of $7,000 consists of three separate premiums: fire and theft ($2,500), public liability ($1,500), and term life insurance on Stekylo that has been pledged to the bank as required collateral for a loan ($3,000).

2. Legal fees include $2,700 for the collection of delinquent accounts receivable, $7,000 for preparing a debenture agreement to obtain an expanded line of credit with the bank, and $8,000 for amending the company’s articles of incorporation. The remaining costs relate to annual audit fees.

3. Repairs and maintenance include the following:

   - Office cleaning, snow removal, lawn care $ 4,500
   - Engine replacements on two delivery trucks 18,000
   - Other 500

   $23,000

4. This year, the company began a new policy of establishing a reserve of 1% of sales for future returns of defective merchandise. This reserve, along with several other minor items,
is included as a deduction under “other” expenses. During the year, only $9,000 of defective merchandise was returned.

5. On the first day of the current taxation year, the company rented additional premises under a 6-year lease agreement. The agreement includes two three-year renewal options. Improvements costing $28,000 were made to the premises. As an inducement to sign the lease, the landlord paid ESL $10,000 to cover some of these improvements. This amount was credited to contributed surplus on the balance sheet.

6. The undepreciated capital cost of certain assets at the end of the previous year was as follows:

<table>
<thead>
<tr>
<th>Class</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Class 8</td>
<td>$27,000</td>
</tr>
<tr>
<td>Class 10</td>
<td>31,000</td>
</tr>
</tbody>
</table>

There were no acquisitions or sales of equipment during the current year.

7. At the end of the previous year, the following additional tax accounts existed:

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Refundable dividend tax on hand</td>
<td>$2,000</td>
</tr>
<tr>
<td>Capital dividend account</td>
<td>9,000</td>
</tr>
<tr>
<td>Cumulative eligible capital</td>
<td>12,000</td>
</tr>
</tbody>
</table>

8. The net gain on land sales ($15,000) resulted from two transactions. One property was acquired five years ago as a possible site for a warehouse. However, when new leased space became available, ESL sold the land for $40,000 more than it cost. The other property was sold for a loss of $25,000 after being held by ESL for only six months. It had been acquired in the expectation that its value would rise rapidly after a new shopping centre was developed nearby. However, the shopping centre project was cancelled, and land values in the area declined.

9. Not reflected in the projected income statement is an anticipated dividend from BPL. Dhillon has informed Stekylo that BPL intends to declare a dividend of $200,000. The dividend will be received before the current year end.

10. Included in the amount for salaries and wages are estimated bonuses of $30,000 for senior staff. These will be accrued at year end. The bonuses will be paid in three instalments of $10,000 over the next taxation year. The first instalment will be paid four months after year end, the remaining two at 8 and 12 months, respectively.
EXHIBIT II
EASTERN SMALLWARES LTD.
Anticipated Developments

1. ESL has just signed a long-term contract to supply products to a large national chain organization. The contract will begin early in the new year. Operating profits for next year will increase by approximately $380,000.

2. Stekylo has agreed to sell 33 1/3% of her common shares in the company to a senior manager for $400,000. She had purchased the entire share capital of the company seven years before, for $570,000. She intends to use all of the proceeds to pay off what she still owes the previous owner of ESL. Stekylo’s personal marginal tax rate is 45% on normal income except dividends, which are subject to a 28% marginal tax rate on eligible dividends and 33% marginal rate on non-eligible dividends.

3. Early in the new year, Stekylo will need $300,000 in cash to finish paying for the construction of her new personal residence. Except for her salary of $80,000 per year from ESL, she has no personal cash. She plans to extract $300,000 from ESL and wants to keep her tax bill to a minimum. The following summary of the ESL balance sheet indicates that there are sufficient assets to fund the distribution:

| Cash, receivables, inventory | $640,000 |
| Equipment and leaseholds     | 108,000  |
| Goodwill, at cost            | 100,000  |
| Investment in bonds          | 320,000  |
| **Total Assets**             | **$1,168,000** |

| Current and long-term liabilities | $366,000 |
| Shareholders’ equity            | 802,000  |
| **Total Liabilities**           | **$1,168,000** |

EXHIBIT III
Information Pertaining to Byron Products Ltd.

1. BPL has consistently earned from operations pre-tax profits of between $150,000 and $200,000. It does not earn any investment income. In the taxation year just passed, BPL earned profits from its business operations of $180,000 and paid taxes of $36,000 on that income.

2. Dhillon and Stekylo have recently signed an agreement which states that if one dies, the survivor must purchase the interest of the deceased. The agreement does not specify how the buy-out is to be structured. In conjunction with the agreement, BPL has purchased a $200,000 term life insurance policy on both individuals, with BPL as the beneficiary. The entire shares of BPL were recently valued at $600,000. At the most recent year end, BPL had retained earnings of $480,000. ESL had purchased its 40% interest for $100,000. The paid-up capital of the BPL shares owned by ESL is $1,000.

3. BPL will soon declare a dividend of $200,000 (see Exhibit I). Dhillon has initiated the dividend in order to free up cash so that he can purchase another business. Dhillon has informed Stekylo that he is about to buy 100% of the shares of a highly profitable manufacturing corporation.
CASE TWO SOLUTION

A. Calculation of tax cost - ESL

Net income per financial statement $228,000
Charitable donations [ITA 18(1)(a)]  5,000
Amortization [ITA 18(1)(b)]  8,000
Term life insurance ($3,000) – deductible
in full as an expense of financing [ITA 20(1)(e.1)]  0
Legal fee for debenture - deductible over
5 years as an expense of financing. Not
deductible this year 4/5 ($7,000) [ITA 20(1)(e.1)]  5,600
Legal fee for amending articles of
incorporation - not deductible because it is
a capital expenditure [ITA 18(1)(b)]. It qualifies as
eligible capital property (see below)  8,000

Eligible capital property deduction [ITA 20(1)(b)]:
Cumulative eligible property -
Opening  $12,000
Addition (legal) 3/4 of $8,000  6,000
$18,000
Current deduction 7% of $18,000  (1,260)
Repairs - engine replacements - are capital
items [ITA 18(1)(b)] - included in CCA calculation  18,000

Reserve for defective merchandise not
deductible ($13,330) [ITA 18(1)(e)] but actual returns are
deductible ($9,000). $13,330-$9,000  4,330

Lease inducement payment ($10,000) is fully
taxable [ITA 12(1)(x)] unless an election is made
to reduce the cost of the leasehold
improvements. To obtain the lowest taxable
income this year the cost of improvements
should be reduced. A decision analysis should
be made (see solution under heading lease
inducement decision)  0

Capital cost allowance [ITA 20(1)(a)]:
Class 13 - Leasehold improvement
Opening  $ 0
Addition  28,000
Deduct lease inducement (above) (10,000)
$18,000

CCA lesser of:  (a) 1/5 (18,000)  $ 3,600
(b) 18,000 /(6+3)  $ 2,000
$2,000 (1/2 rule)  (1,000)
Class 8 - Equipment
Opening $27,000
Additions (disposals) 0
$$27,000$$
CCA @ 20% (5,400)

Class 10 – Automotive
Opening $31,000
Addition (engines) 18,000
Less half-year adjustment
1/2 ($18,000) (9,000)
$$40,000$$
CCA @ 30% (12,000)

Non-taxable portion of capital gains
Marketable securities ½ ($40,000) (20,000)
Capital land sale ½ ($40,000) - land
sold for a gain of $40,000 is a capital gain
due to intention at acquisition. (20,000)
The other piece of land, sold for a loss
of $25,000, appears to be a business
loss because it was acquired for resale.
Anticipated dividend from BPL (40% of $200,000) 80,000
Deferred bonuses - not deductible if
unpaid 180 days after year end [ITA 78(4)]. Two
$10,000 payments will be beyond 180 days 20,000

NET INCOME FOR TAX PURPOSES 317,270

Deduct:
Charitable donations [ITA 110.1] $5,000
Canadian dividends [ITA 112(1)]
   Public corporations 8,000
   BPL 40% ($200,000) 80,000 (93,000)

TAXABLE INCOME $224,270

Determination of Income from an Active Business:
Net income for tax purposes $317,270
Less:
   Investment income – interest $35,000
   Taxable capital gains: securities 20,000
   land 20,000
   Taxable dividends: public corporations 8,000
   BPL 80,000 163,000
Income from an active business $154,270
Estimate of Tax:

<table>
<thead>
<tr>
<th>Income</th>
<th>Rate</th>
<th>Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable income</td>
<td>$224,270</td>
<td></td>
</tr>
<tr>
<td>Less:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Active business income</td>
<td>154,270</td>
<td>15%</td>
</tr>
<tr>
<td>Remainder</td>
<td>$ 70,000</td>
<td>44 2/3%</td>
</tr>
</tbody>
</table>

Total tax: $54,408

Note: The general tax reduction does not apply to the investment income earned by a CCPC.

Part IV Tax on Dividends [ITA 186(1)]:

- Public corporation dividends 8,000 X 1/3 = $2,664
- BPL dividends:
  - BPL is connected with ESL [ITA 186(4)]. The receipt by ESL of BPL dividends are not subject to Part IV tax except to the extent that BPL received a dividend refund on distribution. BPL has no refundable dividend tax on hand (all its income is active business income). = 0

Total part IV tax = $2,664

Total tax:
- on taxable income (Part I) = $54,408
- on dividends (Part IV) = 2,664

Total tax = $57,072

B. Anticipated Profit Increase for Next Year - ESL

Next year's profit increase of $380,000 will push active business income available for the small business deduction beyond the $500,000 annual limit.

<table>
<thead>
<tr>
<th>Projected ABI -</th>
<th>Current</th>
<th>Anticipated income</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$154,270</td>
<td>380,000</td>
</tr>
</tbody>
</table>

Business income in excess of $500,000 will be subject to a rate of approximately 25%. Additional taxes to the shareholder are payable on dividend distributions should they occur. To avoid any double taxation, ESL may consider paying an increased salary or bonus to Stekylo (owner/manager) of at least $34,000. Although Stekylo will pay tax at 45% on this bonus, corporate tax and future tax on dividends will be avoided. Business income over $500,000 is subject to a 25% tax rate which is lower than Stekylo's personal tax rate of 45%, but it means that some double taxation may occur at some future time when dividends are distributed (combined corporate and personal tax of 46%). A bonus paid now reduces income to $500,000 but creates additional current tax (45% vs. 25%) in order to eliminate a potential 1% double tax (46% vs. 45%).
Because of the rapid jump in profits, ESL does not take advantage of its full $500,000 small business deduction limit in the current year and then exceeds it next year.

<table>
<thead>
<tr>
<th></th>
<th>Current Year</th>
<th>Next Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Active business income</td>
<td>$154,000</td>
<td>$534,000</td>
</tr>
<tr>
<td>Annual limit</td>
<td>500,000</td>
<td>500,000</td>
</tr>
<tr>
<td>Excess (shortfall)</td>
<td>$(346,000)</td>
<td>$34,000</td>
</tr>
</tbody>
</table>

ESL should consider not claiming discretionary deductions this year and delaying them until next year. This will increase the current taxes of 15% but reduce next year’s tax at 25% on $34,000.

For example, the current year's reserve for doubtful accounts is $37,000 which does not have to be claimed for tax purposes. So, ESL could claim a reserve of only $3,000 in the current year (forgoing $34,000). As a result, current year’s income will increase by $34,000 but next year's will decrease by $34,000 (because current reserves are always added to next year’s taxable income [ITA 12(1)(d)]. This year’s tax would increase by $5,100 (15% x $34,000) but next year’s tax would decrease by $8,500 (25% x $34,000).

Assuming that excess funds are not being used for business expansion, but rather are held in bond investments as is currently the case (earning 13% interest), the actual saving on present value basis would be $5,066 calculated as follows:

Discount rate - pre-tax 13%
- after-tax 13% - (44 2/3% tax) = 7.19%
  say 7%

Present value of next year's tax savings
$8,500 X .93 $7,905
Cost increase in current year (5,100)
Tax saving $2,805

This action is recommended.

C. Lease Inducement Decision

The lease inducement receipt of $10,000 can be included fully in taxable income this year and taxed at 15% (even if no reserve is claimed for doubtful accounts, above). Or by reducing the cost of leasehold improvements, the tax is paid over time by a reduction of annual CCA. Future tax rates will be 25% on some business income, but the tax cost is delayed.
Assuming a discount rate of 7% (see discussion, above), the following comparison can be made:

<table>
<thead>
<tr>
<th>A)</th>
<th>Included in income in current year:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>10,000 (15% tax)</td>
</tr>
<tr>
<td>Absolute Cost</td>
<td>Present Value</td>
</tr>
<tr>
<td>$1,500</td>
<td>$1,500</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>B)</th>
<th>Reduce cost of improvements:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Current year</td>
</tr>
<tr>
<td></td>
<td>$10,000 (1/9) (1/2 rule) = $555</td>
</tr>
<tr>
<td>(15% tax)</td>
<td>83</td>
</tr>
<tr>
<td></td>
<td>Next seven years</td>
</tr>
<tr>
<td></td>
<td>$10,000 (1/9) = $1,111 (25% tax)</td>
</tr>
<tr>
<td></td>
<td>= $278 X 7 years</td>
</tr>
<tr>
<td></td>
<td>Last year (terminal) – remaining</td>
</tr>
<tr>
<td></td>
<td>unamortized ($1,111 + 555) =</td>
</tr>
<tr>
<td></td>
<td>$1,666 (25% tax)</td>
</tr>
<tr>
<td>Absolute Cost</td>
<td>Present Value</td>
</tr>
<tr>
<td>$2,446</td>
<td>$1,726</td>
</tr>
</tbody>
</table>

* Present value of annuity of $278 for next seven years after current year @ 7%.
** Present value of $417 received at end of Year 8 (eight years after current year) @ 7%.

Given that future tax rates will increase since income will exceed $500,000, it appears preferable to include the lease inducement in income for the current year (this was not reflected in the previous calculation of estimated tax for the current year).

D. Funds for New House

Stekylo requires $300,000 from ESL for construction of her house. The corporation can loan the full amount to Stekylo as a shareholder loan, provided that reasonable terms of repayment exist and the loan is made by virtue of her employment position. Reasonable terms would be similar to a normal mortgage amortization. (The loan is considered conferred qua employee if it can be considered part of a reasonable employee remuneration package [doc 2008-0270201E5] and similar loans are available to non-shareholder employees). The loan does not require interest to be charged, however, a taxable benefit will be conferred on Stekylo equal to the difference between a prescribed interest rate and the amount paid by Stekylo.

It is not necessary to treat the full $300,000 as a loan because there are several other opportunities for the receipt of funds which will have little or no tax cost. These are:

- Declaration of a tax-free capital dividend from the capital dividend account of $49,000 as follows: [ITA 89(1)]
  - Opening balance $ 9,000
  - Add:
    - Tax free portions of capital gains
      - Land 1/2 ($40,000) 20,000
      - Securities ½ ($40,000) 20,000
  - $49,000
• Payment of a taxable dividend sufficient to trigger a refund of the full refundable dividend tax on hand account [ITA 129(1)&(3)]:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>RDTOH at end of previous year</td>
<td>$2,000</td>
</tr>
<tr>
<td>Dividend refund for previous year</td>
<td>$(0)</td>
</tr>
<tr>
<td>Part IV tax (current year)</td>
<td>$2,664</td>
</tr>
<tr>
<td>Refundable portion of part I tax, least of:</td>
<td></td>
</tr>
<tr>
<td>(i) 26 2/3% x Aggregate investment income ($75,000)</td>
<td>$20,000</td>
</tr>
<tr>
<td>(ii) 26 2/3% x Taxable income ($224,270) - Income subject to SBD ($154,270) 26 2/3% of $70,000</td>
<td>$18,670</td>
</tr>
<tr>
<td>(iii) Part I tax</td>
<td>$58,750</td>
</tr>
<tr>
<td>RDTOH end of current year</td>
<td>$23,334</td>
</tr>
</tbody>
</table>

The dividend refund is 1/3 of dividends paid to a maximum of the RDTOH. Therefore, a dividend of $70,000 will result in a $23,334 refund to the corporation. The dividend is taxable to Stekylo at a personal rate of 33%.

Net dividend to Stekylo is $46,900 ($70,000 - 33% of $70,000).

It was previously indicated that ESL should consider paying a bonus to Stekylo next year to reduce the corporate tax. The bonus could be as high as $34,000. Therefore, ESL will owe Stekylo $18,700 as follows:

- **Bonus**: $34,000
- **Less employment withholding tax @ 45%**: $(15,300)

Therefore, the shareholder loan required is calculated as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital dividend</td>
<td>$49,000</td>
</tr>
<tr>
<td>Taxable dividend (net)</td>
<td>46,900</td>
</tr>
<tr>
<td>Bonus (net)</td>
<td>18,700</td>
</tr>
<tr>
<td>Balance as loan to shareholder</td>
<td>185,400</td>
</tr>
<tr>
<td>Total funds</td>
<td>$300,000</td>
</tr>
</tbody>
</table>

E. **Sale of Shares to Senior Manager**

The sale of shares will create a taxable capital gain of $105,000 as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proceeds of disposition</td>
<td>$400,000</td>
</tr>
<tr>
<td>Less ACB 1/3 of $570,000</td>
<td>$(190,000)</td>
</tr>
<tr>
<td>Capital gain</td>
<td>$210,000</td>
</tr>
</tbody>
</table>

**Taxable capital gain (1/2)**: $105,000
At the current time, the company appears not to be a qualified small business corporation which means that the capital gains deduction of $375,000 (1/2 of $750,000) does not apply [ITA 110.6]. To qualify, approximately 90% of the fair market value of the company's assets must be used in an active business, among other things.

Value of corporation in excess of book value:

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Value of shares based on agreed share price -</td>
<td></td>
<td></td>
</tr>
<tr>
<td>$400,000 X 3</td>
<td></td>
<td>$1,200,000</td>
</tr>
<tr>
<td>Book value of equity</td>
<td>$802,000</td>
<td></td>
</tr>
<tr>
<td>Less estimated taxes</td>
<td>($58,050)</td>
<td>(61,000)</td>
</tr>
<tr>
<td>Excess</td>
<td>$456,050</td>
<td></td>
</tr>
<tr>
<td>Book value of assets</td>
<td>$1,168,000</td>
<td></td>
</tr>
<tr>
<td>Add excess above</td>
<td>456,050</td>
<td></td>
</tr>
<tr>
<td>Total fair value</td>
<td>$1,624,050</td>
<td></td>
</tr>
<tr>
<td>Non-business assets (bonds)</td>
<td>$320,000</td>
<td></td>
</tr>
<tr>
<td>Business assets – remainder</td>
<td>1,304,050</td>
<td>$1,624,050</td>
</tr>
<tr>
<td>% business assets $1,304/$1,624</td>
<td>80%</td>
<td></td>
</tr>
</tbody>
</table>

Therefore, a sale will result in a tax cost of $47,250 (45% x $105,000)

The capital gains deduction may be available if ESL distributes all or a portion of the funds needed by Stekylo for her residence. These funds could be obtained by selling the bond investment. For example, if the company simply paid the necessary dividends and bonus to Stekylo early in the new year, the following position may be achieved:

<table>
<thead>
<tr>
<th></th>
<th>Assets</th>
<th>Bonds</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current market value</td>
<td>$1,304,050</td>
<td>$320,000</td>
<td>$1,624,050</td>
</tr>
<tr>
<td>Less:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bonus</td>
<td>(34,000)</td>
<td>(34,000)</td>
<td></td>
</tr>
<tr>
<td>Taxable dividend</td>
<td>(70,000)</td>
<td>(70,000)</td>
<td></td>
</tr>
<tr>
<td>Capital dividend</td>
<td>(49,000)</td>
<td>(49,000)</td>
<td></td>
</tr>
<tr>
<td>Add potential dividend refund</td>
<td>23,000</td>
<td></td>
<td>23,000</td>
</tr>
<tr>
<td></td>
<td>$1,327,050</td>
<td>$67,000</td>
<td>$1,394,050</td>
</tr>
<tr>
<td>Percentage</td>
<td>95%</td>
<td>5%</td>
<td>100%</td>
</tr>
</tbody>
</table>

With careful planning, the tax of $47,250 may be avoided.
F. Acquisition of Business by Dhillon

Currently, BPL enjoys the full use of the small business deduction. As a 40% shareholder, ESL receives the benefit of this and after-tax profits distributed to ESL as dividends flow tax free. Therefore, they can recover 84% of their share of profits (profit minus 15% tax).

If Dhillon acquires another profitable company on his own, that new company and BPL will be associated and must share the small business deduction limit of $500,000 [ITA 125(3)]. Dhillon, as the controlling shareholder, is free to allocate the full amount to his new company, resulting in a significant additional tax burden to BPL and a reduction of ESL’s share of after-tax profit.

Recommend that the shareholder agreement between ESL and Dhillon be amended to agree that the full $500,000 limit be allocated to BPL.

G. Life Insurance and Buy-Sell

The buy-sell agreement indicates that ESL will sell its shares of BPL to Dhillon in the event of Stekylo’s death. Based on current values, the tax cost of this would be as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proceeds of sale 40% X $600,000</td>
<td>$240,000</td>
</tr>
<tr>
<td>Less ACB</td>
<td>$100,000</td>
</tr>
<tr>
<td>Capital gain</td>
<td>$140,000</td>
</tr>
<tr>
<td>Taxable ½</td>
<td>$70,000</td>
</tr>
<tr>
<td>Estimated tax @ 44 2/3%</td>
<td>$31,267</td>
</tr>
</tbody>
</table>

As an alternative, ESL could sell its shares back to BPL. This would normally result in a deemed dividend that flows tax free to ESL. However, on such a buyout, anti-avoidance rules [ITA 55(2)] do not permit the dividend to exceed ESL’s share of BPL accumulated tax earnings.

Normal deemed dividend
- Price 40% X 600,000 = $240,000
- Less paid-up capital = (1,000)
  
  Normal deemed dividend = $239,000

The above deemed dividend is limited to ESL’s share of accumulated earnings which is $192,000 (40% of $480,000). Therefore, on a share buy-back the following would occur:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Price</td>
<td>$240,000</td>
</tr>
<tr>
<td>Less deemed dividend</td>
<td>192,000</td>
</tr>
<tr>
<td>Adjusted proceeds</td>
<td>48,000</td>
</tr>
<tr>
<td>ACB</td>
<td>100,000</td>
</tr>
<tr>
<td>Capital loss</td>
<td>(52,000)</td>
</tr>
<tr>
<td>Reduced [112(3)] due to tax-free dividend</td>
<td>(52,000)</td>
</tr>
<tr>
<td>Loss</td>
<td>$0</td>
</tr>
<tr>
<td>Tax on intercorporate dividend of $192,000</td>
<td>$Nil</td>
</tr>
</tbody>
</table>
Clearly, a sale of shares back to BPL would be advantageous and the agreement should be revised to permit this option to occur.

If BPL receives the life insurance it is not taxable income. In addition, a capital dividend account would be created in an amount equal to the difference between the insurance proceeds and the sum of premiums paid over the years. A portion or all of this capital dividend account could be allocated to any deemed dividend on a share buy-back. It would be to ESL's advantage to receive this type of tax-free dividend, as it could be passed on as a tax-free dividend to ESL's shareholder. The buy-sell agreement should contemplate how this issue is to be dealt with.
CHAPTER 14

MULTIPLE CORPORATIONS AND THEIR REORGANIZATION

Review Questions

1. “A corporate reorganization usually involves a change in form, rather than a change in substance.” Explain this statement.

2. What unique tax treatment does a corporate reorganization provide? What is the logic for permitting this to occur?

3. Is it possible for unrelated corporations to combine their business activities through a reorganization? If it is, what must occur in order to ensure that the transaction will not be treated as an outright sale of property at fair market value?

4. Identify four basic reorganization techniques.

5. Briefly describe two alternative tax treatments when the business assets of one corporation are transferred to another corporation. Are these two alternatives available only if the corporation acquiring the assets is owned by the corporation selling the assets? Explain.

6. If Corporation A wishes to transfer its business operations to Corporation B by way of an asset transfer, must all of the assets relating to that business be transferred? Explain. How will the future income of each corporation be different if some but not all of the business assets are transferred?

7. Describe what takes place when two or more corporations amalgamate.

8. Distinguish between a wind-up of a wholly owned subsidiary corporation and an amalgamation of the parent and subsidiary.

9. What is the tax treatment of a corporation’s unused net capital losses and/or non-capital losses after that corporation has been amalgamated with another corporation or has been wound up into its parent corporation?

10. What form of reorganization permits the current common shareholders to retain their existing value in the corporation and, at the same time, alters the ratio relating to the sharing of future growth beyond the existing value? Explain how this reorganization can be accomplished without any immediate tax consequences to the shareholders.

11. What is a holding corporation?

12. Dividends received by a corporation from another taxable Canadian corporation are excluded from taxable income and therefore are not usually subject to tax. However, in certain circumstances, a Canadian-controlled private corporation may be subject to a special refundable tax on the receipt of Canadian dividends. In what circumstances will this special tax apply? What is the rate of tax, and why is it referred to as a “refundable tax”?
13. What is the primary benefit of using a holding corporation to hold investments in the shares of other corporations, rather than holding those investments personally?

14. Briefly explain why a holding company may be useful when the shares of an active business corporation are being acquired.

15. Briefly explain how using a holding company to own the shares of an active business corporation may be beneficial when the shares of the active business corporation are about to be sold. In what circumstances may using a holding company be disadvantageous when the shares of the active business corporation are being sold? Explain.
Solutions to Review Questions

R14-1. A corporate reorganization normally involves the relocation of a business, or specific assets, from one corporation to another corporation that is owned by the same shareholder or group of shareholders. In other words, the owner continues to conduct the same activities but from within a different entity. This is a change in form but not in substance, because the owners before the reorganization continue ownership after the reorganization.

R14-2. The relocation of a business or specific assets from one corporation requires the transfer of assets (i.e., a sale and a purchase). Normally this would be at fair market value resulting in the creation of taxable income to the transferor. However, when a corporate reorganization occurs, the parties involved in the reorganization may, if they so desire, choose a form of transaction which, for tax purposes, does not result in the fair market value disposition of assets. Consequently, the creation of taxable income is deferred. The logic for permitting this tax treatment was explained in the answer to question 1 above. A real change in ownership has not occurred because the same owner(s) continue to conduct the same activity but from a different entity. In effect, this change in form (but not substance) does not constitute a real sale and so the special tax treatment is provided.

R14-3. Yes, unrelated parties can combine their operations in the form of a reorganization, thereby permitting the opportunity to defer tax. This may be accomplished provided that each of the separate parties has a continued interest in the combined or reorganized entity. For example, the business of two separate corporations owned by different shareholders may combine both businesses into a single entity, whereby the ownership of the new entity includes the shareholders of the other separate entities. In other words, both parties continue ownership. This is different from an outright sale which requires that one party gives up their interest in the business in exchange for cash, notes receivable, or other assets other than shares in the continuing activity.

R14-4. The four basic reorganization techniques are as follows:

- **Asset transfers**: this method permits activities to be combined or separated by transferring assets related to the activity from one entity to another. It is a simple form of reorganization, because it does not involve the restructuring of the corporations. It also provides flexibility, because either all, or only a specified portion, of an entity's activities can be transferred. [ITA 85]

- **Amalgamations**: this method involves the merging of two or more corporations into a new single corporation [ITA 87].

- **Wind-up**: this technique combines the entire activities of a subsidiary corporation with its parent corporation [ITA 88(1)].

- **Share reorganization**: this technique does not alter the activities within the corporation but rather alters the ownership rights of the shareholders [ITA 86].
R14-5. The transfer of assets from one corporation to another involves the actual sale of property with an established price and payment terms. In spite of the established legal price, the transfer price for tax purposes is automatically considered to be equal to the asset's fair market value or, if the corporations so elect, an agreed transfer price can be chosen. The agreed transfer price is normally the property's cost amount for tax purposes.

Normally a transfer at fair market value results in the creation of taxable income to the vendor corporation. However, the corporation acquiring the asset has a higher cost base for tax purposes which may create future tax savings from capital cost allowance deductions. On the other hand, taxable income will not be created for the vendor when the elected transfer price is equal to the asset's cost amount. In this case, the purchaser's cost amount of the assets is tied to the elected price, and future tax deductions are based on the lower elected price.

The ability to use the election option is not restricted to the sale of property from a parent corporation to its owned subsidiary corporation (a vertical transfer). The election option can be used on the sale of corporate assets to any other corporation provided that the rules of the election option are adhered to. For example, the election option can be used when corporation 1 (owned by shareholder X) sells property to corporation 2 (owned by shareholder Y). This is referred to as a horizontal transfer.

R14-6. If Corporation A wants to transfer its business operations to Corporation B it is not always necessary to transfer all of the assets associated with that business. For example, the business operations in Corporation A may utilize land, buildings, equipment and inventory. Corporation B could acquire the right to operate the business by purchasing only the inventory and goodwill, and lease the land, buildings, and equipment from Corporation B. To acquire a business does not mean that one must purchase all of the assets associated with that business, but rather one must obtain the right to use those assets.

While leasing avoids any complications associated with asset transfers, it does, however, change the amount of profits that are shifted from Corporation A to Corporation B. Because Corporation B must pay a rent for the use of the land, buildings, and equipment, the profits associated with the business may decline leaving some rental income in Corporation A.

R14-7. An amalgamation involves the complete merging of two or more corporations by combining their assets and liabilities as well as their shareholdings. All of the predecessor corporations cease to exist and a new legal corporation is born. Effectively, all assets and debt of the old corporations are transferred to a new corporation and each of the shareholders gives up their shares in the old corporation. Shares of the new corporation are distributed to the shareholders in proportion to the value of their shares in the former corporations. [ITA 87]

For tax purposes, the predecessor corporations are deemed to have sold their assets to the new corporation at their tax values. Similarly, the shareholders are deemed to have sold their shares of the former corporation at their cost amounts (ACB) in exchange for shares of the new corporation having the identical cost base. In effect, all former tax positions of the corporations and their shareholders are preserved in the new entity.
R14-8. The wind-up of a subsidiary corporation involves the transfer of all of the assets of the subsidiary to its parent corporation followed by the elimination of the subsidiary corporation. Effectively, the parent continues to exist but in an expanded form [ITA 88(1)]. In contrast, the amalgamation of a parent and subsidiary results in the termination of both corporations and the creation of an entirely new combined entity [ITA 87].

The tax treatment of a wind-up is similar to an amalgamation in that the assets are normally transferred, for tax purposes, at their tax values resulting in no immediate tax consequences. However, in order for this special tax treatment to apply on a wind-up, the parent corporation must own at least 90% of each class of the subsidiary's shares. This requirement does not exist for an amalgamation of a parent and subsidiary.

Under both an amalgamation and a wind-up tax account balances, including losses, carry forward into the combined corporation. However, after a wind-up, the losses of the former subsidiary are not available to the parent until the parent’s taxation year commencing after the year in which the wind-up occurred.

R14-9. Normally, when a corporation that has unused non-capital losses and/or net capital losses is wound-up or amalgamated with another corporation, those losses simply continue to be carried forward in the new entity. In addition, any restrictions that were previously attached to those losses (such as a limited time period for carry forward or a restriction of the types of income that they can be offset against) simply continue in the combined corporation [ITA 87(2.1), 87(2.11), 87(1.1)].

In some circumstances, the status of unused losses of a predecessor corporation may change upon amalgamation. Non-capital losses from a business activity can normally be offset against any other source of income. However, upon a change in control by the shareholders, these unused losses can only be offset against future profits from the business that incurred the loss or from a similar business [ITA 111(5)]. A change in control completely eliminates the unused net capital losses [ITA 111(4)(a)]. An amalgamation within a related group does not constitute a change in control for this purpose. However, the losses may be affected when unrelated corporations are amalgamated. This occurs only when the shareholders of the corporation that has the unused losses does not control the new combined corporation after amalgamation. When this occurs, the net capital losses expire and the non-capital business losses can only be offset against the business profits of the business that incurred the losses or a similar business. If the predecessor corporations are in a similar line of business, the change in control has no real effect on the non-capital losses.

R14-10. The common shareholders of a corporation can alter their sharing ratio of future growth of the entity, but still retain their existing value in the corporation by using the reorganization technique referred to as a reorganization of share capital [ITA 86].

For example, consider a corporation whose common shares are valued at $200,000 and are owned equally by shareholder A and B ($100,000 value each). At this point, all future growth is shared fifty-fifty. Through a reorganization of share capital, A and B could exchange all of their common shares for preferred shares having a value of $200,000 ($100,000 each). At this point, the full value of the company is attached to the preferred shares which are fixed in value and will achieve no further growth. Because the full value of the company is attributed to the preferred shares, new common shares can be issued (as part of the reorganization) at a nominal value. If A subscribes for seven common shares and B for three common shares, any growth in value of the company beyond $200,000 will accrue 70% to A and 30% to B. Therefore, both A and B retain their existing equity value of
$100,000 each but share future growth on a 70-30 basis rather than 50-50.

A reorganization of share capital permits the shareholders to convert their common shares to preferred shares without tax consequences. In other words, the tax status (ACB and paid-up capital) of the new preferred shares is the same as the old common shares [ITA 86(2.1)].

R14-11. A holding corporation is a corporation, owned by an individual or group of individuals, the primary purpose of which is to own shares of other corporations. For example, rather than directly owning the shares of an active business corporation, an individual may own all of the shares of a holding corporation which in turn owns shares in the active business corporation, and perhaps shares of other active business corporations. A holding corporation can be a private corporation owning shares of other private corporations or public corporations. It can also be a public corporation created for the purpose of investing in shares of other public corporations.

R14-12. A Canadian private corporation is subject to a special tax (referred to as a Part IV tax) on the receipt of dividends from other Canadian corporations when the dividend received is from a corporation that is not connected for tax purposes. Normally, a corporation is not connected if it owns 10% or less of the other corporation's voting shares [ITA 186(4)]. The Part IV tax is equal to 1/3 of the dividend received [ITA 186(1)(a)]. It is referred to as a refundable tax because the tax is fully refundable to the corporation when it decides to distribute its earnings to its own shareholders as dividends [ITA 129(1)&(3)].

In some circumstances a Part IV tax will be payable on dividends even when the receiving corporation owns more than 10% of the other corporation's voting shares and is connected for tax purposes. This occurs when the paying distributing dividends from its accumulated investment income. In such cases, the Part IV tax is not 1/3 of the dividend received, but rather is equal to the proportionate share of the paying corporation's refund [ITA 186(1)(b)].

R14-13. The primary benefit of the holding company is that it permits the shareholder to receive dividends from the operating company tax free to be reinvested in other ventures. This would not have occurred if the shares of the operating company were owned directly by an individual. In effect, the holding corporation permits corporate profits to be distributed and then reinvested without immediately paying the second level of tax on corporate distributions. Therefore, a greater amount is available for reinvestment and the second level of tax is delayed until such time as the individual requires the funds for personal use.

R14-14. The holding corporation is especially useful for acquiring the shares of an active business corporation when the purchaser must borrow a portion of the funds required to make the purchase and also looks to the acquired corporation to provide cash dividend distributions to retire the debt. If the shares are acquired by an individual, the corporate profits are first taxed in the corporation and are then taxed a second time when distributed to the shareholder. Therefore, the two levels of tax must be paid before payments can be made against the loan principal.

However, if the individual created a holding corporation that borrowed the funds and purchased the shares of the business corporation, the dividends would flow tax free to the holding corporation which could, in turn, pay off the debt. Because the second level of tax has been avoided, the debt can be retired faster. Also, in some cases, the acquired corporation may have assets that are not needed to operate the business. These assets
can be liquidated and paid to the holding corporation without tax and used to retire the debt further.

In the above situation, the holding corporation could pose a problem because it has no taxable income which can be used to offset the interest costs on the debt. This can be solved by amalgamating the holding corporation with the acquired operating company.

R14-15. If the shares of an operating company that are about to be sold are owned by a holding corporation, a substantial tax-free dividend can be paid to the holding company before the operating company shares are sold. As a result, the value of the operating company's shares will diminish by the amount of the dividend. The shares can then be sold for a lesser amount resulting in less tax on the disposition, and increasing the after-tax proceeds (from the dividend and share sale) available for reinvestment in another venture. This could not have been achieved if the shares of the operating company were owned by an individual.

If the shares of the corporation being sold qualify as small business corporation shares, the holding corporation may create a disadvantage. An individual who sells shares of a qualified small business corporation (QSBC) is entitled to a capital gains deduction on such shares which exempts $750,000 of the gain from tax [ITA 110.6]. However, if the shares are sold by a holding corporation the deduction is not available.
Key Concept Questions

QUESTION ONE

Hazel owns all of the shares of H Ltd. Kristin, owns all of the shares of K Ltd. The owners plan to combine their businesses by amalgamating the two corporations on April 1st of the current year. The shares of H have an ACB of $100 and are currently worth $40,000. The shares of K have an ACB of $200 and are currently worth $60,000. H and K are both Canadian corporations.

Describe the tax implications of the amalgamation of H Ltd. and K Ltd. *Income tax reference: ITA 87(1), (2), (4).*

QUESTION TWO

M Ltd., a Canadian corporation, owns 100% of the shares of P Ltd. The P shares have an ACB of $40,000 and are now worth $100,000. P’s only asset is land having a cost of $25,000 and a current value of $100,000. The land was worth $40,000 when M purchased P’s shares. Both corporations have December 31 year ends.

Determine the tax implications for M Ltd. and P Ltd. from winding up P Ltd. into M Ltd. on April 1, 20X8. *Income tax reference: ITA 88(1), (1.1), (1.2).*

QUESTION THREE

Mr. Senior owns all of the issued shares of X Ltd. These common shares have an ACB and PUC of $100 and are worth $1,200,000. Senior would like to freeze his interest in the company at today’s value so that future increases in value accrue to his son, Mark. To accomplish this, Senior exchanged his common shares for preferred shares of X in the course of a reorganization of share capital. The preferred shares are redeemable for $1,200,000. Mark then acquired newly issued common shares of X for $100.

Determine the tax implications for Mr. Senior. *Income tax reference: ITA 84(3), 86(1), (2.1).*

QUESTION FOUR

Valerie owns all of the common shares of V Ltd. The shares have an ACB and PUC of $10,000 and are worth $800,000. In the course of a reorganization of capital, Valerie exchanges all of her common shares for $700,000 of redeemable preferred shares of V and $100,000 of debt.

Determine the tax implications for Valerie. *Income tax reference: ITA 84(3), 86(1), (2.1).*
QUESTION FIVE

X Ltd. owns all of the shares of Y Ltd. The shares of Y have an adjusted cost base of $40,000 and a fair market value of $940,000. Y has retained earnings of $100,000 (earned after 1971) and an RDTOH balance of nil. Y plans to pay a dividend of $900,000 to X. Subsequently, X will sell the shares of Y Ltd. to an arm's-length person for $40,000.

Determine the tax consequences to X Ltd. of these transactions. *Income tax reference: ITA 55(2).*
Solutions to Key Concept Questions

KC 14-1

[ITA: 87(1), (2), (4) – Amalgamation]

The corporate entity formed as a result of the amalgamation (HK Ltd.) is deemed to be a new corporation with its first taxation year commencing on April 1st. It can select a year-end for tax purposes anytime within 53 weeks after April 1st. The taxation years of H Ltd. and K Ltd. are deemed to have ended on March 31, immediately before the amalgamation [ITA 87(2)(a)].

The amalgamation will result in a tax-free combination because the following conditions have been met [ITA 87(1)]:

- H Ltd. and K Ltd. are Canadian corporations,
- All assets and liabilities of H Ltd. and K Ltd. will become assets and liabilities of HK Ltd.
- Both Hazel and Kristin will be shareholders of HK Ltd.

H Ltd. and K Ltd. are deemed to have sold their assets to HK Ltd. at their tax values (ACB, UCC, CEC). Similarly, Hazel and Kristin are deemed to have sold their shares of H Ltd. and K Ltd. at their tax values in exchange for shares of HK Ltd. that have the same tax values [ITA 87(4)].

All carry forward balances in H Ltd. and K Ltd. (RDTOH, CDA, Losses, GRIP, etc.) become the opening balances in HK Ltd. Any restrictions that were previously attached to the losses simply continue as restrictions in HK Ltd. The former tax positions are preserved in HK Ltd.

Before the amalgamation Hazel owned shares with an ACB of $100 worth $40,000 and Kristin owned shares with an ACB of $200 worth $60,000. After the amalgamation HK Ltd. is worth $100,000. Hazel will own 40% of the shares of HK Ltd. worth $40,000 with an ACB of $100. Kristin will own 60% of the shares of K Ltd. worth $60,000 with an ACB of $200. Any losses in H Ltd. will be subject to the acquisition of control restrictions since Kristin did not control H Ltd. but will control HK Ltd. after the amalgamation.

In its first year, HK Ltd. will be liable for tax instalments based on the combined instalment bases of H Ltd. and K Ltd.
KC 14-2

[ITA: 88(1), (1.1), (1.2) – Tax-deferred Wind-up]

On a wind-up, P Ltd. ceases to exist and M Ltd. continues. Since M Ltd. owns at least 90% of each class of issued shares of P Ltd., the wind-up occurs on a tax-free basis.

M Ltd. is deemed to have sold the shares of P Ltd. at their tax value (ACB $40,000) in exchange for the net assets of P Ltd.

P Ltd. is deemed to have sold its asset (land) to M Ltd. at its tax value ($25,000).

The carry forward balances in P Ltd. (RDTOH, CDA, Losses, GRIP/LRIP, etc.) become available to M Ltd. Any restrictions that were previously attached to the losses simply continue as restrictions in M Ltd. However, the losses are not available to M Ltd. until its taxation year that commences after the year in which the windup takes place. Thus, the taxation year ending December 31, 20X9 is the first taxation year in which M Ltd. can use the losses of P Ltd.

When the ACB of the shares of the subsidiary exceeds the tax values of the net assets of the subsidiary received by the parent on a windup of the subsidiary, it is possible to bump the ACB of the non-depreciable capital property. The amount of the bump allocated cannot raise the ACB of the asset above its fair market value at the time the parent acquired control of the subsidiary.

The bump in this case is calculated as follows:

\[
\begin{align*}
\text{ACB of the shares of P Ltd} & \quad \$40,000 \\
\text{Less: Tax values of the net assets of P Ltd.} & \quad (25,000) \\
\text{Dividends paid by P Ltd. to M Ltd.} & \quad (0) \\
\text{Bump} & \quad \$15,000
\end{align*}
\]

Therefore, M Ltd.'s ACB for the land will be $40,000 ($25,000 + $15,000).

This bump is also available under an amalgamation of a parent with a subsidiary if the parent owns 100% of the subsidiary.

KC 14-3

[ITA: 84(3), 86(1),(2.1) – Exchange of shares in a Reorganization]

Where by amendment to the articles, all the shares of a particular class owned by the shareholder are exchanged for newly issued shares in the course of a capital reorganization, section 86 automatically provides for a deferral of any accrued gain on the shares exchanged provided the value of the non-share consideration plus the PUC of the shares received does not exceed the PUC of the exchanged shares. The PUC of the new shares will normally be equal to the PUC of the exchanged shares less any non-share consideration.
New shares:

- The PUC of the new shares is equal to the PUC of the old shares ($100) since only shares were received (no debt) [ITA 86(2.1)].

- The ACB of the new shares is equal to the ACB of the old shares ($100) since no non-share consideration was received.

When the shares are exchanged, new shares are issued and the old shares are redeemed.

Redemption of old shares:

\[
\begin{array}{l}
\text{Redemption proceeds (PUC of new shares $100 +} \\
\text{Debt $Nil)} \quad \$100 \\
\text{PUC of old shares} \quad (100) \\
\text{Deemed dividend [ITA 84(3)]} \quad $ Nil \\
\text{Proceeds (PUC of old shares) [ITA 54]} \quad $100 \\
\text{ACB} \quad (100) \\
\text{Capital gain} \quad $ Nil \\
\end{array}
\]

In summary, the exchange has occurred on a tax-deferred basis. Mr. Senior now owns preferred shares with the same value, ACB, and PUC as the common shares he owned before the exchange. Therefore, when he disposes of the preferred shares, he will recognize the gain that he deferred.

The common shares held by Mark, will have an ACB of $100 and this is also their current fair market value. However, all future increases in the value of X Ltd. will now accrue to Mark.

**KC 14-4**

[ITA: 84(3), 86(1),(2.1) – Exchange of shares in a Reorganization]

Where by amendment to the articles, all the shares of a particular class owned by the shareholder are exchanged for newly issued shares in the course of a capital reorganization, section 86 automatically provides for a deferral of any accrued gain on the shares exchanged provided the value of the non-share consideration plus the PUC of the shares received does not exceed the PUC of the exchanged shares. The PUC of the new shares will normally be equal to the PUC of the exchanged shares less any non-share consideration.

Where the non-share consideration exceeds the PUC of the old shares, as it does in this case, a deemed dividend occurs [ITA 84(3)]. Valerie is deemed to receive a dividend of $90,000. She will include the grossed-up dividend in her income and claim the dividend tax credit.

When the shares are exchanged, new shares are issued and the old shares are redeemed.

New shares:

- The PUC of the new shares is Nil since the PUC of the old shares was removed on the exchange [ITA 86(2.1)].

- The ACB of the new shares is Nil (ACB of old shares $10,000 - Debt $100,000) [ITA 86(1)(b)].
Redemption of old shares:
Redemption proceeds (PUC of new shares $Nil +
   Debt $100,000) $100,000
PUC of old shares (10,000)
Deemed dividend [ITA 84(3)] $ 90,000

Proceeds (PUC of old shares) [ITA 54] $10,000
ACB (10,000)
Capital gain $  Nil

If the debt had been limited to the PUC ($10,000), Valerie could have avoided paying tax on the exchange.

**KC 14-5**

[ITA: 55(2) – Capital gains strip]

X Ltd. will have a taxable capital gain of $400,000 ($800,000 × ½) and a tax-free dividend of $100,000.

Actual proceeds of disposition $ 40,000
Add: Deemed proceeds –
   Dividend received $900,000
   Retained earnings (post 1971) (100,000)
   Dividend subject to Part IV tax (0) 800,000
Proceeds 840,000
ACB (40,000)
Capital gain $800,000

The result is equivalent to X Ltd. receiving a dividend of $100,000 from Y Ltd. and then selling the shares for their then fair market value of $840,000, giving rise to a capital gain of $800,000.
Problems

PROBLEM ONE

[ITA: 83(2); 84(3); 89(1); 111(4)(5); 125(1)(3); 129(1)(3); 186(1)(4); 256(1)(a)]

Concrete Ltd. is a Canadian-controlled private corporation that manufactures concrete blocks in its Regina plant and also operates a general contracting business. In 20X1, Concrete acquired 100% of the shares of Little Ltd., which owns a concrete plant in Saskatoon. At the time of acquisition, Little had non-capital losses carried forward in the amount of $175,000 and net capital losses carried forward of $10,000. These losses related to the 20X0 fiscal period.

Both Concrete and Little have a December 31 year end. The common shares of Concrete are owned 60% by A Ltd., 35% by B Ltd., and 5% by C Ltd. A Ltd., B Ltd., and C Ltd. are owned by Mr. A, Mr. B, and Mr. C, respectively. They are all employed by Concrete and are not related to each other.

The three shareholders intend to meet to review the current year's financial results (20X2) and to discuss several other matters. The financial results and other issues that will be discussed are outlined below.

1. After it was acquired, Little continued to lose money. For the year ended December 31, 20X2, it suffered a loss of $60,000. At the time of acquisition, the owners planned to make major changes to Little’s operations, but they have not been able to complete these on schedule.

2. Concrete had a pre-tax profit of $190,000 for 20X2. Of this amount, $120,000 related to the general contracting business. The contracting business subcontracted all of its work and maintained only a small staff of estimators and administrators.

3. Concrete has accumulated cash reserves that will not be needed for business expansion. The owners are considering paying a $100,000 dividend out of Concrete to the three corporate shareholders. Each holding company will use its share of the dividend for investment purposes.

4. During the year, an agreement was made among A Ltd., B Ltd., and C Ltd. stating that in the event of the death of A, B or C, Concrete must buy back the shares owned by the deceased’s holding corporation. At the time of the agreement, Concrete purchased a life insurance policy on each individual that would provide it with funds to buy back the shares.

5. Several months earlier, A had suggested that Concrete acquire a profitable swimming pool installation business. B and C had vetoed the idea. A intends to inform B and C that he will make the acquisition on his own and intends to acquire the business through A Ltd.

Required:

1. Diagram the financial structure of the shareholders and the corporations described above.

2. What tax advice would you provide with respect to the operations of the subsidiary, Little, considering its poor financial results?

3. Discuss the implications of declaring a dividend of $100,000 from Concrete.
4. If one of the individuals died, what tax implications would arise from the realization of life insurance proceeds?

5. How might the proposed business acquisition by A Ltd. affect B and C? What addition to the shareholder’s agreement should B and C propose?
Solution to P 14-1

1. The financial structure:

2. Upon acquisition of Little Ltd., a change in control occurred affecting the unused losses at that time. The net capital loss of $10,000 expired [ITA 111(4)(a)]. The non-capital loss of $175,000 became restricted in that it could only be used to offset income from the business that incurred the loss or a similar business [ITA 111(5)]. In addition, the $175,000 can only be used while the loss business continues to operate. The loss of $60,000 (20X2) that occurred after acquisition has no restrictions and can be offset against any other source of income. Because of the existing structure, Concrete Ltd. pays tax on $190,000 of income while Little Ltd. incurs losses that cannot be immediately used.

The owners should consider combining the operations of Little Ltd. and Concrete Ltd. by either an amalgamation or windup. Part of Concrete’s business consists of manufacturing concrete blocks, which is a similar business to that of Little Ltd. Therefore, the $175,000 of pre-control losses can be offset against the future profits of the Regina concrete plant. The post-control losses of $60,000 remain unrestricted and can be used against the future profits of the contracting business. A projection of Concrete’s future profits is not provided. However, if it is assumed that future profits will be similar to 20X2 ($70,000 manufacturing and $120,000 contracting) the first year after the reorganization will use up the following losses:

- pre-control losses--against the manufacturing profits $ 70,000
- post-control losses--against the contracting profits 60,000

$130,000
This will achieve cash savings of $19,500 (assuming a tax rate of 15% on $130,000). The remaining portion of the $175,000 pre-control losses can be used as fast as Concrete can generate manufacturing profits from its Regina plant. The additional cash flow may permit the owners to make the major changes to Little's operations that were originally planned upon acquisition.

3. The proposed dividend of $100,000 by Concrete Ltd. will be paid $60,000 to A Ltd. (60%), $35,000 to B Ltd. (35%), and $5,000 to C Ltd. (5%). A Ltd. and B Ltd. each own more than 10% of Concrete's shares and are connected [ITA 186(4)]. Therefore the dividend receipt will not be subject to the Part IV refundable tax of 1/3 [ITA 186(1)(a)]. However, because C Ltd. owns only 5% of Concrete and is not connected, the dividend receipt of $5,000 will be subject to the 1/3 tax (1/3 x $5,000 = $1,667). This tax is fully refundable to C Ltd. if it should, at a subsequent time, pay a $5,000 dividend to its shareholder, Mr. C [ITA 129(1)&(3)].

There is no indication that Concrete Ltd. has earned any investment income. If that had been the case, the payment of the $100,000 may have triggered a tax refund to Concrete Ltd. (26 2/3% of the investment income that had been taxed at the high corporate rate) [ITA 129(3)]. If this occurred, A Ltd. and B Ltd. would be subject to a Part IV tax equal to their share of the refund (i.e., 60% for A Ltd. and 35% for B Ltd.) [ITA 186(1)(b)].

4. The life insurance policy is owned by Concrete Ltd. and it would receive the life insurance proceeds. To determine if it is taxable, its income type must be determined. It is not employment income, business income or property income. Nor is it a capital gain from the disposition of capital property. Therefore, to be taxable, it must be classified as "other sources of income." A review of the items listed in other sources of income (sections 56-59) indicates that the life insurance proceeds are not included and it is, therefore, a non-taxable receipt.

For a Canadian private corporation, the receipt of non-taxable life insurance proceeds in excess of past premiums paid forms part of its capital dividend account. As a result, this amount is eligible for a tax-free capital dividend distribution [ITA 83(2)]. After Concrete Ltd. buys back its shares from the deceased individual's holding corporations, Concrete Ltd. should declare a tax-free dividend from the capital dividend account to the remaining shareholders' holding corporations. Each of the holding corporations can then declare a tax-free capital dividend to the individual shareholders. This has the effect of reducing the share values (by a tax-free dividend) which, in turn, reduces the potential capital gain on the individual's shares in their holding corporations. Alternatively, when Concrete Ltd. buys back its shares from the deceased individual's holding corporation, all or a portion of the capital dividend account could be allocated to the deemed dividend that would occur on the share buy-back [ITA 84(3) & 83(2)].

5. A Ltd. is associated with Concrete Ltd. because it owns 60% of Concrete's shares [ITA 256(1)(a)]. Consequently, the annual business limit for the small business deduction ($500,000) must be shared by A Ltd. and Concrete Ltd. [ITA 125(3)]. As A Ltd. currently has no active business income, the full limit can be allocated to Concrete Ltd. and therefore B and C obtain their share of the low rate of tax on profits. However, if A Ltd. acquires the profitable swimming pool installation business, it will earn its own active business income. Consequently A, as the controlling party, could choose to allocate all, or a substantial portion, of the annual $500,000 limit to A Ltd. thereby reducing the amount available to Concrete Ltd. (and therefore to B and C). B and C should seek to revise the shareholder agreement to provide that A will allocate the full $500,000 annual limit to
Concrete Ltd. unless Concrete Ltd. earns less than $500,000.
PROBLEM TWO

[ITA: 39(1)(c), 39(9); 84(3); 86; 110.6]

Jimmy Divine owns five of the 100 issued common shares of Poultry Products Ltd. The remaining shares are owned by six other individuals, some of whom are employed by the corporation. The others are passive investors. Divine has informed the shareholders that he wants to dispose of his shares for their market value, which is $60,000. The shares have a paid-up capital of $50, but Divine had purchased the shares a number of years ago from one of the other shareholders for $10,000. None of the other shareholders has funds to purchase Divine’s shares.

Unfortunately, the corporation is also temporarily short of cash. The other shareholders have agreed that the corporation will buy back Divine’s five shares at the rate of one share per year over the next five years but that the total price will remain at $60,000. Divine realizes that the value of the unredeemed shares will grow in the next five years as the company continues to earn profits. He is prepared to forgo these profits, provided that the company pays him a fixed dividend on the unredeemed shares of 8% per annum. The company normally pays non-eligible dividends. In addition, he does not want to pay tax on the share sales until he actually receives the cash for them.

Required:

1. What can the company do to buy back Divine’s shares at the rate of one share per year so that any unredeemed shares will not change in value before they are redeemed?

2. What amount of net income for tax purposes will Divine earn from the share buyback in each of the five years?
Solution to P 14-2

1. The desired result can be achieved by having Poultry Products Ltd. reorganize its share capital. As part of that reorganization, Divine would exchange his five common shares (which have a value of $60,000, an ACB of $10,000 and paid-up capital of $50) for preferred shares of equivalent value. The preferred shares would have an 8% annual dividend and would have the following values:

<table>
<thead>
<tr>
<th></th>
<th>5 shares</th>
<th>1 share</th>
</tr>
</thead>
<tbody>
<tr>
<td>Redemption value</td>
<td>$60,000</td>
<td>$12,000</td>
</tr>
<tr>
<td>ACB</td>
<td>10,000</td>
<td>2,000</td>
</tr>
<tr>
<td>Paid-up capital</td>
<td>50</td>
<td>10</td>
</tr>
</tbody>
</table>

Except for the 8% dividends, the preferred shares would not participate in profits and, therefore, the value of any unredeemed shares would not change from the time of the agreement to the time that they are bought back by the corporation. Because the reorganization of share capital technique places the same value, ACB, and paid-up capital on the preferred shares that were on the common shares exchanged, the tax consequences to Divine will be similar to a buy-back of common shares. However, because the values will remain constant over the five years, the tax consequences will occur in proportion to the gradual buy-back of one share per year [ITA 86].

2. In each of the five years, the buy-back of one share will create both a deemed dividend and a capital loss as follows:

\[
\begin{align*}
\text{Redemption price (1/5 of $60,000)} & \quad $12,000 \\
\text{Less PUC (1/5 of $50)} & \quad (10) \\
\text{Deemed dividend [ITA 84(3)]} & \quad $11,990 \\
\end{align*}
\]

\[
\begin{align*}
\text{Taxable dividend – non-eligible ($11,990 \times 125%)} & \quad $14,988 \\
\text{Proceeds of disposition (1/5 of $60,000)} & \quad $12,000 \\
\text{Less deemed dividend} & \quad (11,990) \\
\text{Adjusted proceeds [ITA 54]} & \quad 10 \\
\text{ACB (1/5 of $10,000)} & \quad (2,000) \\
\text{Capital loss} & \quad ($1,990) \\
\end{align*}
\]

\[
\begin{align*}
\text{Allowable capital loss (1/2)} & \quad $(995) \\
\end{align*}
\]

If Poultry Products Ltd. qualifies as a small business corporation (all or substantially all of its assets are used in an active business), the allowable capital loss of $995 is classified as an allowable business investment loss [ITA 39(1)(c)] and can be offset against any other source of income. If this is assumed to be the case, the share buy-back will increase Divine's annual net income for tax purposes as follows:

\[
\begin{align*}
\text{Taxable dividend} & \quad $14,988 \\
\text{Allowable business investment loss} & \quad (995) \\
\end{align*}
\]

\[
\begin{align*}
\text{Total} & \quad $13,993 \\
\end{align*}
\]
However, if the shares do not qualify as small business corporation shares, the annual loss of $995 can only be used if Divine also has taxable capital gains in those years. Otherwise, the capital loss can be carried back 3 years and forward indefinitely to be offset against taxable capital gains in those years. Also, if Divine had used the capital gains deduction [ITA 110.6] in the past, the ABIL would be restricted [ITA 39(9)] and the loss treated as a regular allowable capital loss.

In addition to the above, Divine will also have a taxable dividend of 8% of the value of any unredeemed shares at the end of each year.
PROBLEM THREE

[ITA: 85(1); 110.6; 112(1); 186]

Betty Borsboom and Walter Good each own 50% of the shares of KM Supplies Ltd. The company has enjoyed steady growth since it began, and all corporate profits have been reinvested in business expansion. The shareholders do not expect this growth to continue, as their market share has reached its peak. In fact, this year, for the first time, the company has generated excess cash flow that is not needed for expansion.

Borsboom and Good plan to meet to discuss what they should do with this excess. Borsboom is 32 years old and Good is 58, and their personal investment strategies are quite different. Borsboom anticipates that as Good reaches retirement age she will have to buy his 50% interest in the company—unless, of course, they decide to sell the entire company to some other party.

The company has invested the excess funds in treasury bills as a temporary measure while the owners are deciding on a course of action. Good has suggested that the company simply find a more permanent investment; Borsboom has concerns about the future implications of this strategy and may suggest that the company establish a policy of paying a dividend with any excess funds generated.

Required:

1. Identify the problems that may arise if these funds, as well as future funds, are left in the company and used to acquire a permanent investment.

2. What impact would a policy of regular dividend distributions have on the wealth accumulation of Borsboom and Good?

3. Could their problems be solved if each organized a separate holding corporation, which would, in turn, acquire their shares in KM Supplies? Explain.
Solution to P 14-3

1. The potential problems if excess funds are left in the corporation and are used to make permanent passive investments are as follows:

   - Leaving the excess funds in the corporation will cause the share values to remain high. This creates a potential additional burden for Borsboom if she is required to buy Good's shares. Because Good is 58 years old and Borsboom is considerably younger, there is a strong likelihood that a buy-out will occur. By leaving funds in the corporation to acquire passive investments, Borsboom will effectively be required to purchase Good's share of the business as well as his share of the investments.

   - From Good's perspective, when a buy-out occurs, he may want to sell his share of the business but may not want to dispose of his share of the investments. If the two are combined, this would be difficult to achieve.

   - The two shareholders may ultimately decide to sell out to a third party. If this occurs, a potential buyer would likely want the business but not the investments. This will complicate the buy-out. While certain problems could be overcome by a reorganization, it may be a cumbersome and complex exercise.

   - Borsboom and Good have different investment strategies and this will complicate the decision process. Conflicts will arise that may affect their relationship and therefore the continued success of the business.

   - Although both are content to invest the excess funds this year, their personal cash requirements may differ in the future. One may need funds for personal reasons and will want a distribution, but the other may not want to do so as additional taxes will have to be paid. This creates another source of conflict.

   - By investing the funds in the existing corporation, the company may not qualify as a small business corporation (because all or substantially all of its assets are not used in an active business) and a future sale of shares will not allow the shareholders to use the $750,000 lifetime capital gains exemption that applies to gains of qualified small business corporation shares [ITA 110.6].

2. All of the above problems could be solved if all excess funds were distributed annually as a dividend. However, under the existing structure, each shareholder would pay tax on the annual dividend distribution (at a rate of approximately 33% net of the dividend tax credit) leaving a significantly less amount of excess cash available for investment. Because tax is paid sooner rather than later, the investment returns of each will be diminished. Therefore, the benefits from the dividend policy would be gained as a result of additional tax costs.

3. Alternatively, each of the shareholders could organize their own holding corporation. Their shares in KM Supplies Ltd. would then be transferred to their separate corporations. Tax could be avoided on the transfer by using the elective option of the Income Tax Act [ITA 85(1)]. Regular dividends would then flow from KM to each holding corporation on a tax-free basis [ITA 112(1), 186(1)]. This would have the following benefits:

   - The value of KM would reflect only the value of the business, making a possible shareholder buy-out easier for Borsboom. Also, there would be greater flexibility if KM is sold to a third party.
• Borsboom and Good could choose their own separate investments eliminating conflict.

• If Good sells out to Borsboom, he could sell the business only but retain his investments for retirement.

• If one of the shareholders needs funds for personal use, they can distribute funds from their holding corporation without imposing the same distribution on the other partner.

All of the above is achieved without incurring tax on the dividend distributions from KM. It should be pointed out that the holding company approach does not solve the problem of losing the capital gains deduction. Because the holding corporation will own the shares of KM, a sale of KM will result in a capital gain in the holding corporations which are not entitled to the capital gains deduction. However, by having the holding corporations in place, the amount of the capital gain on the sale of KM shares can be diminished if, during the years prior to the sale of shares, KM distributes all of its retained earnings as a dividend to the holding companies. This tax-free distribution reduces the value of the shares being sold resulting in a lower capital gain. A substantial tax deferral is, therefore, available.
PROBLEM FOUR

[ITA: 20(1)(c); 54; 55(2); 83(2); 84.1; 85; 87; 89(1); 110.6; 112(1); 129(1),(3)]

Judy Whyte owns all of the common shares of Danube Manufacturing Ltd. Whyte purchased the shares 10 years ago directly from the corporate treasury at a cost of $50,000. The company regularly earns a pre-tax profit from an active business of $180,000. Whyte has decided to sell the shares of the company to Peter Blue for $700,000. Blue has only $400,000 cash available, but a local bank has agreed to provide a loan of $300,000 for the balance of the purchase price.

Information relating to the company as of the last fiscal year end is as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Paid-up capital of the common shares</td>
<td>$ 50,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>500,000</td>
</tr>
</tbody>
</table>

Both Whyte and Blue have other sources of income and are in a 45% marginal tax bracket on regular income, 28% on eligible dividends and 33% on non-eligible dividends. Whyte has asked for your advice with respect to the sale of the company. She has mentioned that a friend recently sold his company after transferring his shares to a holding company and that in so doing he gained some deferral benefits.

You are also the accountant for Blue, and he has also sought your advice.

Required:

1. Compare the tax consequences, to Whyte, of the following alternatives:
   • Whyte sells shares directly to Blue.
   • The corporation buys back all the common shares from Whyte and issues new shares to Blue. This alternative should examine both eligible and non-eligible dividends.

2. Outline to Whyte the advantages, if any, of first transferring the shares to a holding corporation. Show calculations for each of the alternatives mentioned in 1, and inform Whyte of the short-term and long-term implications.

3. How could Whyte transfer her shares of Danube to a new holding corporation without any immediate tax consequences?

4. Assuming that Whyte will sell her shares directly to Blue for $700,000, answer the following questions with respect to Blue:
   
   (a) How will the interest payments on the bank loan be treated for tax purposes?

   (b) If Blue must obtain money from Danube to repay the principal of the bank loan, what is the fastest possible time period that the loan can be repaid? (You may assume that interest can be paid from personal funds.)

   (c) If Blue establishes a holding corporation to borrow money ($300,000) to buy the shares, how fast will he be able to repay the loan principal? (Exclude interest considerations.)
d) If the holding corporation makes the acquisition, what problem does the interest cost present? How can a later corporate reorganization overcome this problem, and when should this occur?

(e) If Blue uses a holding corporation, he will contribute $400,000 of his own cash to the company to assist with the purchase. Should he loan the $400,000 to the corporation or acquire $400,000 of its common shares? Explain.
Solution to P 14-4

1. (a) Sale of shares to Blue:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proceeds</td>
<td>$700,000</td>
</tr>
<tr>
<td>ACB</td>
<td>($50,000)</td>
</tr>
<tr>
<td>Capital gain</td>
<td>$650,000</td>
</tr>
<tr>
<td>Taxable gain ½</td>
<td>$325,000</td>
</tr>
<tr>
<td>Tax @ 45%</td>
<td>$146,250</td>
</tr>
</tbody>
</table>

The above calculation assumes that Whyte has already used up her $750,000 capital gains exemption. If this were not the case a deduction of $750,000 x 1/2 = $375,000 may be available if the corporation is a qualified small business corporation [ITA 110.6].

(b) Buy back of shares:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proceeds</td>
<td>$700,000</td>
</tr>
<tr>
<td>Paid-up capital</td>
<td>($50,000)</td>
</tr>
<tr>
<td>Deemed dividend [ITA 84(3)]</td>
<td>$650,000</td>
</tr>
<tr>
<td>Tax @ 28% if eligible dividend</td>
<td>$182,000</td>
</tr>
<tr>
<td>Tax @ 33% if non-eligible dividend</td>
<td>$214,500</td>
</tr>
</tbody>
</table>

Proceeds of disposition $700,000
less deemed dividend ($650,000)
Adjusted proceeds [ITA 54] $50,000
ACB ($50,000)
Capital gain $0

2. If Whyte first transferred her shares of Danube to a holding corporation in a manner described in part 3 below, the following would occur on the subsequent sale of shares by the holding corporation.

(a) Sale of shares to Blue:

Assuming a corporate tax rate of 44 2/3%, the tax to the holding corporation is $145,168 (44 2/3% x $325,000), close to what it would have been for Whyte ($146,250) on a capital gain of $650,000 ($700,000 - $50,000) of which $325,000 (1/2) was taxable. Although the corporation is subject to tax at 44 2/3%, no double taxation will occur in the long run. The tax-free portion of the capital gain can be distributed as a tax-free capital dividend [ITA 83(2), 89(1)]. The remaining amount, when distributed, will result in a refund of a portion of the corporate taxes paid (26 2/3% of the taxable gain) which eliminates the impact of double taxation [ITA 129(1),(3)]. Therefore, the holding corporation has no negative results from the direct sale of shares, unless, of course, Whyte would be eligible for the capital gains deduction.

(b) Buy-back of shares: The buy-back of shares results in a deemed dividend to the holding corporation which flows tax free between the two corporations [ITA 112(1)]. However, the deemed dividend is $650,000 which is greater than the retained earnings in Danube Ltd. ($500,000). Because of this, the intercorporate dividend is reduced to the retained earnings amount [ITA 55(2)]. Actually, section 55 calculates an amount called the "safe earnings" which may be somewhat different than the
retained earnings. However, retained earnings is used here as an approximation. The balance of the $700,000 is considered to be proceeds of disposition on the sale of shares.

Deemed dividend $500,000
Tax to holding corporation Nil
Proceeds of disposition $700,000
Less deemed dividend (500,000)
Adjusted proceeds [ITA 54] 200,000
ACB (50,000)
Capital gain $150,000
Taxable (1/2) $75,000
Tax @ 44 2/3% $33,500

The use of the holding corporation under this method defers tax on $500,000 due to the tax-free intercorporate dividend. However, at some future time, Whyte will be taxable further when the holding company distributes its retained earnings or the holding corporation's shares are sold.

3. Whyte can transfer her shares of Danube to a holding corporation without tax consequences by using the elective provisions of the Income Tax Act [ITA 85]. Although the legal selling price to the holding company would be $700,000 (the fair market value), for tax purposes an elected price of $50,000 would be chosen (the ACB of the shares). The amount of cash or debt given to Whyte by the holding corporation as consideration is limited to $50,000 (to avoid a deemed dividend [ITA 84.1]) and the balance of the payment must be in the form of issuing shares of the holding company.

4. (a) Interest payments on the loan by Blue to acquire the shares are deductible for tax purposes [ITA 20(1)(c)]. In accordance with the rules for determining property income, interest is deductible if it was incurred to acquire property which in turn is used to generate income. In this case, the shares can generate dividend income.

(b) Danube will have to pay dividends to Blue in order for him to retire the debt. As Danube earns $180,000 annually before tax, the maximum available to Blue for the principal repayment is:

Danube profits $180,000
Tax @ 15% (assumed rate) (27,000)
Available for dividend $153,000
Dividend to Blue $153,000
Tax on dividend @ 33% (50,490)
Available for debt repayment $102,510

The debt can be retired in approximately 3 years.
\[ \frac{\$300,000}{\$102,510} = 3 \text{ years (2.92)} \]

(c) Using a holding company to borrow the money and buy the shares permits the holding company to receive dividends from Danube tax free. Therefore, the holding company could receive a maximum of $153,000 annually that is available for the principal repayment (this ignores the interest requirement). Using this structure, the debt could be repaid in approximately 2 years.

\[ \frac{\$300,000}{\$153,000} = 2 \text{ years (1.96)} \]

(d) The interest cost in the holding corporation creates no tax savings because the holding corporation has no taxable income. Its only income is dividends from Danube which are tax free [ITA 112(1)]. Therefore, the interest expense simply builds up as an unused loss carried forward. This problem can be solved by amalgamating the holding company and Danube Ltd immediately after the shares are purchased [ITA 87]. After the amalgamation, the $300,000 bank loan is part of the business corporation, permitting the interest expense to be offset against the profits of $180,000 annually. In addition, the principal can then be repaid from after-tax corporate profits without the requirement of a dividend distribution.

(e) Blue should loan the $400,000 to the holding company rather than acquire $400,000 of common share capital. This will permit Blue to receive a repayment of the $400,000 capital invested without any tax consequences. Danube Ltd. can earn income, pay tax of 15\%, distribute the after-tax profits to the holding corporation as a tax-free dividend, and the holding corporation can repay the loan. The result would be similar if the holding company and Danube amalgamated as suggested in part (d).

If Blue acquired $400,000 of common shares, their value would increase as profits are earned in Danube. However, if the proper legal steps are taken, a private corporation can reduce its paid up capital by a cash distribution without triggering a dividend (see Chapter 12 of text). This process is more cumbersome than the simple repayment of a loan.
PROBLEM FIVE

[ITA: 87 & 88]

Jaime owns 100% of the issued shares of Big Ltd. which in turn owns 100% of the issued shares of Small Ltd. Big paid $1,000,000 for the shares of Small in 20X3. Small carries on an electronics repair business and has incurred non-capital losses in its years ended December 31, 20X4 and December 31, 20X5 of $20,000 and $30,000 respectively. Jaime plans to merge the two companies by a windup on August 31, 20X6 or an amalgamation on September 1, 20X6. Jaime wants a March 31 year end for the business going forward. Big Ltd. currently has a March 31 year end.

The table below contains the anticipated balance sheet of Small at August 31, 20X6 with the fair market value of the assets both at August 31, 20X6 and at the time Big acquired Small in 20X3.

<table>
<thead>
<tr>
<th>Asset</th>
<th>Cost</th>
<th>FMV Aug. 31, 20X6</th>
<th>FMV in 20X3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shares of Public companies</td>
<td>$10,000</td>
<td>$60,000</td>
<td>$40,000</td>
</tr>
<tr>
<td>Accounts Receivable</td>
<td>80,000</td>
<td>75,000</td>
<td></td>
</tr>
<tr>
<td>Allowance for doubtful accounts</td>
<td>(5,000)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Goodwill</td>
<td>0</td>
<td>200,000</td>
<td>200,000</td>
</tr>
<tr>
<td>Land</td>
<td>120,000</td>
<td>445,000</td>
<td>300,000</td>
</tr>
<tr>
<td>Building</td>
<td>250,000*</td>
<td>400,000</td>
<td>350,000</td>
</tr>
<tr>
<td>Total assets</td>
<td>$455,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bank Loan</td>
<td>$100,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Common shares</td>
<td>5,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Retained earning</td>
<td>350,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total liabilities</td>
<td>$455,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* UCC of building

Small paid dividends of $12,000 to Big in both 20X4 and 20X5.

Required:

Explain the tax consequences for Big Ltd. and Small Ltd. if the merger is accomplished by:

1) a windup, or

2) an amalgamation.
Solution to P 14-5

Under an amalgamation [ITA 87] or a windup [ITA 88(1)] the tax consequences are as follows.

- Small Ltd. is deemed to have disposed of its assets for proceeds equal to the cost amount of the assets immediately before the amalgamation or the winding-up and Big Ltd. is deemed to have acquired the property at a cost equal to the deemed proceeds of the subsidiary.

  Shares of public companies at cost $10,000
  Accounts receivable at face value 80,000
  Land at cost ............................................................... 120,000
  Building at UCC ...................................................................... 250,000
  Goodwill ($4/3 × Nil CEC balance) ............................................ Nil

  $460,000

- “Bump” in A.C.B. of non-depreciable capital property [ITA 88(1)(d)]

  Big Ltd.’s A.C.B. of Small Ltd.’s shares ............................... $1,000,000
  Less cost amount of subsidiary net assets:

    Shares of public companies at cost .................. 10,000
    Accounts receivable ........................................... 80,000
    Land at cost ............................................................. 120,000
    Building at UCC .................................................... 250,000
    Goodwill ($4/3 × Nil CEC balance) ....................... Nil
    Reserve (allowance for doubtful accounts)...... (5,000)
    Loan payable ......................................................... (100,000)

  $355,000

  Add: dividends paid by Subco to Parentco ......... 24,000 379,000

  Maximum bump .......................................................... $621,000

- Limit of bump on non-depreciable capital property:

  Fair market value of Public company shares at time Big Ltd. acquired control ........................................ $40,000
  A.C.B. of Public company shares .................................. 10,000
  Limit of bump on marketable securities ................ $30,000
  Fair market value of land at time Big Ltd. acquired control .... $300,000
  A.C.B. of land .............................................................. 120,000
  Limit of bump on land ................................................... $180,000

  Because the building and the goodwill are not non-depreciable capital properties, the bump cannot be allocated to these two assets [ITA 88(1)(d)].
Allocation of “bump” to public company shares and land:

Assuming that Big Ltd. is likely to sell Small Ltd.’s public company shares before it sells the land, the $621,000 bump should first be allocated first to the public company shares to the $30,000 limit. The remaining $591,000 bump ($621,000 – $30,000) should be allocated to the land to the $180,000 limit. This results in the land and marketable securities having new A.C.B.s as follows:

**Land:**
- A.C.B. before bump .......................................................... $120,000
- Bump allocated ............................................................... 180,000
- A.C.B. after bump ............................................................. $300,000

**Public company shares:**
- A.C.B. before bump .......................................................... $10,000
- Bump allocated ............................................................... 30,000
- A.C.B. after bump ............................................................. $40,000

The remainder of the bump cannot be utilized. Whether the two companies are amalgamated or Small Ltd. is wound up into Big Ltd., the results should be the same, since the “bump” is also available on vertical amalgamations.

Deemed disposition of shares by Big Ltd.

Proceeds equal to greater of:
(a) lesser of:
   (i) PUC of shares of Small Ltd. $ 5,000 } $ 5,000 }
   (ii) cost amount of net assets $355,000 } $1,000,000
total $1,000,000
(b) ACB of shares held by Big Ltd. $1,000,000

ACB
Capital gain (loss) (1,000,000) Nil

Note from this formula that a gain will be rare, since PUC of the Small Ltd. shares would have to be greater than their ACB to Big Ltd. A loss is impossible from this formula, because proceeds cannot be less than ACB.

Losses:

On an amalgamation Big Ltd. and Small Ltd. are both deemed to have a year-end immediately before the amalgamation, August 31, 20X6 [ITA 87(2)(a)]. The new amalgamated corporation begins its first taxation year on the date of the amalgamation, September 1, 20X6. It can select any fiscal year-end within 53 weeks. According to the facts March 31 will be selected. Losses are available in first taxation year of the amalgamated corporation, September 1, 20X6 to March 31, 20X7.

On a windup the losses of Little Ltd. are not deductible by Big Ltd. until Big Ltd.’s first taxation year commencing after the windup [ITA 88(1.1)&(1.2)]. The windup is scheduled to happen on August 31, 20X6 which is during Big Ltd.’s year ending March 31, 20X7.
Thus, Big cannot claim the losses which were incurred in Little Ltd. until its year ending March 31, 20X8.
**PROBLEM SIX**

[ITA: 55(2)]

Holding Ltd., a Canadian-controlled private corporation, acquired 100% of the shares of Operating Ltd., on incorporation in 20X0 for $100,000. The shares of Operating Ltd. have appreciated in value since then. A large part of the share appreciation is attributed to land Operating Ltd owns which has doubled in value. The retained earnings of Operating Ltd. are currently $500,000.

An arm's length company, Acquisition Corporation, has offered to purchase 100% of the shares of Operating Ltd. for $900,000. In the course of the acquisition discussions, Holding Ltd. causes Operating Ltd. to pay a dividend of $800,000. Holding Ltd. will pay $10,000 in Part IV tax on the dividend. Acquisition Ltd. then buys 100% of the Operating Ltd. shares for $100,000.

**Required:**

Explain the tax implications for Holding Ltd. on the sale of the shares of Operating Ltd.
Solution to P 14-6

ITA 55(2) will apply to the transaction, converting a portion of what would have been an $800,000 tax-free intercorporate dividend into proceeds of disposition for capital gains purposes.

ITA 55(2) applies because:
(a) Holding Ltd. and Acquisition Corporation are not related;
(b) Holding Ltd. received a dividend that was deductible under section 112; and
(c) one of the results of the dividend was to effect a significant reduction in the capital gain on the ultimate sale of the shares of Operating Ltd.

The result is as follows:
Of the $800,000 dividend received by Holding Ltd. from Operating Inc., $500,000 can be attributed to post-1971 earnings; therefore, these $500,000 of dividends are excluded from the calculation of the deemed proceeds of disposition of the Operating Inc. shares for purpose of subsection 55(2). Since Holding Ltd. will pay Part IV tax of $10,000 on the dividend a further $30,000 ($10,000 x 3) representing the portion of the dividend subject to Part IV tax is sheltered from the effects of ITA 55(2). The balance of the dividend (i.e., $270,000) will be deemed part of the proceeds of disposition and added to the actual proceeds of $100,000. As a result, the following capital gain on the disposition of the Operating Ltd. shares would be computed:

| Actual proceeds of disposition | $100,000 |
| Add: Deemed proceeds of disposition: | |
| Dividend received | $800,000 |
| Less: post-1971 earnings | (500,000) |
| Dividends subject to Part IV tax | (30,000) | 270,000 |
| Total proceeds of disposition | $370,000 |
| Less: Adjusted cost base | 100,000 |
| Capital gain | $270,000 |

These results are equivalent to Holding Ltd. receiving a dividend from Operating Ltd. of $530,000 and then selling the shares to Acquisition Corporation for their then fair market value of $370,000 (i.e., $900,000 - $530,000), giving rise to a capital gain of $270,000.
CASE

The Mavis Group

[ITA: 85(1); 87; 88(1); 111(1)(a); 111(4),(5); 125(1); 125.1]

Mavis Corporation, a Canadian company, is a major wholesaler of women’s shoes. The company has a history of substantial profits. In 20X7, its net income before tax amounted to $700,000.

Mavis Corporation owns (100%) three subsidiary corporations. The corporate structure is outlined below.

Information relating to the subsidiaries is provided below.

- **Triple A Ltd.** This corporation was acquired five years ago, in 20X2. The company retails women’s casual summer shoes and usually earns an annual pre-tax profit of $100,000.

- **Double A Ltd.** Double A was acquired in 20X3 and retails women’s high-fashion shoes. The company was profitable for two years after acquisition but has since suffered regular losses. At the end of the current year (20X7) it has unused business losses (non-capital losses) of $400,000. Losses of $50,000 are expected for each of the next three years. The company’s assets include land and buildings that have risen in value.

- **Bean Ltd.** This subsidiary operates a canning business, and its main customer is a large chain of retail food stores. The company was acquired in 20X6, and at the time of acquisition had unused business losses of $150,000 and an unused capital loss of $40,000. In 20X7, Bean suffered a further operating loss of $250,000. Management is concerned about the amount of this loss and is considering whether to close the factory or perhaps sell it.

  Bean does not have any significant assets, as it rents its land and building under a short-term lease. It does own the manufacturing equipment, but this has little value.

**Required:**

Review the existing financial structure of the Mavis Group of companies and discuss what steps might be taken to enhance the company’s growth potential.
Solution to Case - Mavis Group

This case deals with two basic issues--loss utilization and reorganization techniques.

Analysis:

The Mavis Group has three specific problems to deal with.

1. The group consists of four separate companies of which two are profitable and two are suffering annual losses. Consequently, tax is required to be paid on the profits but the losses remain unused.

2. If the projections are accurate, it will be a long time (if ever) before sufficient profits will be generated in Double A Ltd. and Bean Ltd. to use the losses.

3. Management wants to take action in Bean Ltd. to stop further losses by closing down the business or selling it. The choice between these two methods may be influenced by the ability to use the existing losses by either the Mavis Group or by a potential buyer.

The Group - Ignoring the accumulated losses of previous years, the group's current year results (20X7) are as follows:

<table>
<thead>
<tr>
<th>Company</th>
<th>Income (Loss)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mavis</td>
<td>$700,000</td>
</tr>
<tr>
<td>Triple A</td>
<td>$100,000</td>
</tr>
<tr>
<td>Double A</td>
<td>$(50,000)</td>
</tr>
<tr>
<td>Bean Ltd.</td>
<td>$(250,000)</td>
</tr>
<tr>
<td>Group Income</td>
<td>$(300,000)</td>
</tr>
<tr>
<td></td>
<td>$500,000</td>
</tr>
</tbody>
</table>

Based on the above, taxes for the year would have been payable on $800,000 even though the group earned only $500,000. Therefore, an excess tax cost of $75,000 was incurred ($300,000 @ 25%). In addition, the unused losses of previous years create a substantial cash potential when they can be used. The loss of cash flow in this case appears significant. It is important to do this analysis before alternative remedies are evaluated. In some cases, the cost of the remedies may overshadow the benefits.

Double A Ltd. - When this company was acquired, there were no accumulated losses. The $400,000 of unused business losses were all incurred after control was acquired and, therefore, the losses are unrestricted and can be offset against any source of income. Double A's business is similar to that of Mavis and Triple A, but that is irrelevant as the losses were incurred after control was achieved. The accumulated losses of $400,000 were incurred in 20X6 and 20X7 (the company was purchased in 20X3 and was profitable in 20X4 and 20X5). Further losses are expected for three more years in 20X8, 20X9 and 20X0. This means that the losses incurred in 20X6 and 20X7 will have used up 4 years and 3 years of their carry-forward limit respectively by the end of 20X0 [ITA 111(1)(a)]. Therefore, if the projections are accurate and if profits after 20X0 are sufficient, the early losses will not expire. However, it will be a long time before they can be used to generate tax savings under the current structure.

Bean Ltd. - The loss status of Bean is quite different from Double A. At the time of acquisition, Bean had accumulated unused losses. With the change in control, the capital losses of $40,000 expired [ITA 111(4)(a)]; the $150,000 of business losses became restricted and are only
allowed to be offset against future profits of Bean or a similar business [ITA 111(5)]. Because Bean's business is not similar to the others in the group, a reorganization that combines Bean's business with a profitable business in the group (e.g., Mavis) will not permit the $150,000 to be offset. However, the post-control losses of $250,000 in Bean are completely unrestricted and can be offset against any source of income; a reorganization would permit these losses to be used.

Alternative Courses of Action:

It is important that students explore a number of alternatives even though some may intuitively appear to be not appropriate. Defining the positive and negative aspects of a number of alternatives develops analytical skills. The following are some, but not all, of the reorganization methods that can be used to utilize the losses. The problems of Double A and Bean are dealt with separately.

**Sell Double A Assets to Triple A** - This option contemplates the sale of assets from a loss company to a profitable company. There are several sub-alternatives. Double A can sell all of its assets or some of its assets. As well, it can sell assets at fair market value or at an elected price. Consider first the sale of all assets at fair market value, which means that the business operations of Double A will then operate within Triple A. The following results:

- The expected future losses of $50,000 annually can be offset against Triple A's profits of $100,000 creating additional cash flow of $12,500 annually ($50,000 @ 25%).

- Double A's assets include land and buildings that have appreciated in value. Therefore, the recapture and capital gains created on the sale will offset some of the $400,000 loss carryforward. While this uses the loss, it does not generate any substantial immediate cash flow because they are not being offset against actual profits but rather against taxable income that was created from the sale. In addition, the amount of income generated from the sale of assets is not known and therefore all of the $400,000 loss may not be used. If this happens, the unused amount will remain in Double A which now has no income source.

Therefore, the above option creates cash flow from the use of future losses and prevents the old losses from expiring but does not create cash flow from the substantial old losses of $400,000. If the assets had been sold, using the elective option, at their cost amounts, all of the old losses ($400,000) would have remained in Double A without a potential income source in the future.

A second possibility would be to sell only the land and building to Triple A at fair market value leaving the business operation to continue in Double A. The only advantage of this is that it would prevent some of the old losses from expiring. But future losses would continue to build up until profits are generated.

**Sell Triple A Assets to Double A** - This option contemplates the sale of Triple A's entire business operations to Double A. As a result, Triple A's future profits of $100,000 could be offset against the accumulated losses and future losses of Double A. Double A's available losses are $550,000 ($400,000 existing plus $50,000 for each of the next 3 years). Therefore, this option will create tax savings of $25,000 annually ($100,000 @ 25%) for each of the next five years if profit levels are the same.
To achieve the above, Triple A must sell its assets, using the elective option, at their cost amounts [ITA 85(1)], otherwise Triple A may incur a tax liability on the sale.

**Amalgamate Triple A and Double A** - This option has the identical effect as the option immediately above. The new amalgamated entity acquires the unrestricted loss carry-overs of $400,000 and can use these losses against the future profits of Triple A's profitable operations. The timing of the amalgamation may be relevant. For example, if the amalgamation takes place shortly after the 20X7 taxation year both of the predecessor corporations will have a short year end (less than 12 months). This short year end counts as one full taxation year against the loss carry-over limit of ten years or 20 years (depending on when the losses were incurred). Similarly if the first taxation year of the new corporation is also a short year, it will count as another full taxation year [ITA 87(2)]. The effect of this should be considered before choosing between the amalgamation and asset transfer approach above.

**Wind-up Double A into Mavis** - This option will transfer the business operations as well as the accumulated losses of $400,000 into Mavis Corporation. Mavis will then operate a wholesale business (profits of $700,000) and a retail business. This option provides an advantage.

- The unused losses of $400,000 will be used up in the first taxation year following the reorganization. This will create tax savings, within one year, of $112,500 (25% of $400,000 old losses + $50,000 new losses). In addition, tax savings of $12,500 (25% of $50,000) will be created in years two and three following the reorganization.

From a cash flow perspective, this option is preferred over the previous options because it creates a large amount of cash savings within a very short time period. The results of this option could also have been achieved by an amalgamation.

**Bean Ltd.** - The options available for Bean must be viewed in the context of management's desire to stop further losses by either closing the business or selling it. First of all, if the business operations of Bean are closed, the $150,000 of pre-control losses will expire. Pre-control losses can only continue if the business that incurred the losses (the canning business) continues to operate [ITA 111(5)(a)(i)]. The $250,000 of post-control losses, however, would remain in Bean Ltd. After the closure, Bean could be amalgamated with Mavis Corp. and the $250,000 of unrestricted losses could be used against its high profits within a short period of time. This would create cash savings of $62,500 (25% of $250,000).

In addition, Mavis may recover some cash from any sale of Bean's assets although this would not be significant as the company leases its land and building on a short-term lease and owns manufacturing equipment of little value.

Alternatively, Mavis could attempt to sell the shares of Bean Ltd. as a going concern operation. If this occurs, the losses of $400,000 ($150,000 pre-control + $250,000 post-control) would remain with the company. These losses would be valuable to a purchaser who is in the same line of business as Bean (i.e., canning). Such a purchaser, if already highly profitable, could acquire the shares and then amalgamate [ITA 87] or wind-up [ITA 88(1)] Bean into its profitable company and within one year use the $400,000 of losses to create tax savings of $100,000 (25% of $400,000). A purchaser of this sort may be prepared to pay a cash price for the shares that reflects some portion of the tax savings that it will achieve with the result that both Mavis and the purchaser achieve a benefit.
CASE TWO

Charles Bert

Charles Bert is a successful Canadian businessman. For the past 15 years, he has been president of Bert-Ram Electronics Ltd., a company he started with Peter Ramper. Ramper, who is not employed by the company, obtained shares in the company in exchange for patent rights on one of his inventions.

For many years, Bert-Ram suffered the typical growing pains of a new business, including cash-flow shortages. In the past few years, however, the company has generated substantial profits as well as cash flow in excess of expansion requirements. Bert is not a “high liver,” and his annual salary is sufficient to meet his personal needs.

Realco Corporation owns two rental properties and generates rental income of $130,000 annually. Bert owns 25% of the common shares of Realco; the remaining shares are owned 25% by each of three other investors.

Bert currently has a net worth of $1,500,000, as follows:

<table>
<thead>
<tr>
<th>Personal assets</th>
<th>$ 300,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common shares of Bert-Ram (75% of the common shares)</td>
<td>800,000</td>
</tr>
<tr>
<td>Bonds</td>
<td>200,000</td>
</tr>
<tr>
<td>Common shares of Realco</td>
<td>200,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$1,500,000</strong></td>
</tr>
</tbody>
</table>

In 20X1, Bert-Ram earned an after-tax profit from business of $500,000, of which only $100,000 was required for business expansion. The company currently has $250,000 of cash invested in bank term deposits. Bert and Ramper recently argued about how to invest this cash—Ramper is keen on the stock market, while Bert prefers real estate investments.

Bert’s personal income for 20X1 consists of the following:

<table>
<thead>
<tr>
<th>Salary (Bert-Ram)</th>
<th>$100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest</td>
<td>15,000</td>
</tr>
<tr>
<td>Dividends:</td>
<td></td>
</tr>
<tr>
<td>Bert-Ram</td>
<td>50,000</td>
</tr>
<tr>
<td>Realco</td>
<td>15,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$180,000</strong></td>
</tr>
</tbody>
</table>

Recently, Bert was given the opportunity to purchase 100% of the common shares of LOBD Software Ltd., a Canadian software wholesaler. The company generates profits of $100,000 after tax and has a strong management team that could run the business without a significant time commitment from Bert. The asking price for the shares is $600,000 cash. The most recent balance sheet of LOBD is shown on the next page.

Bert has decided to purchase the LOBD shares, and his bank has agreed to finance the full $600,000 purchase price. Bert will use his bonds and shares of Bert-Ram as collateral for the purchase.
loan. The bank requires that at least $80,000 of the loan principal be repaid each year in addition to interest.

**Required:**

Review Bert’s financial structure and outline what steps he can take to maximize his net worth in the future.

**LOBD SOFTWARE LTD.**  
**Balance Sheet**  
**May 31, 20X1**

**Assets:**
- Current assets (cash, receivables, and inventory) $565,000
- Fixed assets (at cost):
  - Vehicles $60,000
  - Equipment 110,000
  - Accumulated amortization (65,000)
  - Investment in long-term bonds 100,000

**Liabilities:**
- Accounts payable $350,000
- Income taxes payable 20,000

**Shareholder’s equity:**
- Share capital $10,000
- Retained earnings 390,000

**Total:**  
$770,000

Solution to Case Two – Charles Bert

[ITA: 85(1), 87, 256(1), 186(1), (4)]

This case is reviewed in two parts -- the existing structure and the proposed acquisition of LOBD.

Existing structure

Because Bert's personal cash requirements are fulfilled from his management salary, he follows the policy of reinvesting his after-tax returns from his three investments:

- shares in Bert-Ram (75%)
- shares in Realco
- bonds

The impact of the existing financial structure on his returns together with recommendations for changes are reviewed below for each investment separately. The following tax rates are assumed:

<table>
<thead>
<tr>
<th></th>
<th>Bert:</th>
<th>Bert-Ram:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Eligible dividends</td>
<td>28%</td>
<td>15%</td>
</tr>
<tr>
<td>Non-eligible dividends</td>
<td>33%</td>
<td>Excess ABI</td>
</tr>
<tr>
<td>Other income</td>
<td>45%</td>
<td>25%</td>
</tr>
<tr>
<td>Investment income</td>
<td>44 2/3%</td>
<td>Realco</td>
</tr>
</tbody>
</table>

Bert-Ram Electronics:

Dividends received by Bert from Bert-Ram (other than eligible dividends paid out of high rate business income) are subject to tax at 33% leaving 67% of the dividends available for reinvestment. The company currently has excess cash of $250,000. If this is distributed (Bert's share is 75% of $250,000 = $187,500) Bert will have $125,625 ($187,500 - tax @ 33%) available to invest. The amount available for reinvestment can be expanded in one of two ways.

First of all, the company can stop paying dividends and allow the corporation to invest its after-tax profits in passive investments. This permits the company to purchase a larger investment because the tax on dividend distributions is delayed. However, this creates the following new problems:

- Bert and Ramper want to make different kinds of investments. While Bert is the controlling shareholder and could impose his will on Ramper, it would create a conflict between them that may lead to further problems.

- Not paying dividends will enhance the value of Bert-Ram's shares which makes it more onerous to execute a potential buy-sell arrangement between Bert and Ramper.

- It may be more difficult to sell the shares of Bert-Ram to a future buyer if the company
includes a number of investments in addition to the electronics business.

Alternatively, the problem could be solved by Bert creating his own holding corporation (Holdco). He would then transfer his shares of Bert-Ram to Holdco using the elective option to avoid tax on the transfer [ITA 85(1)]. (Ramper could take similar action). Dividends from Bert-Ram to Holdco would be tax free leaving 100% of the dividend available for reinvestment in Holdco (assuming Bert-Ram has no RDTOH). Ultimately, of course, a second level of tax will have to be paid. That will occur when dividends are paid by the holding company to Bert or when Bert sells the shares of the holding company (or has a deemed disposition on death).

As the amount of future dividends are not known, it is difficult to quantify the benefit of using Holdco. However by making certain assumptions, the magnitude of the benefit can be demonstrated to Bert.

Assumptions  –  after-tax profits of $500,000 continue for 10 years of which $200,000 annually is distributed (Holdco's share is $150,000).
–  Bert can invest the profits at a pre-tax return of 10% (5.5% after-tax).
–  If a holding corporation is used, Holdco will liquidate its investments and pay out dividends at the end of 10 years. Annual earnings in Holdco can be invested at 10% (5.53% after tax ... 10% - 44 2/3% tax = 5.53%)

Without the Holdco, Bert would have $1,293,973 after 10 years calculated as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual dividend</td>
<td>$150,000</td>
</tr>
<tr>
<td>tax @ 33%</td>
<td>49,500</td>
</tr>
<tr>
<td></td>
<td>$100,500</td>
</tr>
<tr>
<td>Compound value of regular deposits:</td>
<td></td>
</tr>
<tr>
<td>$100,500 for 10 years @ 5.5% =</td>
<td>$1,293,973</td>
</tr>
</tbody>
</table>

With Holdco Bert would accumulate $1,469,291 as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compound value of tax free dividend in Holdco:</td>
<td></td>
</tr>
<tr>
<td>$150,000 for 10 years @ 5.53% =</td>
<td>$1,934,018</td>
</tr>
<tr>
<td>Add refund of tax on distribution after 10 years on investment returns:</td>
<td></td>
</tr>
<tr>
<td>Total value</td>
<td>$1,934,018</td>
</tr>
<tr>
<td>less tax free dividends</td>
<td></td>
</tr>
<tr>
<td>$150,000 x 10 years</td>
<td>1,500,000</td>
</tr>
<tr>
<td>after-tax returns</td>
<td>$ 434,018</td>
</tr>
</tbody>
</table>
Pre-tax return:
$434,018/.447 (10.00 - 5.53) $970,957

Dividend refund - 26 2/3% of $970,957 258,954
Dividend from Holdco 2,192,972
Less tax on dividend 33% 723,681

$1,469,291

Therefore, based on the assumptions, the Holdco option will enhance Bert's wealth by $175,318 over 10 years ($1,469,291 - $1,293,973).

It should be pointed out that the Holdco approach does not permit a capital gain deduction if the shares of Bert-Ram are ever sold because the gain would be earned by Holdco and only individuals qualify for the deduction if the shares are small business corporation shares.

Students may suggest the payment of additional salaries instead of paying dividends. This may be prudent in order to avoid the impact of double taxation on the dividend distributions (which may ultimately occur even with the use of Holdco). Bert-Ram has after-tax profits of $500,000 which translates into pre-tax profits of $600,000:

<table>
<thead>
<tr>
<th>Pre-tax</th>
<th>Tax</th>
<th>After-tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>1st</td>
<td>$500,000</td>
<td>$75,000 (15%)</td>
</tr>
<tr>
<td>Excess</td>
<td>100,000</td>
<td>25,000 (25%)</td>
</tr>
<tr>
<td>$600,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Therefore, the ultimate tax cost on the $100,000 of profits taxed at the high rate is approximately 46%:

Corporate tax 25%
Tax on dividend 28% (100 – 25%) 21%

46%

However, because Ramper is not employed by the company, it would not be possible to pay him a proportionate salary as it would likely be disallowed as a deduction based on the test of reasonableness.

Conclusion - Both alternatives (Holdco and cessation of dividend payments) eliminate the potential capital gain deduction. Therefore, the holding company alternative is preferable as it permits each shareholder to use excess cash flow according to their own needs. A third alternative is to simply leave the structure as is and continue to pay taxable dividends from all excess cash not needed for business expansion. While this reduces returns on investment ($175,318 over the next 10 years based on the assumptions) it, nevertheless, keeps the potential capital gains deduction alive [ITA 110.6]. The capital gains deduction shelters from tax up to $750,000 of capital gains on qualified small business corporation shares. This has a
potential tax saving of $168,750 (45% x 1/2 of $750,000) and, therefore, a decision to use Holdco is even more certain.

**Realco:**

Dividends from Realco received by Bert are taxed at the rate of 33%. If the shares of Realco were transferred to a holding corporation owned by Bert no tax deferral would result.

Realco earns rental income and, unless the rental operations employ more than five full-time employees, the income will be classified as specified investment business income. As such, it pays tax at 44 2/3% but is entitled to a refund of 26 2/3% of the rental income when dividends are distributed. If the dividends of Realco were received by Holdco, it would be required to pay a refundable tax equal to its share of Realco's refund. For example, if Holdco's share of Realco's income was $1,000 the following would occur:

```
Realco's income $1,000
  tax @ 44 2/3% (447)
  refund on dividend payment (26 2/3% of $1,000) 267**
  available for dividend $ 820
Holdco's income (dividend) $820
  refundable tax (equal to Realco's refund) (267)
  available for re-investment $553
```

** refund is actually limited to 1/3 of dividend paid.

This can be compared with the current structure which is

```
Dividend $820
  less tax @ 33% (271)
  available for reinvestment $549
```

Consequently, the use of a holding corporation for Realco results in a small tax savings.

**Bond:**

The bond income is currently subject to a 45% tax rate. If it were transferred to Holdco, the rate of tax would be 44 2/3% creating a very small tax deferral. Bert will be indifferent as to holding the bond as a personal investment or in a holding corporation.
Acquisition of LOBD:

The issue in this segment of the case is to develop a structure that will maximize the annual cash flow for the repayment of the debt to fund the acquisition price. In many situations a buyer will look to the acquired business to provide such funds. However, in this case, Bert has other sources from which to do so. The analysis first examines the acquired company as a source of funds and then deals with the other sources.

Funds available from LOBD:

After the acquisition, LOBD has two sources of funds that can be made available for Bert:
- the annual future after-tax profits and,
- the bond investment of $100,000 that is owned by LOBD but is not needed for the business operation.

The case indicates that LOBD earns $100,000 after-tax. However, LOBD's pre-acquisition tax rate is unknown. If its income was subject to the small business deduction, the pre-tax profit (assuming a 15% tax rate) is $117,647 as follows:

\[ x - 0.15x = 100,000 \]
\[ x = 117,647 \]

However, after acquisition, LOBD will be associated with Bert-Ram Electronics [ITA 256(1)(b)] which already uses the full $500,000 small business deduction limit. Therefore, unless Bert changes the allocation, LOBD's profits are subject to a 25% tax rate. Post acquisition after-tax income is only $88,235 annually as follows:

<table>
<thead>
<tr>
<th>Income</th>
<th>$117,647</th>
</tr>
</thead>
<tbody>
<tr>
<td>less tax @ 25%</td>
<td>(29,412)</td>
</tr>
<tr>
<td><strong>Cash applied to loan</strong></td>
<td><strong>$88,235</strong></td>
</tr>
</tbody>
</table>

In order to avoid any double taxation on profit distributions, Bert should consider paying himself a salary or bonus of $117,647 which would eliminate corporate tax and replace it with a single personal tax of the same amount. However, the case indicates that Bert will not be involved in the management of LOBD and therefore such a salary may be considered unreasonable. If this is so, distribution to Bert must be in the form of dividends.

If Bert purchases the shares personally, the following cash flows are available for repayment of the $600,000 bank loan (an interest rate of 10% on the loan is assumed):

Immediately after acquisition, LOBD could cash in its bond and distribute a dividend of $100,000. This would immediately reduce the bank loan to $533,000 ($600,000 - $67,000):

| Dividend | $100,000 |
| tax @ 33% | (33,000 ) |
| cash applied to loan | **$67,000** |
After one year, LOBD's profits of $88,235 would be distributed and, after paying interest and taxes, would leave an additional $34,379 of cash to be applied to the loan principal as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividend received</td>
<td>$88,235</td>
</tr>
<tr>
<td>less tax @ 28% (Eligible dividend)</td>
<td>(24,706)</td>
</tr>
<tr>
<td>Interest paid</td>
<td>$53,000</td>
</tr>
<tr>
<td>10% of $530,000</td>
<td>$53,000</td>
</tr>
<tr>
<td>less tax savings on interest</td>
<td>(23,850)</td>
</tr>
<tr>
<td>45% of $53,000</td>
<td>(27,424)</td>
</tr>
<tr>
<td>Cash applied to loan</td>
<td>$34,379</td>
</tr>
</tbody>
</table>

Notice that the tax on the dividend is only 28% but the interest expense saves taxes at the rate of 45%. This occurs because the dividend tax credit is based on the gross dividends and Bert has other income taxed at a personal rate of 45%. Therefore, in year 1 the bank loan would be reduced by $101,379 ($67,000 + $34,379) to $498,621 which meets the minimum requirements of $80,000.

However, in year 2, LOBD could not provide sufficient funds.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividend in year 2</td>
<td>$88,235</td>
</tr>
<tr>
<td>less tax @ 28%</td>
<td>(24,706)</td>
</tr>
<tr>
<td>Interest on loan</td>
<td>$49,862</td>
</tr>
<tr>
<td>10% of $498,621</td>
<td>$49,862</td>
</tr>
<tr>
<td>less tax saving @ 45%</td>
<td>(22,438)</td>
</tr>
<tr>
<td>Cash applied to loan</td>
<td>$36,105</td>
</tr>
</tbody>
</table>

Therefore, in year 2, Bert must use his personal funds to meet the bank loan requirement.

**Using Holding Company:** As an alternative, Bert could create a holding corporation which would borrow $600,000 and buy the shares of LOBD. This would permit dividends to flow tax free from LOBD to Holdco. Therefore, the initial dividend of $100,000 (from the funds created by the bond sale) would flow tax free to Holdco (assuming LOBD has no RDTOH) and can be applied fully to the loan reducing it immediately to $500,000 rather than $533,000 above.

However, the use of Holdco creates a new problem. As Holdco has no taxable income (its only income is the tax-free dividends), the annual interest expense could not be used and no tax savings would be created. Consequently, the cash flow available to be applied on the loan at the end of year 1 would be $38,235 (compared to $34,379 above) as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividends to Holdco (tax free)</td>
<td>$88,235</td>
</tr>
<tr>
<td>less interest expense (10% of $500,000)</td>
<td>(50,000)</td>
</tr>
<tr>
<td>Cash applied to loan</td>
<td>$38,235</td>
</tr>
</tbody>
</table>

Similar results apply in future years. The problem of the interest deductibility can be solved by amalgamating Holdco and LOBD immediately after the acquisition of LOBD by Holdco.
By combining the two entities, the business operations of LOBD and the bank loan form part of the same corporation. As a result, no dividend payments are necessary and the interest expense can be offset directly against the business profits of LOBD.

Using Holdco followed by an amalgamation provides the following results:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial bank loan</td>
<td>$600,000</td>
</tr>
<tr>
<td>Immediate payment from bond funds</td>
<td>(100,000)</td>
</tr>
<tr>
<td>Remaining loan</td>
<td>$500,000</td>
</tr>
</tbody>
</table>

At the end of year 1, the following cash is available:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profits (pre-tax) LOBD</td>
<td>$117,647</td>
</tr>
<tr>
<td>Less interest expense (10% of $500,000)</td>
<td>(50,000)</td>
</tr>
<tr>
<td></td>
<td>67,647</td>
</tr>
<tr>
<td>Less tax @ 25%</td>
<td>(16,912)</td>
</tr>
<tr>
<td>Cash applied to loan</td>
<td>$ 50,735</td>
</tr>
</tbody>
</table>

Using this structure permits LOBD to provide the maximum funds for retirement of the debt.

Funds available from Other Sources:

Although using Holdco followed by an amalgamation provides the maximum funds from LOBD, it is still not sufficient to meet the requirement of paying a minimum of $80,000 against the loan principal. Bert has other sources from which to meet the obligation:

- He can cash in all or a part of his personal bond investment of $200,000.
- He can use the dividends received from Bert-Ram and Realco.

The extent of the funds available depends on the structure chosen in the first part of the case. For example, if Bert decides to create Holdco to own the shares of Bert-Ram Electronics, that same Holdco could be used to purchase the shares of LOBD. Following the purchase, Holdco could be amalgamated with LOBD creating the following structure.
This structure permits dividends from Bert-Ram to flow into LOBD (Holdco) tax free providing the maximum amount of cash available for the bank loan. In addition, all interest on the loan is deductible against LOBD profits. As Bert-Ram is contemplating an immediate dividend of $250,000 of which $187,500 belongs to Bert (75%), the bank loan could be reduced immediately by the following:

<table>
<thead>
<tr>
<th>LOBD's bond</th>
<th>Dividend from Bert-Ram</th>
</tr>
</thead>
<tbody>
<tr>
<td>$100,000</td>
<td>187,500</td>
</tr>
<tr>
<td><strong>$287,500</strong></td>
<td></td>
</tr>
</tbody>
</table>

In addition, Bert could cash in his personal bonds of $200,000 and apply it to the loan providing a substantial further reduction. The loan could then be rapidly repaid from LOBD profits and future tax-free dividends from Bert-Ram.

For each of the above alternatives, a full annual cash flow analysis could be made using a spreadsheet analysis. Before assigning this case for class discussion or as a hand-in assignment, the directive to do so would be useful. As students will make varying assumptions, an array of cash flows will result. These results highlight the complete impact of the tax factor in funding acquisitions.
CHAPTER 15

PARTNERSHIPS

Review Questions

1. Identify three “non-taxable entities.” Does “non-taxable” mean that the income earned by these entities is not subject to tax? Explain.

2. What is a standard partnership, and how is it different from a joint venture and from a co-ownership?

3. What types of entities can be partners in a standard partnership? Does each partner in a partnership have to be the same type of entity? Explain.

4. Must each partner in a partnership contribute an amount of capital that is proportionate to its profit-sharing ratio? Explain.

5. To what extent is each partner liable for the obligations of the partnership? Compare this with the obligations of shareholders in a corporation.

6. How can a partner that has a substantial net worth organize its investment in a partnership so that its liability exposure is limited?

7. “The amount of tax paid on partnership profits depends on the nature of the separate partners and not on the nature of the partnership itself.” Explain.

8. “Profits of a partnership are included in the income of the partners only when those profits are distributed to them.” Is this statement true? Explain.

9. A partnership may be preferable to a corporation when the business venture is new and expects to incur losses in its early years. Explain why.

10. When net income from business for tax purposes is being determined, the timing of certain expense deductions is discretionary. For example, a taxpayer may claim all of, some of, or none of the available capital cost allowance. Similarly, the deduction of certain reserves is discretionary. In a partnership structure, is the deduction of discretionary items decided by the partnership as a whole, or can each partner make a separate decision on its proportionate share? What conflict can arise as a result?

11. “Partnership profits or losses allocated to the partners retain their source and characteristics.” What does this mean? How does this compare with the manner in which a corporation’s profits or losses affect its shareholders?

12. On distribution, for tax purposes, accumulated partnership profits to partners are treated differently from accumulated corporate profits to shareholders. How?

13. What is a partnership interest? What type of property is it considered to be for tax purposes?

14. The value of the shares of a corporation changes when corporate profits or losses are
accumulated and when corporate assets change in value. The value of a partnership interest changes in exactly the same manner. Explain how the tax treatment applied to the sale of a partnership interest differs radically from that applied to the sale of corporate shares.

15. Explain the general tax implications, both to the partner and to the partnership, when a partner transfers property to the partnership that has appreciated in value beyond its cost amount. Is there an alternative treatment? Explain.

16. “A Canadian-controlled private corporation that earns $100,000 from its own active business plus an additional $400,000 from its 50% interest in a business partnership is entitled to apply the small-business deduction to its combined income of $500,000.” Is this statement correct? Explain.

17. Identify four factors that managers must consider when deciding whether a new business venture with other parties will be organized as a partnership or as a corporation.

18. An investor may be able to afford to lose more money from a failed business venture if it is organized as a partnership, rather than a corporation. Explain why.
Solutions to Review Questions

R15-1. Partnerships, limited partnerships, and joint ventures are all referred to as non-taxable entities. The reference to "non-taxable" does not mean that the income of each entity is not subject to tax, but rather refers to the fact that the entities themselves are not directly liable for the tax on the income earned. Instead, the income from these entities is allocated, for tax purposes, directly to their owners who are liable for the tax.

R15-2. A partnership is the relationship that exists between entities that carry on a business in common with a view to profit. It implies a continuing relationship or going concern. In contrast, a joint venture (which also involves a group of entities carrying on a business activity together) is usually formed for a single purpose or transaction and, therefore, suggests a common activity for a narrow purpose and limited duration. A co-ownership refers to the joint ownership of property by several parties (for example, a unit of investment real estate is often owned by several individuals).

R15-3. A partner in a standard partnership can be any type of entity. Normally, the partners are either individuals or corporations, although other entities such as trusts or other partnerships may also be partners. There is no requirement that the type of partners be the same. In other words an individual, a trust, and a corporation can form a partnership.

R15-4. The contribution of capital by each partner is not the sole basis for determining the profit sharing ratio of the partnership. A partner can participate in a partnership and share profits by contributing capital (money or other property), effort, or a combination of capital and effort. Therefore, a partner may share in profits by providing special expertise or greater management effort even though their financial contribution is non-existent or substantially less than other partners.

R15-5. Each partner is fully liable for all debts and obligations of the partnership. This means that each partner's liability exposure not only goes beyond the amount of their invested capital but may also go beyond their proportionate share of partnership involvement. A partner with a 10% partnership interest may be liable for 100% of the partnership's obligations if the other partners are unable to meet their proportionate commitment. In contrast, shareholders of a corporation are normally at risk only to the extent of their capital invested in the corporation's share capital.

R15-6. A proposed partner that has a substantial net worth can limit its liability exposure from the partnership by organizing a limited value separate corporation to act as the partner. For example, if the required partnership contribution is $100,000, the proposed partner can first contribute $100,000 to his or her holding corporation. The corporation, in turn, becomes the partner by contributing $100,000 to the partnership. As a result, the corporate partner has the full risk exposure but because its net worth is only $100,000, the risk is effectively limited to that amount. [S.96(2.4), 96(2.2)]

R15-7. As the partnership entity is not liable for tax, its earned income is allocated proportionately to the partners for inclusion in their income for tax purposes. Consequently, the amount of tax paid on partnership profits is dependent, in part, on the nature of the partners. For example, if one partner is a corporation and the other an individual, the allocation of business income to each may be subject to different rates of tax. The corporate partner may be able to use the low rate of tax as a result of the small business deduction on some, or all, of its share of the business profits. A second level of tax will also be incurred
when those profits are distributed to the corporate partner's shareholders. On the other hand the individual partner will be subject to tax at his or her personal marginal rate.

R15-8. The statement is not true. Partnership profits are allocated to the partners on the last day of the partnership's fiscal year regardless of whether or not such profits have been distributed. It is conceivable then that a partner may be liable for the full tax liability on its share of income even though the income is retained in the partnership for reinvestment. [S.96(1)]

R15-9. A new venture that is expected to incur losses in its early years and is organized as a partnership allocates those losses to the separate partners as they are incurred. Consequently, the partnership losses can be offset against the other income of each partner creating additional immediate cash from the reduction of taxes otherwise payable on other income. This additional cash flow can be used by the partners to assist the funding requirements of the new venture (i.e., its losses) thereby increasing its chances of success. If the new venture was organized as a corporation, the losses would remain unused until the new venture was profitable, and the cash flow advantage from reduced taxes would be delayed.

R15-10. In a partnership structure, the application of discretionary items such as capital cost allowance, reserves, and method of inventory valuation must be determined and applied by the partnership entity before profits or losses are allocated to the partners. Therefore, each partner cannot make separate decisions with respect to their share of such items. In some circumstances this creates conflict. For example, a partner that has significant losses from other non-partnership activities may want to maximize the partnership profits (e.g., by not claiming capital cost allowance) whereas another partner who has income from other sources would want to minimize the partnership profits. [S.96(1)(c)]

R15-11. Profits or losses allocated to partners retain their source and characteristic. This means that the different types of income earned by the partnership (business income, capital losses and so on) are allocated in the same form to the partners. Therefore, a capital gain earned by a partnership, when allocated, is a capital gain to the partner. In effect, the partnership is a conduit that earns different types of income but then passes it on to the partners as if it was earned directly by them. In contrast, a corporate structure changes the nature of its income when it is passed on to the shareholder. Business income earned by a corporation, once taxed, is paid to the shareholder as a dividend and, therefore, constitutes property income for the shareholder. [S.96(1)]

R15-12. Profits earned and retained by the partnership become part of the partners' capital or equity and can be distributed whenever the partners decide to do so. The distribution of accumulated profits constitutes a return of capital and does not constitute the receipt of income when received by the partners. In comparison, the corporate entity accumulates its after-tax profits as retained earnings and when distributed becomes a taxable dividend to the shareholder.

R15-13. A partner's equity position in a partnership is referred to as a partnership interest for tax purposes. A partnership interest exists whenever a party has rights and obligations as defined by the partnership agreement. For tax purposes, a partnership interest is considered to be capital property to the partner if it was acquired for the purpose of providing a long-term benefit to the owner. Therefore, any gain or loss on disposition results in a capital gain or loss.
R15-14. Similar to the sale of corporate shares, the sale of a partnership interest may result in a capital gain, if its proceeds of disposition exceed its adjusted cost base, or a capital loss, if the cost base exceeds the proceeds of disposition. However, the sale of a partnership interest will not create a capital gain or loss to the extent that its value has been affected by profits retained in the partnership or losses incurred by the partnership. Capital gains or losses occur only to the extent that the individual assets owned by the partnership change in value. [S.100(2),(4)]

The above concept is achieved by an arbitrary annual adjustment to the adjusted cost base of the partnership interest. The ACB is automatically increased by the profits earned by the partnership and allocated to the partners. Therefore, if profits are retained, the value of the interest increases but so does the ACB by an equivalent amount. Similarly, the withdrawal of profits by the partner reduces the value and the ACB. A loss incurred by the partnership has the reverse effect. [S.53(1)(e), 53(1)(c)]

In comparison, a corporate share increases in value when profits are retained but there is no corresponding adjustment to the ACB. And a capital gain will result with respect to that value when the shares are sold.

R15-15. A partnership, although not a taxable entity, is considered to be a separate entity for purposes of holding property. Consequently, if a partner transfers property to the partnership, either as a sale or as a capital contribution, the partner is deemed to have sold the property at its fair market value. If the property's value is greater than the partner's cost amount, taxable income will be created. The partnership acquiring such a property has a cost for tax purposes equal to the property's fair market value. As an alternative, the partner can choose, by means of an election, to transfer the property for tax purposes at the partner's cost amount. This will eliminate taxable income to the partner, but the cost of the property to the partnership is based on the elected amount and not its fair market value. [S.97(1),(2)]

R15-16. The statement is not correct. It is true that a CCPC is entitled to the small business deduction on $500,000 of its active business income. However, the amount of income allocated from a partnership that is eligible to be applied to the limit is restricted. Only the first $500,000 of partnership active business income qualifies for small business deduction eligibility by the corporate partners. The question indicates that the corporate partner's 50% share of partnership profits is $400,000. Therefore, of that amount only $250,000 (50% of the partnership's $500,000 limit) is eligible for the small business deduction provided that the corporate partner has not used up its $500,000 limit. In this case, the CCPC can claim the small business deduction on:

<table>
<thead>
<tr>
<th>It's own profits</th>
<th>100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Partnership profits</td>
<td>250,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>350,000</strong></td>
</tr>
</tbody>
</table>

This indicates that the CCPC could have earned an additional $150,000 from its own activities which would have qualified for the small business deduction. [S.125(1)(a)(ii), 125(2)]
R15-17. The four factors to be considered when deciding between a partnership and a corporation for a new venture are as follows:

- What will be the tax cost on annual profits from the new venture?
- How can anticipated operating losses, if any, be utilized against other sources of income from either the new venture itself or the participants?
- What are the tax implications if the new venture fails and the participants lose all or a portion of their invested funds? In other words, what is the after-tax cost of the loss?
- How can the invested capital and future profits be returned to the participants with the minimum amount of tax?

R15-18. An investor in a failed business venture can afford to lose more money if it was organized as a partnership rather than a corporation because the partnership structure permits the investor to recover a greater amount of tax savings and at an earlier time. For example, a taxpayer in a 45% tax bracket that loses $100,000 from an investment in corporate shares will suffer a capital loss of which only 1/2 is allowable at the time the shares are sold or when the corporation is insolvent. Assuming the capital loss can be used, the after-tax loss will be $77,500 ($100,000 - 45% [1/2 of $100,000]). However, under a partnership structure, the $100,000 loss would take the form of business losses allocated from the partnership thereby allowing tax savings on the full $100,000. The after-tax partnership loss would be only $55,000 ($100,000 - 45% of $100,000). Therefore, the partnership could have lost $140,909 before tax leaving an after-tax loss of $77,500 ($140,909 - 45% of $140,909) which is the same as the $100,000 loss incurred on the corporation structure.
Key Concept Questions

QUESTION ONE

Jennifer Black and Pete White carry on a security service business through a partnership. Jennifer and Pete are both active in the business and share profits equally. In the current year they each received a salary of $40,000 from the partnership.

Black & White Partnership
Income Statement
For the year ended December 31, 20X8

Income:
- Security service fees: $200,000
- Gain on sale of public company shares: 12,000
- Eligible dividends: 10,000
- Interest income: 3,000

Total income: $225,000

Expenses:
- Office rent: 15,000
- Capital cost allowance: 8,000
- Salaries paid to staff: 30,000
- Salaries paid to partners: 80,000
- Donations to registered charities: 2,000

Total expenses: $135,000

Net income: $90,000

Compute net income for tax purposes for the partnership. *Income Tax Act reference: ITA 96(1)(a), (b), (c).*

QUESTION TWO

Jennifer Black is not married. She lives alone. Her sole source of income is from the Black & White Partnership (Question One).

Compute Jennifer’s net income, taxable income and federal tax payable for the current year. *Income Tax Act reference: ITA 96(1)(f); 117, 118(1(c), 118.1(3),(8), 121.*
QUESTION THREE

A Ltd. and B Ltd. are partners in the Triple M partnership. A Ltd. and B Ltd. share equally in the income or loss of the partnership annually. The partnership earned business income of $100,000 and $300,000, respectively, for its years ended June 30, 20X8 and June 30, 20X9.

Income from the Triple M partnership was A Ltd.’s only source of income for its year ended December 31, 20X8. Determine the amount of business income to be reported for tax purposes by A Ltd. for its year ended December 31, 20X8. *Income Tax Act reference: ITA 96(1)(f).*

QUESTION FOUR

Tom, Mary and Chris are partners in the TMC Partnership. Tom is the only partner who is involved in the daily activities of the partnership and, thus, the partnership agreement stipulates that 70% of the partnership business income and losses will be allocated to Tom; the remaining 30% will be shared equally by Mary and Chris. The three partners share equally in all other sources of partnership income. For the current year the TMC Partnership had the following sources of income (losses):

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business income</td>
<td>$400,000</td>
</tr>
<tr>
<td>Rental loss</td>
<td>(30,000)</td>
</tr>
<tr>
<td>Interest income</td>
<td>9,000</td>
</tr>
<tr>
<td>Taxable capital gains</td>
<td>21,000</td>
</tr>
<tr>
<td>Allowable capital losses</td>
<td>(15,000)</td>
</tr>
<tr>
<td></td>
<td><strong>$385,000</strong></td>
</tr>
</tbody>
</table>

The partnership did not distribute any of the current year profits to the partners. Prepare a chart showing the allocation of the income (losses) to the partners for tax purposes. *Income Tax Act reference: ITA 96(1)(f), (g).*

QUESTION FIVE

Canadian partnerships are required to file an annual information return (T5013) containing the following information:

a) Income or loss of the partnership,
b) Name, address and social insurance number (if applicable) of each partner,
c) Share of the income or loss for each partner,
d) Share of each deduction, credit, or other amount for each partner,
e) Share of scientific research & experimental development for each partner,
f) Other information as may be required by the prescribed form.

When is the information return (T5013) due? *Income Tax Act reference: ITA 233(1); Reg 229(1), (5).*
QUESTION SIX

In March of Year 1, Sally and Peter began to carry on business in partnership. Each contributed cash of $75,000 and agreed to share income and losses equally. The following information was provided for the first fiscal year of the partnership.

a) The partnership net income of $328,000 consisted of the following sources of income:
   - Business income $300,000
   - Eligible dividends 20,000
   - Taxable capital gains 10,000
   - Allowable capital losses (2,000)

   $328,000

b) In addition, the partnership received a tax-free capital dividend of $12,000 and donated $3,000 to registered charities.

c) Each partner took draws totalling $60,000.

Determine the adjusted cost base for the partnership interest of each of the partners at January 1, Year 2. Income Tax Act reference: ITA 53(1)(e), 53(2)(c).

QUESTION SEVEN

Lindsay Shaw is a partner in a Canadian partnership. On April 30th of the current year she transferred title of a piece of land that she held as a capital asset to the partnership in exchange for cash of $40,000. The land was valued at $100,000 at the time of the transfer. Lindsay had paid $40,000 for the land when she purchased it several years ago.

Determine the tax consequences resulting from the transfer of title to the land to the partnership. Income Tax Act reference: ITA 97(1).

QUESTION EIGHT

Reconsider the scenario in Question Seven. Assume that Lindsay and her partners made a joint tax election electing to transfer of the land to the partnership at its tax value ($40,000).

Determine the tax consequences resulting from the transfer of the title to the land to the partnership under this assumption. Income Tax Act reference: ITA 97(2).
Solutions to Key Concept Questions

KC 15-1

[ITA: 96(1)(a), (b), (c) – Partnership net income]

The amount of income earned or losses incurred by the partnership is determined as if the partnership were a separate taxable entity.

Partnership net income for tax purposes:

Business income:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial statement income</td>
<td>$90,000</td>
</tr>
<tr>
<td>Add: Salaries paid to partners</td>
<td>80,000</td>
</tr>
<tr>
<td>Donations to registered charities</td>
<td>2,000</td>
</tr>
<tr>
<td>Subtract: Capital gain</td>
<td>(12,000)</td>
</tr>
<tr>
<td>Dividend income</td>
<td>(10,000)</td>
</tr>
<tr>
<td>Interest income</td>
<td>(3,000)</td>
</tr>
<tr>
<td></td>
<td>$147,000</td>
</tr>
</tbody>
</table>

Property income:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Eligible dividends</td>
<td>$10,000</td>
</tr>
<tr>
<td>Interest income</td>
<td>3,000</td>
</tr>
</tbody>
</table>

Taxable capital gains ($12,000 x ½) 

Net income for tax purposes $166,000
KC 15-2

[ITA 96(1)(f); 117, 118(1)(c), 118.1(3),(8), 121 – partnership income retains its source when allocated to partners]

The solution uses 2011 tax brackets and tax credit amounts.

<table>
<thead>
<tr>
<th>Income Type</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employment income</td>
<td>$0</td>
</tr>
<tr>
<td>Business income ($147,000 x 50%)</td>
<td>73,500</td>
</tr>
<tr>
<td>Property income:</td>
<td></td>
</tr>
<tr>
<td>Eligible dividends ($10,000 x 50% x 141%)</td>
<td>7,050</td>
</tr>
<tr>
<td>Interest income ($3,000 x 50%)</td>
<td>1,500</td>
</tr>
<tr>
<td>Taxable capital gain ($6,000 x 50%)</td>
<td>3,000</td>
</tr>
<tr>
<td><strong>Net income</strong></td>
<td><strong>$85,050</strong></td>
</tr>
<tr>
<td><strong>Taxable income</strong></td>
<td><strong>$85,050</strong></td>
</tr>
</tbody>
</table>

**Federal tax:**

- On the first: $41,544 x 15% = $6,232
- On the next: 41,544 x 22% = $9,140
- On the remainder: 1,962 x 26% = $510

**Federal non-refundable tax credits:**

- Basic personal amount: $10,527 x 15% = $1,579
- Donation credit: $200 x 15% = $30
- 800 x 29% = 232
- Dividend tax credit: ($5,000 x 41% x 13/23) = (1,159) = (3,000)

Federal tax payable: $12,882

Note that ITA 118.1(8) allows the allocation of gifts made by a partnership to its members, according to each member’s share in the partnership.

KC 15-3

[ITA 96(1)(f) – Income included in taxation year in which the partnership’s taxation year ends]

For its year ended December 31, 20X8, A Ltd. reports $50,000 of business income, being one-half of the partnership’s business income of $100,000 for the partnership’s year ended June 30, 20X8. The partner, A Ltd., reports its share of the partnership’s income in its taxation year which includes the partnership’s year end.

If all of the members of the partnership are corporations, other than professional corporations, the partnership can select any fiscal period that does not exceed 12 months. However, if any member of the partnership is an individual or a professional corporation, the taxation year of the
partnership must be a calendar year (December 31) [ITA 249.1(1)(b) of the definition of “fiscal period”].

**KC 15-4**

[ITA: 96(1)(f), (g) – allocation of partnership income and losses]

<table>
<thead>
<tr>
<th>Activity</th>
<th>Partnership</th>
<th>Tom</th>
<th>Mary</th>
<th>Chris</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business income (70%/15%/15%)</td>
<td>$400,000</td>
<td>$280,000</td>
<td>$60,000</td>
<td>$60,000</td>
</tr>
<tr>
<td>Rental loss (1/3 each)</td>
<td>(30,000)</td>
<td>(10,000)</td>
<td>(10,000)</td>
<td>(10,000)</td>
</tr>
<tr>
<td>Interest income (1/3 each)</td>
<td>9,000</td>
<td>3,000</td>
<td>3,000</td>
<td>3,000</td>
</tr>
<tr>
<td>Taxable capital gain (1/3 each)</td>
<td>21,000</td>
<td>7,000</td>
<td>7,000</td>
<td>7,000</td>
</tr>
<tr>
<td>Allowable capital loss (1/3 each)</td>
<td>(15,000)</td>
<td>(5,000)</td>
<td>(5,000)</td>
<td>(5,000)</td>
</tr>
<tr>
<td>Total</td>
<td>$385,000</td>
<td>$275,000</td>
<td>$55,000</td>
<td>$55,000</td>
</tr>
</tbody>
</table>

Note that the income is subject to taxation, despite the fact that none of it has been withdrawn from the partnership. The partners are subject to tax on their share of the income earned by the partnership each year regardless of whether the partnership retains or distributes the profits. Profits retained by the partnership form part of each partner’s capital. When accumulated profits are distributed to the partners, this constitutes a return of capital, which is not subject to further taxation.

**KC 15-5**

[ITA 233.1; Reg 229(1), (5). – Partnership information returns (T5013)]

Due date for partnership information returns:

a) Where all of the partners of the partnership are corporations, the information return is due within five months after the end of the fiscal period of the partnership [Reg. 229(5)(a)].

b) Where all of the partners of the partnership are individuals, the information return is due by March 31 of the calendar year following the calendar year in which the fiscal period of the partnership ends [Reg. 229(5)(b)].

c) Where the partners are a mixture of corporations and individuals, the information return is due by the earlier of (a) and (b) above [Reg. 229(5)(c)].
KC 15-6

[ITA 53(1)(e), 53(2)(c) – ACB of Partnership Interest]

The adjusted cost base (ACB) of the partnership interest for each of the partners is computed as follows:

\[
\begin{align*}
\text{ACB} – \text{January 1, Year 1} & : \$ 0 \\
\text{Add: Capital contribution - March, Year 1} & : 75,000 \\
& \quad \text{Business income allocated ($300,000 x 50\%)} : 150,000 \\
& \quad \text{Eligible dividends allocated ($20,000 x 50\%)} : 10,000 \\
& \quad \text{Capital gains ($20,000 x 50\%)} : 10,000 \\
& \quad \text{Tax-free capital dividend ($12,000 x 50\%)} : 6,000 \\
\text{Deduct: Capital loss allocated ($4,000 x 50\%)} & : (2,000) \\
& \quad \text{Donations allocated ($3,000 x 50\%)} : (1,500) \\
& \quad \text{Drawings} : (60,000)
\end{align*}
\]

\[
\text{ACB of partnership interest, January 1, Year 2} : \$187,500
\]

Additional notes:

1) Adjustments to the ACB with respect to capital contributions or drawings are made at the time of the contribution or drawing. In contrast, adjustments relating to allocated amounts from the partnership are made on the first day of the following fiscal period.

2) Each partner is required to include eligible dividends of $14,100, i.e., $10,000 \times 141\%$, in net income for tax purposes for Year 1. However, it is the cash dividend received ($10,000) that is included in calculating the ACB of the partnership interest.

3) Each partner is required to include a taxable capital gain of $5,000, i.e., $10,000 \times \frac{1}{2}$, in net income for tax purposes for Year 1. However, it is the entire capital gain ($10,000) that is included in computing the ACB of the partnership interest.

4) Each partner includes the $1,500 charitable donation allocated in the calculation of their donation tax credit on their personal tax return for Year 1.

KC 15-7

[ITA 97(1) – Contribution of Property to a Partnership at FMV]

For tax purposes, Lindsay is considered to have sold the land to the partnership at fair market value ($100,000) resulting in a taxable capital gain of $30,000 (1/2 x ($100,000 - $40,000)) for Lindsay. The partnership will have an adjusted cost base for the land of $100,000. Lindsay is considered to have made a capital contribution of $60,000 being the excess of the value of the land transferred over the $40,000 received by Lindsay. The adjusted cost base of her partnership interest will be increased by the $60,000.
KC 15-8

[ITA 97(2) – Contribution of Property to a Canadian Partnership at tax value]

ITA 97(2) provides a rollover of property into a Canadian partnership that parallels the rollover provided by ITA 85(1) for transfers to a corporation. The major difference is that land held as inventory is eligible for a ITA 97(2) election whereas it is not eligible for a ITA 85(1) election.

The acceptable range for the elected proceeds is between the ACB of the land ($40,000) and the FMV ($100,000). The elected amount is also limited to the amount of non-partnership interest consideration received.

For tax purposes, Lindsay is considered to have sold the land to the partnership for proceeds equal to the elected amount (tax value ($40,000)) which defers the capital gain. The partnership will have an adjusted cost base for the land equal to the elected amount, $40,000. There is no increase in the adjusted cost base of Lindsay’s partnership interest.

If Lindsay had taken no cash consideration and elected proceeds of $40,000, the ACB of her partnership interest would have increased by $40,000.
PROBLEMS

1. Calculate Gingero’s net income for tax purposes for the 20X1 taxation year.

2. If Gingero had sold his partnership interest at the end of the current year for $300,000, how would his net income for tax purposes have changed?

3. Would it be worthwhile for Gingero to set up a corporation to be the partner in the restaurant? Explain.

4. If Gingero sells his partnership interest in Sweet Tooth to his own corporation, how will this affect his tax position?
Solution to P 15-1

1. The partnership profits, before allocation, for tax purposes are as follows:

<table>
<thead>
<tr>
<th>Income per financial statements</th>
<th>$209,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Add:</td>
<td></td>
</tr>
<tr>
<td>Amortization</td>
<td>12,000</td>
</tr>
<tr>
<td>Donations</td>
<td>3,000</td>
</tr>
<tr>
<td>Taxable capital gains (1/2 of $60,000)</td>
<td>30,000</td>
</tr>
<tr>
<td></td>
<td>254,000</td>
</tr>
<tr>
<td>Deduct:</td>
<td></td>
</tr>
<tr>
<td>Gain on sale of franchise</td>
<td>(60,000)</td>
</tr>
<tr>
<td>Capital cost allowance:</td>
<td></td>
</tr>
<tr>
<td>Class 8 $30,000 @ 20%</td>
<td>$6,000</td>
</tr>
<tr>
<td>Class 43 $20,000 @ 30%</td>
<td>6,000</td>
</tr>
<tr>
<td>(12,000)</td>
<td></td>
</tr>
<tr>
<td>Net income for tax purposes</td>
<td>$182,000</td>
</tr>
</tbody>
</table>

The sources of partnership income and its allocation to Gingero are as follows:

<table>
<thead>
<tr>
<th>Total</th>
<th>Gingero 1/3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividends (non-eligible)</td>
<td>$9,000</td>
</tr>
<tr>
<td>Taxable capital gains</td>
<td>30,000</td>
</tr>
<tr>
<td>Business income</td>
<td>143,000</td>
</tr>
<tr>
<td></td>
<td>$182,000</td>
</tr>
</tbody>
</table>

Gingero's net income for tax purposes is:

a) Employment
   - business (from partnership) $140,000
   - property (dividends from partnership $3,000 x 125%) $3,750
   - 191,417
b) taxable capital gains (from partnership) $10,000

Net income for tax purposes $201,417

2. Before determining any gain or loss from the disposition of the partnership interest it is necessary to calculate its adjusted cost base before the sale. The ACB at the end of the previous year was $40,000. This amount has to be increased by income allocated to Gingero and decreased by his withdrawals for the current year. [S.53(1)(e),53(2)(c)]

Note that the profits allocated for tax purposes include 1/2 of the capital gain on the franchise sale. The cost base increase from profits allocated is designed to eliminate any capital gain on a value increase to the partnership interest from profits retained. This would not be achieved if the cost base adjustment included only 1/2 of the capital gain, as the value increase would relate to the full capital gain. Therefore, for purposes of the ACB adjustment only, the profits allocated include the full capital gain (Gingero's share is 1/3 of $60,000 = $20,000) rather than the taxable capital gain (1/3 of $30,000 = $10,000).
The ACB prior to the sale is calculated as follows:

ACB, January 1, 20X1 $ 40,000
Add:
Profits allocated:
   Net income for tax purposes $60,667
   plus non-taxable portion of
     capital gain ($20,000 - $10,000) 10,000 70,667
   110,667
Deduct:
   Cash withdrawals $10,000
   Donation designated (1/3 of $3,000) 1,000 11,000
ACB, January 1, 20X2 $ 99,667

The sale of the partnership interest would have increased his net income for tax purposes by:

Proceeds of disposition $300,000
less ACB 99,667
Capital gain $ 200,333
Taxable gain 1/2 of $200,333 $100,167

3. Because Gingero has a substantial salary from his employment ($140,000) he is in the top marginal tax bracket (45%). Therefore, the business income and the taxable capital gain from the partnership are taxed at this rate. The non-eligible dividends allocated by the partnership would be taxed at 33% (net of the dividend tax credit).

If Gingero created a corporation to own the partnership interest, the tax rates are assumed to be as follows:

   Business income 15%
   Taxable capital gain 44 2/3%
   Dividends (Part IV tax) 33 1/3%

Therefore, a substantial tax deferral would result on the business income (45% - 15% = 30%) and no deferral would result on the dividend income (assuming they are portfolio dividends). The tax deferral on the business income would only be achieved to the extent that the partnership profits were not withdrawn from the corporation for personal use, in which case a further tax would be payable on the dividend distribution.

4. If the partnership interest were sold to his own corporation he would incur a taxable capital gain of $100,167. Alternatively, he could avoid this taxable gain by electing to transfer the partnership interest to the corporation at its tax cost of $99,667 [S.85(1)] (see Chapters 11 and 12).
PROBLEM TWO

Conquest Enterprises is a partnership that operates a smallwares wholesale firm. The partners are Cameron Traders Ltd. and Kando Construction Ltd. They share profits equally.

The partnership business has improved this year, and it is anticipated that by year end, profits before capital cost allowance will amount to $620,000 (compared with $290,000 the previous year). During the year, the partnership acquired two additional delivery vehicles for $80,000. At the end of the previous year, the partnership held the following property:

<table>
<thead>
<tr>
<th>Class</th>
<th>Undepreciated capital cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$800,000</td>
</tr>
<tr>
<td>8</td>
<td>100,000</td>
</tr>
<tr>
<td>10</td>
<td>100,000</td>
</tr>
</tbody>
</table>

Cameron Traders is a Canadian-controlled private corporation owned by George Cameron. The company operates an import/export business and earns trading commissions from a wide range of customers. For years, it has earned a modest profit ($30,000 last year, after a reasonable salary to Cameron). However, his years of hard work establishing international contacts have finally paid off, and he expects this year’s profits to be $250,000 and future years’ profits to continue at least at this level.

Kando Construction is owned by Sheila Hampton. Kando has suffered major losses over the past years even after earnings have been allocated from the partnership. Currently, the company has unused non-capital losses of $600,000, of which $300,000 will expire in two years. The company appears to have its losses under control and is not in serious financial difficulty, although cash flow has been tight.

The partnership has been seeking to acquire a new warehouse building. Coincidentally, Hampton personally owns a warehouse property, which will be vacated by its tenant in six months. The property has appreciated in value and is worth $80,000 more than its original cost. Hampton has claimed capital cost allowance of $30,000 over the years. She is willing to sell the property to the partnership, as she could use the cash to strengthen Kando. However, she needs all the cash she can get and is not anxious to pay tax on the sale.

Required:

1. Determine the minimum and maximum business income for tax purposes that might be earned by the partnership (Conquest Enterprises) for the current year and allocated to the partners.
2. Which amount of income from the partnership would Cameron Traders and Kando prefer? Explain.
3. Estimate the tax liability of Cameron Traders for the current year.
4. If you owned Cameron Traders, would you recommend that Conquest Enterprises be incorporated? Explain.
5. How would the incorporation of the partnership affect Kando?
6. What can Hampton do to avoid tax on the sale of the warehouse property to the partnership and generate the maximum amount of cash to help Kando?
Solution to P 15-2

1. Discretionary items for determining income for tax purposes (capital cost allowance, reserves, and so on) must be established at the partnership level [S.96(1)]. The available capital cost allowance in this problem is $94,000 calculated as follows:

<table>
<thead>
<tr>
<th>Class 1</th>
<th>$800,000 @ 4%</th>
<th>$32,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Class 8</td>
<td>$100,000 @ 20%</td>
<td>20,000</td>
</tr>
<tr>
<td>Class 10</td>
<td>opening amount $100,000 @ 30%</td>
<td>$30,000</td>
</tr>
<tr>
<td></td>
<td>additions $80,000 @ 30% (1/2)</td>
<td>12,000</td>
</tr>
</tbody>
</table>

Total: $94,000

Therefore, the minimum and maximum partnership profits for allocation are:

<table>
<thead>
<tr>
<th></th>
<th>Minimum</th>
<th>Maximum</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit before CCA</td>
<td>$620,000</td>
<td>$620,000</td>
</tr>
<tr>
<td>CCA</td>
<td>94,000</td>
<td>0</td>
</tr>
<tr>
<td>Minimum CCA</td>
<td>$526,000</td>
<td>$620,000</td>
</tr>
</tbody>
</table>

2. Cameron Traders earns $300,000 from its own business separate from its 50% share of partnership income. As Cameron Traders is taxable on income allocated by the partnership, it would prefer the minimum partnership profits of $526,000 ($263,000 allocated to Traders) after claiming the full CCA.

On the other hand, Kando Construction has a $600,000 loss carry-over of which $300,000 will expire in two years. Therefore, Kando would prefer the maximum profit from the partnership of $620,000 (Kando's share --$310,000) as this higher income can be offset against its losses and, in particular, against the $300,000 losses that are at risk of expiring.

In partnership structures the tax impact is more dynamic because it directly involves the tax status of each partner as well as the partnership entity itself. In this case, the two partners have a conflict and regardless of the decision made one will have a negative effect.

3. As a CCPC, Cameron Traders is assumed to have a tax rate of 15% on $500,000 of active business income and 25% on the excess. As it earns $300,000 from its own business only $200,000 of partnership profits allocated is eligible for the low rate.

There is also a limit on the partnership business income that is eligible for the small business deduction in the corporate partners known as specified partnership income [ITA 125(1)(a)(ii)], calculated as follows:

<table>
<thead>
<tr>
<th></th>
<th>Minimum</th>
<th>Maximum</th>
</tr>
</thead>
<tbody>
<tr>
<td>Partnership income</td>
<td>$526,000</td>
<td>$620,000</td>
</tr>
<tr>
<td>Eligible for SBD (specified partnership income)</td>
<td>$500,000</td>
<td>$500,000</td>
</tr>
<tr>
<td>High rate</td>
<td>26,000</td>
<td>120,000</td>
</tr>
<tr>
<td></td>
<td>$526,000</td>
<td>$620,000</td>
</tr>
</tbody>
</table>
Cameron Traders' share (50%)
Eligible for SBD $250,000
High rate 13,000 60,000
$263,000 $310,000

Even though the partnership allocates $250,000 of income eligible for the SBD, Cameron Traders can only use $200,000 because its own business income is $300,000 ($300,000 + $200,000 = $500,000 limit). Cameron's tax liability will, therefore, be:

<table>
<thead>
<tr>
<th>Minimum</th>
<th>Maximum</th>
</tr>
</thead>
<tbody>
<tr>
<td>Import-Export profit</td>
<td>$300,000</td>
</tr>
<tr>
<td>Partnership profit</td>
<td>263,000</td>
</tr>
<tr>
<td>Total</td>
<td>$563,000</td>
</tr>
<tr>
<td>Tax on 1st $500,000 @ 15%</td>
<td>$ 75,000</td>
</tr>
<tr>
<td>on excess @ 25%</td>
<td>15,750</td>
</tr>
<tr>
<td>$90,750</td>
<td>$102,500</td>
</tr>
</tbody>
</table>

Therefore, if Kando's desire to not claim CCA prevails, Cameron Traders will incur an additional tax cost of $11,750 ($102,500 - $90,750). This additional cost is not permanent as the unclaimed CCA is available for use in future years (gradually at the normal CCA rate for each class).

4. If the partnership (Conquest Enterprises) was incorporated, Cameron Traders and Kando Construction would each own 50% of its shares. Consequently, the new corporation would not be associated with either of its corporate shareholders. Therefore, the new corporation would be entitled to its own $500,000 small business deduction limit. In addition, dividend distributions to Cameron Traders and Kando would flow tax free. Using the minimum profits of the partnership ($526,000) the following taxes would result with respect to Cameron Traders on its 50% interest in Conquest.

Conquest (as a corporation):
Income $526,000
Tax $500,000 @ 15% $75,000
26,000 @ 25% 6,500
$526,000 $81,500

Cameron Traders:
Income (Import-Export) $300,000
Tax @ 15% $45,000
Cameron Traders share of after-tax profits for each structure is compared below:

<table>
<thead>
<tr>
<th></th>
<th>Partnership</th>
<th>Corporation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income</td>
<td>$263,000</td>
<td>$263,000</td>
</tr>
<tr>
<td>- Conquest</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Cameron Traders</td>
<td>300,000</td>
<td>300,000</td>
</tr>
<tr>
<td></td>
<td>563,000</td>
<td>563,000</td>
</tr>
<tr>
<td>Less tax</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Conquest</td>
<td></td>
<td>(50% of $81,500)</td>
</tr>
<tr>
<td></td>
<td>0</td>
<td>(40,750)</td>
</tr>
<tr>
<td>- Cameron Traders</td>
<td>(90,750)</td>
<td>(45,000)</td>
</tr>
<tr>
<td>After-tax income</td>
<td>$463,250</td>
<td>$477,250</td>
</tr>
</tbody>
</table>

Therefore, the corporate structure expands the SBD limit and based on current income would create an annual tax saving of $14,000 ($463,250 - $477,250). In addition, Cameron Traders has $200,000 of additional SBD limit available which can be used if the profit of its import-export business expands beyond $300,000. In effect, using a non-associated corporate entity for Conquest, the available small business deduction base for Cameron Traders and Kando is increased to $750,000 each compared to the partnership structure of $500,000. This is shown below for Cameron Traders.

| SBD limit Cameron Traders | $500,000 |
| SBD limit in Conquest ($500,000) | 250,000 |
| of which Cameron has a 50% interest | $750,000 |

5. As indicated above, converting the partnership to a corporation would also expand the SBD limits for Kando. However, Kando currently is not taxable because of its $600,000 loss carry-over. Consequently, incorporating the partnership would mean that Kando's share of profits would not be able to be offset against its losses from the construction business which magnifies the risk of their expiration. In addition, because Kando's share of Conquests' profits would now be taxable in the new corporation, there would be less cash available for distribution to Kando, which adds to its problem of tight cash flow. Therefore, Kando again finds itself in conflict with the interests of Cameron Traders because of their differing tax positions.

6. If Hampton sells the warehouse property directly to the partnership, she will incur taxable income of $70,000 as follows:

| Recapture of CCA | $30,000 |
| Taxable capital gain (1/2 of $80,000) | 40,000 |
|                  | $70,000 |

Hampton is not entitled to use the election option on the sale to the partnership because she is not a partner [S.97(2)]. As an alternative, Hampton could transfer the property to the partnership by taking the following steps:

- Sell the warehouse property to Kando Construction and avoid tax on this sale by using the election option which permits Hampton to choose an elected price for tax purposes equal to the UCC for the building and the ACB for the land [S.85(1)].
Payment would be in the form of a note payable plus shares.

- Subsequently, Kando Construction would sell the land and building to the partnership at fair market value in exchange for cash. Because Kando acquired the property at an elected price but sold it at fair market value it would incur a taxable capital gain of $40,000 (1/2 of $80,000) and a recapture of $30,000.

The above transactions have the following advantages:

- Hampton avoids personal tax on the sale.

- Kando generates $70,000 of income which can be offset against its losses and is therefore not taxable. In particular, the $70,000 will reduce the losses that will expire in two years.

- Kando receives the full cash value for the sale of the property which will alleviate its cash flow problems.
PROBLEM THREE

Samborski Enterprises Ltd. is a successful Canadian-controlled private corporation operating a plumbing contracting business. The company consistently earns pre-tax profits in excess of $600,000. The profits are typically used to expand the company’s own business or to buy out smaller businesses in the same industry. Usually, these acquisitions have been successful; they have provided after-tax returns on investment of between 14% and 20%.

Three years ago, the company invested $300,000 in common shares of TQ Ltd. This represented a 30% interest in that company. The other shares were acquired by two other investors. Samborski and the other shareholders created TQ to manufacture a new type of pipe that was expected to revolutionize the plumbing industry. The venture was not successful, and the shareholders decided to shut down the operations. After the assets were sold and the liabilities were paid, there was nothing left for the shareholders. Over the three years, the company had lost $1,000,000, as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>$ 500,000</td>
</tr>
<tr>
<td>Year 2</td>
<td>300,000</td>
</tr>
<tr>
<td>Year 3 (including the sale of assets)</td>
<td>200,000</td>
</tr>
<tr>
<td></td>
<td><strong>$1,000,000</strong></td>
</tr>
</tbody>
</table>

The shareholders were relieved to close the business before further losses were incurred, as they would have had to either contribute additional capital or declare bankruptcy. They have instructed their lawyer to wind up the corporation. At the time the venture was organized, the investors had considered structuring the venture as a partnership. But after only a brief discussion, the idea was rejected because of the potential risk associated with the venture; as well, none of the parties had wanted exposure beyond their initial investment.

Required:

1. Considering that Samborski Enterprises invested $300,000 in share capital three years ago, what after-tax cash loss has it suffered from this investment? Determine the loss on a net present value basis.

2. How much would Samborski Enterprises have lost if it had chosen a partnership structure for TQ, rather than a corporate structure?

3. “If the partnership structure had been used, the new venture could have lost even more money and Samborski Enterprises would have been no worse off than if it had used the corporate structure and lost $1,000,000.” Is this statement true? If it is, what would have been the amount of this extra loss?

4. Assume the following scenario: TQ was organized as a partnership, but to ensure limited liability, Samborski Enterprises organized a subsidiary corporation, to which it contributed capital of $300,000; the subsidiary corporation then invested the $300,000 as a partner of TQ. Explain how Samborski Enterprises might have utilized its $300,000 loss, and calculate the amount of its after-tax cash loss in a manner similar to that used in 1 and 2 above.
Solution to P 15-3

1. As the new venture with other parties was organized as a corporation, the losses incurred in TQ cannot be used directly by Samborski who owns 33% of TQ's common shares. Instead, upon wind up of the corporation, Samborski will realize a capital loss of $300,000 of which $150,000 is allowable for tax purposes. It is evident that TQ qualifies as a small business corporation (as it would not have been possible for it to have substantial non-business investments in view of the losses) and, therefore, the $150,000 loss qualifies as an allowable business investment loss [S.39(1)(c)] which can be offset against all other sources of Samborski's income. It is presumed that TQ is wound up, as instructed by the shareholders, at the end of year 3 and, therefore, the loss occurs at that time. [S.88(2)].

To determine a net present value of the cash flow, a discount rate must be chosen. As Samborski normally earns a 14% to 20% return (after-tax) on its acquisitions and operations, an average discount rate of 17% is used (20% + 14% = 34%/2 = 17%).

The after-tax loss to Samborski on the TQ investment is approximately $253,500 calculated as follows:

<table>
<thead>
<tr>
<th>Cash Flow</th>
<th>NPV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial investment $300,000</td>
<td>$300,000</td>
</tr>
<tr>
<td>Less tax saving from loss:</td>
<td></td>
</tr>
<tr>
<td>Year 3 (25% x $150,000)</td>
<td>(37,500)</td>
</tr>
<tr>
<td>$262,500</td>
<td>$276,750</td>
</tr>
</tbody>
</table>

The corporate structure permits Samborski to recognize only one-half of its loss for tax purposes and the related tax savings occur only when the shares are disposed of. The timing of the loss recognition could have been advanced if Samborski (and the other shareholders) had contributed most of their investment as a loan to TQ. For example, TQ could have issued 10 common shares for $1 each. Samborski's investment would then have consisted of $3 of share capital and a loan of $299,997. The capital loss on a loan can be recognized when it is determined to be uncollectible [S.50(1)] and it may have been possible to justify that position in year 2 creating a tax saving earlier which would have reduced the after-tax loss on a net present value basis.

2. If the new venture had been organized as a partnership, Samborski could have used 30% of TQ's operating losses against its other income sources annually as they occurred. Therefore, the full amount of the losses would create tax savings and those savings would occur sooner than under the corporate structure. As Samborski has substantial other income ($600,000) it is subject to a 25% tax rate.

Notice that the operating losses of the partnership are the same as the capital invested and, therefore, Samborski recognizes its full $300,000 loss as a business loss allocated from the partnership. The net loss under this structure is approximately $225,000 calculated as follows:
Cash Flow | NPV
---|---
Initial investment | $300,000 | $300,000
Less tax savings from loss allocations:
  Year 1 | (37,500) | (31,875)
    (25% X [30% of $500,000])
  Year 2 | (22,500) | (16,425)
    (25% x [30% of $300,000])
  Year 3 | (15,000) | (9,300)
    (25% x [30% of $200,000])
After-tax loss | $225,000 | $242,400

There would be no capital gain or loss on the disposition of the partnership interest upon the wind-up of the partnership. As all the capital invested was lost, the proceeds of disposition would be nil. Also the ACB of the partnership interest which was originally $300,000 is reduced to NIL by the losses allocated to Samborski (30% of $1,000,000). Therefore, the proceeds and the ACB are nil and no tax implications occur. [S.98(3)]

Based on the outcome of the investment, a partnership structure would have reduced Samborski's net after-tax loss by $34,350 ($276,750 - $242,400).

3. Because the partnership structure creates more tax savings from the loss and at an earlier time, the new venture could have lost more than the $1,000,000 as a partnership and still left Samborski no worse off than using the corporate structure and losing $1,000,000.

Ignoring the time factor of the losses, the corporate structure resulted in an after-tax loss to Samborski of $262,500 from his share of the $1,000,000 loss ($300,000). As the partnership losses are fully deductible as a business loss, saving taxes at a 25% rate, Samborski could have lost approximately $350,000 under a partnership structure resulting in the same after-tax loss of $262,500 as follows:

\[ x - .25x = 262,500 \]
\[ x = 350,000 \]

This represents 30% of the venture's loss which means that the venture could have lost $1,166,667 ($350,000/.30) under the partnership structure to equate to a $1,000,000 loss under the corporate structure.

4. If Samborski had created a separate subsidiary corporation (capitalized with $300,000) and used that corporation to act as a 30% partner of TQ, the annual losses allocated to the corporation would remain unused and could not be immediately offset against Samborski's other income.

However, after TQ (partnership) was wound up and the extent of the liability was known, the corporate partner (which is owned 100% by Samborski) can be amalgamated with Samborski Enterprises. Assuming that this occurred at the end of year 3, the entire business losses of the former corporate partner ($300,000) could be offset against Samborski's other income in year four. The after-tax loss from using this structure is as follows:
Cash Flow  |  NPV
---|---
Initial investment  |  $300,000  |  $300,000
Less tax saving from loss:
Year 4 (25% x $300,000)  |  (75,000)  |  (39,750)

$225,000  |  $260,250

This is better than the corporate structure but worse than the direct partnership structure. The price of limiting liability using a separate corporation as a partner is the timing of the loss utilization which occurs in the first year following amalgamation (year 4). The three structures discussed are compared below:

<table>
<thead>
<tr>
<th>After-tax Loss (NPV)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Separate corporation</td>
</tr>
<tr>
<td>Partnership (subsidiary as partner)</td>
</tr>
<tr>
<td>Partnership (Samborski as partner)</td>
</tr>
</tbody>
</table>
CASE

Dart and Silver

Heather Dart owns 100% of the shares of Dart Ltd., a Canadian-controlled private corporation. The company operates a successful printing business that produces advertising flyers and catalogues. Dart Ltd. has retained earnings of $1.5 million and earned profits of $600,000 in the previous year.

David Silver is the editor of a local newspaper and earns a substantial salary. For years, he has envisioned publishing a high-quality magazine that would capture the interests of western Canadians. Silver has had many discussions with Heather Dart, and they have decided to develop and publish People West. Silver will quit his job and work full time on the new venture, for which he will be paid a good salary. Heather Dart will not work for the venture but will provide production advice, especially in the start-up phase.

The new venture will require owners’ capital of $600,000. As the venture will be shared on a 50/50 basis, both parties must provide $300,000 at the outset. This is not a problem for Heather Dart, as she has decided that Dart Ltd. will provide her share of the capital and will be the owner of her portion. But obtaining the $300,000 is not so easy for Silver: he has personal savings of only $280,000 and will have to obtain a second mortgage on his house for the balance.

The venture will require, in addition to the owners’ capital, financing of $400,000, which a local bank has agreed to advance. A financial advisor has developed financial projections after discussions with David Silver. These are summarized in the following table:

<table>
<thead>
<tr>
<th>Year</th>
<th>Income (loss)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$(200,000)</td>
</tr>
<tr>
<td>2</td>
<td>(120,000)</td>
</tr>
<tr>
<td>3</td>
<td>80,000</td>
</tr>
<tr>
<td>4</td>
<td>250,000</td>
</tr>
<tr>
<td>5</td>
<td>500,000</td>
</tr>
</tbody>
</table>

In addition, Heather Dart has asked that the financial advisor prepare a report outlining alternative organization structures for the venture.

Required:

As the financial advisor, prepare the report.
Solution to Case - Dart and Silver

There are two basic alternative structures for the new venture—a partnership or a separate corporation. In turn, each alternative has sub-alternatives. The analysis for each structure is different for Dart and for Silver and is reviewed separately. The report should address the following issues with respect to each alternative.

1. The utilization of operating losses in the start-up years.
2. The rates of tax applicable on future profits.
3. The tax savings that can be generated if the venture fails and the investors lose all or a portion of their investment.
4. The repatriation of future profits and capital invested to the investors for their reinvestment.
5. The overall risk exposure of each structure.

A review of the above items is summarized below:

From Dart's Perspective

Heather Dart intends to use Dart Ltd. as the vehicle for investing in the new venture as it has retained earnings of $1.5M and substantial cash flows. The two basic structures are diagrammed below.

![Diagram of partnership and corporate structures]

**Start-up losses** -- Under the partnership structure, the projected losses in the first two years ($320,000, Dart's share $160,000) can be offset, as they occur, against Dart's other business income ($600,000 annually). This will create tax savings for Dart in the first two years of $40,000 (25% of $160,000) (this may be lower to the extent that tax rates are reduced by the M&P credit). This additional cash flow can be used by Dart for other investments, or it could be available to the new venture if losses are greater than expected or expected cash flows are delayed.

Under the corporate structure, the losses would remain unused in the first two years awaiting profits from the new venture. As profits are expected by year 3, the delay in the loss utilization may not be a serious cost. However, the projections may be inaccurate and the delay could be
much longer. Clearly the partnership structure is advantageous here as the additional early cash flow may be an important factor in the success of the venture.

**Future tax rates** -- Under the partnership structure, Dart's share of the income is simply included with its other income for tax purposes. As Dart has already used its SBD limit any new venture income will be taxed at the high rate of 25%. At full potential, Dart's share of the new venture profits is $250,000 (1/2 of $500,000) which will leave after tax profits of $187,500 ($250,000 - 25% of $250,000)

As a separate corporation, Dart Ltd. and the new corporation would not be associated (Dart Ltd. does not control) and, therefore, the new venture would be entitled to its own SBD limit of $500,000 of which Dart's share is one-half. At full potential, the new ventures after-tax profits will be as follows:

<table>
<thead>
<tr>
<th>Income</th>
<th>$500,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>less tax: 15% of $500,000</td>
<td>(75,000)</td>
</tr>
<tr>
<td><strong>$425,000</strong></td>
<td></td>
</tr>
</tbody>
</table>

Dart's share is $212,500 under the corporate structure compared to the partnership profits of only $187,500. As dividends flow tax free to Dart Ltd. greater after-tax returns will be achieved.

**Downside risk** -- If the new venture fails completely and is organized as a partnership, Dart will recognize its loss in the form of annual business losses allocated from the partnership. For example, if the venture loses $600,000 (Dart's share $300,000) after ceasing operations, Dart will lose all of its $300,000 investment. The business losses allocated save taxes of $75,000 (25% of $300,000) leaving a net loss of only $225,000. In addition, the tax savings occur annually as the losses occur.

As a corporation, the failure of the venture would leave the business losses locked into the corporation and, because Dart owns only 50% of its shares, it would be difficult to take steps to use those losses. Therefore, Dart would likely incur a capital loss on the share capital invested (of which only 1/2 is allowable). As the capital loss will likely qualify as an allowable business investment loss (from a small business corporation) [S.39(1)(c)], it can be offset against Dart's other income. This will create tax savings of $37,500 (25% of $150,000). Therefore, the corporate structure has a downside risk of $262,500 ($300,000 - $37,500) compared to the partnership structure of $225,000. Dart could consider taking steps to utilize the full losses in the new venture corporation. For example, it could transfer profitable activities to the corporation. This would be difficult because of the involvement of Silver. Alternatively, Dart could acquire Silver's share and then amalgamate the new venture corporation with Dart. However, this constitutes a change in control and the loss carry-overs could only be used if Dart was in a similar line of business and continued to operate the new venture business [S.111(5)] (see Chapter 10 and 13).

**Repatriation of future profits** -- Both the partnership and corporation provide the same result. Dividends received by Dart from the new venture corporation are tax free and not subject to the special refundable Part IV tax. Withdrawals from the partnership do not constitute a distribution of income but rather a return of capital.

**Overall risk exposure** -- The partnership structure presents Dart with a significant risk exposure beyond the $300,000 that it will invest. If the venture fails, the debts created by the losses and the unpaid portion of the bank loan must be paid by the partners. As Silver will use
most of his net worth to invest in the venture, he would not likely be able to support any additional liability. As each partner is ultimately responsible for the full obligations of the partnership, Dart would be called upon to settle all obligations (Dart's net worth is $1.5M).

Using a corporation for the new venture would limit Dart's liability to the amount of capital invested ($300,000) unless special guarantees are required for the new venture bank loan.

Limited liability could also be achieved using the partnership structure if Dart created a limited value subsidiary corporation to act as the partner in the new venture partnership (as follows):

In the above structure, Newco is the partner and is responsible for the partnership obligations. However, because Newco would be capitalized with only $300,000 (which would then be invested in the partnership) and because it is itself a limited liability entity, Dart would only be exposed for $300,000. While this structure limits liability, it also means that the partnership losses that occur annually and are allocated to Newco will remain unused as Newco has no other sources of income. Although, at some future point, when Dart is satisfied that the risk exposure is not a problem, Newco could be amalgamated with Dart and the accumulated losses used against Dart's income providing the maximum tax recovery. Therefore, this structure limits liability but as a consequence, delays the use of the losses (see solution to Problem 3).

Summary and evaluation:

Dart's preferred organization structure with respect to the above issues is summarized below:

<table>
<thead>
<tr>
<th>Preferred Structure</th>
<th>Start-up losses</th>
<th>Future profits</th>
<th>Downside risk</th>
<th>Repatriation of profits</th>
<th>Overall risk exposure</th>
</tr>
</thead>
<tbody>
<tr>
<td>Partnership</td>
<td>Partnership</td>
<td>Corporation</td>
<td>Partnership</td>
<td>Indifferent</td>
<td>Corporation</td>
</tr>
</tbody>
</table>
Clearly Dart has conflicting preferences. The early loss utilization in the partnership structure is important to Dart as it will generate tax savings of $40,000 in the first two years. This cash recovery is 13% of the original $300,000 invested. On the other hand, if profits are realized as projected, a corporate structure creates an expansion of the small business deduction limit and increases Dart's return on investment by a significant amount. At full potential, and after the losses are recovered, the partnership return could be 63% ($187,500/$300,000) whereas the corporate return could be 71% ($212,500/$300,000).

Excluding the concern for overall liability, it would be preferable and possible for Dart to start the venture off as a partnership and retain it as such for the loss period. As the new venture becomes profitable, it could be converted to a corporation, without tax consequences, using the reorganization techniques permitted. This two-step structure allows immediate loss utilization plus the lowest tax rates on profits. This, of course, still leaves Dart with its overall risk exposure in the early years, and a realistic assessment of that risk should be examined before such a decision is made. If the risk exposure is too high, then the initial structure should be a partnership structure using the limited value corporation as the partner (described above). This limits liability, but if that risk turns out to be unfounded, a reorganization can be made later by amalgamating the corporate partner (Newco) with Dart to use the full losses plus convert the partnership to a corporation to take advantage of the lower tax rates.

From Silver's Perspective
The basic alternative structures present less conflict for Silver because of his existing situation. Silver's only income source will be his salary from the new venture, which will be taxable in spite of the fact that the new venture will lose money in its first two years and perhaps beyond if the projected results are not achieved.

In order for Silver to be able to reduce his personal tax liability from the new venture losses, it would be necessary to use a partnership structure whereby Silver, the individual, is a 50% partner. As such, any annual salary allocated to him would be offset by the allocated losses. This, of course, would be advantageous to Silver. However, the risk associated with this structure is overpowering. It appears that, after the investment of $300,000 in the venture, Silver's only remaining asset is the equity in his house (after the second mortgage of $20,000) as all his other savings will be used for the new venture. Therefore, if the venture fails completely and suffers losses beyond his contribution, he would be personally liable and risks losing everything he owns. It is likely that he would not choose this structure in view of this risk.

Consequently, if the partnership structure is to be used, Silver would want to create a limited value corporation to act as the partner. This structure would be as follows:

```
Silver
100%

Newco
50%

Partnership
```
Silver would capitalize Newco with $300,000 consisting of a minimum of common share capital and the balance by way of a shareholder loan or preferred shares. Under this structure, the following would occur:

- Annual new venture losses would be allocated to Newco but remain unused until the venture generates profits.

- When partnership profits occur, Newco will be entitled to apply the small business deduction to $250,000 of those profits annually (specified partnership income, being 50% of the partnership $500,000 notional limit). Newco would have an additional $250,000 of SBD limit available if it earned its own active business income from other sources.

- If the venture fails completely, Newco will have substantial business losses accumulated. These would remain unused unless Silver could find a way of generating income in Newco. If this is not available, Newco could be wound up, creating a capital loss of $300,000 ($150,000 allowable) for Silver personally. Newco is a small business corporation and, therefore, the loss may qualify as an allowable business investment loss permitting it to be deducted against any income source of Silver. To the extent that the loss results from a shareholder loan, an ABIL results [S.39(1)(c), 50(1)]. However, the loss from the shares will only qualify if the shares are sold to a non-related party (which is unlikely), the corporation is legally bankrupt, which may not have occurred or, as provided by section 50(1)(iii), the corporation is insolvent and has ceased activity (the shares must have a NIL value). Therefore, it is in Silver's interest to capitalize Newco from the outset with as much shareholder loan as possible.

- Income from the partnership would not be taxable when distributed to Newco. Such funds could then be paid to Silver as a repayment of the shareholder loan without tax consequences. After the loan is paid, taxable dividend distributions must be used in which case some double taxation may occur if some of Newco's income is not subject to the small business deduction.

Alternatively, if the new venture is organized as a corporation, Silver could also create Newco (as above) to act as a holding company to own 50% of the new venture corporation's shares. The structure would be as follows:
This structure has the following results:

- Annual losses remain in the new venture corporation until profits are generated.

- Future profits will be subject to the small business deduction on $500,000 of income of which Silver indirectly shares one-half ($250,000).

- If the new venture corporation fails, Newco would realize an allowable business investment loss of $150,000 (1/2 of $300,000 invested). As Newco has no other income, this loss also remains unused. However, as Newco has no value, Silver would realize an allowable business investment loss on his loan to Newco. Newco qualifies as a small business corporation because its assets consist of shares in a connected corporation that in turn had all of its assets used in an active business.

- Future profits of the new venture corporation could be paid as tax free dividends to Newco. That cash could then be used to repay Silver’s shareholder loan without tax consequences.

Both of the above basic structures provide similar results with one exception. If the new venture fails, under the partnership structure, Newco has accumulated business losses unused whereas under a corporate structure Newco has unused losses of only 1/2 of the amount invested (ABIL). The partnership structure would, therefore, be preferable only if Silver was able to generate other sources of income in Newco to use those losses. At the present time this appears unlikely, but his circumstances may change. Therefore, all else being equal the partnership structure, using Newco as a partner appears to be preferable.
CHAPTER 16

LIMITED PARTNERSHIPS AND JOINT VENTURES

Review Questions

1. A limited partnership consists of two general classes of partners. Identify these classes, and describe the rights and obligations of each.

2. What can be done by a general partner to limit the extent of its obligations to the limited partnership?


4. What key factors distinguish the limited partnership from the standard partnership?

5. “A limited partnership provides broader access to sources of capital.” Is this statement true? Explain.

6. Why is there less risk for the passive investor when a business venture is organized as a limited partnership, rather than a corporation?

7. Why is it that the passive investor in a profitable business venture may receive a higher rate of return if the venture is organized as a limited partnership, rather than a corporation?

8. What is a joint venture, and how is it different from a partnership?

9. With respect to the following, how does the tax treatment applied to a joint venture differ from that for a partnership?

   (a) Determination of capital cost allowance.

   (b) Active business income eligible for the small-business deduction.
Solutions to Review Questions

R16-1. The two classes of partners required in a limited partnership structure are general partners and limited partners. The general partner is fully liable for the obligations of the partnership entity (i.e., beyond its proportionate ownership ratio) and is also responsible for managing its business affairs. Limited partners, on the other hand, are responsible for the partnership obligations only to the extent of their investment in the partnership entity (similar to the limited liability aspect of a shareholder in a corporation). In addition, to qualify as a limited partner, the investor must not take part in the management and control of the partnership business. By definition, limited partners are passive investors. [s.96(2.4), 96(2.2)]

R16-2. An investor who intends to be a general partner (and, therefore, is exposed to full risk) can limit the extent of its financial risk by creating a separate corporation with a limited amount of capital to act as the general partner. As the corporation has limited capital (i.e., the amount required for investment in the partnership) and is itself a limited liability entity, it can only suffer losses to the extent of its net worth, even though it is liable for the partnership's obligations.

R16-3. Similar to the standard partnership, the limited partnership is not a taxable entity. Instead its net income or loss is allocated, for tax purposes, to the general and limited partners in accordance with their profit sharing ratios. The income or loss allocated retains its source and characteristic and is included in the partners' income calculation in its original form. The tax treatment of the income allocated is thus dependent on the nature of each partner (i.e., whether they are individuals or corporations). For example, dividends allocated to an individual partner are subject to a gross-up and dividend tax credit, but if allocated to a corporate party would be treated as an intercorporate dividend excluded from taxable income (but perhaps subject to a Part IV tax).

R16-4. The factors that distinguish a limited partnership from a standard partnership are as follows: [s.96(2.4)]

- Some partners in a limited partnership have limited liability. In a standard partnership each partner is fully exposed to the entity's obligations.
- Limited partnerships must have some partners who are not active in management (i.e., are passive investors). The standard partnership does not have this requirement.
- In a limited partnership, the losses allocated to the limited partners can only be used by them to a maximum of their "at risk" amount. In a standard partnership, all losses allocated are available for partner use.

R16-5. Yes, the statement is true when made in comparison to a standard partnership. In a standard partnership, the unlimited liability feature tends to discourage the participation of investors who are not active in management. In particular, it discourages the interest of a large number of small passive investors from investing a small amount for a minor partnership interest because the risk of unlimited liability is too high.

However, in a limited partnership, the requirement that limited partners be passive investors in exchange for limited liability permits the partnership base to be divided into a large number of small units. A small investor can, therefore, participate with a limited amount of risk. This is similar to a corporation issuing shares to a number of smaller investors except that the limited partnership has the added advantage of being able to allocate its losses to the limited partners to create tax savings for them personally.
R16-6. As a passive investor, an investment in a corporation or a limited partnership has limited liability. Therefore, the amount that the investor can lose in each structure is finite and in this sense each structure presents equal risk. However, the tax savings that can result from suffering a loss in each structure is different. An investment loss from corporate shares results in a capital loss of which only 1/2 is allowed for tax purposes at the time the shares are disposed. In a limited partnership, the passive investor can usually deduct the full amount of the loss, and the loss is recognized annually as the partnership allocates business losses to the partners. For example, a taxpayer in a 45% tax bracket who lost $10,000 in a share investment would suffer an after-tax loss of $7,750 ($10,000 - 45% [1/2 of $10,000]), but in a limited partnership investment would lose only $5,500 ($10,000 - 45% of $10,000). Therefore, the downside risk of a limited partnership structure is less for the passive investor than in a corporate structure.

R16-7. A passive investor in a profitable venture that is organized as a corporation distributes its profits as dividends. When the passive investor is an individual, the dividend is taxable and, therefore, two levels of tax occur (corporate and personal). Where the corporation is a public company or a CCPC earning income in excess of the small business deduction limit, some double taxation will occur. For example, from $1,000 of venture profits the investor may receive a return of $540 as follows:

<table>
<thead>
<tr>
<th>Corporate income</th>
<th>$1,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax @ 25%</td>
<td>(250)</td>
</tr>
<tr>
<td>Dividend distribution – Eligible</td>
<td>750</td>
</tr>
<tr>
<td>Tax @ 28%</td>
<td>(210)</td>
</tr>
<tr>
<td>Net to investor</td>
<td>$ 540</td>
</tr>
</tbody>
</table>

However, under a limited partnership structure, the venture income is taxed only once at the partner level. Therefore, $1,000 of venture profits may provide an after-tax return to the investor of $550 ($1,000 - personal tax @ 45%). Because the limited partnership can avoid double taxation for individual partners, greater after-tax returns can be achieved.

R16-8. A joint venture is an association of two or more entities for a given limited purpose without the usual powers and responsibilities of a partnership. The primary feature that distinguishes a joint venture from a partnership is the concept of limited purpose. A partnership usually represents an ongoing business relationship whereas the joint venture is formed for the purpose of completing a single transaction or activity of a limited duration.

R16-9. In a partnership, the amount of capital cost allowance must be established by the partnership and each partner is subject to that determination. In a joint venture, title to property remains in the hands of the participants and, therefore, each participant can claim all or a portion of the CCA permitted annually. This same treatment applies to other types of discretionary items for tax purposes (e.g., reserves).

Active business income earned by a partnership is subject to a notional small business deduction limit of $500,000 which must be shared by the corporate partners in their profit sharing ratios. In a joint venture structure, no such limit applies. For example, if a joint venture earns $700,000 of active business income, a 50% corporate joint venture participant (CCPC) would be entitled to apply the small business deduction on its full share of joint venture profits ($350,000) provided that it has not already used its limit from its own other business activities.
Key Concept Questions

QUESTION ONE

On March 1 of the current year, Mathew acquired a one percent interest in a partnership that carries on a nursing home business in several provinces in Canada. Mathew paid $10,000 for the partnership interest. The partnership reported a loss for the current year. Mathew was allocated a business loss of $16,000 from the partnership. *Income Tax Act reference: ITA 96(2.1), 111(1)(e).*

Describe the tax implications of the loss for Mathew under the following two assumptions:

1) Mathew has a limited partnership interest, and
2) Mathew has a general partnership interest.

QUESTION TWO

Bill owns a 5% interest in a limited partnership. The adjusted cost base of his partnership interest at the beginning of the current year was $40,000. For the current year Bill was allocated $8,000 of capital gains and $22,000 of business income from the partnership. At the end of the current year Bill had a loan from the partnership in the amount of $12,000.

Determine Bill’s at-risk amount at the end of the current year. *Income Tax Act reference: ITA 96(2.2).*
Solutions to Key Concept Questions

KC 16-1

[ITA 96(2.1); 111(1)(e) – Limited partnership – at-risk rules]

1) If Mathew has a general partnership interest then the entire $16,000 loss is deductible against his other sources of income for the current year.

2) If Mathew has a limited partnership interest then Mathew can claim the loss only to the extent of his investment in the partnership, $10,000, being the amount at-risk of being lost if the business venture of the partnership fails. The excess limited partnership loss, $6,000, can be carried forward indefinitely and can only be claimed to the extent of the at-risk amount from that same partnership. There is no carry back of limited partnership losses. The at-risk rules do not apply to capital losses or farm losses incurred by the partnership.

KC 16-2

[ITA 96(2.2) – Limited partnership – at-risk amount]

The at-risk amount is calculated at the end of a partnership’s fiscal period as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>ACB of the partnership interest (beginning of year)</td>
<td>$40,000</td>
</tr>
<tr>
<td>Share of income for the current year:</td>
<td></td>
</tr>
<tr>
<td>Capital gains</td>
<td>$ 8,000</td>
</tr>
<tr>
<td>Business income</td>
<td>22,000</td>
</tr>
<tr>
<td>Balance of loan received from the partnership</td>
<td>(12,000)</td>
</tr>
<tr>
<td>At-risk amount (end of current year)</td>
<td>$58,000</td>
</tr>
</tbody>
</table>
Problems

PROBLEM ONE

[ITA: 51(1),(2); 96(1); 121; 125(1)]

Georgio Enterprises is a limited partnership that operates a chain of family restaurants. The partnership was profitable from its inception and is now generating consistent annual pre-tax profits of $1,000,000.

The partnership includes 20 limited partners, each of whom contributed $60,000 when the venture began. The limited partners, as a group, share 40% of Georgio’s annual profits. As the partnership has not expanded for several years, most of the annual profits are distributed to the partners within six months of the year end.

Most of the limited partners are individuals who are subject to a marginal personal tax rate of 45%.

Required:

1. What is the annual after-tax return on investment for each limited partner?
2. If Georgio Enterprises had been organized as a corporation, how would the rate of return to the investors differ? Show calculations.
3. Assume that Georgio Enterprises (as a limited partnership) made an annual cash distribution sufficient only to cover each limited partner’s tax liability, and retained the balance for expansion. How would the investors’ after-tax returns be affected by this, considering that in order to realize their investment they may have to sell their partnership interest for an increased value? Would the return on investment be different if Georgio were a corporation and paid no dividends?
Solution to P 16-1

1. The annual after-tax return on investment for each limited partner is 18% calculated as follows:

   Partnership income $1,000,000
   Limited partners share (40%) $400,000
   Income allocated to each limited partner (1/20 of $400,000) $20,000
   Less tax @ 45% (9,000)
   After-tax return $11,000

   Return on investment:
   $11,000 = 18%
   $60,000

2. If Georgio Enterprises had been organized as a corporation, the return to the investors would vary depending on whether the entity was a public corporation or a CCPC.

   As a public corporation, the return on investment would have been 18% as follows:

   Corporate income $1,000,000
   less corporate tax @ 25% (250,000)
   Available for dividend $750,000
   Investors total share of dividend (40%) $300,000
   Each investor's dividend (1/20 of $300,000) $15,000
   Less tax on eligible dividend (28%) (4,200)
   After-tax return $10,800

   Return on investment:
   $10,800 = 18%
   $60,000

   As a Canadian-controlled private corporation, the return on investment would have been as follows:

   Corporate income $1,000,000
   Less tax
   $500,000 @ 15% $75,000
   $500,000 @ 25% 125,000 (200,000)
   available dividend $800,000
   Investors' share of dividend (40%) $320,000
Dividends | Eligible | Non-eligible
------- | ------- | -------
($500,000 - $75,000) | $425,000 | $375,000
($500,000 - $125,000) | $170,000 | $150,000
Investors’ share of dividends (40%) | $7,500 | $8,500
Each investors dividend (1/20) | (2,100) | (2,805)
Less tax (eligible @ 28%; non-eligible @ 33%) after-tax return | $5,400 | $5,695
Return on investment:
\[
\frac{(5,400 + 5,695)}{60,000} = 18\%
\]

The after-tax returns of each structure are compared below:

- Limited partnership: 18%
- Public corporation: 18%
- CCPC: 18%

Note that a calculation of the CCPCs general rate income pool (GRIP) account is necessary for an accurate allocation of dividends between eligible and non-eligible.

3. If the limited partnership retains a portion of its profits for business expansion, the value of the investor’s partnership interest would be higher as a result of this expanded capital base in the partnership, compared to the value if all profits were distributed. However, under a partnership structure, the adjusted cost base of the partnership interest would be arbitrarily increased by the amount of profits allocated but retained (ACB is increased by profits allocated and reduced by distributions to partners). Therefore, if the investor sells the limited partnership interest at this higher value, a capital gain would not be realized on the value attributed to the profits retained. Consequently, but for the timing of the cash realization (immediate distribution versus a sale later), the investor’s after-tax return on investment would not be changed. [s.53(1)&(2)]

On the other hand, if the venture was a corporation and profits were retained forcing the investors to realize their returns by a share sale, the result would not be comparable. The value increase attributed to the profit retention would result in a capital gain to the investor of which 1/2 would be taxable. In other words, the return is realized as a capital gain rather than as a dividend. Consequently, the investor’s after-tax return would be affected. For example, if the investor is in a 45% tax bracket, a capital gain would result in a tax cost of 22.5% (1/2 of 45%) whereas a dividend distribution may result in a tax cost of 28% or 33% (net of the dividend tax credit—see Chapter 10). Alternatively, if the investor has not used up his or her capital gain deduction and the corporation is a small business corporation, the capital gain may be tax free whereas the realization by dividend would be taxed at 33%.
PROBLEM TWO

[ITA: 20(1)(a); 96(1) ]

A new business venture requires $600,000 of equity capital from passive investors in addition to the $400,000 of capital that is being provided by the initiator of the project. The $600,000 will be raised by selling 30 units for $20,000 each. The 30 unit holders will participate in 60% of the venture’s profits.

It is anticipated that business operations will begin on October 1, 20X1. The entity will use a December 31 year end. Investors must contribute their funds on October 1, 20X1. The equity capital of $1,000,000 will be used as shown below.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Working capital</td>
<td>$200,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>300,000</td>
</tr>
<tr>
<td>Start-up costs, staff training, and opening advertising</td>
<td>200,000</td>
</tr>
<tr>
<td>Operating losses:</td>
<td></td>
</tr>
<tr>
<td>20X1 (for the three-month period)</td>
<td>250,000</td>
</tr>
<tr>
<td>20X2</td>
<td>50,000</td>
</tr>
<tr>
<td></td>
<td>$1,000,000</td>
</tr>
</tbody>
</table>

The initiator is uncertain how to organize the new venture and is trying to decide between a separate corporation that will issue shares, and a limited partnership.

**Required:**

Which type of entity will make it easier for the initiator to raise the $600,000 of equity capital from passive investors? Explain, using a single investor as an example.
Solution to P 16-2

In addition to the potential benefits that will accrue from the new venture's success, potential investors are interested in limiting their liability, minimizing the cash required for the investment, and minimizing the after-tax loss (or downside risk) if the venture should fail. As both the corporate structure and the limited partnership structure provide limited liability, the attractiveness of one versus the other relates to the latter two items.

Corporate Structure:

To obtain one of the 30 investment units, the passive investor will be required to come up with a cash contribution of $20,000. No cash recovery of this amount will occur until the venture is profitable and begins paying taxable dividends. The venture will suffer losses in the first few years but those losses will be locked into the corporation and provide no cash flow from tax savings until new venture profits are achieved. If the venture fails and the shares are disposed of for a full loss of $20,000, the after-tax loss will be $15,500 as follows (assumes ACL can be used or it is an ABIL):

\[
\begin{align*}
\text{Cash invested (and lost)} & \quad \$20,000 \\
\text{less tax saving from capital loss (45\% \times 1/2 \text{ of } $20,000)} & \quad (4,500) \\
\text{After-tax loss} & \quad 15,500
\end{align*}
\]

Limited Partnership Structure:

Under this structure, invested funds will be used for working capital, equipment acquisition, start up costs and initial losses from operations. These losses are allocated to the limited partners for tax purposes creating tax savings in a short period of time.

The losses for tax purposes that will be allocated are as follows:

\[
\begin{align*}
\text{Period 1} & \quad \begin{align*}
\text{(3 months)} & \quad \text{Year 2}
\end{align*} \\
\text{Operating loss} & \quad 250,000 & \quad 50,000 \\
\text{Start-up costs} & \quad 200,000 & \quad 0 \\
\text{Capital cost allowance (below)} & \quad 7,500 & \quad 58,500 \\
\text{Total losses for allocation} & \quad 457,500 & \quad 108,500
\end{align*}
\]

\textit{Capital cost allowance} - It is assumed that the equipment is class 8 (20\% CCA rate). In the first period only 1/2 of the normal CCA is available and this must be pro-rated for the short year (3 months).

\[
\begin{align*}
\text{Period 1: CCA - } & \quad 300,000 \times 20\% = 60,000 \times 1/2 \times 3/12 \quad 7,500 \\
\text{Period 2: CCA - } & \quad 300,000 - 7,500 = 292,500 \times 20\% \quad 58,500
\end{align*}
\]
The allocation of the above losses will create tax savings for each limited partnership unit as follows:

<table>
<thead>
<tr>
<th></th>
<th>Period 1</th>
<th>Year 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total losses allocated</td>
<td>$457,500</td>
<td>$108,500</td>
</tr>
<tr>
<td>Available to limited partners (60%)</td>
<td>$274,500</td>
<td>$65,100</td>
</tr>
<tr>
<td>Loss per unit holder (1/30)</td>
<td>$9,150</td>
<td>$2,170</td>
</tr>
<tr>
<td>Tax savings @ 45%</td>
<td>$4,118</td>
<td>$977</td>
</tr>
</tbody>
</table>

Therefore, within three months of the investment, the investor can reduce their taxes otherwise payable by $4,118 and within 15 months by $977. The initial investment of $20,000 is reduced to $14,905 ($20,000 – ($4,118 + $977)) in a relatively short period of time.

In addition, if further losses are sustained and the venture fails, the limited partner’s maximum loss of $20,000 is allocated as a business loss (fully deductible). The after-tax loss (downside risk) if this occurs is:

| Total loss | $20,000 |
| less tax savings @ 45% | (9,000) |
| **$11,000** |

The two structures are compared below:

<table>
<thead>
<tr>
<th></th>
<th>Limited Partnership</th>
<th>Corporation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash required after 15 months</td>
<td>$14,905</td>
<td>$20,000</td>
</tr>
<tr>
<td>Downside risk</td>
<td>$11,000</td>
<td>$15,500</td>
</tr>
</tbody>
</table>

It is clear that the limited partnership will be more attractive to the passive investor.
CASES

Contesso Travel Inns Ltd.

Contesso Travel Inns Ltd. is a successful Canadian-controlled private corporation that owns and operates a small chain of eight hotels in western Canada. The hotels offer high-quality lodging at economy rates and provide only limited services to their guests. Contesso has succeeded because of its unique approach to the lodging industry and its strong hotel management expertise. The company has designed and constructed all of its existing units—in fact, a sister corporation owned by the same shareholders (Contesso Developments Ltd.) maintains a small staff whose sole function is to develop new hotels. Contesso Developments has made a profit on each of the eight hotels it has developed over the past five years.

Contesso’s success has been noticed in the hotel industry, and a number of similar hotels have sprung up across the country. The executives of Contesso realize that a race is on and that a number of other companies will be competing for the most suitable sites for expansion. They estimate that within eight years, the number of remaining quality sites will decline considerably as more hotels are developed across the country.

Contesso seriously considered going public and raising a large amount of capital to embark on a major expansion program. However, it rejected this proposal because it would have had to give up a significant percentage of its equity and because it could not project a realistic expansion plan in view of the increasing competition. At the same time, the company cannot expand rapidly while still owning each new hotel, as each unit requires more than $2,000,000 in equity capital as well as mortgage financing.

Contesso, therefore, has decided to concentrate on its two strengths—hotel management and hotel development—and to permit outside investors to own each unit. The expansion plan is as follows:

• Contesso will identify and secure the right to acquire suitable sites.
• The equity requirement for each new hotel is approximately $2,000,000. This will be obtained for each project by the issuing of 200 ownership units to private investors. Each investor may acquire any number of the 200 units. Contesso will receive a fee for organizing the investors and issuing the ownership units.
• Contesso Developments will develop the hotels and assist with the acquisition of all equipment. In addition, the company will arrange mortgage financing for a fee.
• Each hotel will be managed by Contesso under a long-term contract (12 years) in exchange for a fee of 5% of the hotel’s gross revenue.

Contesso’s executives are satisfied that this plan will result in rapid expansion and, as well, provide their company with significant from management fees and development profits. Also, after the expansion program is complete, the company will be in a solid position to acquire ownership of the hotels if the outside investors wish to sell. Each new hotel will be sold to a different investor group in a different city, and the company executives are uncertain about which organization structure to choose. Each new hotel could be organized as a separate corporation, in which case 200 common shares would be issued; or each could be organized as a limited partnership, in which case 200 limited partnership units would be issued.

Financial information relating to each expansion unit is provided in Exhibits I and II.
Required:

Prepare an analysis of the financial information and advise Contesso which organization structure will be most attractive to prospective investors for each of the hotel units.

EXHIBIT I
CONTESSO TRAVEL INNS
Financial Requirements and Cost Allocations

1. Project cost and financing
   Cost:
   - Land, building, equipment, and start-up costs \( \$4,500,000 \)
   Financing:
   - 1st mortgage (35-year amortization), interest at 12% \( \$2,500,000 \)
   - Investors’ contributions: \( 200 \times \$10,000 = \$2,000,000 \)
   \( \$4,500,000 \)

2. Cost allocations
   - Land \( \$400,000 \)
   - Building \( 2,600,000 \)
   - Furniture and equipment \( 500,000 \)
   - Landscaping \( 50,000 \)
   - Linens and supplies \( 90,000 \)
   - Costs of arranging mortgage \( 70,000 \)
   - Opening advertising and staff training \( 290,000 \)
   - Agent’s fees for selling equity units \( 350,000 \)
   - Expense of issuing units (prospectus, legal, etc.) \( 150,000 \)
   \( \$4,500,000 \)

EXHIBIT II
CONTESSO TRAVEL INNS
Anticipated Operating Information

<table>
<thead>
<tr>
<th>Year</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Average room rate</td>
<td>40</td>
<td>42</td>
<td>44</td>
<td>46</td>
</tr>
<tr>
<td>Occupancy percentage</td>
<td>60%</td>
<td>63%</td>
<td>66%</td>
<td>70%</td>
</tr>
<tr>
<td>Gross revenue</td>
<td>( $400,000^{*} )</td>
<td>( $900,000 )</td>
<td>( $1,100,000 )</td>
<td>( $1,200,000 )</td>
</tr>
<tr>
<td>Operating profit before debt service and depreciation</td>
<td>200,000</td>
<td>400,000</td>
<td>480,000</td>
<td>520,000</td>
</tr>
</tbody>
</table>

* Note: The entity’s year end will be December 31. Information for year 1 represents a half-year operation period. Also, the operating profits exclude any of the start-up cost allocations of \( \$4,500,000 \).
Solution to Case - Contesso Travel Inns Ltd.

This case requires students to determine net income for tax purposes using the rules established in Chapter 4 and then apply the result to alternative organizational structures for the proposed expansion program. To complete the analysis, assumptions must be made for the corporate and investor tax rates, as well as a discount rate for present value calculations. The assumed rates are indicated as they apply.

Project Income for Tax Purposes

Although the operating results for the first four years are provided, they must be converted into the annual amounts for tax purposes. The required adjustments result from interest on the mortgage plus the write-off of all or portions of the initial costs of $4,500,000. The income or loss for tax purposes is summarized below:

<table>
<thead>
<tr>
<th>Year</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Operating profit before debt service and depreciation</td>
<td>$200,000</td>
<td>$400,000</td>
<td>$480,000</td>
</tr>
<tr>
<td></td>
<td>Less:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Interest on mortgage (note 1)</td>
<td>149,940</td>
<td>299,430</td>
<td>298,770</td>
</tr>
<tr>
<td></td>
<td>CCA (Note 2)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>- building</td>
<td>39,000</td>
<td>153,660</td>
<td>144,440</td>
</tr>
<tr>
<td></td>
<td>- equipment</td>
<td>25,000</td>
<td>95,000</td>
<td>76,000</td>
</tr>
<tr>
<td></td>
<td>- linen</td>
<td>45,000</td>
<td>--</td>
<td>--</td>
</tr>
<tr>
<td></td>
<td>Landscaping (note 3)</td>
<td>50,000</td>
<td>--</td>
<td>--</td>
</tr>
<tr>
<td></td>
<td>Costs incurred to arrange financing and issue units (note 4)</td>
<td>114,000</td>
<td>114,000</td>
<td>114,000</td>
</tr>
<tr>
<td></td>
<td>Opening costs</td>
<td>290,000</td>
<td>--</td>
<td>--</td>
</tr>
<tr>
<td></td>
<td>Total deductions</td>
<td>712,940</td>
<td>707,090</td>
<td>633,210</td>
</tr>
<tr>
<td></td>
<td>Income(loss) for tax</td>
<td>$(512,940)</td>
<td>$(307,090)</td>
<td>$(153,210)</td>
</tr>
</tbody>
</table>

Note 1: The mortgage interest is based on a monthly payment amortized over 35 years on $2,500,000. The first period represents only one-half a year as indicated in the question.

Note 2: The building is Class 1 - 6% (assumed building built after March 18, 2007 and placed in a separate CCA class). In the first year, the 1/2 rule applies [Reg. 1100(2)]. In addition, because it is a short year (6 months) additional pro-rating of 1/2 applies [Reg. 1100(3)]. Year 1 CCA is: $2,600,000 x 6% x 1/2 x 1/2 = $39,000

Equipment is class 8 - 20%. Year 1 CCA is: $500,000 x 20% x 1/2 x 1/2 = $25,000
Linen is class 12 - 100% and the 1/2 rule for new acquisitions does not apply. However, it is necessary to pro-rate the CCA in year 1 for the short year (1/2 year). Year 1 CCA is: $90,000 x 100% x 1/2 year = $45,000

Note 3: Landscaping is a capital item but is specifically allowed as a full deduction in the year paid [s. 20(1)(aa)].

Note 4: Costs incurred to borrow money and issue shares or units are capital items but are specifically permitted as a deduction over 5 years at 1/5 per year [s.20(1)(e)].

Cost of arranging mortgage $70,000
Fees for selling equity units 350,000
Expense of issuing units 150,000

$570,000

Annual deduction (1/5) $114,000

Limited Partnership Structure

Under this structure, the losses for tax purposes are allocated to each limited partner and can be used to offset their other sources of income. This creates tax savings for each of the four periods as follows (assuming each investor is subject to a tax rate of 45%) Initial investment per unit holder:

\[
\frac{2,000,000}{200} = \$10,000
\]

Tax savings per unit holder:

<table>
<thead>
<tr>
<th>Year</th>
<th>Loss</th>
<th>Unit Holder</th>
<th>Tax saving @45%</th>
<th>Present Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$512,940</td>
<td>$2,565</td>
<td>$1,154</td>
<td>$1,154</td>
</tr>
<tr>
<td>2</td>
<td>307,090</td>
<td>1,535</td>
<td>691</td>
<td>615</td>
</tr>
<tr>
<td>3</td>
<td>153,210</td>
<td>766</td>
<td>345</td>
<td>276</td>
</tr>
<tr>
<td>4</td>
<td>88,594</td>
<td>443</td>
<td>199</td>
<td>141</td>
</tr>
<tr>
<td></td>
<td>$1,061,834</td>
<td>$5,309</td>
<td>$2,389</td>
<td>$2,186*</td>
</tr>
</tbody>
</table>

*Assumes a discount rate of 12% and the tax savings in year 1 occur immediately.

Therefore, the net cash cost of the investment of $10,000 under a limited partnership structure is $7,814 ($10,000 - $2,186).

Future profits allocated are subject to a tax rate of 45% for an individual investor.

If the anticipated earnings are not achieved and greater losses are incurred, the investor receives further write-offs for tax purposes up to a maximum of $10,000, or $4,500 (45%) of tax savings. Therefore, the maximum loss to the investor is $5,500 ($10,000 - tax savings of $4,500). The tax savings will occur as soon as the losses are incurred. [s.96(2.1)]
Corporate Structure

If a corporate structure is used, the annual losses in the first four years are locked into the corporation and can only be used as future profits, if any, occur. Therefore, the investor's cash cost of buying shares is actually $10,000 compared to $7,841 for a limited partnership unit.

Future profits of the venture are subject to the small business deduction on the first $500,000 of annual profits (or $2,500 per investor). When these profits are distributed, no double taxation occurs and the total tax for the corporation and the investor is 45%, the same as for the limited partnership. However, profits over $500,000 (over $2,500 per investor) are subject to a higher corporate tax rate (approximately 25% on the excess over $500,000) and consequently some double taxation occurs on distribution to the shareholders. The total tax on these earnings (corporation plus shareholder) is approximately 46% (on income taxed at 25%) compared to only 45% under the limited partnership structure.

If the venture is unsuccessful, the investor can only recognize a loss when the shares are sold or the company is legally bankrupt or fully insolvent. Such a loss would likely qualify as an allowable business investment loss \([s.39(1)(c)]\) and the maximum loss would be:

<table>
<thead>
<tr>
<th>Actual loss</th>
<th>$10,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax saving</td>
<td></td>
</tr>
<tr>
<td>45% (1/2) ($10,000)</td>
<td>(2,250)</td>
</tr>
<tr>
<td></td>
<td>$7,750</td>
</tr>
</tbody>
</table>

This can be compared to the maximum limited partnership loss of $5,500 (above) keeping in mind that the limited partnership tax savings from the loss will occur much sooner. Therefore, the spread between the two on a present value basis is even greater.

The above analysis indicates that the limited partnership structure will be more attractive to the investors.
CASE TWO

Realco*

Realco, a real estate developer, is proposing to obtain land and build a small mall that will house five stores. The five stores that lease the property will be responsible for all operating costs (maintenance, property taxes, utilities and repairs, and so on). The project will be constructed in 20X1 on behalf of a group of investors and will cost $700,000, as follows:

- Building $430,000
- Land 120,000
- Parking lot 40,000
- Interest during construction period 30,000
- Landscaping 20,000
- Mortgage finder’s fee 6,000
- Legal fees:
  - Land purchase 4,000
  - Mortgage documents 2,000
  - Investor offering 6,000
  - Appraisal fee for mortgage 4,000
  - Broker's fee for finding investors 38,000

$700,000

The maximum mortgage available on the proposed property is $450,000. The annual interest rate will be 11%. The only security required for the mortgage is the property itself. Realco has found 10 individuals who are each prepared to borrow $25,000 personally to invest. Its role in the project is now simply to develop the property on behalf of the investors. The ownership structure has yet to be determined. It is expected that the property will be rented beginning in January 20X2 for 10 years at $75,000 per year and that the property will be sold to the tenants at the end of the lease. The sale price will be based on the fair market value at that time. After the property is sold, the ownership structure will be liquidated, with all proceeds going to the investors.

Realco has asked you to prepare a report that analyzes alternative structures for holding the property and recommends the best from a tax perspective. The investors are interested in paying the minimum amount of tax over the life of the investment. Indicate in your report what the maximum tax write-off would be in 20X1 and 20X2, as well as the possible ramifications if one of the investors decides to dispose of his or her interest before the end of 10 years.

Required:

Prepare the report.

* Adapted, with permission, from the 1989 Uniform Final Examination © 1989 of the Canadian Institute of Chartered Accountants, Toronto, Canada. Any changes in the original material are the sole responsibility of the authors and have not been reviewed or endorsed by the CICA.
Solution to Case Two – Realco

Similar to the previous case, students must first determine the tax treatment of certain costs associated with the project and then determine their impact on alternative organization structures. In addition, each investor will borrow the full amount of funds required for his or her contribution to the venture and, therefore, incurs interest costs separate from the project. The rate of interest on these loans may vary for each investor but is assumed to be 11%, similar to the rate available on the mortgage.

It is important to recognize that Realco’s role in the project is only that of a developer. Presumably, Realco will profit from the sale of the raw land to the project, and from construction fees, but will not participate as an owner in the completed rental property.

The total project will cost $700,000 and will be financed as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1st mortgage (11%)</td>
<td>$450,000</td>
</tr>
<tr>
<td>Investor contributions</td>
<td></td>
</tr>
<tr>
<td>$25,000 x 10 investors</td>
<td></td>
</tr>
<tr>
<td></td>
<td>$700,000</td>
</tr>
</tbody>
</table>

The project will be completed by the end of 20X1. Part of the total costs of $700,000 includes interest during the construction period. It is assumed that this interest relates to a separate bridge financing loan during the construction period. Therefore, the mortgage funds and the investor contributions are assumed to be received by the project at the end of 20X1 resulting in no interest cost from those sources in 20X1.

There are three basic structures that can be used for the 10 investors:

- Separate corporation
- Partnership (standard or limited)
- Co-ownership

The tax impact for a standard partnership and a limited partnership are similar and are, therefore, reviewed together recognizing that the limited liability feature would be different. The issue of limited liability has less importance in this case because of the nature of the project. Normally, a rental property investment is less risky than an active business. Students should recognize this when comparing this issue to the other tax issues under each structure.

An important issue in the case is that the project is considered to be a rental property. Therefore, the available CCA is restricted to the net rental income with respect to the building. A similar restriction applies to the parking lot under the leasing property rules [Reg. 1100 (15)].

These restrictions may apply differently under each alternative depending on where the CCA must be applied (i.e., at the entity level or at the participant level). They also do not apply to a corporation whose principal business is the leasing of property [Reg. 1100(12)].

In reviewing each structure the following concerns should be addressed:

- what is the amount of deductions available and when will they occur?
- how will annual rental profits be taxed when earned and when distributed to investors?
- what are the tax implications at the end of 10 years when the property is sold and the
proceeds distributed to the investors?

- How may an investor dispose of his or her interest before the project is liquidated if the need arises?

### Review of the Development Costs

The development costs are reviewed below and then summarized for the first two years (20X1 and 20X2).

**Interest during construction period** - Although interest is normally deductible, s.18(3.1) denies the deduction of most expenses incurred during the period of construction. Therefore, the $30,000 is capitalized and added to the building cost for tax purposes (even though part of the interest may relate to the land).

**Landscaping** - This cost is also a capital item but is specifically permitted as a deduction [s.20(1)(aa)]. The restriction under section 18(3.1) above does not apply to landscaping (by exception) even though it relates to the construction period.

**Mortgage finder’s fee** - This also is a capital item but s.20(1)(e) specifically permits a deduction for costs incurred to obtain financing. The cost can be deducted at the rate of 1/5 per year over a five year period. This same rule also applies to the other costs associated with obtaining the mortgage:

- *Legal fees for mortgage documents*
- *Appraisal fee for mortgage*

**Legal fees (land purchase)** - This is a capital item and is added to the land cost. Therefore, no deduction occurs until the land is sold.

**Legal fees (investor offering)** - The cost incurred to issue shares, partnership units or syndicate units (co-ownership) can be deducted [s. 20(1)(e)] at 1/5 of the cost per year (the same as the financing costs). The same applies to the *broker’s fee* for finding the investors.

**Building** - The building qualifies as Class 1 with a CCA rate of 6% (assumed acquired after March 18, 2007 and placed in a separate class). The depreciable amount is $460,000 (building cost $430,000 + $30,000 interest during construction period).

**Parking lot** - This cost qualifies as a class 17 property with CCA at the rate of 8%.

The project deductions, excluding the CCA and the investor's individual interest costs, for 20X1 and 20X2 are as follows:
Co-ownership Structure

Under this structure, each investor will own directly a proportionate share of the property. As such, each investor owns 1/10 of the land and completed building. Each investor is entitled to claim all or a portion of the permitted CCA in any year separate from the other investors, which provides greater flexibility for each investor.

A single investor's position for 20X1 and 20X2 using this structure is as follows:

<table>
<thead>
<tr>
<th></th>
<th>20X1</th>
<th>20X2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of issuing debt or units:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mortgage finders fee</td>
<td>$ 6,000</td>
<td></td>
</tr>
<tr>
<td>Legal --mortgage documents</td>
<td>2,000</td>
<td></td>
</tr>
<tr>
<td>--investor offering</td>
<td>6,000</td>
<td></td>
</tr>
<tr>
<td>Appraisal fee</td>
<td>4,000</td>
<td></td>
</tr>
<tr>
<td>Broker--selling units</td>
<td>38,000</td>
<td></td>
</tr>
<tr>
<td>Deduction 1/5 of $56,000</td>
<td>11,200</td>
<td>11,200</td>
</tr>
<tr>
<td>Mortgage interest (11% of $450,000)</td>
<td>-</td>
<td>49,500</td>
</tr>
<tr>
<td></td>
<td>$21,200</td>
<td>$60,700</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Co-ownership Structure</th>
</tr>
</thead>
</table>

Notice that the net rental income (loss) before CCA includes the investor's interest on his or her loan of $25,000 used to fund the equity contribution. Consequently, the determination of net rental income for purposes of applying the CCA restriction on rental property (building) and leasing property (parking lot) is first reduced by the loan interest.

The co-ownership structure also provides the following:

- Taxable rental income in the future (after CCA) will be taxed at the investor's personal rates.
• After 10 years, when the property is sold, each investor will realize a recapture of CCA and a capital gain for tax purposes.

• If an investor decides to sell his or her 1/10 interest in the project, the property sold would be land, building, and parking lot. This would be attractive to a purchaser as the acquisition of this property would permit the new purchaser to claim CCA based on the acquisition price at the time. This would not occur if the new purchaser acquired shares in a corporation or a partnership interest.

**Partnership/Limited partnership structure**

Under this structure, each investor will acquire a partnership interest rather than directly owning land and building as in the co-ownership structure. Capital cost allowance must be claimed at the partnership level before an allocation is made to each partner. The amount of CCA is limited to the net rental income of the partnership. Each investor’s personal tax position in years 20X1 and 20X2 is as follows:

<table>
<thead>
<tr>
<th></th>
<th>20X1</th>
<th>20X2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rental income</td>
<td>$0</td>
<td>$75,000</td>
</tr>
<tr>
<td>Project deductions (above)</td>
<td>(21,200)</td>
<td>(60,700)</td>
</tr>
<tr>
<td>Partnership CCA:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Building 6% of $460,000</td>
<td>$27,600</td>
<td>0</td>
</tr>
<tr>
<td>Parking lot 8% of $40,000</td>
<td>3,200</td>
<td></td>
</tr>
<tr>
<td>Total (limited to $14,300)</td>
<td>$30,800</td>
<td>14,300</td>
</tr>
<tr>
<td>Investors share (1/10)</td>
<td>$(2,120)</td>
<td>$0</td>
</tr>
<tr>
<td>Loss for tax purposes</td>
<td>$(2,120)</td>
<td>$(2,750)</td>
</tr>
</tbody>
</table>

Notice that the 1/2 rule was not applied to the CCA in 20X2. It has been assumed that the construction was completed in 20X1 and CCA could have been applied in 20X1 but for the rental property restriction. As the one-half rule applies to the year of acquisition (20X1) it is not applied in 20X2.

Also, notice that under this structure, the CCA has been deducted at the partnership level before the allocation to investors. As a result, the investor can deduct, separately, the loan interest on the $25,000 equity contribution achieving greater tax deductions than was permitted under the co-ownership structure.

The partnership structure also provides the following:

• Future profits from rentals will be taxed at the investor’s personal rates because of the partnership allocation.

• When the property is sold by the partnership, a recapture and capital gain will occur. This income is allocated to the partners and treated accordingly.

• If the investor wishes to dispose of his or her interest before the project is sold, it will require a sale of the partnership interest. As mentioned previously, this may be less attractive to the potential purchaser because future CCA will remain unchanged.
Corporation structure

Holding the real estate in a corporation affects two important items. First of all, any losses within the corporation are locked into the corporation and remain as a carry-over for use against future rental profits. And second, because the corporation's only activity will be the rental project, its principal business is the leasing of property and consequently restrictions on CCA for rental properties and leasing properties do not apply [Reg. 1100(12) and information bulletin IT-371-paragraph 9]. This means that the corporation can claim CCA to create a loss from the rental activity, but because there is no other income, the loss remains as a carry-over subject to the ten year limit. Provided that taxable income will be achieved within ten years, which appears likely in this case, it would be prudent to claim CCA early and create a loss carry-over as this will result in faster deductions.

The "available-for-use" rules may deny the deduction of CCA in 20X1, depending on its completion date. The calculations below assume the property is available for use by the end of 20X1. Their application would not change the corporation's taxable income position for 20X1 and 20X2 but may affect the carry-over position. The corporation and each investor's position for 20X1 and 20X2 are as follows: [s.13(26)&(27)]

<table>
<thead>
<tr>
<th></th>
<th>20X1</th>
<th>20X2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rental income</td>
<td>$0</td>
<td>$75,000</td>
</tr>
<tr>
<td>Project deductions</td>
<td>$(21,200)</td>
<td>$(60,700)</td>
</tr>
<tr>
<td></td>
<td>$(21,200)</td>
<td>14,300</td>
</tr>
<tr>
<td>CCA - building (1/2 in 20X1)</td>
<td>(13,800)</td>
<td>(26,772)</td>
</tr>
<tr>
<td>- parking lot (1/2 in 20X1)</td>
<td>(1,600)</td>
<td>(3,072)</td>
</tr>
<tr>
<td>Corporation loss</td>
<td>$(36,600)</td>
<td>$(15,544)</td>
</tr>
<tr>
<td>Investors position:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dividends</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>Less interest on $25,000</td>
<td>0</td>
<td>$(2,750)</td>
</tr>
<tr>
<td>Loss for tax purposes</td>
<td>$0</td>
<td>$(2,750)</td>
</tr>
</tbody>
</table>

The corporate structure also provides the following:

- When rental profits occur, corporate taxes will be applicable at the high corporate rate (44 2/3%). However, on distribution, a tax refund equal to 26 2/3% of the rental income occurs and this together with the dividend tax credit for the individual investor will not create any significant double taxation (see Chapter 13).

- When the project is sold, the corporation will incur a recapture of CCA and a capital gain. While the corporation is taxable on this income, the refund mechanism, the dividend tax credit, and the tax-free capital dividend on the non-taxable portion of the capital gain, all serve to eliminate any significant double taxation when the corporation is wound up. The individuals will realize their investment from dividends.

- A departure from the project before the 10 year expected wind-up date would require a sale of shares. As indicated previously, this would be less attractive to a purchaser than purchasing a direct 1/10 interest in the land and building.
Conclusion

It is difficult to assess the best structure from a tax perspective without projecting the after-tax cash flows over the life of the project. The partnership/limited partnership structure provides the highest deductions for each investor in the first two years. However, if one excludes the consideration of the possibility of having to sell a proportionate interest before the expected liquidation date, the corporate structure appears to be preferable because:

- The corporation results in a faster deduction of CCA. Because CCA can be claimed in the early years, creating a loss carry-over, that carry-over can be used in full whenever rental profits are generated. For example, if in year 6, after the start-up costs are used up and interest expense has declined, there is a net rental income, the loss carry-over can be fully utilized. In the other structures, any unused CCA can only be deducted at the normal CCA rate of 6% on the building.

- In addition to the above, each investor can fully deduct the interest cost on his or her $25,000 loan.

Therefore, with the exception of the first year losses of $2,120 per investor, the corporation provides the deductions at the fastest rate. This combined with the fact that income earned by the corporation does not result in double taxation on distribution means that taxation under the corporate structure results in the maximum delay of tax. This must be weighed against the other factors--the preference of which may vary with each investor.
CHAPTER 17

TRUSTS

Review Questions

1. What is a trust, and how does it differ from a partnership and corporation?

2. Briefly explain the basic unique features of a trust?

3. What are the definitions of a testamentary trust and an inter vivos trust?

4. What are the differences between a personal trust and a commercial trust?

5. Explain when a trust is liable for tax in Canada.

6. What are the unique features for determining the taxable income of a trust?

7. “A trust is considered to be an individual for tax purposes and therefore its taxation year is the calendar year.” Is this statement true? Explain.

8. Compare the methods for calculating tax payable for testamentary trusts and inter vivos trusts.

9. A trust can deduct from taxable income amounts allocated to a beneficiary. Identify the unique features of this process and how the allocation may differ from allocation made by a partnership.

10. “Capital assets held by a trust are only subject to tax on a disposition that results from a sale or when they are distributed to beneficiaries.” Is this statement correct? Explain.

11. How does a spousal testamentary trust differ from a non-spousal testamentary trust?

12. What is an income trust? Briefly explain why they are used.
Solutions to Review Questions

R17-1. A trust is an arrangement whereby a person (the settlor) places property under the management of a trustee for the benefit of one or more persons (beneficiaries).

Unlike a corporation, a trust does not have the status of a legal person. The format of a trust is closer to that of a partnership in that its existence is created by the writing of a trust document or deed spelling out the obligations of the trust.

Unlike a partnership, a trust is a separate taxable entity.

R17-2. Unique features of a trust:

- Income earned by a trust can be taxed in the trust or all or some of the income can be allocated to beneficiaries and taxed as part of their income [S104(13)].

- The trust claims a deduction in computing net income for income allocated to beneficiaries [S.104(6)]. Thus, trust income is only taxed once.

- Income taxed in the trust forms part of the trust's capital and is not subject to further tax when it is eventually distributed to the beneficiaries [S.108(1)].

R17-3. An inter vivos trust is created during the settlor's lifetime whereas a testamentary trust is created on the settlor's death [S.108(1)].

R17-4. Personal trusts include both inter vivos and testamentary trusts whose beneficiaries did not purchase their trust interests. Commercial trusts generally refer to trusts whose beneficiaries purchase their trust interests or units.

R17-5. A trust is taxable in Canada if it is resident in Canada at any time during the year. The residency of a trust is determined by the resident status of the trustees who manage and control the trust property.

R17-6. Unique features for determining taxable income of a trust include the following:

- Income allocated to beneficiaries is deductible in determining the net income of the trust [S.104(6), (24)]. Income not allocated to beneficiaries is taxable to the trust, but thereafter can be distributed to the beneficiaries tax free.

- A trust can designate for tax purposes an amount that is actually payable to a beneficiary, not to have been payable. The designated amount is taxed in the trust [S.104(13.1),(13.2)].

- In some circumstances, a trust can allocate income for tax purposes even though it is not payable to the beneficiary. This may occur when trusts are created for minor children and income is accumulated on their behalf until they are 21 years of age or older. [S.104(18)].

R17-7. It is true that a trust is considered to be an individual and as such its taxation year is automatically the calendar year, December 31 [S.249(1)]. The taxation year for an inter vivos trust is always the calendar year. However, a testamentary trust may choose any taxation year end that ends within twelve months of the trust's inception [S.104(23)].
R17-8. To calculate tax, a testamentary trust uses the graduated tax scale applicable for individuals. An inter vivos trust must use the highest federal personal tax rate (29%) and the applicable province’s highest tax rate for all of its income [S.122(1)]. Neither trust can deduct personal tax credits.

R17-9. The trust can allocate income to beneficiaries thereby reducing the trust income [S.104(6)]. In making the allocation, the trust designates the type of income being allocated. The income designated by the trust can be net taxable capital gains (net of current year capital losses) [S.104(21),(21.3)], taxable Canadian dividends – (Eligible) or (Non-eligible) [S.104(19)], tax-free capital dividends [S.104(20)], foreign income and related foreign tax paid [S.104(22)], and other income. All other income allocated from the trust does not retain its character and is taxed in the beneficiary’s tax return as income from property [S.108(5)]. The beneficiary may claim the related dividend tax credit, foreign tax credit, and capital gains deduction if the taxable capital gain allocated qualifies [S.104(21.2)].

The trustee can allocated income types to beneficiaries in different proportions. For example, if attribution is a concern, the trustee may allocate more capital gains to a beneficiary who is under age 18 (since capital gains earned by minors are not subject to attribution). Other beneficiaries may then receive a greater proportion of other types of income.

R17-10. The statement is not correct. Inter vivos and testamentary trusts are deemed to have disposed of certain properties at fair market value on its 21st anniversary date and every 21 years thereafter [S.104(4),(5)]. The properties include:

- capital property [S.104(4)]
- depreciable property [S.104(5)]
- land that is inventory [S.104(4)]
- resource property [S.104(5.2)]

The trust is deemed to reacquire the properties at that market value, which becomes the new cost for tax purposes of the property for the trust. Property owned by a spousal trust is excluded from this 21-year deemed disposition rule.

A trust can often successfully avoid the deemed disposition rule by transferring the particular properties to the beneficiary prior to the 21-year anniversary date. Such transfers are normally deemed to be a disposition at the property’s cost amount [S.107(2)]. The beneficiary simply takes over the tax position of the property received from the trust. Once the property is in the hands of the beneficiary, the gain will be taxed when the property is sold by the beneficiary or upon his/her death.

R17-11. A trust is a spousal trust if the spouse of the settlor is entitled to receive all of the income of the trust and no person other than that spouse can use or receive the capital of the trust before the death of the spouse [S.70(6)&104(4)].

When the trust is a spousal trust, the following unique rules apply:

- When property is transferred to the trust, the settlor is deemed to have sold the property at its tax value [S.70(6)]. Therefore, the tax value of the property prior to its transfer is assumed by the trust.

- The 21-year deemed disposition requirement is waived for the first 21-year anniversary [S.104(4)]. Therefore in most situations, the property remains without tax until the death of the beneficiary spouse.
• Upon the death of the spouse who is the beneficiary, the spousal trust property is deemed to be sold at market value [S.104(4)].

R17-12. An income trust is used as a structure to operate a business. The primary incentives for using income trusts (prior to October 31, 2006) as an alternative to the corporate structure were:

• The trust income was not taxable because its income could be allocated to the unit holders (beneficiaries) and taxed as part of their income; and

• The allocation to unit holders retained its source and characteristic for tax preferred income like capital gains and dividends.

A corporation pays tax on its earnings and distributes after-tax income. An income trust that is an investment trust (used to operate an active business) created after October 31, 2006 pays a distributions tax on the amount of distributions to investors [ITA 122(1)(b), 122(1.01)]. The rate of tax is a combination of a federal rate plus an additional rate in lieu of provincial tax. The combined rate of tax is 25% (2012) (15% federal + 10% addition). This rate is similar to the combined federal and provincial general tax rate for corporations. The distribution does not retain the characteristics of its source in the trust. Instead, the trust distribution is deemed to be an eligible dividend. Investment trusts are referred to as “specified investment flow-throughs (SIFTs).

The new rules apply to income trusts (excluding REITs) in existence before October 31, 2006 starting in 2012.
Key Concept Questions

QUESTION ONE

In each of the following cases, an individual has established a trust.

1) Anita established a family trust to hold investments in shares of public corporations for the benefit of her children.

2) Bob established a trust for the benefit of his wife. His wife is entitled to receive all of the income from the trust and no one, other than his wife, can have the use or enjoyment of the assets held by the trust until after her death.

3) Carol’s will directed that on her death a trust be established to hold assets for her children until the youngest reaches age 25.

4) Dan died in the current year leaving substantial assets under the control of the executor of his estate.

Determine the type of trust that has been established in each case. *Income Tax Act reference: ITA 108(1).*

QUESTION TWO

During the current year an inter vivos trust received the following income:

<table>
<thead>
<tr>
<th>Income Type</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest</td>
<td>$30,000</td>
</tr>
<tr>
<td>Eligible dividends</td>
<td>20,000</td>
</tr>
<tr>
<td>Capital gains</td>
<td>12,000</td>
</tr>
</tbody>
</table>

One half of the income was paid to a beneficiary of the trust, Gail, a 22 year-old student, with no other source of income. The remainder of the income was retained by the trust. The trust designated the source of the income paid to the beneficiary as follows: interest $15,000, eligible dividends $10,000 and capital gains $6,000.

Determine the net income, taxable income and federal tax payable for both Gail and the trust. *Income Tax Act reference: ITA 104(2), (6), (19), (21); 122(1), (1.1).*

QUESTION THREE

During the current year a testamentary trust earned interest income of $45,000, all of which was paid to Bill, the sole beneficiary of the trust. Bill has other sources of income which total $300,000.

What can be done to reduce the overall tax liability? *Income Tax Act reference: ITA 104(13.1).*
QUESTION FOUR

During the current year, a trust had the following income (losses):

Capital gains $20,000
Capital losses (50,000)
Business loss (40,000)

$(70,000)

Beverley, the sole beneficiary of the trust has income from other sources that puts her in the top tax bracket. Determine the appropriate allocation of income from the trust. *Income Tax Act reference: ITA 104(21).*

QUESTION FIVE

A trust had the following results for the current year:

Capital gains $100,000
Capital losses 20,000

The trust has net capital losses of $35,000 incurred in 2006 available. Determine the maximum amount that can be allocated to a beneficiary. *Income Tax Act reference: ITA 104(21), (21.3).*

QUESTION SIX

Susan, age 14, is the sole beneficiary of a trust. The trust document indicates that the income earned by the trust is to be retained by the trust until Susan turns 18.

Does this mean that the income must be subject to tax in the trust until Susan turns 18? *Income Tax Act reference: ITA 104(18).*
Solutions to Key Concept Questions

KC 17-1

[ITA: 108(1) – Types of Trusts]

1) The family trust established by Anita is an inter vivos trust. It was established by Anita during her lifetime.
2) The trust established by Bob is an inter vivos trust. The trust appears to be a qualifying spousal trust and as such Bob can transfer assets to the trust on a tax-deferred basis [ITA 73(1)].
3) The trust established on Carol's death is a testamentary trust.
4) The trust established on Dan's death is a testamentary trust.

KC 17-2

[ITA: 104(2), (6), (19), (21); 122(1), (1.1) – Trusts – Liability for tax & Income Determination]

For tax purposes the trust is considered to be an individual [ITA 104(2)]. Therefore, the eligible dividends are subject to the 41% gross-up and the dividend tax credit.

Unlike an individual, a trust is permitted to deduct in computing net income, any income paid or payable to beneficiaries [ITA 104(6)].

<table>
<thead>
<tr>
<th>Amount Received</th>
<th>Allocated to Gail</th>
<th>Retained by Trust</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest</td>
<td>$30,000</td>
<td>$15,000</td>
</tr>
<tr>
<td>Eligible dividends</td>
<td>20,000</td>
<td>10,000</td>
</tr>
<tr>
<td>Capital gains</td>
<td>12,000</td>
<td>6,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$62,000</strong></td>
<td><strong>$31,000</strong></td>
</tr>
</tbody>
</table>

Net income and taxable income for the trust and for Gail is the same.

<table>
<thead>
<tr>
<th></th>
<th>Gail</th>
<th>Trust</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest</td>
<td>$15,000</td>
<td>$15,000</td>
</tr>
<tr>
<td>Eligible dividends ($10,000 x 141%)</td>
<td>14,100</td>
<td>14,100</td>
</tr>
<tr>
<td>Taxable capital gain</td>
<td>3,000</td>
<td>3,000</td>
</tr>
<tr>
<td><strong>Net Income</strong></td>
<td><strong>$32,100</strong></td>
<td><strong>$32,100</strong></td>
</tr>
<tr>
<td><strong>Taxable Income</strong></td>
<td><strong>$32,100</strong></td>
<td><strong>$32,100</strong></td>
</tr>
</tbody>
</table>

Since the trust is an inter vivos trust, the highest federal personal tax rate (29%) must be applied to all of its income. (Testamentary trusts use the same four federal tax brackets used by individuals.) Deductions for personal tax credits are not permitted to a trust [ITA 122(1.1)].
Federal tax calculation:

<table>
<thead>
<tr>
<th></th>
<th>Gail</th>
<th>Trust</th>
</tr>
</thead>
<tbody>
<tr>
<td>Federal tax @ 15% @ 29%</td>
<td>$4,815</td>
<td>$9,309</td>
</tr>
<tr>
<td>Basic personal tax credit $10,527 x 15%</td>
<td>(1,579)</td>
<td>NA</td>
</tr>
<tr>
<td>Dividend tax credit ($4,100 x 13/23)</td>
<td>(2,317)</td>
<td>(2,317)</td>
</tr>
<tr>
<td>Federal tax payable</td>
<td>$919</td>
<td>$6,992</td>
</tr>
</tbody>
</table>

**KC 17-3**

[ITA: 104(13.1) – Trusts – Amounts deemed not paid]

A trust can choose to designate an amount that is actually payable to a beneficiary, not to have been payable. The designated amount is then taxed in the trust rather than as part of the beneficiary’s income.

Bill’s $300,000 of other income puts him in the top tax bracket. Thus, income paid to him by the trust, if included on his tax return, will be subject to tax at the top tax bracket for individuals.

The graduated rates that apply to individuals, apply to testamentary trusts as well.

Thus, the trust should designate the $45,000 not to have been payable to Bill. The income will be taxed in the trust instead of in Bill's tax return. Significant tax savings will result.

**KC 17-4**

[ITA 104(21)]

Losses incurred in the trust cannot be allocated to beneficiaries. Where losses exceed income for the year, they remain with the trust and may be carried back or forward in accordance with the normal loss carry-over rules. The trust, in this case, has a net capital loss of $15,000 (($20,000 - $50,000) x ½) that can be carried back three years and forward indefinitely to be used against taxable capital gains earned in the trust. The trust has a non-capital loss of $40,000 that can be carried back three years and forward twenty years to be used against all sources of income earned in the trust.

**KC 17-5**

[ITA 104(21), (21.3) – Trusts – Net taxable capital gains]

A trust is permitted to designate, in respect of a beneficiary under the trust, a portion of its net taxable capital gains [ITA 104(21)]. The expression “net taxable capital gains” is defined in ITA 104(21.3) as the excess of the taxable capital gains for the year over the total of:

- Allowable capital losses for the year and
- Net capital losses deducted in the year.

In this case the trust’s net taxable capital gains balance is $5,000 and, thus, that is the maximum amount that can be designated.
Taxable capital gains ($100,000 x ½) $50,000
Allowable capital losses ($20,000 x ½) $(10,000)
Net capital losses deducted in the year (35,000) (45,000)

Net taxable capital gains balance $ 5,000

KC 17-6

[ITA: 104(18) – Trusts – Amounts Retained for Beneficiary Under Age 21]

Provided the eventual payment is not subject to any future condition, income that is retained by the trust for a beneficiary who is under age 21 at the end of the year can be deducted by the trust and taxed in the hands of the beneficiary. When these amounts are eventually distributed to Susan, they will be received by Susan on a tax free basis.
Problems

PROBLEM ONE

[ITA: 74.1(2); 104(4),(6),(14),(18),(19),(21); 107(2); 108(1), (5); 122(1); 249.1(1)]

Rhonda is divorced and lives with her 12-year-old daughter. Rhonda plans to settle a trust for her daughter and transfer $200,000 in cash to it, which will be invested for the benefit of her daughter. The terms of the trust are as follows:

1. The trust will invest the funds in Canadian marketable securities.

2. Income will accrue annually to the benefit of the daughter. However, no income will be distributed until the daughter reaches 21 years of age.

3. When the daughter reaches the age of 35 all of the trust’s capital will be distributed and the trust will cease. The trustee has developed a financial plan that includes certain mutual fund investments.

The anticipated annual return on the investment is 12%. Returns that are distributed by the mutual funds will be reinvested in the funds. It is expected that the 12% annual return will consist of the following:

<table>
<thead>
<tr>
<th>Component</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest</td>
<td>1%</td>
</tr>
<tr>
<td>Dividends</td>
<td>3%</td>
</tr>
<tr>
<td>Capital gains</td>
<td>4%</td>
</tr>
<tr>
<td>Total mutual fund allocations</td>
<td>8%</td>
</tr>
<tr>
<td>Capital growth</td>
<td>4%</td>
</tr>
<tr>
<td>Total annual return</td>
<td>12%</td>
</tr>
</tbody>
</table>

Required:

Explain the overall tax treatment of the trust during its existence and recommend any tax planning opportunities that are available to the trustee.
Solution to P 17-1

Since Rhonda is settling the trust during her lifetime, the trust is an inter vivos trust [S.108(1)]. Therefore, the trust will have a December 31 year end [S.249.1(1)] and the tax rate applicable to income taxed in the trust is the highest federal personal rate (29%) plus the applicable province’s top personal tax rate [S.122(1)].

Under the terms of the trust, the income earned by the trust cannot be distributed to the daughter until she turns age twenty-one. Trust income not paid out in a taxation year is generally considered not to be an amount payable to a beneficiary for calculating the taxable income of the trust [S.104(24)]. However, trust income will be considered payable to a beneficiary in a taxation year where [S.104(18)]:

- The beneficiary is less than 21 years of age at the end of the year;
- The beneficiary’s right to the income is vested by the end of the year and not because of the exercise or non-exercise of a discretionary power; and
- The beneficiary’s right is not subject to any future condition (other than a condition that the individual survive to an age not exceeding 40 years).

In this case the trust has been created for a 12-year old child and the income is accumulated on the child’s behalf until she turns twenty-one. Thus, the income earned by the trust is considered to be payable to a beneficiary annually and thus, deductible in computing the net income of the trust for tax purposes [S.104(6)].

The dividends and capital gains allocated will retain their source and character [S.104(19),(21)]. The interest will be considered other income from property [S.108(5)]. The daughter will be taxed at the graduated rates applicable to individuals and will be able to claim the dividend tax credit in addition to her personal tax credits.

The interest and dividend income allocated to the daughter will attribute to Rhonda and be included in her income and not the daughter’s income until the year the daughter turns 18 [S.74.1(2)]. However, income earned as a result of reinvesting past income is not subject to the attribution rules. Capital gains allocated will not attribute as capital gains earned by minors are never subject to attribution.

The trustees could elect to have the interest and dividend income taxed in the trust until the daughter turns 18 [S.104(13.1)]. The tax will still be calculated at the top marginal rate for individuals but will be paid by the trust instead of Rhonda.

The trust is to exist for 23 years, until the daughter reaches age 35, at which time the capital of the trust will be distributed to the daughter and the trust will cease. The trust will be deemed to have sold its mutual fund investments at fair market value on its 21\textsuperscript{st} anniversary date and is required to recognize the relevant gains or losses [S.104(4)]. The trust is then deemed to reacquire the investments at that fair market value, which becomes the new cost of the property for tax purposes for the trust [S.104(4)].

If the trustees could distribute the capital of the trust before the daughter turns 35, the trust may be able to avoid the deemed disposition at fair market value by transferring the investments to the daughter prior to the 21-year anniversary date. The trust would be deemed to dispose of the investments at the ACB and the daughter is deemed to acquire them at that same amount [S.107(2)]. In this way, gains on the mutual funds will not be recognized for tax purposes until the daughter sells them.
If the trust document has not been finalized Rhonda should consider changing it to give the trustees discretion to distribute capital to the daughter earlier.
PROBLEM TWO

[ITA: 70(5),(6); 104(4),(6),(13.1),(13.2); 107(2); 108(1); 122(1)]

Harvey’s last will and testament provides for bequests to his spouse, daughter and grandson. Upon his death, his wife is to receive $200,000 in cash. In addition, $800,000 of specific assets are to be held in trust on her behalf. This trust is required to pay his wife, during her lifetime, all of the annual income generated by the trust. Upon the death of his wife, the trust’s assets will be distributed equally to his daughter and grandson. The remaining assets in Harvey’s estate are to be divided into separate trusts for each of his daughter and grandson. Harvey has indicated that a particular real estate investment be shared 50% by the trust for his wife and 25% for each of the other trusts.

The trust for his daughter will require all income to be distributed annually until she reaches the age of 40 at which time the assets will be distributed to her. The trust for the grandchild will hold all of its income in trust until he reaches the age of 25. Thereafter, the grandson will receive the annual income and upon reaching the age of 40 will receive all of the assets owned by the trust.

Harvey died in 20X9 when his daughter was 35 years old and his grandson was 15. The following assets are transferred to the trusts.

<table>
<thead>
<tr>
<th>Property (Market Value)</th>
<th>Wife</th>
<th>Daughter</th>
<th>Grandson</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>$100,000</td>
<td>$50,000</td>
<td>$50,000</td>
</tr>
<tr>
<td>Building</td>
<td>400,000</td>
<td>200,000</td>
<td>200,000</td>
</tr>
<tr>
<td>Bonds</td>
<td>100,000</td>
<td>300,000</td>
<td>300,000</td>
</tr>
<tr>
<td>Stocks (public corporations)</td>
<td>200,000</td>
<td>200,000</td>
<td>200,000</td>
</tr>
<tr>
<td></td>
<td>$800,000</td>
<td>$750,000</td>
<td>$750,000</td>
</tr>
</tbody>
</table>

The land and building represents a single rental property that generates net cash rental income of $100,000. The property was purchased in 20X1 for $800,000 (land $150,000; building $650,000). The UCC of the building at the time of death was $500,000. Future rental income will be shared 50% by the trust for Harvey’s wife and 25% for each of the other two trusts. The bonds earn interest at the rate of 6% and the stocks generate dividends of 3%. The stock portfolio has a cost base of $600,000. Harvey’s spouse will have earned income of $30,000 from sources other than the trust. His daughter earns an annual salary of $100,000 and his grandson has no income.

Required:

1. What are the tax consequences to Harvey at the time of death relating to the assets described above?

2. What are the cost amounts for tax purposes of the assets received by each of the trusts?

3. Develop a plan for each trust for managing the trust income that will minimize the overall tax for the beneficiaries and the trusts. Show calculations where appropriate.

4. What are the tax consequences that will result when the trust assets are distributed to the beneficiaries? Assume the trust will own the same assets throughout.
**Solution to P 17-2**

**Part I**

Harvey will have taxable capital gains of $50,000 and recapture of $75,000 from the disposal of his assets on his death.

There is no income for tax purposes from the bequest of $200,000 cash to his wife.

The trusts settled on Harvey’s death are testamentary trusts [S.108(1)]. The trust settled for his spouse is a testamentary spousal trust [S.70(6)] since:

(a) his wife is to receive all of the income of the trust during her lifetime, and
(b) no person, except his wife, may before her death receive any of the income or the capital of the trust.

Harvey will be deemed to dispose of the assets left to the spousal trust at their respective tax values [S.70(6)]. He will be deemed to dispose of the assets left to the other trusts at their respective fair market values [S.70(5)].

**Assets transferred to spousal trust:**

<table>
<thead>
<tr>
<th></th>
<th>Land</th>
<th>Building</th>
<th>Bonds</th>
<th>Stocks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proceeds</td>
<td>$75,000</td>
<td>$325,000</td>
<td>$100,000</td>
<td>$200,000</td>
</tr>
<tr>
<td>ACB</td>
<td>75,000</td>
<td>325,000</td>
<td>100,000</td>
<td>200,000</td>
</tr>
<tr>
<td>Capital gain</td>
<td>Nil</td>
<td>Nil</td>
<td>Nil</td>
<td>Nil</td>
</tr>
<tr>
<td>Recapture – Building UCC x ½</td>
<td>$250,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Proceeds (equal to UCC)</td>
<td>(250,000)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Recapture</td>
<td>$Nil</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Assets transferred to the trust for the daughter and the trust for the grandson, combined:**

<table>
<thead>
<tr>
<th></th>
<th>Land</th>
<th>Building</th>
<th>Bonds</th>
<th>Stocks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proceeds</td>
<td>$100,000</td>
<td>$400,000</td>
<td>$600,000</td>
<td>$400,000</td>
</tr>
<tr>
<td>ACB</td>
<td>75,000</td>
<td>325,000</td>
<td>600,000</td>
<td>400,000</td>
</tr>
<tr>
<td>Capital gain</td>
<td>$25,000</td>
<td>$75,000</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>Taxable capital gain</td>
<td>$12,500</td>
<td>$37,500</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Recapture – Building UCC x ½</td>
<td>$250,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cost</td>
<td>(325,000)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Recapture</td>
<td>($75,000)</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Part 2

The trust acquires the assets at an amount equal to the proceeds to the deceased, Harvey [S.70(6)]. Cost amounts for tax purposes of each of the assets received by each of the trusts:

<table>
<thead>
<tr>
<th></th>
<th>Spousal Trust</th>
<th>Trust for Daughter</th>
<th>Trust for Grandson</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>$ 75,000</td>
<td>$ 50,000</td>
<td>$ 50,000</td>
</tr>
<tr>
<td>Building</td>
<td>250,000</td>
<td>200,000</td>
<td>200,000</td>
</tr>
<tr>
<td>Bonds</td>
<td>100,000</td>
<td>300,000</td>
<td>300,000</td>
</tr>
<tr>
<td>Stocks</td>
<td>200,000</td>
<td>200,000</td>
<td>200,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$625,000</strong></td>
<td><strong>$750,000</strong></td>
<td><strong>$750,000</strong></td>
</tr>
</tbody>
</table>

Part 3

Spousal trust:

Annual income:
- Net cash rental income ($100,000 x 50%) $50,000
- CCA ($250,000 x 4%) (10,000)
- Net rental income 40,000
- Bond interest ($100,000 x 6%) 6,000
- Dividends ($200,000 x 3% x 141%) 8,460
  
  Income payable to a beneficiary (spouse) [S.104(6)] (54,460)

Trust net income for tax purposes $ Nil

Harvey’s spouse will have income of $30,000 from sources other than the trust. Thus, she will have income of $84,460 subject to tax annually. To minimize the tax paid by the trust and the spouse, combined, the trust should designate for tax purposes $42,230 of the income payable to the spouse, not to have been payable [S.104(13.1),(13.2)]. The designated amount will be taxed in the trust using the graduated tax scale applicable for individuals since the trust is a testamentary trust [S.122(1)]. In this way the trust and the spouse will each have $42,230 of income subject to tax at the graduated rates, annually. The dividend income allocated to the spouse retains its source and character. Thus, the spouse is entitled to the related dividend tax credit. The income subject to tax in the trust becomes part of the trust’s residual capital and can subsequently be distributed tax free.

Trust for 35-year old daughter:

Annual income:
- Net cash rental income ($100,000 x 25%) $25,000
- CCA ($200,000 x 4%) (8,000)
- Net rental income 17,000
- Bond interest ($300,000 x 6%) 18,000
- Dividends ($200,000 x 3% x 141%) 8,460
  
  Income payable to a beneficiary (daughter) [S.104(6)] (43,460)

Trust net income for tax purposes $ Nil
The trust requires all income to be distributed annually. Since the daughter earns an annual salary of $100,000 in addition to the trust income, the tax paid by the trust and daughter, combined, will be minimized if the trust designates for tax purposes the $43,460 of income payable to the daughter, not to have been payable [S.104(13.2),(13.2)]. The income will be taxed in the trust using the graduated tax scale applicable for individuals.

Trust for 15-year old grandson:

The trust for the grandson will earn $43,460 of income for tax purposes annually, the same as the trust for the daughter. The trust requires that all of the income be held in the trust until the grandson reaches the age of 25. Thereafter, the grandson will receive the annual income and upon reaching the age of 40 will receive all of the assets owned by the trust. Since the trust was created for a minor child and the income is accumulating on the child’s behalf until the child turns 25, the income earned by the trust is deemed for tax purposes [S.104(18)] to be payable to a beneficiary annually and thus, deductible in computing the net income of the trust [S.104(6)].

The income will be taxed in the grandson’s tax return using the graduated rates applicable to individuals and will be reduced by the personal tax credits. The dividend income allocated by the trust will retain its character and, thus, the grandson is entitled to the related dividend tax credit.

Since the settler of the trust is deceased, attribution of income is not applicable.

It would also be advantageous to take advantage of the fact that a testamentary trust is subject to graduated rates, for the trust to elect under S.104(13.1) and (13.2) to deem as not payable to the grandson some of the income deemed by S.104(18) to be payable to the grandson. Reducing the grandson’s income down to $41,544 [2011 rates] by the trust deeming $1,916 not to be payable to the grandson and instead taxable in the trust, will cause this amount, otherwise taxable at a federal rate of 22% in the hands of the grandson to be taxable at a federal rate of 15% in the hands of the trust, thus saving $134 (i.e. 7% of $1,916).

Part 4

Distribution of trust assets to beneficiaries:

When the trust property is transferred from the daughter’s trust to the daughter, the property is deemed to be sold by the trust at its cost amount and the daughter assumes the tax position formerly held by the trust [S.107(2)]. The cost amounts for the trust assets are as follows:

- Land (ACB) $50,000
- Building (UCC) $200,000 – CCA claimed by the trust
- Bonds (ACB) $300,000
- Stocks (ACB) $200,000

The daughter will have a capital cost for the building of $200,000. Therefore, on a subsequent sale of the building by the daughter potential recapture of CCA can occur.

The same tax consequences will occur when the trust property is transferred from the grandson’s trust to the grandson.

Special rules apply for the spousal trust. The distribution of the trust assets occurs on the death of the spouse. The spousal trust property is deemed to be sold at market value [S.104(4)]. Capital gains will occur to the extent the value of the assets exceeds the ACB of the assets at the time of Harvey’s death. Recapture will occur to the extent the cost of the building exceeds its UCC.
PROBLEM THREE

K Inc. is a Canadian corporation whose shares are traded on a stock exchange. K operates three divisions within its corporate structure. Two of the divisions are in the technology field and are in the early stages of their growth cycles. They are both profitable with strong research and development capabilities. The third division is older and very mature. Its products are widely accepted and profitable. Its income and cash flow are very stable and predictable. K’s management feels that its share value is not fully exploited because the divisions have diverse characteristics. Consequently raising capital for new development in younger divisions is costly.

To alleviate this problem K is considering selling off the third division as a separate entity. They feel this can be achieved by setting up a separate corporation to house the division. The separate corporation would issue shares to the public and the funds used to acquire the division from K Inc. Management has also been looking at the use of an income trust as an alternative to the corporate format.

K has requested your advice on this matter.

Required:

1. Explain to K how each of the structures work with respect to profits, tax, and distribution to investors. Demonstrate with calculations where possible.

2. Is an income trust appropriate in this situation? Explain.

3. Would your answer to (2) above be different if the third division was a group of real estate rental properties?
Solution to P 17-3

Part 1

A corporation pays tax on its earnings and distributes after-tax income. An income trust that is an investment trust (used to operate an active business) created after October 31, 2006 pays a distributions tax on the amount of distributions to investors [ITA 122(1)(b), 122(1.01)]. The rate of tax is a combination of a federal rate plus an additional rate in lieu of provincial tax. The combined rate of tax is 25% (2012) (15% federal + 10% addition). This rate is similar to the combined federal and provincial general tax rate for corporations. The distribution does not retain its characteristics of its source in the trust. Instead, the trust distribution is deemed to be an eligible dividend. Investment trusts are referred to as “specified investment flow-throughs (SIFTs).

The following example demonstrates the tax treatment of $100,000 of business income earned by an income trust and a public corporation.

<table>
<thead>
<tr>
<th></th>
<th>Income Trust</th>
<th>Public Corporation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business income</td>
<td>$100,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Deduct</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Distribution tax (25%)</td>
<td>(25,000)</td>
<td>N/A</td>
</tr>
<tr>
<td>Corporate tax (25%)</td>
<td>N/A</td>
<td>(25,000)</td>
</tr>
<tr>
<td>Net after-tax</td>
<td>$ 75,000</td>
<td>$ 75,000</td>
</tr>
</tbody>
</table>

Investors:

<table>
<thead>
<tr>
<th></th>
<th>$75,000</th>
<th>$75,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total distribution to investors</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tax status to investors</td>
<td>Eligible dividends</td>
<td>Eligible dividends</td>
</tr>
<tr>
<td>Tax paid by individual in the top marginal tax bracket (28%)</td>
<td>$21,000</td>
<td>$21,000</td>
</tr>
<tr>
<td>Net cash to investor</td>
<td>$54,000</td>
<td>$54,000</td>
</tr>
</tbody>
</table>

Part 2

Because of the distributions tax, there is no longer a benefit to be achieved by carrying on business through an income trust as opposed to a corporation.

Part 3

An income trust would be appropriate if the division was a group of real estate rental properties. A real estate investment trust (REIT) is not a SIFT and thus is not subject to tax on its distributions. The trust income is not taxable in the trust if the income is allocated to the unit holders and taxed as part of their income. Thus, there is no double taxation. The income allocated to the unit holders retains its source and characteristics for tax preferred income like capital gains and dividends.

In order to achieve the elimination of tax to the trust, all, or substantially all, of its income must be allocated. This provides an incentive to distribute the earnings rather than retain them for expansion. An income trust is appropriate in this situation since the income and cash flow should be stable and predictable.
CHAPTER 18

BUSINESS ACQUISITIONS AND DIVESTITURES—ASSETS VERSUS SHARES

Review Questions

1. “The sale of business assets by a vendor corporation normally results in two levels of tax, rather than a single level of tax, as is the case when the shares of the business corporation are sold.” Explain this statement.

2. In general terms, what types of gains or losses may occur for tax purposes when specific business assets are sold?

3. If a business is to be sold on terms that require deferred payments, why may the timing of the related tax cost to the vendor be different if the specific business assets, rather than the shares of the business corporation, are sold?

4. If a group of business assets is sold with specific values attached to each item, what difference, if any, does it make whether the terms of payment (that is, the amount of cash and deferred payments) are expressed separately for each asset sold or as a total for the group of assets sold?

5. When a corporation sells its business by disposing of its business assets, the amount of tax to the corporation resulting from the sale can be determined with relative certainty. Does the same degree of certainty exist with respect to determining the second level of tax when the proceeds of the asset sale are distributed to the shareholder? Explain.

6. The after-tax cash flow from the earnings of the acquired business may be different for the purchasers if they acquire the shares of the vendor corporation, rather than its specific assets. Explain why.

7. Why is it important for the purchaser to establish an accurate value for each individual asset acquired when a group of business assets is being purchased for an agreed-upon total price?

8. “When a purchaser acquires the shares of a vendor corporation, it may be assuming a potential tax liability of the vendor corporation.” What is meant by this statement? To the extent that such a potential liability exists, what impact may this have on the purchase price, and how can it be measured?

9. To what extent, if any, should the vendor to be concerned about the tax status of the purchaser when contemplating the sale of a business?

10. Why is it important for the purchaser of a business to anticipate the post-acquisition organization structure before making the acquisition?
11. When a business can be sold under either an asset sale or a share sale, why is it important that both the vendor and the purchaser attempt to determine the vendor’s tax cost from the sale under a worst-case scenario?

12. What is the worst-case scenario when an individual who owns the shares of a business corporation is considering the sale of that business? How is that individual’s tax position affected if the business for sale is held within a corporation that is a subsidiary of a large public corporation?

13. What are the three major tax issues that a purchaser must examine when deciding whether to acquire the assets or the shares of a business?
Solutions to Review Questions

R18-1. When a vendor corporation sells its specific business assets (land, buildings, equipment, goodwill and so on) the corporation will incur a tax liability on gains arising from the asset sales. While this leaves after-tax proceeds in the corporation for possible investment, those proceeds must ultimately flow to the shareholder at which time a second level of tax will occur. Even if dividend distributions are not made, the shareholder may incur a second level of tax when the shares are sold or deemed to be sold on death.

If the shares of the business corporation are sold, the corporation does not incur a tax liability because it retains ownership of all of the business assets. Only the shareholder may incur a tax liability resulting from the gain on the share sale. Therefore, the amount and timing of tax to the vendor is different under each alternative.

R18-2. In general terms, the sale of business assets will consist of inventory, depreciable property, capital property, and eligible capital property. As a result, the sale of a group of business assets will normally produce the following types of income/loss:

- Inventory - business income/loss
- Depreciable property - recapture of capital cost allowance/terminal loss (business income) and perhaps taxable capital gains (no capital losses on depreciable prop)
- Capital property - capital gains/losses
- Eligible capital property - business income/loss

R18-3. If the shares of the corporation are sold, the entire gain would be a capital gain to the vendor. As a result, the full amount would be eligible for the application of the capital gains reserve provisions which permits (within limits) the gain to be recognized for tax purposes over a period of years in relation to the receipt of the deferred proceeds. However, if the corporation sells specific assets it will incur several types of gains depending on the nature of the property sold (recapture of CCA, capital gains, and eligible capital property gains). The capital gains reserve provisions would therefore apply only to the capital gain portion of the income created. Keep in mind that eligible capital property gains cannot be recognized in relation to the payment terms (see Chapter 6). Therefore, under an asset sale, the recapture of CCA and eligible capital property gains cannot be deferred even if the terms of payment are deferred. The timing of the tax liability will vary between an asset sale and a share sale.

R18-4. If the deferred payment terms are expressed in the agreement as a portion of the total price (i.e., the combined price of several assets), the amount of the deferred portion is allocated proportionately to each of the assets in the group. Consequently, some of the deferred payments would be allocated to assets that will create income that is not eligible for a reserve (e.g., depreciable equipment creates a recapture of CCA) and a lesser amount of the deferred proceeds applies to the assets that are eligible for the reserve. If the agreement defines the terms of payment separately for each asset in the group, the maximum deferred proceeds can be allocated to those assets which qualify for deferred recognition of income such as capital gains.

R18-5. When corporate assets are sold, the amount and timing of the resulting tax to the corporation can be determined with relative certainty because the selling price, cost amounts, and payment terms are known for each asset sold. However, the timing of the second level of tax
on the distribution of the corporation’s after-tax proceeds to the shareholder are discretionary. In other words, after the sale, the corporation can retain its proceeds for reinvestment, distribute all of the proceeds immediately, or distribute the proceeds over a period of time. A delay in the distribution means that the tax rates that may apply at some future time are uncertain and therefore an accurate assessment of the decision to delay the distribution is more difficult.

R18-6. When a purchaser acquires a business, it obtains ownership of a group of assets as well as the right to carry on the acquired business to generate profits. The amount of pre-tax profits acquired will be similar regardless of whether assets or shares of the acquired business are purchased. However, when assets are purchased, the amount of deductions from capital cost allowance and eligible capital property write-offs are based upon the fair market value of each asset purchased. On the other hand, when shares are acquired, the specific assets housed within the acquired corporation remain at their undepreciated value at the time of the sale. Therefore, the amount of deductions for tax purposes will be different under each method.

R18-7. A major factor in deciding on the acquisition of a business is the amount of after-tax cash flows that are expected after acquisition. Therefore, the amount of CCA and eligible capital property deductions for tax purposes that will be available is of paramount importance in projecting that cash flow. When a single purchase price is specified for the entire group of assets acquired, the purchaser must know how the total price will be allocated to each asset in order to determine the expected tax costs on future profits. As CRA has the power to allocate the unspecified value of each asset in accordance with its apparent fair market value, consideration of this issue by the purchaser before the purchase provides a greater degree of certainty with respect to anticipated after-tax cash flows.

R18-8. When shares of a business corporation are acquired, the asset base within the acquired corporation is not disturbed. Consequently, the cost base and undepreciated capital cost of the assets within the company remain unchanged. In effect, the purchaser, through the share acquisition, takes over the tax position of the vendor corporation. If the acquired corporation should subsequently sell some of its assets at values greater than their cost amounts, the corporation will incur a tax liability. Because of this inherited potential tax liability, the purchaser may attempt to discount the price of the shares as compensation. It is difficult to measure what the discount should be because it is not certain if or when the potential tax liability may occur. The final discount achieved, if any, is therefore a function of the negotiation process.

R18-9. The purchaser’s willingness to purchase and the price that they are prepared to pay is dependent largely upon the expected after-tax profits after acquisition. The tax status of the purchaser may result in the acquired profits being subject to a different tax cost than that applied to the vendor. For example, the vendor may be entitled to use the small business deduction whereas the purchaser may not because of its other sources of income. This will affect the price the purchaser is willing to pay. As different purchasers may each have a different tax status, the vendor may achieve the highest price from the one which will incur the lowest tax cost on future profits. The vendor must therefore attempt to anticipate a proposed purchaser’s tax position.

R18-10. It is important to recognize that the post-acquisition structure for the purchaser is not static. For example, if a corporate purchaser acquires the shares of a vendor corporation it will, immediately after the purchase, have a parent-subsidiary structure where the operations of each are separated. However, after the acquisition the two corporations could be
amalgamated, combining their operations. This may or may not present tax advantages for the purchaser. For example, combining manufacturing activities with other types of income may expand the M & P profits for tax purpose as a result of the arbitrary formula, thereby decreasing the provincial tax in provinces with M&P tax incentives. Knowing that this advantage will occur will assist the purchaser in establishing the expected cash flows from the purchase and the maximum purchase price that it is willing to pay in exchange for those cash flows.

R18-11. Once a business has been targeted for acquisition, it is important to establish the worst case scenario for the vendor. Both the vendor and the purchaser are interested in this analysis. For example, if the worst case scenario for a vendor is an asset sale and the net after-tax proceeds from this type of sale are known, the vendor can then establish a price for the sale of shares which would provide the same after-tax proceeds. This information is critical to vendors because it permits them to establish a minimum share price that equates, on an after-tax basis, to an asset price. Presumably a vendor would not accept a share price that is below this minimum.

At the same time, if a purchaser knows the tax position of the vendor and what share price equates to an asset price in a worst case scenario, they have a starting point from which to begin their negotiations.

R18-12. Normally, when an individual who owns the shares of a business corporation is considering the sale of the business, the worst-case scenario is an asset sale whereby the vendor corporation pays tax on the sale of the individual assets, and then immediately winds-up the corporation by distributing the after-tax proceeds, resulting in a second level of tax to the shareholder. In this case, because the corporation is closely held, the full impact on the corporation and the shareholder must be considered.

When the business for sale is held in a subsidiary of a public corporation, the distribution of after-tax proceeds from the subsidiary's sale of assets does not create a second level of tax as inter-corporate dividends to the parent corporation are tax free. It would be unrealistic to examine the tax impact on the shareholders of the public parent corporation as the sale would not likely alter its normal dividend policy.

R18-13. When contemplating a business acquisition, the purchaser should examine the following issues:

- The rate of tax that will apply, after acquisition, on expected profits.
- The amount of cash flow to be generated from tax savings on deductions of CCA and eligible capital property write-offs.
- Where the purchase is a share acquisition, assess the likelihood of incurring additional tax liabilities if the acquired corporation should subsequently dispose of any of the assets it holds.
Problems

PROBLEM ONE

Carl owns 100% of the common shares of Extra Ltd., a Canadian-controlled private corporation operating a wholesale business in eastern Canada. Extra’s fiscal year end is May 31, 20X8. It is now April 15, 20X8, and Carl has just signed a letter of intent to sell the wholesale business to Q Ltd.

The initial discussions involved the sale of specific assets of Extra, but a sale of the shares of the company may also be considered. Carl has requested your assistance in estimating the tax liability to Extra if the business assets are sold. Information relating to the sale and to the current year’s operating income is provided below.

1. The balance sheet of Extra at May 31, 20X8, is estimated as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts receivable</td>
<td>$120,000</td>
</tr>
<tr>
<td>Inventory, at cost</td>
<td>400,000</td>
</tr>
<tr>
<td>Land, at cost</td>
<td>30,000</td>
</tr>
<tr>
<td>Building, at book value</td>
<td>280,000</td>
</tr>
<tr>
<td>Equipment, at book value</td>
<td>170,000</td>
</tr>
<tr>
<td>Licence, at book value</td>
<td>40,000</td>
</tr>
<tr>
<td><strong>Total Assets</strong></td>
<td><strong>1,040,000</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liabilities</td>
<td>$600,000</td>
</tr>
<tr>
<td>Share capital</td>
<td>1,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>439,000</td>
</tr>
<tr>
<td><strong>Total Liabilities</strong></td>
<td><strong>1,040,000</strong></td>
</tr>
</tbody>
</table>

2. Net income before income tax and net gains from the sale of assets for the year ended May 31, 20X8, is estimated as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income from wholesale operations</td>
<td>$490,000</td>
</tr>
<tr>
<td>Dividend income</td>
<td>1,000</td>
</tr>
<tr>
<td><strong>Net income before tax</strong></td>
<td><strong>491,000</strong></td>
</tr>
</tbody>
</table>

The following additional information relates to the net income:

- The dividend income is from a Canadian public corporation, the shares of which were sold during the year for proceeds equal to their original cost.
- Expenses deducted from revenues included the following items:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Legal fees for collection of bad debts</td>
<td>$2,000</td>
</tr>
<tr>
<td>Donations to registered charities</td>
<td>3,000</td>
</tr>
<tr>
<td>Meals and beverages to entertain customers</td>
<td>4,000</td>
</tr>
<tr>
<td>Dividend paid to Carl on March 31, 20X8</td>
<td>20,000</td>
</tr>
<tr>
<td>Replacing a broken window in the building</td>
<td>2,400</td>
</tr>
</tbody>
</table>
3. The 20X7 income tax return indicates the following tax account balances:

- RDTOH: NIL
- Capital dividend account: NIL
- Cumulative eligible capital: NIL
- GRIP: NIL
- Undepreciated capital cost:
  - Class 1: 290,000
  - Class 8: 140,000
  - Class 14: 42,000

4. The letter of intent regarding the sale of the business indicates that the closing date will be May 31, 20X8. The letter included the following list of assets to be sold, together with each asset’s estimated market value. For information, the original cost of each asset is provided.

<table>
<thead>
<tr>
<th></th>
<th>Market value</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts receivable</td>
<td>$120,000</td>
<td>$120,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>410,000</td>
<td>400,000</td>
</tr>
<tr>
<td>Land</td>
<td>40,000</td>
<td>30,000</td>
</tr>
<tr>
<td>Building</td>
<td>400,000</td>
<td>320,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>90,000</td>
<td>200,000</td>
</tr>
<tr>
<td>Licence</td>
<td>45,000</td>
<td>50,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>100,000</td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$1,205,000</strong></td>
<td><strong>$1,120,000</strong></td>
</tr>
</tbody>
</table>

Payment for the above assets would consist of cash plus the assumption of Extra’s liabilities.

5. You have suggested to Carl that he consider selling the common shares of Extra, rather than the specific assets. You have estimated the market value of the shares to be $600,000. The shares were acquired in 20X1 for a cost of $100,000. In previous years, Carl had used the capital gains deduction to exempt $120,000 of gains from tax. His cumulative net investment loss (CNIL) at the end of 20X8 is estimated to be $40,000.

Required:

1. Under Part I of the Income Tax Act, determine the minimum income for tax purposes and the minimum taxable income for Extra for the 20X8 taxation year, assuming that all assets are sold.
2. Based on your answer to Requirement 1, calculate the minimum Part I and Part IV federal income tax for the 20X8 taxation year. Your answer should include a calculation of the RDTOH and dividend refund, if any.
3. If an agreement is made to sell the assets of Extra, would you recommend the planned closing date of May 31, 20X8, or a delay of one day to June 1, 20X8? Explain.
4. Briefly outline what the purchaser should consider when choosing between the purchase of assets and the purchase of shares.
5. If Carl decides to sell the shares of Extra, what amount will be added to his net income for tax purposes in his 20X8 taxation year?
Solution to P 18-1

Part 1

Net income and Taxable income:
Income per financial statement $491,000
Dividend paid to shareholder 20,000
Charitable donation 3,000
Meals and beverages (50% x $4,000) 2,000
Political contributions 1,000
Sale of inventory ($410,000 - $400,000) 10,000
Taxable capital gains:
  Land ½($40,000 - $30,000) 5,000
  Building ½($400,000 - $320,000) 40,000
Recapture of CCA:
  Building - class 1 - ($320,000 - $290,000) 30,000
  Licence - class 14 - ($45,000 - $42,000) 3,000
Terminal loss:
  Equipment - class 8 - ($90,000 - $140,000) (50,000)
Sale of goodwill – (2/3)(3/4)($100,000 - 0) 50,000
  (assume no amount previously deducted from CEC)

Net income for tax purposes 604,000

Deduct:
  Dividends (1,000)
  Charitable donations (3,000)

Taxable income $600,000

Part 2

Federal Part I tax (2012):
Basic rate - 38% x $600,000 $228,000
Abatement - 10% x $600,000 (60,000)

168,000

Small business deduction - 17% x lesser of:
  Active business income $558,000**
  Taxable income $600,000
  Annual limit $500,000 x 17% (85,000)

**Active business income:
Net income for tax purposes $604,000
Less:
  Taxable capital gains (5,000 + 40,000) (45,000)
  Dividends (1,000)

$558,000
General rate reduction – 13% of amount by which
Taxable income ($600,000) exceeds total of:
    income subject to M&P deduction (0) +
    income subject to SBD ($500,000) +
    investment income ($45,000).
13% ($600,000 – $545,000) (7,150)

Additional refundable tax on investment income -
    6 2/3% x lesser of:
    Aggregate investment income ($5,000 + $40,000) $45,000
    Taxable income less amount on which
    SBD is computed ($600,000 - $500,000) $100,000
6 2/3% x $45,000 3,000

Part IV tax:
    Public corporation dividends – 1,000 x 1/3 $333

RDTOH:
    Opening $ 0
    Part IV tax 333
Refundable portion of Part I tax - lesser of:
    (i) 26 2/3%($45,000 aggregate investment income) $12,000
    (ii) 26 2/3%($600,000 - $500,000) taxable income
         less amount on which SBD is computed $26,667
    (iii) Part I tax (above) $78,850 12,000

Part 3

Extra's 20X8 active business income of $559,000 is $59,000 above the small business deduction
limit. Consequently, a higher corporate tax rate will be applied to some of the income created on the
sale of assets. If the business was sold on June 1, 20X8, the first day of the next taxation year, a
new $500,000 small business deduction limit would be available for any business income created on
the sale of assets (e.g. recapture of CCA and income from the sale of goodwill). The recommended
closing date would be June 1, 20X8. In addition a delay in the payment of tax would also result.

Part 4

The purchaser should consider the following when choosing the method of purchase:

- The amount of capital cost allowance that will be available after acquisition. When assets are
  purchased, the price in excess of book value is allocated to each asset and future CCA is based
  on the new cost (market value at time of sale). When shares are purchased the assets in the
  corporation retain their original tax status and CCA will continue as in the past.

- If an asset sale is to take place the purchaser should consider the allocation of the total
  purchase to the various assets with a view to increasing future CCA as much as possible.
• Under a share sale, the purchaser should anticipate the potential tax liability if some or all of the acquired corporation’s assets are subsequently disposed of and the likelihood of this happening.

Part 5

The asset composition of Extra Ltd. indicates that it is a qualified small business corporation (QSBC). Therefore Carl will be entitled to a capital gains deduction. The amount available is $630,000 ($750,000 - $120,000 used in past years). The increase to his net income for tax purposes would be $Nil calculated as follows:

<table>
<thead>
<tr>
<th>Proceeds</th>
<th>$600,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>ACB</td>
<td>(100,000)</td>
</tr>
</tbody>
</table>

Capital gain $500,000

Taxable capital gain - \(\frac{1}{2}(500,000)\) $250,000

Capital gains deduction available:

\[
\frac{1}{2} \text{of } 630,000 = 315,000
\]

Less CNIL (40,000) $275,000

Increase in net income for tax purposes $Nil
PROBLEM TWO

Subpump Limited is an active business corporation owned 50% by Simpson and 50% by Clowes. The owners have been attempting to sell the company for several years and have recently received an offer from a serious buyer.

As of December 31, 20X1, the company’s financial position was as follows:

<table>
<thead>
<tr>
<th>Assets</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts receivable</td>
<td>$200,000</td>
</tr>
<tr>
<td>Inventory (at cost)</td>
<td>70,000</td>
</tr>
<tr>
<td>Land</td>
<td>100,000</td>
</tr>
<tr>
<td>Building (at cost)</td>
<td>$150,000</td>
</tr>
<tr>
<td>Accumulated capital cost allowance</td>
<td>(60,000)</td>
</tr>
<tr>
<td>Equipment (at undepreciated capital cost)</td>
<td>40,000</td>
</tr>
<tr>
<td>Goodwill (at cost)</td>
<td>30,000</td>
</tr>
<tr>
<td><strong>Total Assets</strong></td>
<td><strong>$530,000</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities and Shareholders’ Equity</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Current liabilities</td>
<td>$250,000</td>
</tr>
<tr>
<td>Shareholders’ equity:</td>
<td></td>
</tr>
<tr>
<td>Common shares</td>
<td>$1,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>279,000</td>
</tr>
<tr>
<td><strong>Total Shareholders’ equity</strong></td>
<td><strong>280,000</strong></td>
</tr>
<tr>
<td><strong>Total Liabilities and Shareholders’ Equity</strong></td>
<td><strong>$530,000</strong></td>
</tr>
</tbody>
</table>

Additional information

1. Relevant asset values are as follows:

<table>
<thead>
<tr>
<th>Fair market value</th>
<th>Cumulative eligible capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory</td>
<td>$75,000</td>
</tr>
<tr>
<td>Land</td>
<td>120,000</td>
</tr>
<tr>
<td>Building</td>
<td>170,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>35,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>50,000</td>
</tr>
</tbody>
</table>

2. On December 31, 20X1, the company had a balance of $9,000 in its capital dividend account. The balances in the RDTOH and GRIP accounts were NIL.

3. Each owner acquired his shares of Subpump 10 years ago for $50,000.

4. Clowes once owned shares of another small business corporation. He sold them last year and realized a capital gain of $800,000. He claimed the maximum capital gain deduction at that time.
5. The purchaser has stated two alternatives in his purchase offer:
   • A purchase of all assets at fair market value and an assumption of all liabilities. The balance will be paid in cash immediately.
   • A purchase of the shares for $340,000 in cash.

6. Both shareholders want to go their separate ways after the sale. Because of this, Clowes thinks the sale of shares is the best alternative, as it avoids additional tax costs.

7. Both shareholders are in a 45% marginal tax bracket. Both expect to remain in that bracket in the future. The combined (federal and provincial) marginal tax rate for both shareholders is 28% on eligible dividends and 33% on non-eligible dividends received (net of the dividend tax credit) and 45% on other income. Subpump’s tax rate is 25% on business income not subject to the small-business deduction and 15% on earnings subject to the small-business deduction. Investment income is subject to a 38% tax rate plus a 6 2/3% refundable tax.

**Required:**

1. Which offer should the shareholders accept? Show all calculations.

2. If the assets are sold, is there any way that the two shareholders can divide the cash remaining in the company without paying personal tax? If so, what is it?
Solution to P 18-2

Part I

The following calculations compare the after-tax proceeds of each alternative under the existing structure, assuming that the two owners plan to take their share of the proceeds and go their separate ways. It is also assumed that a sale would take place early in the new year and, therefore, if assets are sold the corporation would have the full small business deduction limit of $500,000 available. There are several pre-sale actions that could be taken to defer the potential tax liabilities and these are discussed subsequently.

Sale of Shares:

If shares are sold, each shareholder will realize a taxable capital gain as follows:

<table>
<thead>
<tr>
<th></th>
<th>Simpson</th>
<th>Clowes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proceeds (1/2 of $340,000)</td>
<td>$170,000</td>
<td>$170,000</td>
</tr>
<tr>
<td>ACB (50,000)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital gain</td>
<td>$120,000</td>
<td></td>
</tr>
<tr>
<td>Taxable (1/2)</td>
<td>$60,000</td>
<td></td>
</tr>
</tbody>
</table>

The after-tax proceeds for the two shareholders will differ. The corporation appears to be a qualified small business corporation (QSBC). It is a CCPC with all of its assets used in an active business. Throughout the past 24 months it has been a CCPC, no unrelated person has owned the shares currently owned by either shareholder and it likely met the 50% asset test. Therefore, it appears that Subpump Limited is a QSBC and, thus, the capital gains deduction may be available (1/2 of $750,000 = $375,000). However, shareholder Clowes has already used his full capital gains exemption. The after-tax proceeds for each are as follows:

If a tax-free capital dividend of $9,000 is distributed, the selling price of the shares will be reduced before the sale. This dividend would reduce the remaining capital gain to be taxed as follows:

<table>
<thead>
<tr>
<th></th>
<th>Simpson</th>
<th>Clowes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proceeds</td>
<td>$170,000</td>
<td>$170,000</td>
</tr>
<tr>
<td>Less tax:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Simpson</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>Clowes 45% x $60,000</td>
<td></td>
<td>(27,000)</td>
</tr>
<tr>
<td>After-tax proceeds</td>
<td>$170,000</td>
<td>$143,000</td>
</tr>
</tbody>
</table>

It should be pointed out that at the time of sale, the corporation had a balance in its CDA account of $9,000. This amount could be distributed as a tax-free capital dividend before the sale which would, in turn, reduce the selling price of the shares to $331,000 from $340,000. This would not assist Simpson but would increase Clowes’ after-tax proceeds to $144,102 as follows:

<table>
<thead>
<tr>
<th></th>
<th>Simpson</th>
<th>Clowes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proceeds from shares (1/2 of $331,000)</td>
<td>$165,500</td>
<td></td>
</tr>
<tr>
<td>Tax free capital dividends (1/2 of $9,000)</td>
<td>4,500</td>
<td></td>
</tr>
<tr>
<td></td>
<td>170,000</td>
<td></td>
</tr>
<tr>
<td>Less tax:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>45% of 1/2 ($165,500 - $50,000)</td>
<td>(25,988)</td>
<td></td>
</tr>
<tr>
<td>After-tax proceeds</td>
<td>$144,012</td>
<td></td>
</tr>
</tbody>
</table>

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The remainder of the solution assumes that the capital dividend is paid before the shares are sold.

Sale of Assets (then wind-up) [S.88(2)]:

The after-tax proceeds from an asset sale followed by a wind-up of the corporation are summarized below followed by supporting calculations.

Proceeds received from sale of:

<table>
<thead>
<tr>
<th>Asset</th>
<th>Proceeds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts receivable</td>
<td>$200,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>75,000</td>
</tr>
<tr>
<td>Land</td>
<td>120,000</td>
</tr>
<tr>
<td>Building</td>
<td>170,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>35,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>50,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>650,000</strong></td>
</tr>
</tbody>
</table>

Less liabilities

<table>
<thead>
<tr>
<th>Liability</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(250,000)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>400,000</strong></td>
</tr>
</tbody>
</table>

Less corporate tax (note 1)

<table>
<thead>
<tr>
<th>Taxable Income (CDA)</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory</td>
<td>$5,000</td>
</tr>
<tr>
<td>Land</td>
<td>$10,000</td>
</tr>
<tr>
<td>Building (recapture)</td>
<td>60,000</td>
</tr>
<tr>
<td>Equipment</td>
<td></td>
</tr>
<tr>
<td>Goodwill</td>
<td>28,500</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$88,500</td>
</tr>
</tbody>
</table>

Note 1 - The sale of assets by the corporation creates the following income:

<table>
<thead>
<tr>
<th>Asset</th>
<th>Business Income</th>
<th>Taxable Capital Gains</th>
<th>Non-taxable Income (CDA)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory</td>
<td>$5,000</td>
<td>$10,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>Land</td>
<td></td>
<td>10,000</td>
<td>10,000</td>
</tr>
<tr>
<td>Building</td>
<td></td>
<td>60,000</td>
<td></td>
</tr>
<tr>
<td>Equipment</td>
<td></td>
<td>(5,000)</td>
<td>10,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>28,500</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$88,500</td>
<td>$20,000</td>
<td>30,000</td>
</tr>
</tbody>
</table>

Opening CDA balance

<table>
<thead>
<tr>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>9,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
</tr>
</tbody>
</table>

The original cost of the goodwill was $30,000. Therefore, $22,500 (3/4 x $30,000) was included in the CEC account and written down to $4,000. The credit balance in the CEC after the sale is $33,500 (3/4 x $50,000 – $4,000). Of this amount the taxable portion is $28,500 [(22,500 – $4,000) = $18,500] + [2/3 x ($33,500 – $18,500) = $10,000].
Corporate tax:
On business income
($88,500 @ 15%)  $13,275
On taxable capital gains
($20,000 @ 44 2/3%)  8,933
$22,208

Note 2 – Since Subpump is a CCPC, a portion of the tax on the investment income (i.e., the taxable capital gains) is refundable when taxable dividends are paid to the shareholders. The maximum refund is $5,334 (26 2/3% of $20,000).

Note 3 - The funds available for distribution on wind-up ($383,126) in excess of the PUC $1,000 is deemed to be a dividend [S.84(3)]. Since the corporation has a Capital Dividend Account of $39,000, an election can be made to pay $39,000 of the dividend as a tax-free capital dividend [S.83(2)]. Thus, the funds available for distribution will consist of the following amounts:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Paid-up capital</td>
<td>$ 1,000</td>
</tr>
<tr>
<td>Tax-free capital dividend (election)</td>
<td></td>
</tr>
<tr>
<td>On hand before sale</td>
<td>$ 9,000</td>
</tr>
<tr>
<td>Created from the sale</td>
<td>30,000</td>
</tr>
<tr>
<td>Taxable dividend (the remainder)</td>
<td>343,126</td>
</tr>
<tr>
<td></td>
<td>$383,126</td>
</tr>
</tbody>
</table>

Simpson and Clowes will each receive half:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>PUC</td>
<td>$ 500</td>
</tr>
<tr>
<td>Capital dividend</td>
<td>19,500</td>
</tr>
<tr>
<td>Taxable dividend</td>
<td>171,563</td>
</tr>
<tr>
<td></td>
<td>$191,563</td>
</tr>
</tbody>
</table>

Tax on taxable dividend (non-eligible assumed) = $171,563 x 33% = $56,616.

As well the shareholders will have a loss on disposition of shares.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proceeds ($191,563 – dividends)</td>
<td>$ 500</td>
</tr>
<tr>
<td>ACB</td>
<td>(50,000)</td>
</tr>
<tr>
<td>Capital loss</td>
<td>$(49,500)</td>
</tr>
<tr>
<td>Allowable (1/2)</td>
<td>$(24,750)</td>
</tr>
</tbody>
</table>

As the corporation is a small business corporation, the capital loss normally would qualify as an allowable business investment loss [s.39(1)(c)] that can be offset against all sources of income. However, in the case of Clowes, the capital loss does not qualify as an ABIL because of the capital gains deduction claimed in a prior year [s.39(9)]. Therefore, his loss remains an allowable capital loss can only be used in the current year if he has sufficient net taxable capital gains from other sources. This is assumed to be the case for Clowes. Therefore, the allowable capital loss for Clowes and the ABIL for Simpson will create tax savings of $11,138 (45% of $24,750).
The net tax on wind-up for each shareholder is:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax on dividends</td>
<td>$56,616</td>
</tr>
<tr>
<td>Less tax savings on ABIL or ACL</td>
<td>(11,138)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$45,478</strong></td>
</tr>
</tbody>
</table>

The after-tax proceeds from the sale of assets versus the sale of shares are compared below for each shareholder:

<table>
<thead>
<tr>
<th>Description</th>
<th>Simpson</th>
<th>Clowes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sale of shares</td>
<td>$170,000</td>
<td>$143,000</td>
</tr>
<tr>
<td>Sale of assets ($191,563 - $45,478)</td>
<td>$146,085</td>
<td>$146,085</td>
</tr>
</tbody>
</table>

The results indicate that each shareholder prefers a different form of transaction. Because Simpson qualifies for the capital gain deduction, he prefers a sale of shares providing net proceeds of $170,000. Clowes prefers a sale of assets because the combination of dividends and tax savings from the allowable capital loss on wind-up provide a lower tax cost, in this case. If Clowes has no taxable capital gains and, thus, cannot use the allowable capital loss, his after-tax proceeds on the sale of the assets will be reduced by $11,138 to $134,947, in which case, Clowes will also prefer a share sale.

**Part 2**

If assets are sold, the funds available in the corporation that are available for distribution to the shareholders is $383,126 (see above). The additional tax on the dividend distribution could be avoided if each shareholder created his or her own holding corporation and transferred to it their shares of Subpump Ltd. This could be achieved without tax consequences to Simpson and Clowes by electing a transfer price, for tax purposes, equal to the ACB of the shares [s.85(1)]. Subsequently, Subpump would pay a dividend of $383,126 to the holding companies. While normally the dividend would flow tax free, the holding companies will have to pay a Part IV tax equal to the refund received by Subpump Ltd. ($5,334) [s.186(1)]. Therefore, the net proceeds to the holding corporations is $377,792 ($383,126 - $5,334). Each holding company would therefore have $188,896 of after-tax proceeds to reinvest.

While the above appears attractive, it is useful to project the tax consequences that may result when the funds are ultimately distributed to the shareholders. After the transfer of shares to a holding corporation, using the election option, each shareholder would have a note receivable from the Holdco for $50,000 (ACB of note is also $50,000) plus share capital, as this would be required to meet the election requirements. The shares would have an ACB and a paid-up capital of zero for tax purposes. Therefore, if Holdco distributes its funds the following would occur:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Funds for distribution</td>
<td>$188,896</td>
</tr>
<tr>
<td>Add refund from dividend (1/2 of $5,334)</td>
<td>2,667</td>
</tr>
<tr>
<td><strong>Funds distributed</strong></td>
<td><strong>$191,563</strong></td>
</tr>
</tbody>
</table>
The $191,563 would be paid as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Repayment of debt</td>
<td>$ 50,000</td>
</tr>
<tr>
<td>Redemption of shares</td>
<td>141,563</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$191,563</strong></td>
</tr>
</tbody>
</table>

The share redemption results in a deemed dividend of $141,563 of which $19,500, is a tax-free capital dividend and $122,063 is a taxable dividend, creating tax of $40,281 (33% of $122,063). No tax occurs on the debt. The net proceeds to the shareholder would be $151,282 ($191,563 - $40,281). In comparison, if Subpump was wound-up directly to the shareholders as calculated previously, the net proceeds would be $146,085. This difference occurs because the Holdco approach results in a lower dividend amount but also eliminates the capital loss that occurred on wind-up.
PROBLEM THREE

Cole and Barker each own 50% of the shares of NRS Ltd., a Canadian-controlled private corporation. NRS had conducted a small active business, which was closed down two years ago, in late 20X0. The corporation sold its assets at that time and used the resulting cash to purchase several commercial real estate properties. At present, the corporation owns three parcels of real estate (all purchased before March 19, 2007), as follows:

<table>
<thead>
<tr>
<th>Parcel</th>
<th>Cost</th>
<th>Current fair market value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Parcel 1 (acquired 20X0):</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Land</td>
<td>$10,000</td>
<td>$16,000</td>
</tr>
<tr>
<td>Building</td>
<td>40,000</td>
<td>60,000</td>
</tr>
<tr>
<td>Parcel 2 (acquired 20X0):</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Land</td>
<td>30,000</td>
<td>40,000</td>
</tr>
<tr>
<td>Building</td>
<td>70,000</td>
<td>80,000</td>
</tr>
<tr>
<td>Parcel 3 (acquired 20X1):</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Land</td>
<td>15,000</td>
<td>23,000</td>
</tr>
<tr>
<td>Building</td>
<td>30,000</td>
<td>42,000</td>
</tr>
</tbody>
</table>

Barker has recently informed Cole that he intends to withdraw as a shareholder of the company and wants to convert his shares to cash. In addition, he wants to own outright all of the real estate known as Parcel 3. The shareholders' agreement calls for a wind-up of the corporation when one shareholder wishes to leave; however, Cole wants to keep NRS for himself. The shareholders have therefore agreed to the following:

1. Barker will dispose of his shares for cash at fair market value (transaction date: January 1, 20X3).
2. Immediately thereafter, Barker will purchase from NRS, for cash, the Parcel 3 real estate (transaction date: January 2, 20X3).

At December 31, 20X2, the year end of NRS, the corporate balance sheet is as follows:

**Assets**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$ 10,000</td>
</tr>
<tr>
<td>Land (parcels 1, 2, 3) at cost</td>
<td>55,000</td>
</tr>
<tr>
<td>Buildings (parcels 1, 2, 3) at cost</td>
<td>$140,000</td>
</tr>
<tr>
<td>Accounting depreciation</td>
<td>(25,000)</td>
</tr>
<tr>
<td></td>
<td>115,000</td>
</tr>
<tr>
<td></td>
<td>$180,000</td>
</tr>
</tbody>
</table>

**Liabilities and Shareholders’ Equity**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mortgage payable</td>
<td>$ 40,000</td>
</tr>
<tr>
<td>Shareholders’ equity:</td>
<td></td>
</tr>
<tr>
<td>Common shares (paid-up capital)</td>
<td>$ 2,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>138,000</td>
</tr>
<tr>
<td></td>
<td>140,000</td>
</tr>
<tr>
<td></td>
<td>$180,000</td>
</tr>
</tbody>
</table>

Barker had acquired his shares for $5,000. The paid-up capital of his shares is $1,000, as indicated.
on the balance sheet (1/2 of $2,000). The corporation’s retained earnings of $138,000 consist of a number of items from past years, as follows:

<table>
<thead>
<tr>
<th>Income before tax</th>
<th>Income after tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Previous business operations</td>
<td>$98,570</td>
</tr>
<tr>
<td>Net rentals on real estate</td>
<td>4,204</td>
</tr>
<tr>
<td>(after capital cost allowance)</td>
<td>(41% + 6 2/3%)</td>
</tr>
<tr>
<td>Taxable capital gain</td>
<td>63,061</td>
</tr>
<tr>
<td>(41% + 6 2/3%)</td>
<td>33,000</td>
</tr>
<tr>
<td>Non-taxable portion of capital gain</td>
<td>20,000</td>
</tr>
<tr>
<td>$185,835</td>
<td>$47,835</td>
</tr>
</tbody>
</table>

Barker’s personal marginal tax rate is 28% on eligible dividends and 33% on non-eligible dividends received (net of the dividend tax credit) and 45% on other taxable income. He has already used up his capital gain deduction.

**Required:**

1. In view of the shareholders’ agreement, determine the value of the common shares owned by Barker.

2. What action should NRS take before Barker disposes of his shares? What effect will this have on the value of those shares and on the related tax when the shares are sold?

3. Describe the two basic ways in which Barker can dispose of his NRS shares, and recommend the best alternative. Show calculations to support your recommendation.

4. What are the tax consequences to NRS in 20X3 as a result of the sale of the parcel 3 real estate?
Solution to P 18-3

1. A reasonable method of determining the value of the share price for the vendor would be to equate it to the terms of the shareholders agreement. The agreement requires that, if one of the shareholders decides to depart, the corporation will wind-up. Given that this is not going to occur (but either partner can invoke it) a reasonable price for the shares would be one that, after tax on the sale, leaves the individual with the same after-tax proceeds as if the corporation was wound-up. Therefore, the first step is to determine a wind-up value of the company.

Before calculating the wind-up value, it is necessary to determine the UCC of the three buildings as this was not provided.

<table>
<thead>
<tr>
<th></th>
<th>Class 1(A)</th>
<th>Class 1(B)</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X0:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Purchase</td>
<td>$40,000</td>
<td>$70,000</td>
</tr>
<tr>
<td>CCA -- 4% x ½</td>
<td>(800)</td>
<td>(1,400)</td>
</tr>
<tr>
<td></td>
<td>39,200</td>
<td>68,600</td>
</tr>
<tr>
<td>20X1:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Purchase</td>
<td>30,000</td>
<td>--</td>
</tr>
<tr>
<td>CCA</td>
<td>(2,168)*</td>
<td>(2,744)</td>
</tr>
<tr>
<td></td>
<td>67,032</td>
<td>65,856</td>
</tr>
<tr>
<td>20X2:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>CCA</td>
<td>(2,681)</td>
<td>(2,634)</td>
</tr>
<tr>
<td>UCC</td>
<td>$64,351</td>
<td>$63,222</td>
</tr>
</tbody>
</table>

4% of $39,200 = $1,568
4% of $30,000 (1/2) = 600

$2,168

Notice that the building from Parcel 2 is in a separate CCA class because it cost more than $50,000 [Reg. 1101(1ac)] whereas the other two properties are combined in a single class.

On wind-up, the three parcels of land would either be sold or distributed to the shareholders. In either case, a fair market value distribution will occur. The taxable income tax to the corporation from this would be as follows:

<table>
<thead>
<tr>
<th></th>
<th>Land</th>
<th>Building</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Parcel 1</td>
<td>$6,000</td>
<td>$20,000</td>
<td>$26,000</td>
</tr>
<tr>
<td>Parcel 2</td>
<td>10,000</td>
<td>10,000</td>
<td>20,000</td>
</tr>
<tr>
<td>Parcel 3</td>
<td>8,000</td>
<td>12,000</td>
<td>20,000</td>
</tr>
<tr>
<td></td>
<td>$24,000</td>
<td>$42,000</td>
<td>$66,000</td>
</tr>
</tbody>
</table>

Taxable gain (1/2 of $66,000)

$33,000

Recapture:

<table>
<thead>
<tr>
<th></th>
<th>Land</th>
<th>Building</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Parcel 1 &amp; 3 ($40,000 + $30,000 = $70,000 - $64,351)</td>
<td></td>
<td></td>
<td>$5,649</td>
</tr>
<tr>
<td>Parcel 2 ($70,000 - $63,222)</td>
<td>6,778</td>
<td>12,427</td>
<td></td>
</tr>
<tr>
<td>Total taxable income</td>
<td></td>
<td>$45,427</td>
<td></td>
</tr>
</tbody>
</table>

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The recapture of CCA is specified investment business income and, therefore, all taxable income is subject to a 44 2/3% refundable tax followed by a refund of 26 2/3% upon distribution.

The after-tax proceeds on wind-up for the shareholders are as follows:

**Asset values:**

- **Cash** $10,000
- **Values of real estate:**
  - Parcel 1 $76,000
  - Parcel 2 $120,000
  - Parcel 3 $65,000
  - Total $261,000
- Less mortgage payable $(40,000)
- Tax on sale (44 2/3% of $45,427) $(20,290)
- Less refund of tax (Note 1) $30,052
- Available for distribution $240,762
- Less tax on distribution (Note 2) $(61,301)
- **After tax proceeds** $179,461
- Barker's shares (1/2) $89,730

**Note 1** - On wind-up, the dividend payments will trigger a refund of a portion of the taxes paid on taxable capital gains and specified investment business income. Analysis of the retained earnings account indicates that before the sale of assets, $67,265 of prior earnings is eligible for the refund ($4,204 of rental income plus taxable capital gains of $63,061). Therefore, the refund of tax to the corporation on wind-up is calculated as follows:

- **Income eligible:**
  - Prior years $67,265
  - Created on real estate sales (above) $45,427
  - Total $112,692
- **Refund - 26 2/3% of $112,692** $30,052

**Note 2** - The funds available for distribution on wind-up ($240,762) in excess of the PUC $2,000 is deemed to be a dividend [S.84(2)]. Since the corporation has a Capital Dividend Account of $53,000, an election can be made to pay $53,000 of the dividend as a tax-free capital dividend [S.83(2)]. Thus, the funds available for distribution will consist of the following amounts:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Paid up capital</td>
<td>$2,000</td>
</tr>
<tr>
<td>Tax-free capital dividends [s.83(2)]:</td>
<td></td>
</tr>
<tr>
<td>Available before asset sale</td>
<td>$20,000</td>
</tr>
<tr>
<td>Non-taxable portion of capital gains (1/2 of $66,000)</td>
<td>$33,000 $53,000</td>
</tr>
<tr>
<td>Taxable dividends (remainder)</td>
<td>$185,762</td>
</tr>
</tbody>
</table>
$240,762

Tax on taxable dividends – Non-eligible
33% of $185,762

$61,301

On wind-up each shareholder would also incur a capital loss on disposition of his or her shares. For example, Barker would have proceeds of disposition of $1,000 and an ACB of $5,000 resulting in a capital loss of $4,000 (1/2 of $4,000 = $2,000 allowable for tax purposes). The corporation does not qualify as a small business corporation and, therefore, the capital loss can only be offset against other capital gains. It is assumed that the shareholders have no personal capital gains and the capital loss creates no tax savings. If this were not assumed, the above tax cost on wind-up would be reduced accordingly.

Share Value - As Barker would receive $89,730 after-tax if the corporation were wound up, an equivalent share value can be calculated as follows:

\[
\text{Share Value - tax on sale} = \$89,730
\]

\[
X - 45\% \times \frac{1}{2} (x - \text{ACB}) = \$89,730
\]

\[
X - 45\% \times \frac{1}{2} (x - 5,000) = \$89,730
\]

\[
x = \$114,329
\]

2. It is always tax efficient to distribute the maximum available tax-free dividends from the capital dividend account of the corporation prior to the sale of shares. This reduces the value of the shares and accordingly reduces the amount of taxable capital gain realized on their disposition. In this case, the company has $20,000 of capital dividend account (the non-taxable portion of prior capital gains included in retained earnings). A tax-free dividend of $20,000 could be paid of which $10,000 would be received by each shareholder. The company has only $10,000 of cash on hand and, therefore, Barker's dividend could be paid in cash and Cole's dividend paid as a note payable. This would not create a problem for Cole as he will retain ownership of the corporation.

If the share price of $114,329 (as calculated in 1 above) is accepted, the prior tax-free dividend would result in the following after-tax proceeds to Barker:

Proceeds:
From tax free dividend
From share sale ($114,329 - $10,000)

$10,000
104,329
114,329

Less tax on sale of shares:
45% of 1/2 ($104,329 - $5,000)

(22,349)

After-tax proceeds
$91,980

Increase in after-tax proceeds
($91,980 - $89,730)

$2,250

However, from Cole's perspective, it is arguable that this procedure is unfair. The share price calculated above in part 1 ($114,329) was predicated on the basis of providing a share price
equivalent to the wind-up value of the company. As the wind-up value included the presumed
distribution of the existing tax-free dividends ($20,000 plus additional tax-free dividends from
asset sales $33,000), the share price equivalent reflects the benefit of the tax-free dividends.
In other words, Cole should indicate that the share value equivalent to the wind-up should be
calculated after the tax-free capital dividend is paid as follows:

\[
\begin{align*}
\text{Barker's wind-up value in part 1 above} & \quad \$89,730 \\
\text{Less portion applicable to the existing capital dividend (1/2 of $20,000)} & \quad (10,000) \\
\text{Revised wind-up value} & \quad \$79,730 \\
\end{align*}
\]

Equivalent share price:

\[
x - 45\% \left( \frac{1}{2} \right) (x - \$5,000) = \$79,730
\]

\[
x = \$101,426
\]

Therefore Barker's total proceeds would be:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Share price</td>
<td>$101,426</td>
</tr>
<tr>
<td>Prior tax free dividend</td>
<td>10,000</td>
</tr>
<tr>
<td>Less tax on sale of shares</td>
<td></td>
</tr>
<tr>
<td>45% of 1/2 ($101,426 - $5,000)</td>
<td>(21,696)</td>
</tr>
<tr>
<td>After tax proceeds</td>
<td>$89,730</td>
</tr>
</tbody>
</table>

3. Once the share price is established, Barker can sell his shares to Cole (the other shareholder)
or back to the corporation for cancellation. The after-tax proceeds to Barker under each of
these alternatives are outlined below.

**Sale of Shares to Cole:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proceeds</td>
<td>$114,329</td>
</tr>
<tr>
<td>Less tax on sale</td>
<td></td>
</tr>
<tr>
<td>45% of 1/2 ($114,329 - $5,000)</td>
<td>(24,634)</td>
</tr>
<tr>
<td>After-tax proceeds (as in part 1)</td>
<td>$89,730</td>
</tr>
</tbody>
</table>

**Sales of Shares to Corporation:**

This transaction results in a deemed dividend.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Price</td>
<td>$114,329</td>
</tr>
<tr>
<td>Less paid-up capital</td>
<td>(1,000)</td>
</tr>
<tr>
<td>Deemed dividend [s.84(3)]</td>
<td>$113,329</td>
</tr>
<tr>
<td>Tax @ 33%</td>
<td>$37,399</td>
</tr>
</tbody>
</table>
Proceeds $114,329
Less tax (37,399)
After tax proceeds $76,930

In addition, the sale of shares to the corporation results in an allowable capital loss of $2,000 as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proceeds</td>
<td>$114,329</td>
</tr>
<tr>
<td>Less deemed dividend</td>
<td>(113,329)</td>
</tr>
<tr>
<td>Adjusted proceeds [s.54]</td>
<td>1,000</td>
</tr>
<tr>
<td>ACB</td>
<td>(5,000)</td>
</tr>
<tr>
<td>Capital loss</td>
<td>$(4,000)</td>
</tr>
<tr>
<td>Allowable (1/2)</td>
<td>$(2,000)</td>
</tr>
</tbody>
</table>

As indicated in part 1, the capital loss does not qualify as an ABIL and it was assumed that Barker has no capital gains against which the $2,000 loss can be offset.

The share sale to Cole is preferable to Barker because it yields greater after-tax proceeds. This is due to the fact that the deemed dividend is taxed at a rate of 33%, whereas, the capital gain rate is 22.5% (1/2 of 45%).

Although not preferred by Barker, if the corporation buys-back its own shares for $114,329 an assessment must be made as to where it can get the funds to accomplish this. The company has cash on hand of only $10,000. However, after the share buy-back, Barker will purchase, for cash, real estate parcel 3 for $65,000 (land $23,000, building $42,000). In addition, the deemed dividend will create a tax refund based on the retained earnings relating to taxable capital gains and rental income (RDTOH). The potential refund is $17,940 (26 2/3% of [63,061 + 4,204]). The balance of the share buy-back would have to be funded by a cash contribution from Cole or by borrowing additional funds. The funding is broken down as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash on hand</td>
<td>$10,000</td>
</tr>
<tr>
<td>Contra of amount due by Barker</td>
<td>65,000</td>
</tr>
<tr>
<td>Corporate tax refund</td>
<td>17,940</td>
</tr>
<tr>
<td>Additional cash required</td>
<td>21,389</td>
</tr>
<tr>
<td></td>
<td>$114,329</td>
</tr>
</tbody>
</table>

The share buy back is attractive to Cole because it creates the tax refund of $17,940 that otherwise would not have been created if he had personally purchased the shares. It also enables him to use the existing corporate funds without distributing taxable dividends to himself.
4. Because the building in parcel 3 originally cost less than $50,000 it is pooled in a class with
the building of parcel 1. Consequently, the sale by NRS to Barker will not create taxable
income from the recapture of CCA.

\[
\begin{array}{ll}
\text{UCC before the sale (see part 1)} & \$64,351 \\
\text{Sale of building (to a maximum of cost)} & (30,000) \\
\text{UCC after sale} & \$34,351 \\
\end{array}
\]

However, NRS would incur a taxable capital gain of $10,000 calculated as follows:

\[
\begin{array}{ll}
\text{Land} \ ($23,000 - $15,000 = $8,000 \times 1/2) & \$4,000 \\
\text{Building} \ ($42,000 - $30,000 = $12,000 \times 1/2) & 6,000 \\
\hline
\text{Total} & \$10,000 \\
\end{array}
\]

The resulting tax is $4,467 (44 2/3% of $10,000). A portion of this tax (26 2/3% of $10,000 =
$2,667) is refundable if NRS makes a dividend distribution. Therefore, even though the share
price was determined on the assumption that a wind-up would create a recapture of CCA, the
recapture in fact does not occur at this time.
PROBLEM FOUR

For several years, Conrad Stone had wanted to acquire the Pineview Motel. The motel had a prime location and was thriving. Part of its property was adjacent to a scenic river, which was used as a picnic area for guests.

Stone felt that if he acquired the property, he could continue to operate the motel business but could also piece off its excess land along the river and develop a condominium project. Although the river frontage was not zoned for that purpose, Stone felt that with some effort, this could be changed.

The motel and the land were owned by Henson Enterprises Ltd., a corporation owned by Sheila Henson. She had refused two previous offers from Stone for the land, building, and equipment of the motel, partly because her corporation would have been heavily taxed on the sale.

After further pressure from Stone, Henson agreed to sell, provided that Stone purchased her shares of Henson Enterprises. In this manner, she would be able to claim the maximum capital gain deduction on the sale.

The most recent balance sheet of Henson Enterprises is shown at the top of the next page. The retained earnings of the corporation are relatively low because Henson has withdrawn most of the earnings through regular dividend distributions.

Over the years, Henson has claimed accounting amortization at a rate equal to the capital cost allowance rate permitted for tax purposes. At the end of the most recent year, the undepreciated capital cost was $350,000 for the building and $30,000 for the equipment. To determine the share price, Henson first obtained an independent appraisal of the land, building, and equipment. She then suggested a price of $530,000, calculated as follows:

Asset values:
- Current assets $15,000
- Land (appraised) 150,000
- Building (appraised) 850,000
- Equipment (appraised) 30,000
  \[= 1,045,000\]

Liabilities:
- Current liabilities $15,000
- Mortgage payable 500,000
- Share price 515,000
  \[= 530,000\]

Stone realized that buying the shares at that price would be a problem because the corporation would retain a potential tax liability in the event that its property is ever sold. After negotiations, Henson dropped the price to $450,000 and Stone purchased the shares for that amount of cash. Stone was not overly concerned about the corporation’s tax liability, as the reduced price would provide some relief and he had no intention of selling the property. He would continue to operate the motel and begin to develop the condominium project.
Balance Sheet

Assets

<table>
<thead>
<tr>
<th>Asset Type</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Assets</td>
<td>$15,000</td>
</tr>
<tr>
<td>Land (at cost)</td>
<td>100,000</td>
</tr>
<tr>
<td>Building (at cost)</td>
<td>$700,000</td>
</tr>
<tr>
<td>Equipment (at cost)</td>
<td>100,000</td>
</tr>
<tr>
<td></td>
<td>800,000</td>
</tr>
<tr>
<td>Accumulated amortization</td>
<td>(370,000)</td>
</tr>
<tr>
<td></td>
<td>430,000</td>
</tr>
<tr>
<td></td>
<td>$545,000</td>
</tr>
</tbody>
</table>

Liabilities and Shareholder’s Equity

<table>
<thead>
<tr>
<th>Liability Type</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current liabilities</td>
<td>$15,000</td>
</tr>
<tr>
<td>Mortgage payable</td>
<td>500,000</td>
</tr>
<tr>
<td>Shareholder’s equity:</td>
<td>515,000</td>
</tr>
<tr>
<td>Common shares</td>
<td>$1,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>29,000</td>
</tr>
<tr>
<td></td>
<td>30,000</td>
</tr>
<tr>
<td></td>
<td>$545,000</td>
</tr>
</tbody>
</table>

To purchase the shares, Stone used $50,000 of his savings and borrowed $400,000 from his bank, using his personal residence and the acquired shares as collateral. The bank loan is payable on demand.

Two months after Stone purchased the shares, the city announced that it intended to expropriate all of the motel’s property to develop a riverbank park. The city had the property appraised and told Henson Enterprises that it would pay the appraised amount for the land, building, and equipment. The appraisal values arrived at by the city were the same as those obtained by Henson two months earlier.

Henson Enterprises has a tax rate of 15% on income subject to the small-business deduction, 25% on other business income, and 44 2/3% on investment income. Stone has a marginal tax rate of 28% on eligible dividends and 33% on non-eligible dividends received (net of the dividend tax credit) and 45% on other income. Prior to the expropriation, all business income earned by Henson Enterprises had been eligible for the small business deduction.

Required:

1. Determine the tax liability of Henson Enterprises as a result of the expropriation.
2. Determine what Stone’s financial position will be after he repays his bank loan.
3. Would the result in 2 have been different if Stone had organized a holding corporation to borrow from the bank and purchase the shares? Explain, providing the calculations.
Solution to P 18-4

This problem highlights the importance, for a purchaser of corporate shares, of assessing the impact of potential tax liabilities that are inherited with the change in corporate ownership. It also emphasizes how alternative organization structures can affect that impact.

1. Because Stone acquired the shares of Henson Enterprises, the tax cost of each asset within the corporation remains at the amounts that existed before the change in ownership. Therefore, the sale of the land, buildings, and equipment result in the following income and tax liability:

   **Land:**
   - Sale price $150,000
   - ACB $100,000
   - Capital gain $50,000
   - Taxable (1/2) $25,000

   **Building:**
   - Sale price $850,000
   - ACB $700,000
   - Capital gain $150,000
   - Taxable (1/2) $75,000
   - Recapture (Cost $700,000 - UCC $350,000) $350,000

   **Equipment:**
   - Sale price $30,000
   - UCC $30,000
   - Recapture $0

   The recapture of CCA on the building is active business income because the building was used in an active business (motel) rather than as a passive rental property. The tax resulting from the sale is $105,670 calculated as follows:

   **Active business income**
   - $350,000 @ 15% $52,500
   
   **Taxable capital gains**
   - $25,000 + $75,000 = $100,000
   - @ (44 2/3%) 44,667
   - $97,167

   The above calculation assumes that the corporation did not earn any active business income from the motel operations from the previous year end to the date of expropriation, thereby permitting the small business deduction on the $350,000 recapture.
2. The bank loan was taken out by Stone personally as he acquired the shares as a personal investment. Therefore, to repay the bank loan the corporation would have to distribute its after-tax proceeds from the expropriation as dividends to Stone, who would incur a further tax before the loan principal was repaid. However, before doing this, the liabilities of the corporation would first have to be paid. The net funds available for distribution to Stone after all of this is only $459,500 calculated as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current assets of corporation</td>
<td>$15,000</td>
</tr>
<tr>
<td>Proceeds from expropriation</td>
<td>$1,030,000</td>
</tr>
<tr>
<td>Less corporate debt</td>
<td>($515,000)</td>
</tr>
<tr>
<td>Less corporate tax on sale (above)</td>
<td>($97,167 )</td>
</tr>
<tr>
<td>Add tax refund on payment of dividend</td>
<td>$26,667</td>
</tr>
<tr>
<td>Available for distribution</td>
<td>$459,500</td>
</tr>
</tbody>
</table>

The distribution of the above net proceeds would consist of the following:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Paid-up capital of shares</td>
<td>$1,000</td>
</tr>
<tr>
<td>Tax free capital dividend (non-taxable portion of capital gains realized, ½ of $50,000 + ½ of $150,000)</td>
<td>$100,000</td>
</tr>
<tr>
<td>Taxable dividend (remainder)</td>
<td>$358,500</td>
</tr>
<tr>
<td>Tax on dividend – Non-eligible (33% of $358,500)</td>
<td>$118,305</td>
</tr>
</tbody>
</table>

In addition, on wind-up of the corporation, Stone would incur an allowable capital loss of $224,500 as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proceeds of disposition</td>
<td>$1,000</td>
</tr>
<tr>
<td>Less ACB</td>
<td>($450,000)</td>
</tr>
<tr>
<td>Capital loss</td>
<td>($449,000)</td>
</tr>
<tr>
<td>Allowable (1/2)</td>
<td>($224,500)</td>
</tr>
</tbody>
</table>

However, this loss would not qualify as an allowable business investment loss [S.39(1)(a)] and would therefore remain unused until Stone was able to realize taxable capital gains. To qualify as an ABIL the shares must be small business corporation shares (which they are) and the loss must result from a sale to a non-arm's length party or as a deemed sale when the corporation is bankrupt or insolvent [S. 50(1)]. At the time of wind-up, the corporation is not insolvent, and as Stone controls the company, the sale of shares to the company on wind-up is not a sale to a non-arm's length party. Because no immediate tax savings will result from the capital loss, Stone's after-tax proceeds available for the bank loan repayment are:
Distribution received $459,500
Less tax (118,305)
Net proceeds $341,195

As the bank loan is $400,000 there is a significant shortfall. Because of the tax treatment, Stone purchased shares for $450,000 and then received a net amount of only $341,195 upon liquidation resulting in a cash loss of $108,805 (although part of this may be recovered if and when he can use the capital loss carry-over).

3. If Stone had used a holding corporation to purchase the shares, the bank loan of $400,000 would have been taken out by the holding corporation. Holdco's balance sheet after the purchase would have been as follows:

| Investment in shares of Henson | $450,000 |
| Bank loan                     | $400,000 |
| Due to shareholder and share capital | 50,000 |
| **Total**                     | **$450,000** |

If this structure were used, the tax cost of distributing Henson's after-tax proceeds from the expropriation would be different. The dividend received by the holding corporation would not be taxable except to the extent that Henson received a refund as a result of its dividend distribution [S.186(1)]. As indicated in part 2 above, this amounts to $26,667. Therefore, after distribution, the holding corporation would have the following after-tax proceeds available for the bank loan:

| Proceeds distributed             | $459,500 |
| Part IV tax on dividend          | (26,667) |
| Net proceeds                     | **$432,833** |

Therefore, this structure provides additional cash of $91,638 ($432,833 - $341,195) compared to the original structure.

If Holdco was used and the property was not expropriated, the interest expense in Holdco from the bank loan would not have any taxable income from which it could be offset. However, this problem could be easily overcome by amalgamating Holdco with Henson Enterprises (see Chapter 14).
PROBLEM FIVE

Kronin Enterprises Ltd. is a public corporation operating a successful retail business that generates profits in excess of $700,000 annually. The company is about to acquire a wholesale business operated by KTL Ltd. A recent balance sheet for KTL is presented below.

### Assets

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current assets</td>
<td>$100,000</td>
</tr>
<tr>
<td>Land (at cost)</td>
<td>50,000</td>
</tr>
<tr>
<td>Building (at cost)</td>
<td>$400,000</td>
</tr>
<tr>
<td>Equipment (at cost)</td>
<td>700,000</td>
</tr>
<tr>
<td>Accumulated amortization</td>
<td>(400,000)</td>
</tr>
<tr>
<td>Goodwill (at cost)</td>
<td>200,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$1,050,000</td>
</tr>
</tbody>
</table>

### Liabilities and Shareholders’ Equity

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liabilities</td>
<td>$600,000</td>
</tr>
<tr>
<td>Shareholders’ equity:</td>
<td></td>
</tr>
<tr>
<td>Common shares</td>
<td>$20,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>430,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>450,000</td>
</tr>
</tbody>
</table>

For tax purposes, the building (class 1) has an undepreciated capital cost of $300,000, and the equipment (class 8) has an undepreciated capital cost of $350,000. With respect to the goodwill, the amount of cumulative eligible capital is $100,000.

KTL has offered to sell the assets to Kronin for the following values and payment terms:

### Values:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current assets</td>
<td>$100,000</td>
</tr>
<tr>
<td>Land</td>
<td>75,000</td>
</tr>
<tr>
<td>Building</td>
<td>550,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>600,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>400,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$1,725,000</td>
</tr>
</tbody>
</table>

### Terms of payment:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assumption of KTL liabilities</td>
<td>$600,000</td>
</tr>
<tr>
<td>Cash</td>
<td>1,125,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$1,725,000</td>
</tr>
</tbody>
</table>

Last year, KTL earned a pre-tax accounting profit of $220,000 after deducting $30,000 of amortization. Kronin is confident that it can achieve at least the same level of profits after acquisition. Kronin has virtually decided to purchase the assets of KTL, provided that the investment will generate a minimum acceptable return on investment of 12% after tax.
At a recent meeting, the KTL executives stated that they may want to sell the shares, rather than the assets, and do so at a price different from the asset price. They will present an offer to Kronin shortly. Kronin thinks it would be useful to learn what share price would provide the same rate of return as would be achieved after a purchase of assets. The company could then make a quick assessment of the forthcoming share price. Kronin is subject to a 25% corporate tax rate.

**Required:**

1. Assuming that an acquisition would be in the form of an asset purchase, should the purchase be made, considering Kronin’s minimum return-on-investment requirement?

2. What share price would provide Kronin with the same rate of return as on a purchase of assets? Show calculations.
Solution to P 18-5

The purpose of this question is to highlight the after-tax returns that may be achieved from acquiring a business in the form of a share purchase versus an asset purchase. The information indicates that Kronin will make the purchase if they achieve a minimum after-tax return of 12%. It is presumed that this implies an annual average rate of return based on the initial purchase price. In other words, the investment should provide a return of 12% from annual after-tax cash flow without considering the ultimate cash recovery that would occur when the investment is disposed of at some future time.

1. Assuming that the pre-tax profits of the acquired business will remain unchanged in the future, the amount of after-tax profits will vary annually as a result of the deduction for tax purposes of CCA and eligible capital property write-offs. The present value of the tax shield (cash flow from deductions for tax purposes), from these items can be determined separately using the formula:

\[ \frac{C \times T \times R}{R \times I} \]

where:
- \(C\) = tax cost
- \(T\) = tax rate
- \(R\) = CCA rate
- \(I\) = discount rate or normal rate of return

The formula ignores the one-half CCA rule in the year of acquisition. As Kronin has its own substantial active business, the one-half rule may or may not apply depending on whether Kronin sold any assets from their existing CCA pools. If the one-half rule did apply, this formula would be insignificantly different.

Without the deduction of CCA and eligible capital property write-offs, the after-tax profits of the acquired business would be as follows:

- Expected profits $220,000
- Add amortization 30,000
- Pre-tax cash profits $250,000
- Less tax @ 25% (62,500)
- $187,500

Therefore, even without the benefit of tax savings from the deduction of CCA and eligible capital property, the minimum rate of return is achieved (as calculated below).

\[ \frac{$187,500}{$1,125,000} = 16.7\% \]
Given that Kronin can reinvest its funds to yield a minimum of 12% after-tax, the net present value of the tax savings from deductions for tax purposes of the acquisition price is as follows:

**Building:**
\[
\frac{550,000 \times 0.25 \times 0.04}{0.04 + 0.12} = \$34,375
\]

**Equipment:**
\[
\frac{600,000 \times 0.25 \times 0.20}{0.20 + 0.12} = 93,750
\]

**Goodwill:**
(3/4 of the $400,000 cost ($300,000) is eligible for deduction)
\[
\frac{300,000 \times 0.25 \times 0.07}{0.07 + 0.12} = 27,632
\]

Therefore, the purchase of the business will provide an additional net present value return of $155,757. (Note – solution assumes the building was used by KTL prior to March 19, 2007 and therefore CCA @4% is appropriate.)

2. If shares are purchased, the cost amounts of the assets owned by the corporation will remain at the amounts prior to the takeover. Consequently, the tax savings from CCA and eligible capital property deductions will be different. The tax values at the time of acquisition are:

- Building – UCC: $300,000
- Equipment – UCC: $350,000
- Goodwill - cumulative eligible capital: $100,000

Therefore, the present value of tax savings from the continued deduction of these items is as follows:

**Building:**
\[
\frac{300,000 \times 0.25 \times 0.04}{0.04 + 0.12} = \$18,750
\]

**Equipment:**
\[
\frac{350,000 \times 0.25 \times 0.20}{0.20 + 0.12} = 54,688
\]

**Goodwill:**
\[
\frac{100,000 \times 0.25 \times 0.07}{0.07 + 0.12} = 9,211
\]
\[
\frac{100,000 \times 0.25 \times 0.07}{0.07 + 0.12} = 9,211
\]
Clearly, the purchase of shares results in greater tax costs on future profits compared to the purchase of specific assets. The net present value of the additional tax costs is $73,108 as follows:

\[
\begin{align*}
\text{PV of tax saving from an asset purchase} & \quad \$155,757 \\
\text{PV of tax savings from a share purchase} & \quad \$82,649 \\
\hline
\text{Total} & \quad \$73,108
\end{align*}
\]

As the purchase of assets requires a cash investment by Kronin of $1,125,000 the share price should be discounted by $73,108 to $1,051,892 to provide the same after-tax return on investment for Kronin from the acquisition. With this information, Kronin can easily assess the share price that will be offered by KTL. If the offer is less than $1,051,892, it should be accepted; if not, the original asset offer should stand.
PROBLEM SIX

When selling a business it is important to know if the corporation that owns the “for sale” business qualifies as a small business corporation. If so, the shareholder(s) may qualify for all or some of the $750,000 capital gains exemption if the shares are sold. This question examines this qualification.

The following four situations, A through D, are independent.

<table>
<thead>
<tr>
<th>CCPC A</th>
<th>CCPC B</th>
<th>CCPC C</th>
<th>CCPC D</th>
</tr>
</thead>
<tbody>
<tr>
<td>Term deposits</td>
<td>$ 0</td>
<td>$ 0</td>
<td>$15,000</td>
</tr>
<tr>
<td>Land</td>
<td>50,000</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Building</td>
<td>35,000</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Equipment</td>
<td>0</td>
<td>80,000</td>
<td>0</td>
</tr>
<tr>
<td>Shares of X Ltd.</td>
<td>0</td>
<td>20,000</td>
<td>0</td>
</tr>
<tr>
<td>Shares of Y Ltd.</td>
<td>15,000</td>
<td>0</td>
<td>15,000</td>
</tr>
<tr>
<td>Liabilities</td>
<td>100,000</td>
<td>100,000</td>
<td>30,000</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>10,000</td>
<td>2,000</td>
<td>0</td>
</tr>
<tr>
<td>Bank loan</td>
<td>10,000</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Assets net of liabilities</td>
<td>$ 80,000</td>
<td>$ 98,000</td>
<td>$30,000</td>
</tr>
</tbody>
</table>

Additional information:

- In each of the above situations, the land, building and equipment are used by the owner in an active business carried on in Canada, with the exception of D. In the case of D, the land and building are leased to Spousecorp, a CCPC, and are used by Spousecorp in its active business, which it carries on in Canada. D is owned by the spouse of the sole shareholder of Spousecorp.
- X Ltd. is a public company.
- Y Ltd. is a small business corporation, owned 50% by each of A and C.

Required:

Determine which of the above CCPCs are small business corporations and state the reason for your conclusion.
Solution to P 18-6

[ITA: 248(1) Small Business Corporation definition]

A Small Business Corporation (SBC) is defined in S.248(1). In general terms, a SBC is a CCPC with 90% or more of the fair market value of its assets -

- Used in an active business carried on in Canada by the corporation or a related corporation, or
- Shares or debt of a connected SBC, or
- A combination of the two.

CCPC A is a SBC. 100% of the FMV of its assets are a combination of assets used in an active business carried on by A in Canada and shares of a connected SBC, Y Ltd. CCPC A and Y Ltd. are connected corporations since A owns more than 10% of the issued shares of Y Ltd. [S.186(4)].

CCPC B is NOT a SBC. Only 80% of the FMV of its assets are used in an active business. Therefore, it does not meet the "all" or "substantially all" test, interpreted to be 90% by CRA.

CCPC C is NOT a SBC. Only 50% of the FMV of its assets are qualifying assets, being shares of a connected SBC.

CCPC D is a SBC. 100% of its assets are used in an active business carried on in Canada by a corporation related to D, Spouse Co.

Whether or not a corporation is a SBC is significant for tax purposes. For example,

1) Capital gains deduction – For the capital gain to qualify for the capital gains deduction [S.110.6], the shares disposed must be qualified small business corporation shares (QSBC). One of the tests for QSBC shares is that the corporation be a SBC at the time the shares are sold.

2) Allowable Business Investment Loss – For the loss to qualify as a Business Investment Loss [S.39(1)(c)], the shares disposed must be a SBC.

3) Corporate Attribution Rules on transfer and loans to corporations [S.74.4(2)] – This attribution will not apply where the corporation is a SBC [S.74.4(2)(c)].
PROBLEM SEVEN

When selling a business it is important to know if the corporation that owns the “for sale” business is a qualified small business corporation. If so, the shareholder(s) may qualify for all or some of the $750,000 capital gains exemption if the shares are sold. This question examines this qualification.

The following four situations, (a) through (d), are independent.

<table>
<thead>
<tr>
<th>Assets used in an active business*</th>
<th>Investment in Subco</th>
<th>Other Assets</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) Holdco</td>
<td>$60,000</td>
<td>$25,000</td>
<td>$15,000</td>
</tr>
<tr>
<td>Subco</td>
<td>20,000</td>
<td>0</td>
<td>80,000</td>
</tr>
<tr>
<td>(b) Holdco</td>
<td>$30,000</td>
<td>$50,000</td>
<td>20,000</td>
</tr>
<tr>
<td>Subco</td>
<td>95,000</td>
<td>0</td>
<td>5,000</td>
</tr>
<tr>
<td>(c) Holdco</td>
<td>$45,000</td>
<td>$15,000</td>
<td>40,000</td>
</tr>
<tr>
<td>Subco</td>
<td>70,000</td>
<td>0</td>
<td>30,000</td>
</tr>
<tr>
<td>(d) Holdco</td>
<td>$0</td>
<td>$75,000</td>
<td>$25,000</td>
</tr>
<tr>
<td>Subco</td>
<td>92,000</td>
<td>0</td>
<td>8,000</td>
</tr>
</tbody>
</table>

* In each case, the active business is carried on in Canada and Holdco owns 100% of Subco.

The shares of Holdco and Subco have not changed hands since their incorporation five years ago. The assets of Holdco and Subco are stated at their fair market values in the chart, above. The assets and their values have remained constant for the past three years.

**Required:**

For each of (a), (b), (c), and (d), determine whether the shares of Holdco will be Qualified Small Business Corporation (QSBC) shares at the close of business tomorrow. Assume that all steps necessary to make Holdco a small business corporation at the close of business tomorrow will be taken.
Solution to P 18-7

A qualified small business corporation share (QSBC) is defined in S.110.6(1) as one which meets all of the following tests:

1) SBC at time of disposition,

2) throughout the 24 months preceding disposition -
   
   (i) shares were not owned by an unrelated person,
   
   (ii) CCPC

   With greater than 50% of the FMV of assets -
   
   a) used in an active business carried on primarily in Canada by the corporation or a RELATED corporation, or
   
   b) SHARES or DEBT of a CONNECTED corporation meeting the holding period test & the 50% asset test *
   
   c) combination of (a) & (b)

* Where holding co. involved, the 24 month period test becomes a 90/50 test or a 50/90 test for Holdco/Connected corp.

For each of situations (a) through (d), the question states that the corporation will be a SBC at the time of disposition, throughout the 24 months preceding the disposition, the shares were not owned by an unrelated person and the corporation was a CCPC. Therefore, the only question remaining is whether or not the 50% asset test has been met for the 24 months.

Situation (a)

In this case, more than 50% of the FMV of the assets of Holdco are used in an active business carried on by Holdco. Therefore, Holdco meets the asset test.

Situation (b)

In this case, more than 50% of the FMV of the assets of Holdco are a combination of (i) assets used in an active business carried on in Canada and (ii) shares of a connected corporation with more than 90% of the FMV of its assets used in an active business carried on in Canada. Therefore, Holdco will meet the asset test.
Situation (c)

In this case, Holdco does not have more than 50% of the FMV of its assets used in an active business or invested in shares of connected small business corporations, or a combination of the two.

Since Holdco cannot meet the 50% test on assets used in an active business and cannot meet the 90% test on a combination of business assets and investments in Subco; then the connected company, Subco, must meet a 90% test based on its own assets, in order that it can be included in Holdco’s 50% test. In this case, Subco does not meet this test. Therefore, Holdco will not meet the asset test.

Situation (d)

In this case, Holdco does not have any assets used in an active business. However, Subco meets the 90% test based on its own assets and, therefore, can qualify for inclusion in Holdco’s 50% test. Thus, Holdco has more than 50% of the FMV of its assets invested in shares of a connected corporation with more than 90% of the FMV of its assets used in an active business carried on in Canada. Therefore, Holdco will meet the asset test.
CASES

Bayly Corporation

Bayly Corporation owns and operates a successful chain of retail pipe and tobacco stores. Bayly is a private corporation owned 100% by a large venture capital corporation. During 20X1, Bayly earned a net profit before tax of $2,000,000, and its most recent balance sheet (see Exhibit 1, next page) shows its financial strength.

Bayly has accumulated large cash reserves for the purpose of acquiring a pipe-manufacturing business. Initially, Bayly was going to construct its own manufacturing plant, but recently it has targeted TOTO Pipes Ltd., a manufacturer of bluestem pipes, as a possible acquisition.

Donna Rose has been given the assignment of reporting to the VP Finance on the feasibility of acquiring TOTO. Rose attends a meeting with the shareholders of TOTO Pipes and the vice-president of Bayly Corporation. The meeting is short, as its purpose is to get acquainted and gather preliminary information. Rose is able to gather the following information:

1. The common shares of TOTO are owned equally by John Drabinsky and Walter Scully. They started the corporation 15 years ago, when pipe smoking was again becoming popular.

2. In addition to providing the initial share capital, Scully had provided a substantial shareholder loan to TOTO Pipes that enabled the company to survive during its critical start-up years. This loan was paid off two years ago. Scully is a director of TOTO Pipes but is only partly active in its management. He also owns another business, with his son and daughter, where he spends most of his time. Walter Drabinsky is the president and senior manager.

3. Both Drabinsky and Scully are 62 years of age.

4. Drabinsky indicates that he and Scully are prepared to sell all of the assets of TOTO Pipes for the values indicated under “Additional Information” in Exhibit II. If, however, Bayly wants to acquire the shares, they are willing to consider a price of $2,600,000.

5. Certain financial information is provided by Drabinsky (see Exhibit II, page 583).

After the meeting, Bayly’s vice-president instructs Rose to prepare a preliminary report on the proposed acquisition. “First of all, we want to know if the prices indicated make sense, considering that Bayly’s parent company insisted on a 13% after-tax return before approving any major capital acquisitions. I’m a little concerned about the life expectancy of the business because the patent on their major product has a life of only 10 years. They seem to be willing to accept a lower price for the shares than for the assets, and I wonder if they may be willing to accept an even lower share price. It would be useful to have this information before we enter into serious negotiations. In addition, provide any other analysis that might help us make a decision.”

Rose begins her assignment by gathering certain tax information and determines that the maximum personal tax rates are 45% on most types of income. Dividends, however, are subject to 28% tax rate on eligible dividends and a 33% rate on non-eligible dividends (net of the dividend tax credit). Rose was unable to determine what dividends from TOTO would be eligible or non-eligible and would have to make an assumption. The corporate rates of tax are 15% for income subject to the small-business deduction, 25% for non-manufacturing income not subject to the small-business
deduction, and 23% for manufacturing income. The tax rate on investment income is 44 2/3%, which includes the 6 2/3% refundable tax.

Required:

Prepare the preliminary report.

EXHIBIT I
BAYLY CORPORATION
Balance Sheet
December 31, 20X1

Assets

Current assets:
- Cash $200,000
- Bank term deposits 3,000,000
- Accounts receivable 400,000
- Inventory 2,400,000

Fixed assets:
- Land 400,000
- Buildings and equipment (at cost) 1,600,000
- Accumulated amortization (700,000) 900,000

Total Assets $7,300,000

Liabilities and Shareholders’ Equity

Current liabilities:
- Accounts payable $700,000
- Bank loan 600,000
- Mortgage payable 2,000,000

Total Current Liabilities 1,300,000

Shareholders’ equity:
- Common shares $100,000
- Retained earnings 3,900,000

Total Shareholders’ Equity 4,000,000

Total Liabilities and Shareholders’ Equity $7,300,000

Additional information

1. The building and equipment are all used to house the retail outlets and management staff.

2. Total wages paid in 20X1 amounted to $500,000.
EXHIBIT II
TOTO PIPES LTD.
Balance Sheet
December 31, 20X1

Assets

Current assets:
- Cash and receivables $  600,000
- Inventory 700,000

Fixed assets:
- Land 100,000
- Building (at cost) $  400,000
- Equipment (at cost) 800,000
  Accumulated amortization (500,000) 700,000
- Patents (on bluestem pipes, at cost) –0–
- Goodwill (at cost) 100,000
  $2,200,000

Liabilities and Shareholders’ Equity

Liabilities:
- Accounts payable $   500,000
- Bank loan (seven-year term) 300,000
  800,000

Shareholders’ equity:
- Capital shares $  100,000
- Retained earnings 1,300,000
  1,400,000
  $2,200,000

Additional information

1. Over the past three years, the company profits have averaged $750,000 before depreciation, amortization, and income taxes. This average is expected to continue in future years.

2. The company operates solely in Manitoba.

3. Total salaries paid in 20X1 amounted to $400,000, of which $300,000 related directly to manufacturing and $100,000 was for management.

4. All fixed assets were used for manufacturing purposes.

5. The patent on a special pipe filter has 10 years of legal life remaining.

6. Inventory shows a cost of $700,000. However, the company has indicated that the actual cost was $800,000, as the company intentionally lowered its inventory to reduce taxes.
7. The fair market values of other assets are as follows:

<table>
<thead>
<tr>
<th>Asset</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>$200,000</td>
</tr>
<tr>
<td>Building</td>
<td>700,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>600,000</td>
</tr>
<tr>
<td>Patent</td>
<td>300,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>400,000</td>
</tr>
</tbody>
</table>

8. The UCC of the depreciable assets is as follows:

<table>
<thead>
<tr>
<th>Class</th>
<th>UCC</th>
</tr>
</thead>
<tbody>
<tr>
<td>Class 3</td>
<td>$150,000</td>
</tr>
<tr>
<td>Class 43</td>
<td>300,000</td>
</tr>
<tr>
<td>Class 44</td>
<td>0</td>
</tr>
</tbody>
</table>

The balance in the cumulative eligible capital account is $40,000.

9. The general rate income pool (GRIP) balance is nil.
Solution to Case - Bayly Corporation

The case is analyzed in two parts. The first part examines whether or not the purchase should be made given the alternative price and buy-out methods offered in the preliminary discussions. The second part examines if there is room for further negotiation of the share price originally suggested.

Part 1

If Bayly purchases the assets of TOTO, it is presumed that it would acquire all assets including the accounts receivable. The balance sheet of TOTO indicates a single amount for cash and receivables ($600,000). It is assumed that only a nominal portion of this amount represents cash. A buyer would not purchase the vendor's cash but would have to inject a cash amount as permanent working capital once the business is acquired. Of course, if shares are acquired the cash balance will remain in the acquired corporation. In order to compare the asset price to a share price, it is assumed that Bayly will incur a cost of $600,000 for the cash and receivables indicated on TOTO's balance sheet.

The purchase price and payment terms of an asset acquisition are as follows:

<table>
<thead>
<tr>
<th>Price:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash and receivables</td>
<td>$ 600,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>800,000</td>
</tr>
<tr>
<td>Land</td>
<td>200,000</td>
</tr>
<tr>
<td>Building</td>
<td>700,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>600,000</td>
</tr>
<tr>
<td>Patent</td>
<td>300,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>400,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$3,600,000</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Payment:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Assumption of TOTO debt</td>
<td>$ 800,000</td>
</tr>
<tr>
<td>Cash payment</td>
<td>2,800,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$3,600,000</strong></td>
</tr>
</tbody>
</table>

Therefore, the cash requirements for the asset purchase and share purchase are compared as follows:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td>$2,800,000</td>
</tr>
<tr>
<td>Shares</td>
<td>$2,600,000</td>
</tr>
</tbody>
</table>

Before comparing the cash flows from each of the above alternatives, it is important to consider the post-acquisition structure and the related tax impact. If Bayly acquires the assets of TOTO, the business operations of Bayly (retail) and TOTO (manufacturing) will be combined in one entity. It is not necessary to maintain this structure. As an alternative, the assets acquired from TOTO could be transferred to a subsidiary corporation shortly after the takeover. These two structures result in different tax costs. If the two operations remain combined, the amount of profit qualifying for the federal and provincial M & P tax deduction is determined by the arbitrary formula. The result is an expansion of M & P profit beyond what it actually is. Remember, the M&P profit is first applied to the small business deduction limit of $500,000. This amount is not eligible for the M&P deduction. The case states that the M&P tax rate is 23%, a reduction of 2% from the 25% rate for other business
income. This reduction would be from provincial or territorial incentives. As Bayly is a subsidiary of a large venture capital company, it is assumed that Bayly is not entitled to the small business deduction. Therefore, the incremental value of the M&P status is estimated below:

Manufacturing capital:
- Building (TOTO) $700,000
- Equipment (TOTO) 600,000
  $1,300,000

$1,300,000 x 10% x 100/85 = $152,941

Total Capital:
- Building (TOTO) $700,000
- Equipment (TOTO) 600,000
- Building and Equipment (Bayly) 1,600,000
  $2,900,000

$2,900,000 x 10% = $290,000

Manufacturing labor:
- Total $300,000 x 100/75 = $400,000

Total labor:
- TOTO $400,000
- Bayly 500,000
  $900,000

Pre-tax profits:
- Bayly $2,000,000
- TOTO 750,000
  $2,750,000

Note: The pre-tax profits of $750,000 attributed to TOTO would actually be lower after deducting CCA and eligible capital property write-offs. However, for estimating the incremental effect, the $750,000 is used for purposes of simplification.

The M & P profits for the combined operations are:

$152,941 (MC) + $400,000 (ML) x $2,750,000 = $1,278,000

$290,000 (TC) + $900,000 (TL)

If the assets were transferred to a subsidiary corporation, the above calculation would change dramatically. The MC and ML would remain the same, but the TC and TL would be reduced to include only TOTO's assets. Also, the applicable profits would be reduced to $750,000. The result is that M & P profits are equal to their actual amount of $750,000.

Therefore, combining the operations results in the following annual tax savings:

M & P profits (combined) $1,278,000
M & P profits (separated) 750,000
Expansion $528,000

Tax saving (annually) 25%-23% = 2% $10,560
If Bayly purchases TOTO's shares, there are also two possible organizational structures. TOTO can remain as a subsidiary corporation in which case the maximum M & P profit is $750,000, or after acquisition Bayly and TOTO can be amalgamated requiring a broader use of the M & P formula. Keep in mind that if shares are acquired, the cost amounts of the assets in TOTO remain as they were before acquisition. Therefore, the MC and TC in the formula are altered. If shares are acquired and then an amalgamation is implemented, the resulting M & P profits would be $1,257,000 as follows:

<table>
<thead>
<tr>
<th>MC</th>
<th>Building</th>
<th>$400,000</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Equipment</td>
<td>$800,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$1,200,000</td>
</tr>
</tbody>
</table>

$1,200,000 x 10% x 100/85 = $141,176

<table>
<thead>
<tr>
<th>TC</th>
<th>TOTO (above)</th>
<th>$1,200,000</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Bayly</td>
<td>$1,600,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$2,800,000</td>
</tr>
</tbody>
</table>

$2,800,000 x 10% = $280,000

$141,176 + $400,000 x $2,750,000 = $1,257,000

$280,000 + $900,000

As this is $511,000 higher than the actual of $750,000, the annual tax saving if shares are purchased followed by a reorganization is $10,220 (2% of $511,000) which is not significantly less than acquiring the assets.

It is important to recognize that the above tax saving is unique to this particular purchaser. It occurs because of Bayly's existing financial structure. A different purchaser may not have the same savings. It is, therefore, important for the purchaser to anticipate post-acquisition tax costs as it will affect the amount they are prepared to pay. Students should also recognize that the vendors should also attempt (but may not be able) to determine the purchaser's position as it may enable them to negotiate a higher selling price.

The Decision to Purchase:

In order to assess if the acquisition will meet the company's minimum requirement of providing a 13% after-tax return, Donna Rose must estimate the future cash flows. This analysis is a problem for two reasons:

1. The patent on TOTO's product expires in ten years and profitability beyond that point is extremely uncertain.

2. If the business operations are unprofitable after ten years, a liquidation of the business at that time may be required and it is difficult to assess the after-tax proceeds that would be recovered from the sale of the assets.

However, as a starting point, Rose can make a rough assessment by assuming a conservative position. For example, she can assume that profits will be generated for ten years only and that after
ten years the business will be liquidated for a price that will provide no proceeds to Bayly. This provides a worst-case scenario from which a discussion can be held to identify other possible scenarios and the likelihood of their occurrence.

**Asset Acquisition:**

Before determining the related cash flows, it is necessary to determine the types of assets being acquired and their related tax savings.

**Building -** M&P building is a Class 1 property with CCA at 4% declining balance. It does not qualify for CCA at 10% since the building was used by TOTO before March 19, 2007. (The building was Class 3 with a CCA rate of 5% in TOTO.)

**Equipment -** M&P equipment acquired between March 19, 2007 and December 31, 2013 qualifies for Class 29 CCA at 50% straight-line. (The equipment was Class 43 with a CCA rate of 30% declining balance in TOTO.)

**Patent -** Because of its limited life it qualifies as a Class 44 property with CCA at 25% declining balance. By election, Bayly can choose to treat the patent as class 14 property with CCA on a straight line basis over its legal life (10% per year).

**Goodwill -** Is eligible capital property and 3/4's of its cost (3/4 of $400,000 = $300,000) is deducted at 7% annually, declining balance.

With respect to the building, equipment, and goodwill, the present value of tax savings can be determined using the formula:

\[
\frac{C \times T \times R}{R + I}
\]

Where the discount rate (I) is 13%, that being the minimum required return. It is important to recognize that the formula does not consider the application of the one-half rule for CCA (building and equipment only) in the year of acquisition. However, the impact of this is marginal. In addition, the formula imputes the cash savings over the time period reflected in the CCA rate. For the building (4%) and goodwill (7%) this is longer than the ten years assumed. However, the result is conservative because if the assets are liquidated for no value after ten years, a terminal loss would occur at that time enhancing the NPV of tax savings. Therefore, with these limitations, the NPV of an asset acquisition is as follows:

**Cash out:**
- Purchase price: $(2,800,000)

**Cash in:**
- Profit - pre-tax: $750,000
- tax before CCA @ 23%: 172,500

PV of $577,500 annually for 10 years: 3,135,825

M & P savings if entities are combined
- PV of $10,560 annually for 10 years: 57,000

Patent - $300,000 x .23 x .25 = 45,395

Building - $700,000 x .23 x .04 = 37,882

Equipment - $600,000 x .23 x .50 = 109,524

Goodwill - $300,000 x .23 x .07 = 24,150

Net Present Value $ 609,776

Therefore, in spite of the conservative assumptions, the purchase of assets will provide a complete recovery of the purchase price plus a return that is greater than 13% after tax.

Rose should also point out in her report that if Bayly wants to operate TOTO as a separate subsidiary, the M & P tax savings of $57,000 would be lost and, therefore, this becomes the cost of choosing that structure. This would reduce the NPV of cash flows to $552,776 ($609,776 - $57,000). Rose should realize that the assumed liquidation of the business to provide no proceeds after ten years may be unrealistic, especially considering that the assets acquired include land and buildings that are currently valued at $900,000 ($200,000 + $700,000). Therefore, the returns are likely to be higher.

Share Acquisition:

If shares are acquired, the after-tax cash flows are altered significantly. First of all the purchase price is reduced by $200,000 ($2,800,000 - $2,600,000). However, in exchange for this reduced price, the amount of available CCA is reduced because the tax values of the assets remain as they were prior to the acquisition. Notice also that the CCA rate on the building will be 5% (Class 3) rather than 4% (Class 1).

Also, if, after the purchase of shares, TOTO is amalgamated with Bayly, an M & P tax saving of $10,560 will be created annually. The PV of this annual saving is $57,000.

The tax savings from CCA and eligible capital property write-offs under an asset purchase are as follows:

Building - $150,000 x .23 x .05 = $9,583

Equipment - $300,000 x .23 x .30 = 48,140

Patent - 0

Goodwill - $40,000 x .23 x .07 = 3,220

Another important difference is that if shares are acquired, the inventory cost in TOTO remains at
$700,000 compared to the asset purchase cost of $800,000. This will result in additional taxes of $23,000 (23% of $100,000) in the first year of operations. The PV of this extra cost is $20,240.

Compared to an asset purchase, share purchase will reduce the NPV of cash flows as follows:

<table>
<thead>
<tr>
<th>Asset</th>
<th>Share Purchase</th>
<th>Cash Flow Decrease</th>
</tr>
</thead>
<tbody>
<tr>
<td>Building</td>
<td>$37,882</td>
<td>$9,583</td>
</tr>
<tr>
<td>Equipment</td>
<td>109,524</td>
<td>48,140</td>
</tr>
<tr>
<td>Patent</td>
<td>45,395</td>
<td>0</td>
</tr>
<tr>
<td>Goodwill</td>
<td>24,150</td>
<td>3,220</td>
</tr>
<tr>
<td>M &amp; P savings</td>
<td>57,000</td>
<td>57,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>0</td>
<td>20,240</td>
</tr>
</tbody>
</table>

$135,768

Therefore, the share acquisition at a price of $2,600,000 should be accepted because the cash saving of $200,000 from the purchase price is more than the increased tax costs on a PV basis.

Part 2

In order to determine if the vendors may accept a lower share price than the $2,600,000 stated in the initial meeting, Rose must first assess the after-tax position of the vendors if an asset sale takes place and then determine a share price equivalent.

To do this, Rose should attempt to establish a worst-case scenario for the vendors. Presumably, this occurs if the assets are sold and the after-tax proceeds are distributed to the two shareholders. The share price equivalent calculation must then consider whether each of the shareholders is eligible for the $750,000 capital gains exemption on the sale of qualified small business corporation shares.

As the discussion in the case has related to the corporate balance sheet at December 31, 20X1, it is assumed that a sale would take place on January 1, 20X2, the beginning of the new taxation year. Therefore, there would be no profits from operations, leaving the full amount of the small business exemption available for any business income created on the sale. Profits in excess of $500,000 will not be eligible for the M & P tax deduction because at the end of the taxation year no manufacturing assets are owned and no labor costs were incurred.

After reviewing the worst-case scenario, Rose must assess the likelihood of its occurrence. In this regard, she should attempt to anticipate any tax planning activities that the vendors can carry-out to reduce the impact of the worst-case scenario. These items are discussed subsequently.
The after-tax proceeds to the two shareholders under an asset sale and wind-up are as follows:

Sale price of assets:
(as previously calculated) $3,600,000
Less liabilities assumed (800,000)
Net price 2,800,000
Corporate tax (Note 1) (315,085)
2,484,915
Tax refund on distribution (Note 2) 93,000
Available for distribution 2,577,915
Shareholder tax on distribution (Note 3) (640,652)
After-tax proceeds $1,937,263

Note 1 - The taxable income and tax resulting from the sale of assets is as follows:

<table>
<thead>
<tr>
<th>Business Income</th>
<th>Taxable Capital Gains</th>
<th>Non-taxable Income (CDA)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory ($800,000 - $700,000)</td>
<td>$100,000</td>
<td></td>
</tr>
<tr>
<td>Land 1/2 of ($200,000 - $100,000)</td>
<td>$50,000</td>
<td>$50,000</td>
</tr>
<tr>
<td>Building 1/2 of ($700,000 - $400,000)</td>
<td>150,000</td>
<td>150,000</td>
</tr>
<tr>
<td>(recapture $400,000 - $150,000)</td>
<td>250,000</td>
<td></td>
</tr>
<tr>
<td>Equipment (recapture $600,000 - $300,000)</td>
<td>300,000</td>
<td></td>
</tr>
<tr>
<td>Patent 1/2 of ($300,000 - 0)</td>
<td>150,000</td>
<td>150,000</td>
</tr>
<tr>
<td>Goodwill * Below</td>
<td>185,000</td>
<td></td>
</tr>
</tbody>
</table>

$835,000 $350,000 $500,000

* Taxable portion of goodwill. Credit balance in CEC is $260,000 (3/4 x 400,000 – 40,000). Of this amount $35,000 represents recovery of amounts previously deducted (3/4 x 100,000 = 75,000 – 40,000). Two-thirds of the remainder is also taxable as business income which is $150,000 [2/3 x (260,000 – 35,000)]. Total business income is $185,000 (35,000 + 150,000).

Corporate tax:
$500,000 @ 15% $75,000
335,000 @ 25% 83,750
$835,000

$350,000 X (44 2/3%) 156,335

$315,085

Note 2 - Upon payment of dividends, a portion of the tax on the capital gains will be refunded. The refundable portion is:

26 2/3% of $350,000 = $93,000
Note 3 - The funds available for distribution on wind-up ($2,577,915) in excess of the PUC $100,000 is deemed to be a dividend [S.84(2)]. Since the corporation has a Capital Dividend Account of $500,000, an election can be made to pay $500,000 of the dividend as a tax-free capital dividend [S.83(2)]. Thus, the funds available for distribution will consist of the following:

<table>
<thead>
<tr>
<th>Paid-up capital shares</th>
<th>$ 100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax-free capital dividend (non-</td>
<td>500,000</td>
</tr>
<tr>
<td>taxable income above</td>
<td></td>
</tr>
<tr>
<td>Taxable dividend (remainder)</td>
<td>1,977,915</td>
</tr>
<tr>
<td>$2,577,915</td>
<td></td>
</tr>
</tbody>
</table>

The GRIP addition is $241,200 (72% x (taxable income $1,185,000 – SBD income $500,000 – All $350,000)). It is assumed that the corporation elects to pay an eligible dividend of $241,200, leaving the non-eligible dividend amount of $1,736,715. The shareholder tax (for both shareholders combined) on the distribution is:

\[
\begin{align*}
&241,200 @ 28% \\
&1,736,715 @ 33% \\
&2,577,915
\end{align*}
\]

$241,200 @ 28% = 67,536

1,736,715 @ 33% = 573,116

2,577,915

The wind-up also results in a share disposition for $100,000 but the ACB of the shares to the shareholders is also $100,000 and therefore no tax impact occurs.

As the two shareholders will receive after-tax proceeds of $1,937,263 ($2,577,915 - $640,652) from an asset sale and wind-up, an equivalent share price that, after tax on the capital gain, would provide the same proceeds would be as follows:

\[
x - 45% \left( \frac{1}{2} \right) (x - 100,000) = 1,937,263
\]

\[
x = 2,470,662
\]

Therefore, it would appear that further negotiations on the share price may result in a price reduction ($2,600,000 – $2,470,662).

Notice, however, that the above calculation assumes that each shareholder does not have the capital gains exemption on qualified small business corporation shares. If this were available, an equivalent share price would be substantially lower as follows:

\[
x - 45% \left( \frac{1}{2} \right) (x - 100,000 - 750,000) = 1,937,263
\]

\[
x = 2,252,920
\]

While the shareholders would likely be unwilling to give away the full benefit of the capital gains exemption by reducing the price to $2,252,920, a negotiated adjustment may be possible. For example, a share price of $2,500,000 would reduce Bayly's purchase cost by $300,000 ($2,800,000 - $2,500,000) compared to the asset price. It would also provide the shareholders with after-tax proceeds of:

<table>
<thead>
<tr>
<th>Proceeds</th>
<th>$2,500,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less tax</td>
<td></td>
</tr>
<tr>
<td>45% (1/2) ($2,500,000 - 100,000 - 750,000)</td>
<td>(371,250)</td>
</tr>
<tr>
<td>$2,128,750</td>
<td></td>
</tr>
</tbody>
</table>
Therefore, if the capital gains exemption is available, there is more room for negotiation.

Rose should also be aware that the vendors may be in a position to defer a substantial portion of the worst-case scenario tax costs. Almost half of the tax cost resulting from an asset sale and wind-up results from personal tax on the dividend payout ($640,652, see Note 3 above). This cost could be deferred if each of the shareholders created separate holding corporations and transferred to them their shares in TOTO (using the elective option). Therefore, the dividends on wind-up of TOTO after the asset sale would flow tax free to the holding corporation except for the part IV tax that is equal to the refund received by TOTO. The after-tax proceeds to the two holding corporations combined would be as follows:

<table>
<thead>
<tr>
<th>Distributed from TOTO</th>
<th>$2,577,915</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less part IV tax (equal to TOTO's refund)</td>
<td>(93,000)</td>
</tr>
</tbody>
</table>

Net proceeds $2,484,915

While this is only a tax deferral, it still may be a preferred option for the shareholders. Certainly if they do not have the capital gains exemption, it would be preferred. If they do have the capital gains exemption, they are not likely to alter their initial share price offer of $2,600,000.

Note - When examining the worst-case scenario (sale of assets followed by a wind-up), the possibility of avoiding double taxation by paying a bonus to the shareholders should be discussed. A portion of the income from the sale of assets ($335,000 of business income) was subject to a tax rate of 46% (corporate tax of 25% plus tax to shareholders on the dividend). If a bonus of $335,000 was paid ($172,500 to each shareholder) the total tax would amount to only 45% rather than 46%. This would increase the after-tax proceeds to the shareholders by $3,350 (46% - 45% = 1% x $335,000) and the equivalent share price would be affected accordingly. Students should examine the reasonableness of such a bonus with respect to shareholder Scully who is a director of TOTO but does not participate actively in its management.
CHAPTER 19

BUSINESS ACQUISITIONS AND DIVESTITURES—
TAX-DEFERRED SALES

Review Questions

1. While vendors may gain a tax advantage by selling a business using a tax-deferred method, they may be subjecting themselves to more risk in terms of ultimately realizing the proceeds from the sale. How is a tax-deferred sale of a business distinguished from a taxable sale? Why does a tax-deferred sale involve greater risk?

2. Give three basic reasons that a vendor may be prepared to accept a greater risk in exchange for a tax deferral on the sale of a business.

3. What four basic methods can be used to achieve a tax-deferred sale?

4. What advantages and disadvantages may arise for the purchaser when the specific business assets are acquired from a vendor corporation and the parties elect transfer prices for tax purposes at amounts that will defer tax to the vendor?

5. What is a share-for-share exchange? How does it differ from a sale of shares in which the vendor and the purchaser elect a specific price for tax purposes?

6. Why is a business acquisition using the share-for-share technique attractive to both the purchaser and the vendor?

7. A tax-deferred sale of a business by a reorganization of share capital may present more risk to the vendor than a sale of its shares to a corporate purchaser and an election of a transfer price for tax purposes. Explain why.

8. When a business owned by a closely held corporation is being sold, the vendor is often persuaded to use tax-deferred methods to structure the sale. What is a closely held corporation? What features may such a corporation have that make a tax-deferred sale attractive?

9. Why may the owner of a business want to transfer a business to children during his or her lifetime, rather than by way of an estate transfer upon death?

10. What feature is often found when a business is being transferred to a family member? How is the tax-deferred method of sale consistent with this feature?

11. How may the sale of a corporation’s specific business assets to a purchaser with limited resources provide greater flexibility than the sale of shares of the corporation?
Solutions to Review Questions

R19-1. In order to achieve a deferral of tax on the sale of a business (from either an asset sale or a share sale) the vendor must be prepared to accept all or a specified portion of the payment in the form of shares of the purchaser's corporation or of the vendor corporation. Such shares can be common shares or preferred shares. In other words, the vendor maintains a partial continuing equity interest in the business being sold. In comparison, a taxable sale normally results in the exchange of business assets or shares of the business corporation for assets other than shares. Payment terms from a taxable sale usually include cash and/or the deferred payment of cash secured by notes bearing interest.

A tax deferred sale results in a greater risk for the vendor because the deferred payment portion of the price that consists of shares is less secure than debt. Subsequent realization of the common or preferred shares depends upon the continued success of the purchaser corporation after it has met its own obligations. In comparison, the rights of a creditor take precedence over the shareholders.

R19-2. A vendor may be prepared to accept a greater risk to achieve tax deferral on a business sale for the following reasons:

- The vendor wants to participate in the continued growth of the business and the sale actually constitutes a business combination or merger of two active business enterprises.
- The vendor wants to enhance his or her after-tax return on investment from the proceeds of sale. By deferring the tax, the full amount of the proceeds from the sale may provide annual returns from a combination of dividends and interest. In comparison, in a taxable sale, only the after-tax proceeds provide annual returns.
- The desired purchaser may not have sufficient capital to fund the purchase and no other acceptable buyers are available.

R19-3. To achieve a tax-deferred sale of a business, the following basic alternative methods are available.

- Sale of assets from the vendor to the purchaser corporation at fair market value but, for tax purposes, electing a transfer price equal to the assets' tax values [S.85(1)].
- Sale of the vendor corporation's shares to the purchaser corporation using an elected transfer price for tax purposes equal to the vendor's adjusted cost base of the shares [S.85(1)].
- An amalgamation of the vendor corporation and the purchaser corporation [S.87(1)].
- A reorganization of the share capital of the vendor corporation whereby the purchaser obtains common shares but the vendor maintains a continuing interest in the form of preferred shares [S.86(1)].

R19-4. The purchase of business assets using the elective option for tax purposes requires that a portion of the purchase price be paid by the purchasing corporation issuing preferred and/or common shares (this portion is the difference between the elected tax price and the fair market value). The major advantage for the purchaser is that the acquisition can be achieved with the minimum amount of cash and/or debt. Depending on the terms attached to the share consideration, this method may provide greater future cash flow to the purchaser and may not impair its borrowing capacity thereby enhancing the probability of the continued success of the acquired business.
However, this form of purchase has the following disadvantages:

- The assets acquired have a lower cost amount for tax purposes which limits the amount of future CCA and eligible capital property write-offs. Consequently, future tax costs on profits are greater.
- Because the assets acquired have a cost amount for tax purposes that is lower than the fair market value price paid, a potential tax liability for the purchaser exists if, subsequent to the acquisition, it is necessary for the purchaser to dispose of all or some of the assets purchased.
- Normally, the purchaser is required to pay regular dividends on the shares issued to the vendor. While the dividend rate may be less than a normal interest rate, the dividend costs are not deductible from the purchaser’s income for tax purposes. Therefore, the after-tax cost of servicing the shares may be greater than the after-tax cost of servicing debt.

R19-5. A share for share exchange occurs when a purchasing corporation acquires the shares of another corporation (from the existing shareholders) and the payment to the vendors consist entirely of shares issued by the purchasing corporation. When this occurs, and provided that certain other conditions are met, each separate vendor is entitled to arbitrarily decide that, for tax purposes, the transfer price is equal to the cost amount, thereby deferring tax on the sale [S.85.1(1)]. This could also have been achieved by using the formal election option [S.85(1)]. However, unlike the election option, the share for share exchange is decided by only the vendor without the purchaser’s participation. The purchaser’s cost of the shares acquired is the lesser of fair market value or the paid up capital of the vendor’s shares [S.85.1(1)(b)].

The election option is a formal process requiring the filing of certain forms (i.e., T5027) whereas the share-for-share exchange method is informal and each vendor decides on their position when completing their annual tax return. In addition, the share for share exchange method must have no non-share consideration [S.85.1(2)(d)], whereas the election option permits non-share consideration within specified limits.

R19-6. The share for share exchange method is attractive to the vendor because it provides maximum flexibility. If some of the vendors want to realize cash from the sale, they can tender for sale all or a portion of their exchanged shares after the share for share transaction has occurred. On the other hand, if they wish to remain as a shareholder of the purchaser corporation, they can do so without incurring a tax liability on the sale of their old shares, thereby earning investment returns on the pre-tax proceeds of sale rather than on the after-tax proceeds. The share for share exchange method is attractive to the purchaser because the acquisition can be achieved without a cash or debt requirement. However, there is also a negative aspect for the purchaser. The ACB of the acquired shares is normally the shares paid up capital amount [S.85.1(1)(b)] (normally lower than market value) and, therefore, a subsequent sale may result in a higher than normal taxable capital gain.

R19-7. When a business is sold using the share reorganization technique [S.86(1)], the previous shareholder normally exchanges his or her common shares for preferred shares of the vendor corporation. This presents two risks for the previous shareholders. First of all, the entire payment consists of share capital with no debt or cash. Secondly, the share capital received represents a continued interest in the vendor corporation only. Consequently, the ability to realize the value of the preferred shares at a future time rests solely with the continued success of the vendor corporation.

In contrast, the sale of shares to a purchaser corporation using the election option provides payment by a combination of cash, share capital, and debt from the purchaser corporation. The existence of cash and debt by itself presents less risk of realization. In addition, the ability
to realize the share consideration (and the debt) at some future time depends upon the continued success of the purchaser corporation and the vendor corporation combined. This is especially important when the purchasing corporation has substantial value of its own.

R19-8. A closely held corporation is one that is owned by a single shareholder, or a relatively small number of shareholders, such that the relationship between the corporation and the shareholders is very close. Often, the following features of a closely held corporation are evident that induce a preference for a tax-deferred method of sale:

- The owner(s) of the business is usually under greater pressure to sell the business to family members or to senior employees who have provided long service to the entity. Typically, both employees and family members do not have substantial cash resources to make the purchase and, therefore, require substantial and long-term financing from the vendor.

- A closely held business is often sold in response to the owner's desire for partial or full retirement. Therefore, there is a desire to maximize future income from investment of the sale proceeds. A taxable sale diminishes to amount of proceeds available to reinvest and accordingly reduces the amount of future income for retirement.

R19-9. When an individual leaves shares of his or her business corporation to children by way of an estate transfer on death, the shares are deemed to have been sold for tax purposes at their fair market value at that time. The resulting tax diminishes the value of the estate. If shares are transferred to the children at an earlier time, presumably the tax liability would be lower because the value of the shares would be lower. This, combined with the opportunity of using a tax-deferred method of transfer, results in a lower tax liability on death than would otherwise have occurred. In other words, at the time of transfer, the shareholders' potential capital gain is "frozen" at the value at that time, permitting continued growth to accrue to the benefit of the children. A further reason for a transfer before death is to provide an orderly succession and continuity of management responsibility.

R19-10. When a business is sold to a third party the vendor is usually concerned with the security of the payment terms in order to ensure the full realization of the value of the business. The vendor will, therefore, only use the tax deferred method if they are satisfied that the payment in the form of shares is reasonably secure. However, when a sale is being made to a family member, the vendor is often less concerned about security because the value of the business will likely be transferred to that family member on the death of the owner in any case. Therefore, the deferral of tax often becomes the primary factor in choosing a method of sale to a family member. As the tax deferral methods provide less security (because of the requirement for full or partial payment in the form of shares) they are consistent with the owner's desire and need for security and, therefore, become a viable option.

R19-11. When a business is sold to a purchaser who has limited resources, it may require that the vendor finance a large portion of the purchase price by granting deferred payment terms. Therefore, security for the vendor becomes a primary issue. It is recognized that in order to own and operate a business it is not always necessary to own all of the assets needed for its operation. The business can be operated by having the right to use those assets without their ownership. If the sale of a business is structured as an asset sale (as opposed to a share sale) the vendor can retain ownership of some of the assets (e.g., land, buildings, and equipment) and lease them to the purchaser in exchange for rent. This is attractive to the purchaser with limited resources because less cash and debt is required to complete the purchase.
It is also attractive to the vendor because retained ownership of the certain assets provides maximum security and, at the same time, defers the related tax liability that would have occurred from the sale. In comparison, a sale of shares of the vendor corporation does not permit specific assets to be retained unless certain reorganization activities are carried out first. Therefore, the sale of assets appears to provide greater flexibility.
Problems

PROBLEM ONE

[ITA: 85(1)]

For the past 30 years, Janice Kalinsky has been the president and owner of JK Wholesale Ltd. In contemplation of retirement, she has entered into negotiations to sell the shares of JK to Kaplan Brothers Ltd., a company that has been her major competitor. Although Kalinsky’s planned retirement date is still five years away, she is prepared to sell now so that she can have a defined amount of capital available to provide a retirement income. Kaplan Brothers has offered to purchase her shares in JK for $700,000. The shares have a cost base of $200,000. Kalinsky intends to invest the proceeds from the sale in interest-bearing securities that yield a 10% return for five years. The accumulated funds will provide her with a retirement income at the end of five years. In the meantime, she will be employed as the executive director of a national trade association.

Kalinsky is concerned about the amount of tax payable on the sale and has had discussions with Kaplan Brothers about using the elective provisions of the Income Tax Act to defer her tax on the sale of shares. Kaplan Brothers has agreed to this and has presented her with two options:

1. Purchase of her shares for $700,000, payable immediately in cash.

2. Purchase of her shares for $700,000, using the elective provisions of the Income Tax Act to defer her tax liability. Payment would consist of debt with 10% interest and preferred shares with an annual cumulative dividend rate of 8%. Kaplan Brothers would repay the full amount of the debt and redeem the preferred shares at the end of five years.

Kalinsky’s personal marginal tax rate is 28% on eligible dividends and 33% on non-eligible dividends (net of the dividend tax credit) and 45% on other income. She used up her full capital gain exemption several years ago while selling a related business corporation. Kaplan Brothers has earned profits of $400,000 before tax for the past two years.

Required:

1. Determine the amount of capital that Kalinsky will have for retirement purposes at the end of five years under each of the alternative buy-out methods.

2. What other factors must Kalinsky consider before she decides which option to accept?

3. What are the benefits and costs of option 2 for Kaplan Brothers?
Solution to P 19-1

1. After five years, Kalinsky will have the following amounts of capital for retirement:

Option 1 (Sale of Shares for Cash):

Under this option, Kalinsky incurs taxable income in the year of the sale in the form of a capital gain. As she has already used her capital gain exemption, the proceeds available for reinvestment are diminished by the related tax liability.

- Proceeds from sale: $700,000
- Less tax: 45% of (1/2) ($700,000-$200,000) = 112,500
- After-tax proceeds: $587,500

As the $587,500 will be invested to return 5.5% after-tax (10% - tax @ 45%) the compounded value after 5 years is $767,839 (future value of a present sum of $587,500 for 5 years at 5.5%).

Option 2 (Sale of Shares - Elected Value):

Under this option, the sale price remains at $700,000 but for tax purposes an elected price of $200,000 (ACB) is used resulting in no taxable income in the year of sale. As the non-share consideration under the election option is limited to the elected price of $200,000 the full consideration consists of:

- Debt (10% interest): $200,000
- Preferred shares (8% dividend): $500,000

The ACB of the debt for Kalinsky is $200,000 (being the elected transfer price) [S.85(1)(f)]. Therefore, on repayment no capital gain will occur. The preferred shares have an ACB of zero [S.85(1)(g)] as the elective option provides for a maximum ACB allocation of $200,000 (being the elected price on transfer) which was fully allocated to the debt. In addition, the paid-up capital amount of the preferred shares is also reduced to zero. Therefore, upon redemption after year 5 the following occurs:
Redemption price $500,000
less paid-up capital 0
Deemed dividend [S.84(3)] $500,000
Proceeds of disposition $500,000
less deemed dividend (500,000)
Adjusted proceeds [S.54] 0
ACB 0
Capital gain $ 0

Tax on redemption (dividend assumed to be non-eligible)
$500,000 @ 33% $165,000

After 5 years, Kalinsky will have the following amount:

Interest accumulated:
Annual interest 5.5% of $200,000 = $11,000
Compounded value, $11,000 x 5.5% x 4 years = $50,392 + $11,000 = $ 61,392

Dividends accumulated and reinvested in interest securities at 5.5% after-tax.
Annual dividend (5.4% of $500,000)
$27,000. Compounded value, $27,000 x 5.5% x 4 years = $123,690 + $27,000 = 150,690

Proceeds from redemption of debt and shares:
($700,000 - tax of $165,000) 535,000

$747,082

Therefore, option 2 provides the greater after-tax result for Kalinsky.

2. Under option 2 Kalinsky must take into account the possibility of the purchaser being unable to pay the full $700,000 at the end of five years. In effect, she has sold her business and invested the full proceeds in a private corporation of which she has no element of control. The value of that investment is fully dependent on the financial strength of Kaplan Brothers Ltd. Therefore, to achieve a greater return on investment she exposes the investment to significant risk, which may be imprudent considering her planned retirement.

3. If option 2 is accepted, the obvious benefit for Kaplan is that the purchase will require no immediate cash and the full price is deferred for five years. This reduced cash requirement leaves Kaplan's resources intact for further business expansion. In addition, because most of the amount owed consists of preferred share capital ($500,000), the consequence of defaulting on annual dividend payments or the required redemption is not as severe as if the amount was owed in the form of debt. Therefore, Option 2 presents less risk for Kaplan.

In exchange for this reduced risk Kaplan will incur additional financing costs because of the dividend requirement on the preferred shares. As the dividends are not deductible from Kaplan's annual income they must first pay tax at approximately 25% on profits before the dividend cost. Over the five year period, Kaplan will incur the following costs:
Interest:
$200,000 @ 10% = $20,000 x 5 years $100,000
Dividends:
$500,000 @ 8% = $40,000 x 5 years 200,000
$300,000

To service the above cost, Kaplan will have to use the following amounts of profits:

Interest (fully deductible) $100,000
Dividends
x - 25%x = $200,000 266,667
$366,667

In comparison, if option 1 were used and Kaplan had to borrow $700,000 at 10% in order to make the cash payment, the interest cost would be $350,000 (10% of $700,000 = $70,000 x 5 years) which (because it is all deductible) would use up only $350,000 of its future profits. Therefore, the price of choosing option 2, and achieving less risk, is $16,667 ($366,667 - $350,000). In other words, the real cost of the 8% dividend is 10.7% (x - 25%x = 8%). Note: The combined income of JK and Kaplan results in the combined entities being subject to the 25% tax rate on income over the $500,000 (the small business deduction limit).
PROBLEM TWO

[ITA: 40(1)(iii); 55(2); 83(1); 85(1); 86(1); 125(1),(2); 129(1),(3)]

Shane Plastics Ltd. is a Canadian-controlled private corporation. All of its outstanding common shares are owned by KS Holdings Ltd., a company owned by Karl Shane. KS Holdings also owns several real estate investments. Shane wants to sell the plastics business to four senior employees, one of whom is his son. Shane realizes that none of the employees has substantial financial resources and that they may be able to contribute only 25% of the purchase price. Even to obtain this amount, the four employees would likely have to take out personal loans.

A financial institution is prepared to finance the balance of the purchase price provided that Shane agrees to be the guarantor of the loan. Shane may be prepared to do this, even though it would leave the business with a severe debt load and no flexibility should the business have temporary problems.

The employees have asked Shane to finance the purchase by permitting a flexible, eight-year payment schedule. Shane is not averse to this offer, provided that he can continue to have some say in the major decisions of the business until most of the payments have been made.

The most recent balance sheet of Shane Plastics is summarized in the following table:

<table>
<thead>
<tr>
<th>Asset Category</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current assets (cash, receivables, inventory)</td>
<td>$500,000</td>
</tr>
<tr>
<td>Land</td>
<td>50,000</td>
</tr>
<tr>
<td>Building</td>
<td>$600,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>350,000</td>
</tr>
<tr>
<td>Accumulated amortization</td>
<td>(400,000)</td>
</tr>
<tr>
<td>Marketable securities (bonds)</td>
<td>100,000</td>
</tr>
<tr>
<td></td>
<td>$1,200,000</td>
</tr>
<tr>
<td>Current liabilities</td>
<td>$300,000</td>
</tr>
<tr>
<td>Mortgage on land and building</td>
<td>400,000</td>
</tr>
<tr>
<td>Shareholders’ equity:</td>
<td></td>
</tr>
<tr>
<td>Share capital</td>
<td>$10,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>490,000</td>
</tr>
<tr>
<td></td>
<td>500,000</td>
</tr>
<tr>
<td></td>
<td>$1,200,000</td>
</tr>
</tbody>
</table>

The following additional information is available:

1. The undepreciated capital cost of the depreciable property is as follows:
   - Building $490,000
   - Equipment 100,000

2. The asset values are as follows:
   - Current assets $500,000
   - Land 100,000
   - Building 720,000
   - Equipment 300,000
   - Marketable securities 100,000
In addition, the value of goodwill has been estimated at $400,000.

3. KS Holdings acquired the shares of Shane Plastics a number of years ago at a cost of $200,000. Recently, a competitor had offered to purchase the shares of Shane Plastics for $1,200,000; Shane had refused the offer because he wanted to sell to the employees.

Shane is prepared to accept the deferred payment schedule suggested by the employees but has concerns about the immediate tax liability associated with the sale. Shane is 50 years old and intends to maintain KS Holdings to hold his investment portfolio. He will also continue to be employed by Shane Plastics after the business has been acquired by the employees.

**Required:**

1. Assuming that either an asset sale by Shane Plastics or a share sale by KS Holdings will be made at fair market values, with deferred payments over eight years, which method should Shane prefer? You may assume a corporate tax rate of 25% on business income.

2. Suggest and briefly discuss several alternative methods that will defer the tax liabilities on the sale and also assist the purchasers in making the acquisition, considering their limited resources. Be as specific as possible, given the information provided.
Solution to P 19-2

Part 1

Keeping in mind that Karl Shane will continue to own KS Holdings for the purpose of maintaining an investment portfolio, it is not necessary to consider the ultimate tax consequences that would occur if the proceeds from the sale are distributed to Karl Shane personally.

Sale of Shares for $1,200,000:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proceeds</td>
<td>$1,200,000</td>
</tr>
<tr>
<td>ACB</td>
<td>$(200,000)</td>
</tr>
<tr>
<td>Capital gain</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Taxable gain (1/2)</td>
<td>$500,000</td>
</tr>
<tr>
<td>Tax @ 44 2/3% to KS Holding</td>
<td>$223,335</td>
</tr>
</tbody>
</table>

Available for reinvestment:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proceeds</td>
<td>$1,200,000</td>
</tr>
<tr>
<td>less tax</td>
<td>$(223,335)</td>
</tr>
<tr>
<td></td>
<td>$976,665</td>
</tr>
</tbody>
</table>

Sale of Assets by Shane Plastics:

It is recognized that the buyers would not likely want to purchase the bonds ($100,000) as they are not needed for the business. Even if the bonds were sold, no tax consequence would result as their fair value is equal to their cost base.

Assets sold:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current assets</td>
<td>$500,000</td>
</tr>
<tr>
<td>Land</td>
<td>$100,000</td>
</tr>
<tr>
<td>Building</td>
<td>$720,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>$300,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>$400,000</td>
</tr>
<tr>
<td></td>
<td>$2,020,000</td>
</tr>
<tr>
<td>less liabilities assumed</td>
<td>$(700,000)</td>
</tr>
<tr>
<td></td>
<td>$1,320,000</td>
</tr>
<tr>
<td>Tax to Shane Plastics (below)</td>
<td>$(165,467)</td>
</tr>
<tr>
<td></td>
<td>$1,154,533</td>
</tr>
<tr>
<td>Add bonds remaining</td>
<td>$100,000</td>
</tr>
<tr>
<td></td>
<td>$1,254,533</td>
</tr>
</tbody>
</table>

Available for reinvestment
### Tax on Sale:

<table>
<thead>
<tr>
<th>Business Income</th>
<th>Taxable Capital Gains</th>
<th>Tax-Free Gain</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land ($100-$50=$50) (1/2)</td>
<td>$25,000</td>
<td>$25,000</td>
</tr>
<tr>
<td>Building ($720-$600=$120) (1/2)</td>
<td>60,000</td>
<td>60,000</td>
</tr>
<tr>
<td>Building ($600-$490=$110)</td>
<td>$110,000</td>
<td></td>
</tr>
<tr>
<td>Equipment ($300-$100)</td>
<td>200,000</td>
<td></td>
</tr>
<tr>
<td>Goodwill ($400) (3/4)(2/3)</td>
<td>200,000</td>
<td>200,000</td>
</tr>
</tbody>
</table>

$510,000 $85,000 $285,000

Tax on $510,000 @ 25% $127,500
Tax on $85,000 @ 44 2/3% $37,967 $165,467

Refundable tax $85,000 x 26 2/3% = $22,667. However, the refundable tax will not be recovered until such time as KS Holdings pays a dividend.

On the asset sale, the tax payable by Shane Plastics could have been reduced if the sale date chosen was the first day of a new taxation year. If this were done, there would be no other business income earned (from operations) in that year and consequently the small business deduction would be available on the first $500,000 of business income from the sale [S.125(1)&(2)].

### Evaluation:

Based on the after-tax proceeds available for reinvestment, Shane would prefer an asset sale as it would leave $1,254,533 available for reinvestment compared to $976,665 under the share sale.

However, this difference of $277,868 should be tempered by the following:

- **On the sale of assets**, $510,000 was business income taxed at 25%. At some future time this income will be distributed to Shane personally which will result in an element of double taxation. The sale of shares results in tax at 44 2/3% on the taxable capital gains, but this tax is eligible for a partial refund when distributed as a dividend [S.129(1)&(3)].

- **To the extent that deferred proceeds will occur** (i.e., over the eight year period), it will not cause a delay in taxes on the recapture of capital cost allowance (on the equipment and the building) nor on the gain on sale of goodwill. However, the tax on the capital gains can be deferred (the capital gains reserve is limited to five years - see Chapter 8) [S.40(1)(iii)]. If the shares are sold the entire gain is a capital gain and the full use of the capital gain reserve can be achieved.

- **The sale of assets creates tax-free capital gains of $285,000** which can be distributed through to Shane as a tax-free dividend [S.83(2)]. The sale of shares, however, creates a tax-free amount of $500,000 (1/2 of $1,000,000). If Shane is subject to a tax rate of 33% on dividends this will ultimately create tax savings of $70,950 ($500,000 - $285,000 = $215,000 x 33%).
Part 2

A number of alternatives are available to defer the tax on the sale. These are described in terms of the two basic methods of a share sale and an asset sale.

Share Sale:

(a) At a very minimum, prior to a share sale, Shane Plastics could cash in the $100,000 of bonds and pay a dividend to KS Holdings Ltd. of $100,000. The dividend flows tax-free to KS Holdings (assuming no RDTOH in Shane) but also reduces the value of the shares to $1,100,000 from $1,200,000. The tax on the sale would then be $201,002 ($1,100,000 - $200,000 = $900,000 (1/2) = $450,000 @ 44 2/3%) compared to $223,335 in part 1 above. This would increase the after-tax proceeds for KS Holdings.

(b) Alternatively, Shane Plastics could declare a dividend of $490,000 before the sale of shares of which $100,000 would be paid in cash (from the bond) with the balance of $390,000 being owed to KS Holdings with defined terms of repayment plus interest. The share value would be reduced to $710,000 ($1,200,000 - $490,000) and KS Holdings after-tax proceeds would be as follows:

<table>
<thead>
<tr>
<th>Cash</th>
<th>$100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Note receivable</td>
<td>390,000</td>
</tr>
<tr>
<td>Proceeds from sale of shares</td>
<td>710,000</td>
</tr>
<tr>
<td>1,200,000</td>
<td></td>
</tr>
<tr>
<td>Less tax on share sale:</td>
<td></td>
</tr>
<tr>
<td>44 2/3% x 1/2 ($710,000-$200,000)</td>
<td>(113,901)</td>
</tr>
<tr>
<td>Net proceeds</td>
<td>$1,086,099</td>
</tr>
</tbody>
</table>

This method benefits Shane but does not substantially reduce the price for the purchasers. Effectively, they still must pay $710,000 for the shares plus the debt of $390,000 for a total of $1,100,000. [Note that the dividend was limited to $490,000 being the maximum dividend permitted by S.55(2) on an arms-length sale].

(c) The above tax of $113,901 could also be deferred if the purchasers created a corporation to buy the shares and the shares were transferred using the elective provisions of the Income Tax Act [S.85(1)]. The legal selling price would be $710,000, but for tax purposes a price of $200,000 (the ACB) would be chosen. KS Holdings could receive cash and/or debt of $200,000 and the balance as preferred shares of the purchaser's corporation (with a reasonable dividend rate).

(d) A share reorganization could also be used whereby KS Holdings converts its common shares of Shane Plastics into preferred shares of Shane Plastics [S.86(1)] (with a reasonable dividend rate). This could be done after Shane pays a dividend of $490,000 as described in (b) above. Consequently, there would be no immediate tax to KS Holdings and they would have proceeds of:

| Cash (dividend)               | $100,000 |
| Note receivable (dividend)    | 390,000  |
| Preferred shares of Shane     | 710,000  |
| $1,200,000                    |          |
Asset Sale:

(a) One method of deferring tax on the sale of the business is to limit the assets sold to those that are essential for the purchaser. In particular, the land and building could be retained by Shane Plastics and leased to the new owners of the business. This avoids tax on the recapture of CCA and capital gain, and allows Shane to earn a return (from rents) on the fair value of the land and building rather than on the after-tax proceeds if they were sold. Similarly, Shane Plastics could retain ownership of the equipment and lease it to the purchasers of the business.

If the above assets are not sold, the purchasers would be acquiring only the current assets and goodwill as follows:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Current assets</td>
<td>$500,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>400,000</td>
</tr>
<tr>
<td>less current liabilities assumed</td>
<td>(300,000)</td>
</tr>
<tr>
<td>Net purchase price</td>
<td>$600,000</td>
</tr>
</tbody>
</table>

Shane Plastics would have the following:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Proceeds from sale (net)</td>
<td>$ 600,000</td>
</tr>
<tr>
<td>Land</td>
<td>100,000</td>
</tr>
<tr>
<td>Building</td>
<td>720,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>300,000</td>
</tr>
<tr>
<td>Bond</td>
<td>100,000</td>
</tr>
<tr>
<td>less mortgage on land and building</td>
<td>(400,000)</td>
</tr>
<tr>
<td>less tax on sale:</td>
<td></td>
</tr>
<tr>
<td>25% (2/3 x 3/4 of goodwill $400,000)</td>
<td>(50,000)</td>
</tr>
<tr>
<td>Net available for investment</td>
<td>$1,370,000</td>
</tr>
</tbody>
</table>

This method enhances Shane's position but also helps the purchasers by reducing the purchase commitment to $600,000. This permits the purchasers to use their limited resources for either a down payment or for business operations, rather than for real estate.

(b) Assets could be sold to a corporation organized by the purchasers and tax deferred by using the elective provision of the Income Tax Act for each asset sold [S.85(1)]. The elected prices for tax purposes would be:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Current assets</td>
<td>$ 500,000 (no election necessary)</td>
</tr>
<tr>
<td>Land</td>
<td>50,000 (ACB)</td>
</tr>
<tr>
<td>Building</td>
<td>490,000 (UCC)</td>
</tr>
<tr>
<td>Equipment</td>
<td>100,000 (UCC)</td>
</tr>
<tr>
<td>Goodwill</td>
<td>NIL</td>
</tr>
<tr>
<td></td>
<td>$1,140,000</td>
</tr>
</tbody>
</table>
Shane Plastics would then have the following:

**Proceeds from sale:**
- Assets at fair market value $2,020,000

**Consideration:**
- Assumption of debt $700,000
- Payable in cash or a note $440,000
- Shares of purchaser (preferred) 880,000

**Position after sale:**
- Due from purchase $440,000
- Shares in purchaser corporation 880,000
- Bonds 100,000

$2,020,000

Obviously, this method provides the greatest tax deferral for Shane. However, the purchaser can only deduct CCA based on the elected values and not on the fair values which decreases the future after-tax income for the purchaser compared to an asset purchase without using the elective provisions. However, because a large portion of Shane's proceeds is in the form of shares of the purchaser corporation, a greater amount of risk is being taken. The price for this risk and the flexible terms of repayment may be that the purchasers must accept the added tax burden of the elective provisions.

**Conclusions:**

The above options are not all inclusive and the students may create several other variations. The authors' preference from the above options is a limited sale of assets whereby Shane retains title to the land and building, and perhaps the equipment, in exchange for a fair rental. This method provides:

- Maximum security for Shane because ownership of the high price assets are retained.
- Substantial tax deferral for Shane.
- A net purchase price for the buyer ($600,000) that is more consistent with their financial capabilities.
- No shifting of tax burdens. The buyers can deduct the cost of goodwill as eligible capital property. The deferred tax on the building, land and equipment remains as Shane's responsibility if those assets are subsequently sold.
PROBLEM THREE

[ITA: 86(1)]

Andy Marcus is the sole shareholder of Marcus Ltd., a Canadian-controlled private corporation. The common shares of Marcus Ltd. have a fair market value of $300,000, an ACB of $50,000, and a PUC of $1000. Through an amendment to the Articles of Marcus Ltd. all of the common shares are converted to preferred shares redeemable for $300,000 in the course of a reorganization of share capital.

Required:

Indicate the tax consequences of the transaction for Andy.
Solution to P 19-3

On an exchange of shares in the course of a capital reorganization, the recognition of the accrued gain on the exchanged shares is deferred for tax purposes, automatically [S.86(1)].

Since Andy exchanged all of her common shares of Marcus Ltd. for preferred shares, Andy is deemed to dispose of the common shares for proceeds equal to their ACB ($50,000) and the ACB of the preferred shares acquired by Andy is deemed to be $50,000. The calculation of these amounts is as follows:

<table>
<thead>
<tr>
<th>ACB of the old shares</th>
<th>$50,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minus FMV of non-share consideration</td>
<td>(0)</td>
</tr>
<tr>
<td>ACB of new shares [S.86(1)(b)]</td>
<td>$50,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>ACB of new shares</th>
<th>$50,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Plus FMV of non-share consideration</td>
<td>0</td>
</tr>
<tr>
<td>Deemed proceeds for old shares [S.86(1)(c)]</td>
<td>$50,000</td>
</tr>
</tbody>
</table>

Effectively, new shares are issued and the old shares are redeemed. On the redemption there is a deemed dividend equal to non-share consideration received in excess of the PUC. In this case there was no non-share consideration.

The PUC of the new preferred shares = PUC of old common shares – boot [S.86(2.1)]. Therefore, the PUC of the preferred shares received by Andy is $1,000.
PROBLEM FOUR

[ITA: 85.1]

Marie Hobbins owns all of the issued shares of H Ltd. She acquired the shares for $100,000 from a stranger in 20X0. The shares of H Ltd. have a PUC of $100. A widely-held Canadian public company, P Corp, is interested in acquiring H Ltd. Marie is considering a proposal to sell her shares to P Corp in exchange for common shares of P Corp of the same value, $900,000.

Required:

1. Describe the tax consequences for Marie and P Corp if the transaction takes place as described above.

2. Marie is certain that the shares of H Ltd. are QSBC shares. She would like to use the capital gains deduction to shelter her gain on the sale of her H Ltd. shares. Is this possible?
Solution to P 19-4

Part 1

Shares of a Canadian corporation, P Corp, are issued to Marie by P Corp in exchange for shares of a taxable Canadian Corporation, H Ltd. Marie did not receive any non-share consideration. Marie and P Corp were at arm’s length before the exchange and Marie will neither control nor own more than 50% of the fair market value of P Corp after the exchange. Thus, S.85.1 applies.

Provided Marie does not include any portion of the gain on the exchange of the shares in her tax return, the tax consequences to her will be as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proceeds for H Ltd. shares (equal to ACB) [S.85.1(1)(a)(i)]</td>
<td>$100,000</td>
</tr>
<tr>
<td>ACB of H Ltd. shares</td>
<td>(100,000)</td>
</tr>
<tr>
<td>Capital gain</td>
<td>$0</td>
</tr>
</tbody>
</table>

ACB of the P Corp shares received by Marie is equal to the ACB of her exchanged H Ltd. shares, $100,000 [S.85.1(1)(a)(ii)]. The PUC of the P Corp shares received by Marie is $100 being equal to the PUC of her exchanged H Ltd. shares [S.85.1(2.1)].

P Corp is deemed to have an ACB of $100 for the shares of H Ltd. acquired [S.85.1(1)(b)]. The ACB is deemed to be the lesser of:

- FMV of H Ltd. shares before the exchange $900,000, and
- PUC of H Ltd. shares before the exchange $100.

Part 2

If Marie chooses to do so, she may report the capital gain on the disposition of the H Ltd. shares on her tax return [S.85.1(1)].

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proceeds (FMV)</td>
<td>$900,000</td>
</tr>
<tr>
<td>ACB</td>
<td>(100,000)</td>
</tr>
<tr>
<td>Capital gain</td>
<td>$800,000</td>
</tr>
<tr>
<td>Taxable capital gain (1/2)</td>
<td>$400,000</td>
</tr>
<tr>
<td>Capital gains deduction ($750,000 x ½)</td>
<td>$(375,000)</td>
</tr>
<tr>
<td>Net</td>
<td>$25,000</td>
</tr>
</tbody>
</table>

In this case only $25,000 is subject to tax.
PROBLEM FIVE

[ITA: 84.1(1), 85(1)]

Robert Blackwell owns 100% of the outstanding shares of Black Inc., a qualified small business corporation. The shares have a paid-up capital (PUC) and an adjusted cost base of $50,000 and a fair market value of $1,000,000. In order to make full use of his lifetime capital gains exemption, Robert uses Section 85 of the Income Tax Act to transfer these shares to Holdings Ltd. at an elected value of $800,000. As consideration he receives a note for $700,000 and preferred shares with a fair market value and a legal stated capital of $300,000. Robert owns all of the shares of Holdings Ltd.

Required:

What are the tax consequences of this transaction for Robert?
Solution to P 19-5

For tax purposes Robert will have:

- a deemed dividend of $650,000 equal to the non-share consideration he received in excess of $50,000 (PUC & ACB) [S.84.1(1)(b)]; and

- a taxable capital gain of $50,000 calculated as follows:
  Proceeds elected under section 85 $800,000
  Less amount deemed to be a dividend (650,000)
  Adjusted proceeds [S.54] 150,000
  ACB (50,000)
  Capital gain $100,000
  Taxable capital gain (1/2) $ 50,000

- The preferred shares of Holdings Ltd. received by Robert will have an ACB of $100,000 [S.85(1)(g)] and a PUC of Nil [S.84.1(1)(a)].
CASES

Delwin Corporation

[ITA: 39(1)(c); 39(9); 83(3); 85(1); 86(1); 89(1); 110.6; 125(1)&(2); 125.1; 129(1)&(3); Reg. 5200]

Carla Delwin has requested that you review her current financial position and her proposed plans and provide her with tax advice. In response to her request, you have gathered together the following information:

Delwin Corporation Ltd. is a Canadian-controlled private corporation that owns several retail clothing stores. Its common shares are owned 80% by Delwin and 20% by one of her senior managers. Information relating to the shares is as follows:

<table>
<thead>
<tr>
<th></th>
<th>Delwin</th>
<th>Manager</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of shares</td>
<td>800</td>
<td>200</td>
</tr>
<tr>
<td>Paid-up capital</td>
<td>$8,000</td>
<td>$2,000</td>
</tr>
<tr>
<td>Cost</td>
<td>$8,000</td>
<td>$25,000</td>
</tr>
</tbody>
</table>

In the current year, DCL earned taxable income of $540,000 from the retail operations. It is expected that this level of profit will be maintained next year.

DCL is planning to expand into the manufacturing business and is currently negotiating for the purchase of equipment that will be used to manufacture winter ski jackets. Because the ski jackets have a ready market in her retail stores, profits are expected to be at least $40,000 in the first year.

The expansion will be funded by cash generated from the sale of a building. The building was sold last year and resulted in a capital gain of $200,000 to DCL. The funds are currently invested in short-term bank certificates.

After a major dispute with the senior manager, it was agreed that early in the new year, the manager would sell his shares for $120,000, leaving Delwin with 100% of the company. The parties have not discussed how to structure the transaction. However, Delwin has indicated to the manager that the full price will be paid in cash.

Delwin personally owns a commercial building that has generated rental revenue for several years. The current lease will end in the near future, and she has decided that rather than renew the lease, she will use the building to open a new retail location. The property was acquired a number of years ago for $100,000 ($80,000 for the building, $20,000 for the land). To date, she has claimed capital cost allowance totalling $30,000. A recent appraisal indicates that the land is worth $30,000 and the building $90,000. Delwin wishes to transfer the land and building to DCL.

In addition, Delwin personally owns several investments that generate Canadian dividends and interest income. She has been wondering if there would be any tax advantage to incorporating these investments.

Delwin contributes the maximum to retirement plans, and her RRSP currently has a value of $200,000, consisting solely of common share investments. Delwin’s son Eric, who had managed one of the retail stores, has recently been promoted to take on greater management responsibilities. Delwin has promised Eric that after a two-year period, he can become a 50% shareholder in DCL. She wants to know how this can be achieved, considering that Eric will have no money to make the
acquisition. Also, Delwin is not anxious to pay tax when she restructures the ownership within the family.

**Required:**

Prepare a report to Delwin providing the tax advice she has requested. Include the tax implications to the manager on the proposed sale of shares.
Solution to Case - Delwin Corporation

As this case involves a number of separate issues which have been reviewed in detail in solutions to previous chapters, the solution is presented in point form for discussion purposes and represents the key items that should be covered in the report requested.

1. Business income of DCL is in excess of $500,000. This excess is subject to the high rate of tax of approximately 25%. This is less than Delwin’s personal rate of 45%. Some double taxation will occur in the future when dividends are paid. If dividends are anticipated in the near future then a bonus should be paid now to reduce income to the $500,000 SBD limit [S.125(2)] and avoid the double tax. Otherwise, Delwin must determine if the current tax deferral (25% vs. 45%) is more valuable than some double tax in the future.

2. DCL incurred a capital gain last year creating a capital dividend account of $100,000 (1/2 of $200,000) [s.83(2); 89(1)].

   The capital dividend account should be paid out as a tax-free dividend as soon as possible to reduce the value of shares thereby reducing the potential capital gain on a share sale.

   The capital gain also created refundable taxes (26 2/3% of 1/2 [$200,000]) [S.129(3)] which will be refunded to DCL if regular dividends are declared and paid [S.129(1)].

3. Buyout of Manager’s shares—2 Basic Methods:

   Direct Purchase of Shares by Carla:
   - Carla can fund the purchase with the tax-free capital dividends and from the bonus suggested above.
   - Manager will incur a capital gain of $95,000 ($120-$25) of which 1/2 is taxable.
   - Manager can use the capital gains deduction if it is still available to him and the shares are qualified small business corporation shares [S.110.6].

   DCL Buyback of Shares from Manager:
   - cancellation of shares is funded with corporate funds.
   - results in deemed dividend of $118,000 ($120-$2) [S.84(3)].
   - This will trigger refund of refundable taxes and assist funding of purchase price.
   - Manager will also have a capital loss of $23,000. Deemed proceeds ($120-$118) [S.54] = $2,000-ACB of $25,000 = $23,000 (1/2 allowable).
   - Qualifies as allowable business investment loss if DCL is a small business corporation [S.39(1)(c)] (unless capital gain deduction was used in prior year) [S.39(9)] and can be offset against other income.
   - Manager may consider creation of holding company to receive deemed dividend.

4. Building Transfer to DCL:

   ● sell at FMV (no election):
     Carla’s—Income:  
     Recapture  
     capital gain, building  
     capital gain, land  

     ($30,000)  
     5,000  
     5,000
5. Investment income:
   ● No benefits achieved by incorporation as corporate rate is similar to or higher than maximum personal rate. On flow through the partial refund of taxes to the corporation integrates corporate and personal tax and no ultimate benefit is achieved.

6. Carla's RRSP consists of common stocks only. Therefore, the fund earns capital gains and dividends, both of which would have preferential tax treatment if earned personally (capital gains only 1/2 taxable and dividends have dividend tax credit). While these gains are not taxable in the RRSP, they become fully taxable as pension income on ultimate payout. Carla presently has interest bearing securities in her personal name which have no preferential tax treatment. Consider revising investment policy to maximize preferred gains in personal name and, if interest income is desired, earn that income in an RRSP.

7. Manufacturing income from expansion will be subject to the federal and, possibly, provincial/territorial manufacturing credits when manufacturing profits exceed the $500,000 small business deduction limit [S.125.1]. Manufacturing income for this credit is determined by a formula based on the ratio of manufacturing capital and manufacturing labour to total capital and labour employed [Reg. 5200]. The formula should be examined to see if it expands or reduces M & P income when the manufacturing and retail profits are combined. If not, consider the effect of using a separate corporation. A separate corporation will isolate the M&P profits, and the $500,000 small business deduction limit can be allocated to the retail corporation [S.125(2)&(3)] making the M&P profits immediately eligible for the M&P credit.

8. Transfer of ownership to Eric:

   There are several ways in which Eric can acquire 50% ownership without cash and without tax to Carla:

   ● share reorganization whereby Carla converts all her common shares to preferred shares for full value of company [S.86(1)]. DCL then issues new common shares in desired ratio for a nominal value.

   ● Carla sells 50% of shares to holding corporation owned by Eric in exchange for preferred
shares of the holding corporation and avoids tax by using the election option [S.85(1)].

- DCL sells assets to a new corporation owned 50/50 by Carla and Eric. Avoids tax on transfer of assets by using the elective option [S.85(1)].
CASE TWO*

Mattjon Limited

Matthew and Jonathan have owned a manufacturing company, Mattjon Limited, for 20 years. Matthew, who is 55 years old, retired from the business on December 31, 20X0. He and his wife plan to travel throughout Canada during his retirement.

It is now January 5, 20X1. Jonathan would like to purchase Matthew’s 50% share of Mattjon. A recent appraisal put the value of the company at $2 million. Jonathan does not have the cash resources to complete the purchase and is concerned about his ability to meet the debt service costs if he has to borrow money to purchase Matthew’s shares.

As the two men are friends, Jonathan would like to structure the purchase so that it provides the greatest possible tax deferral to Matthew. Jonathan has heard that holding companies are sometimes used in these situations, but he does not know what such an arrangement would involve. He has also heard about the capital gains deduction and wonders whether it could be applied to this transaction.

Neither Jonathan nor Matthew has disposed of any capital property in the past. Extracts from the balance sheet of Mattjon are provided in Exhibit I on the next page. The owners of Mattjon have asked you to prepare a memo suggesting how this transaction might be structured.

Required:

Prepare the memo.

* Adapted, with permission, from the 1990 Uniform Final Examination ©1990 of the Canadian Institute of Chartered Accountants, Toronto, Canada. Any changes to the original material are the sole responsibility of W.J. Buckwold and have not been reviewed or endorsed by the CICA.
EXHIBIT I
MATTJON LIMITED
Extracts from Balance Sheet
As at December 31, 20X0
(unaudited)

Assets (Note 1)

<table>
<thead>
<tr>
<th>Current:</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$25,000</td>
<td></td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>150,000</td>
<td></td>
</tr>
<tr>
<td>Inventory</td>
<td>300,000</td>
<td>$475,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Fixed:</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Land (note 1)</td>
<td>$50,000</td>
<td></td>
</tr>
<tr>
<td>Building (net of accumulated amortization)</td>
<td>100,000</td>
<td></td>
</tr>
<tr>
<td>Machinery and equipment (net of accumulated amortization)</td>
<td>75,000</td>
<td>225,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Long term:</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Government bonds</td>
<td>300,000</td>
<td></td>
</tr>
</tbody>
</table>

$1,000,000

Liabilities

<table>
<thead>
<tr>
<th>Accounts payable</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>$70,000</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Income and other taxes payable</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>30,000</td>
<td>$100,000</td>
</tr>
</tbody>
</table>

Shareholders’ Equity

<table>
<thead>
<tr>
<th>Capital stock (Note 2):</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>2 common shares</td>
<td>$200</td>
<td></td>
</tr>
<tr>
<td>600 class A preferred shares</td>
<td>60,000</td>
<td></td>
</tr>
<tr>
<td>600 class B preferred shares</td>
<td>60,000</td>
<td></td>
</tr>
<tr>
<td>Retained earnings (Note 3)</td>
<td>779,800</td>
<td>900,000</td>
</tr>
</tbody>
</table>

$1,000,000

Note 1: Mattjon is considering relocating its facilities to cheaper industrial land, as a recent appraisal valued the company’s land at $550,000. The market value of all other assets approximates book value. Mattjon uses capital cost allowance rates for purposes of financial statement amortization.

Note 2: For tax purposes, all shares have paid-up capital and an adjusted cost base equal to $100 per share. Matthew owns the class A preferred shares and Jonathan the class B preferred shares. Both classes of preferred shares are non-voting, non-participating, and redeemable at their paid-up capital of $100 per share.

Note 3: All of the retained earnings are represented by part profits that have qualified for the small business deduction.
Solution to Case Two – Mattjon Limited

[ITA: 20(1)(c), 40(1)(iii), 55(2), 84(3), 85(1), 86, 87, 88(1), 110.6(1), 127.5, 186(1)]

This case involves items that were reviewed in previous chapters and, therefore, the solution is presented in point form. It assumes personal marginal tax rates of 33% for non-eligible dividends and 45% on other income.

Alternatives for Buy-out

- Matthew sells his shares to Jonathan or to a holding company organized by Jonathan.
- Mattjon Ltd. redeems Matthew’s shares.
- Mattjon Ltd. redeems shares after Matthew transfers them to his new holding company.

Each of the above is reviewed below.

Sale of shares by Matthew to Jonathan (or his Holdco.)

- Estimated tax from the sale is approximately $211,000 as follows:
  45% x 1/2($1,000,000 - [$60,000 + $100])
  - The capital gains exemption ($750,000) is only applicable if the shares are qualified small business corporation shares (QSBC) [S.110.6]. To qualify, the shares must be small business corporations shares (SBC) at the time of sale (CCPC with at least 90% of the FMV of its assets used in an active business) [S.248]. In addition, throughout the 24 months preceding the sale, three tests must be met:
    1) Corporation must be a CCPC
    2) The shares were not owned by an unrelated person, and
    3) More than 50% of the FMV of the corporation’s assets were used in an active business.
   All tests appear to be met except the SBC test.

- The shares currently do not qualify as SBC shares as shown below:

  Total assets (at book value) $1,000,000
  Add land value in excess of book value $550,000 - $50,000 = 500,000
  Fair market value of assets $1,500,000
  Fair market value of business assets $1,500,000 - $300,000 (bond) = $1,200,000
  Current % business assets $1,200,000/$1,500,000 = 80%

- Consider using deferred payments terms to obtain maximum use of the capital gain reserve [S.40(1)(iii)].

- Seek alternatives to change the status of the shares so that they are SBC shares before the transaction date (see below). If this can be achieved tax savings of $168,750 will occur from the capital gains deduction (45% x (1/2)(750,000)).
• Consider the possible impact of the alternative minimum tax [S.127.5] as a result of the capital gain deduction.

**Creating Small Business Corporation Shares**

• In order to achieve this, Mattjon Ltd. must reduce the investment in the bonds to increase the % of business assets. Cashing in all or a part of the bonds should not trigger any taxable income unless the bond values have risen substantially.

• The cash from the bonds can be used in a number of ways to affect the % of business assets. Several of these are described below.

• Pay all of the liabilities which currently are $100,000.

• Purchase new assets that are for business use if they are needed (example - inventory or equipment).

• Redeem the preferred shares of each shareholder ($60,000 + $60,000 = $120,000). The redemption has no tax cost to either shareholder because the share value is equal to the paid-up capital and the ACB.

• The following recalculation of the *business* asset percentage is made assuming that $220,000 of the bonds are cashed and used to pay the liabilities of $100,000 and redeem the preferred shares for $120,000.

  | Business assets remain unchanged (above) | $1,200,000 |
  | Total assets are reduced by $220,000 |  |
  | from the sale of bonds and disbursement |  |
  | of the funds ($1,500,000 - $220,000) | $1,280,000 |
  | % business assets - $1,200,000/$1,280,000 | 94% |

The above qualifies the shares as SBC shares. Thus, Mattjon Ltd. would be a QSBC and Matthew would be entitled to the capital gain deduction.

• The bond funds could also be disbursed by declaring dividends. When considering this option attempt to determine if there is a balance in the capital dividend account (to declare a tax free dividend) and/or in the RDTOH account (which will trigger a refund when taxable dividends are paid).

**Mattjon Ltd. Redeems Shares From Matthew**

• The share redemption results in a deemed dividend to Jonathan of $939,900 ($1,000,000 - [[$60,000 + $100]]) causing a tax of approximately $310,000 (33% x $939,900 = $310,167). [Note that the dividend is non-eligible since all of the retained earnings of Mattjon Limited are represented by past profits that have qualified for the small business deduction.]

• This tax is greater than the previous option of Jonathan selling shares to Matthew without the capital gain deduction ($211,000).
**Mattjon Redeems Shares From Matthew's new Holdco**

- Matthew would first transfer his shares of Mattjon Ltd. to a new Holding company. To avoid tax on the transfer an elected value is chosen under section 85. The elected amount could result in a gain sufficient to use the capital gains deduction.

- The redemption of shares results in a deemed dividend [S.84(3)] up to a maximum of Matthew's retained earnings ("safe earnings") [S.55(2)]. That is - 1/2 of $779,800 = $389,900 (the actual calculation may be different than the retained earnings). The deemed dividend to the holding company is tax free (unless Mattjon is entitled to a dividend refund) [S.186(1)].

- The balance of the proceeds of $610,100 ($1,000,000 - $389,900) is considered to be proceeds of disposition [S.54]. This will result in a capital gain of $550,000 ($610,100 - [$60,000 +$100]) - depending on the elected price chosen on the transfer to the holding company. Tax to the corporation would be $122,834 (44 2/3% x ½ x $550,000) unless a higher elected value was used on the transfer to the holding company.

- This option results in a lower tax than the other options with the exception of the capital gain deduction alternative.

**Jonathan's Perspective:**

**Jonathan Purchases Matthew's Shares**

- To fund the purchase Jonathan will require a bank loan or financing from Matthew (deferred payment terms). In either case, the interest cost is deductible for tax purposes.

- To pay the debt will require that Jonathan take funds from Mattjon Ltd. as they are available.

- One obvious method to get funds from Mattjon is to declare taxable dividends. However, other methods of obtaining the funds should be considered. Some other methods are:
  1) Redeem the preferred shares ($60,000) which does not incur any tax.
  2) After the land is sold (as is planned), the capital gain of $500,000 ($550,000 - $50,000) will create a capital dividend account of $250,000 (1/2 of $500,000). This can be distributed as a tax-free capital dividend [S.83(2)].
  3) If annual business income is over $500,000 a bonus to Jonathan can be paid to avoid the small amount of double taxation.

**Mattjon Ltd. Redeems Shares**

- Under this option Mattjon Ltd. could fund part of the purchase directly from corporate funds generated from the after-tax proceeds on the proposed land sale. The balance of the purchase price could be funded with a loan. The loan interest would be deductible against the corporate profits [S.20(1)(c)].

- This option eliminates the need to declare taxable dividends to Matthew as in the previous option.

- Deferred payments to Matthew could also be used. This could be achieved by first doing a share reorganization under section 86. Matthew would convert his existing common shares to fixed value preferred shares (with a defined dividend rate). The preferred shares could then be redeemed in stages over an agreed period of time. With common shares this would be difficult
because their value would change over time.

Jonathan Creates Holdco. to Buy Matthew's Shares

- Under this option a newly created Holdco would purchase Matthew's shares. To fund the initial purchase, Holdco would obtain a loan and/or be financed by Matthew.

- To obtain funds to repay the debt principal, Holdco could receive dividends from Mattjon Ltd. tax free.

- Dividends from Mattjon would also be paid on Jonathan's existing shares. To avoid tax on these dividends, the existing shares should be transferred to Holdco. This can be achieved without tax by using the elective provisions of section 85. Perhaps Jonathan could elect a price that allows him to use up his capital gain deduction if the steps are taken to qualify the shares.

- Interest incurred by Holdco on the loans is deductible, but Holdco will have no taxable income to deduct it from (the dividends are tax free). Therefore, tax losses will accumulate. To avoid this, Mattjon and the new Holdco should amalgamate [S.87] (or Mattjon should wind-up into Holdco [S.88(1)]). Future interest would then be deductible against the business profits.

- An amalgamation causes a deemed year end for both companies but wind-up does not.

- The wind-up or amalgamation has the potential to cause an increase in the ACB of the land as a result of the share purchase.

Conclusion

Matthew will prefer to sell shares if the capital gain deduction is available.

Given the above, Jonathan would be best served by setting up a holding company to purchase Matthew's shares. Immediately following the acquisition Holdco and Mattjon Ltd. would be combined. This permits Jonathan to make the purchase entirely with funds generated by Mattjon Ltd. without first distributing those funds to him personally.
CHAPTER 20

DOMESTIC AND INTERNATIONAL BUSINESS EXPANSION

Review Questions

1. Domestic and international expansion decisions, like any investment decisions, should attempt to utilize a structure that will minimize the start-up cash requirements and maximize the cash returns to the initiator. Briefly outline the fundamental tax considerations that are relevant to the expansion process.

2. What are the two basic organization structures that can be used for domestic expansion activities without the participation of new equity investors? What is the major difference between these structures regarding tax?

3. The rates of applicable provincial tax and tax on manufacturing profits may be different solely as a result of the expansion structure chosen for new activities. Explain why.

4. What are the basic organization structures that can be used for domestic expansion activities requiring additional capital from new equity participants?

5. When new equity participants are required in order to complete an expansion, what decisions must be made before an analysis of the organizational structure is performed?

6. Is it possible to increase the after-tax rate of return by choosing to give up more equity, rather than less, when new equity participants are required for expansion? Explain.

7. What are the primary business structures used to conduct foreign expansion activities?

8. In most cases, what must be true before a Canadian entity will be subject to foreign taxes on foreign business activities?

9. When the tax rates in a foreign country are lower than Canadian tax rates, will the use of a foreign branch structure to conduct the Canadian entity’s foreign activities be advantageous? Explain.

10. In what circumstances is a foreign branch structure preferable to a foreign corporation structure?

11. Assume that a Canadian individual owns a substantial portion of a foreign corporation’s shares and receives a dividend from them. Would the tax treatment applied to that dividend be different if it were first paid to a Canadian corporation owned by that individual?

12. “If foreign tax rates are the same as Canadian tax rates, a Canadian corporation conducting profitable foreign activities will not care whether a foreign branch or a foreign corporation is used to house the foreign operations.” Is this statement true? Explain.

13. A Canadian business corporation may, in addition to providing equity capital, support its foreign operations by providing loan capital, management services, technology, and equipment. What general implications does the foreign organization structure (branch versus
corporation) have on these additional support activities?

14. Why may a Canadian business entity attempt to underprice or overprice products sold to its foreign subsidiary corporation? How do Canadian tax laws treat such transactions?

15. What tax consequences may result when the business operations of a foreign branch are transferred to a newly created foreign subsidiary corporation? How does this compare with the tax treatment resulting from the transfer of a Canadian branch operation to a Canadian subsidiary corporation?
Solutions to Review Questions

R20-1. When choosing an expansion structure, the decision-maker should consider the tax implications of future profits, the utilization of possible start-up losses, an expansion failure, and the repatriation of both the capital invested and accumulated profits.

R20-2. Domestic expansion without the participation of new equity investors can be structured as either a division of the existing corporation or as a separate subsidiary corporation. The major tax difference between these two structures relate to tax savings that occur from the utilization of losses, both in the start-up phase and those resulting from a complete failure. In the division structure, the losses are merged for tax purposes with the existing operations, creating immediate tax savings whereas, in the corporate structure, the losses must await the arrival of profits from the expansion activity.

Therefore, when start-up losses are expected, the divisional structure requires a reduced cash commitment. If the expansion fails completely, the losses that are locked into a separate corporation may be utilized by the parent entity if a wind-up or an amalgamation occurs but the tax savings are delayed until after that has occurred. Such a reorganization may not be available where the failed expansion corporation is permitted to become bankrupt to limit the losses.

R20-3. Under a divisional structure, the amount of income subject to tax in other provinces (which may apply different rates of tax) is determined by an arbitrary formula based on the ratio of sales and wages in the other province to the total sales and wages of the entire entity. Consequently, the amount of expansion income subject to tax in the new province may be different from the actual expansion profits. In contrast, expanding to another province by housing that expansion in a separate corporation, results in the actual expansion profits being subject to tax in the new province.

Similar differences can occur for manufacturing activities because of the requirement to determine M & P profits eligible for the rate reduction (13% in 2012) by the arbitrary formula (based on the ratio of manufacturing capital and labor employed by the entire entity). By separating the expansion activity in a separate corporation, this ratio is affected.

R20-4. When the expansion project requires additional capital from outside investors, the primary available structures are:

- separate corporation
- standard partnership
- limited partnership

R20-5. Before choosing an expansion structure that involves outside equity participants, the project initiator must decide:

- whether or not the new investors will participate only in the expansion project or in the existing operations as well.
- if the new participants will be active in management or passive investors.
- if funds should be sought from a large number of investors (each investing small amounts) or from a small number of investors (investing large amounts).
- whether or not the project can be divided into separate parts attracting different participants for each.
- the amount of equity that will be given up to obtain the expansion funds.
R20-6. In some circumstances, giving up additional equity may increase after-tax returns if it results in lower tax rates on the project profits. For example, retaining 50% equity in an expansion project organized as a Canadian-controlled private corporation may create the ability to obtain a new small business deduction limit on the new project profits, as it would not be associated with the initiator corporation. Consequently, a portion of the initiator's share of profits would be taxed at 15% (in some provinces) rather than at the higher corporate rate of approximately 25%. In comparison, if the initiator had retained 55% of the project's equity, all profits would be subject to the high tax rate. Therefore, although giving up additional equity results in a lower share of pre-tax profits, the after-tax profits may be higher.

R20-7. Foreign business expansion activities can be achieved through direct sales from the home based entity, or by establishing either a foreign branch location or a separate foreign corporation to house those activities.

R20-8. A Canadian entity will normally be subject to foreign tax on their foreign business activities if they carry on business in the foreign country from a permanent establishment located in that country. The term "permanent establishment" is usually defined in the tax treaty between Canada and the particular foreign country. In most treaties, the term means a fixed place of business from which foreign operations are conducted and includes a place of management, a branch, an office or factory (although a fixed place of business used primarily for storage or display of merchandise is usually excluded). Therefore, direct sales do not qualify as carrying on business in the foreign country and are not subject to the foreign tax.

R20-9. The profits of a foreign branch location will be subject to tax in the foreign country. However, because the foreign branch is formally a part of the Canadian entity (i.e., it is not a separate corporation) and the Canadian resident entity is taxable on its world income, the foreign branch profits are also taxable in Canada. The applicable Canadian tax can be reduced by the tax paid to the foreign country (foreign tax credit) thereby eliminating double taxation. Consequently, no advantage is gained under the branch structure when the foreign tax rate is lower than the Canadian tax rate because the higher Canadian rates prevail.

R20-10. Although the branch structure does not result in preferential tax rates on annual foreign profits, it has one major advantage over the corporate structure. If losses are incurred from the foreign branch operation, they can be used immediately to offset income from the home-based operations thereby creating cash flow from tax savings. This improved cash flow can be retained in Canada or reinvested in the foreign branch to enhance the opportunity for long-term success. In effect, it reduces the amount of funding required to service the foreign expansion.

R20-11. The receipt of a foreign dividend by a Canadian individual is included in his or her income as fully taxable property income without the benefit of the dividend tax credit that would apply to the receipt of Canadian dividends. For example, an individual in a 45% tax bracket would pay a tax equal to 45% of the actual dividend. While the foreign country would impose a withholding tax on the dividend, Canadian taxes are reduced by an equal amount from the application of the foreign tax credit. In contrast, if the foreign dividend was first paid to a Canadian corporation and then passed on as a Canadian dividend to the individual shareholder, the result is quite different. The foreign corporation would qualify as a foreign affiliate of the Canadian corporation and, therefore, the foreign dividend is not subject to Canadian corporate tax. This means that the foreign withholding tax on the dividend becomes a cost because no foreign tax credit can be applied. However, when the foreign dividend income is passed on to the shareholder as a dividend from the Canadian corporation it becomes eligible for the dividend tax credit. For example, if the foreign withholding tax rate is 10% and the individual tax rate is 28% on
Canadian eligible dividends - after the dividend tax credit, the total tax paid is only 35% as follows:

<table>
<thead>
<tr>
<th>Income</th>
<th>Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign dividend</td>
<td>$100</td>
</tr>
<tr>
<td>Foreign withholding tax (10%)</td>
<td>10</td>
</tr>
<tr>
<td>Net to Canadian corporation</td>
<td>90</td>
</tr>
<tr>
<td>Tax on Canadian dividend (28%)</td>
<td>25</td>
</tr>
<tr>
<td>Net to individual</td>
<td>$65</td>
</tr>
</tbody>
</table>

R20-12. The statement is not necessarily true. In a branch structure, if the foreign operation is subject to a 25% foreign tax rate which is the same as the Canadian tax rate, the total tax paid upon repatriation of the foreign profits is 25%. In other words, the foreign tax of 25% reduces the Canadian tax by an equivalent amount from the foreign tax credit mechanism and there is no further tax when those profits are transferred to Canada (this may not always be the case as some countries impose a special branch tax that is similar to a withholding tax).

In comparison, a foreign corporation would be subject to 25% tax on its profits but a further withholding tax would be paid on a dividend distribution of those profits to the Canadian corporate shareholder. Because the foreign dividend (received from a foreign affiliate) is not taxable to the Canadian corporation, a foreign tax credit for the withholding tax would not be available. Therefore, the foreign corporate structure tax cost is ultimately higher by an amount equal to the withholding tax rate.

R20-13. Providing support activities to a foreign branch operation such as capital funds, equipment, technology and management services does not alter the normal tax treatment of the foreign activities. Because the branch is a part of the Canadian entity, it simply requires a cost allocation to the foreign branch for the costs incurred on its behalf. However, when a foreign corporation is established, there is an actual separation of the foreign activities from the Canadian entity. As a result, providing the above mentioned support activities to the foreign corporation require compensation in the form of interest, rents, royalties and management fees.

These costs to the foreign corporation reduce the amount of foreign income that is subject to foreign corporate tax and increases the income of the Canadian entity. Most countries impose a withholding tax on the payment of interest, rents, royalties and management fees paid to Canada. However, because the receipt of these payments is taxable in Canada, the foreign tax credit will eliminate the impact of the imposed withholding tax.

R20-14. In some situations, the process of selling in a foreign market involves activities in both Canada and the foreign country. For example, a Canadian manufacturer may sell finished goods or component parts to its foreign corporation for completion, packaging, and selling. Therefore, an element of profit belongs to both countries. Where the tax rate in the foreign country is lower, there is a tendency to under-price the sale of product to the foreign corporation in order that they may earn a greater portion of the profit. Where the foreign country has a higher tax rate, the reverse is true.

Canadian tax law deals with this by imposing a reasonableness test on the transfer prices of products and services to the foreign corporation. Therefore, regardless of the price established, the products and services sold to the foreign corporation are, for tax purposes, deemed to be sold at a price that would reasonably have been expected if the sale had been to an arm's length party.
R20-15. Properties of a foreign branch are owned by the Canadian corporation. Therefore, the incorporation of a foreign branch involves the sale of assets (inventory, equipment, goodwill and so on) from a Canadian corporation to a foreign corporation. The sale of assets at fair market value may, therefore, result in taxable gains. In comparison, the transfer of assets to a Canadian corporation can eliminate the creation of taxable income by electing to transfer the assets at tax values rather than at fair market values. Under Canadian tax law, this option applies only where the assets are transferred to another Canadian corporation. Therefore, in choosing an initial expansion structure, it is important to anticipate the potential tax implications if it should become necessary to alter the initial structure.
Problems

PROBLEM ONE

Sanford Pipe Ltd. is a Canadian corporation operating a profitable business in eastern Canada. Four years ago, the company attempted to expand its operations to northern Mexico. At that time, Sanford invested $700,000 in a newly created Mexican subsidiary corporation. That corporation used those funds to acquire special equipment and as working capital for the new venture.

From the beginning, the foreign operations were plagued by a number of unexpected setbacks, including labour and production problems. As these setbacks occurred, Sanford contributed additional cash to keep the operations afloat. Sanford finally recognized that the Mexican subsidiary had no future and decided to close it. After the equipment was sold and all liabilities were paid, the Mexican corporation was wound up, and Sanford received $200,000.

The financial results of the Mexican venture are summarized below.

<table>
<thead>
<tr>
<th>Year</th>
<th>Losses incurred</th>
<th>Cash provided by Sanford</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X1</td>
<td>$300,000</td>
<td>$  700,000</td>
</tr>
<tr>
<td>20X2</td>
<td>200,000</td>
<td>100,000</td>
</tr>
<tr>
<td>20X3</td>
<td>200,000</td>
<td>200,000</td>
</tr>
<tr>
<td>20X4</td>
<td>100,000</td>
<td>--0--</td>
</tr>
<tr>
<td></td>
<td>$800,000</td>
<td>$1,000,000</td>
</tr>
</tbody>
</table>

The president of Sanford regretted the decision to undertake the foreign expansion. Not only did it result in a substantial loss, but the cash requirements also resulted in the company forgoing a number of other opportunities that could have yielded 15% after tax.

Assume Sanford is subject to a 25% corporate tax rate.

Required:

1. Determine the after-tax loss in cash flow terms to Sanford as a result of the foreign venture.

2. If the foreign venture had been organized as a foreign branch of Sanford, how much would it have lost?
Solution to P 20-1

1. Because the foreign operation was organized as a subsidiary corporation, the total business losses of $800,000 cannot be used by the Canadian parent for tax purposes. Therefore, Sanford must recognize their loss as a loss of capital invested. There is no indication of whether the capital was provided as share capital or loans but either way, for tax purposes, Sanford will incur a capital loss upon the wind-up of the Mexican corporation as follows:

   Capital invested ($700 + $100 + $200) $1,000,000
   Less recovered on wind-up 200,000
   Allowable capital loss (1/2) $400,000

   The capital loss does not qualify as an allowable business investment loss because the Mexican corporation does not qualify as a small business corporation. Therefore, the $400,000 loss can only be offset against other taxable capital gains of Sanford. If Sanford has other capital gains in the year of wind-up, the tax savings from the loss would be $100,000 (25% of $400,000). If not, the capital loss would be carried forward indefinitely.

Sanford's real loss from the expansion can be measured in after-tax cash flow terms considering that the cash investments were made over a period of time and the cash recovery occurs at the time of wind-up. The loss, in net present value terms, is determined below under the following assumptions:

   - Cash contributions are made at the beginning of each year.
   - The wind-up occurs at the end of year four.
   - Tax losses occur at the end of the particular year.
   - An appropriate discount rate is 15% being the after-tax return that was available from other opportunities.

   The loss is determined on a worst case scenario (the capital loss cannot be used) and on a best case scenario (the capital loss can be used immediately).

Worst case:

<table>
<thead>
<tr>
<th>Year</th>
<th>Actual Cash Flow</th>
<th>NPV</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X1 (beginning)</td>
<td>$700,000</td>
<td>$700,000</td>
</tr>
<tr>
<td>20X2 (beginning)</td>
<td>100,000</td>
<td>87,000</td>
</tr>
<tr>
<td>20X3 (beginning)</td>
<td>200,000</td>
<td>152,000</td>
</tr>
<tr>
<td>20X4 (end)</td>
<td>(200,000)</td>
<td>(114,000)</td>
</tr>
<tr>
<td>Net</td>
<td>$800,000</td>
<td>$825,000</td>
</tr>
</tbody>
</table>

Best case:

<table>
<thead>
<tr>
<th></th>
<th>Actual Cash Flow</th>
<th>NPV</th>
</tr>
</thead>
<tbody>
<tr>
<td>As above</td>
<td>$800,000</td>
<td>$825,000</td>
</tr>
<tr>
<td>Tax savings from capital loss, end of year four</td>
<td>(100,000)</td>
<td>(57,000)</td>
</tr>
<tr>
<td>Net</td>
<td>$700,000</td>
<td>$768,000</td>
</tr>
</tbody>
</table>
2. If the Mexican venture had been organized as a branch of Sanford Pipe Ltd., the annual business losses would have been fully deductible against the other income of Sanford in the years in which they occurred but no capital loss would have occurred when the project closed. The tax savings which occur at the end of each year would have been as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Loss</th>
<th>Tax savings (25%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X1</td>
<td>$300,000</td>
<td>$75,000</td>
</tr>
<tr>
<td>20X2</td>
<td>200,000</td>
<td>50,000</td>
</tr>
<tr>
<td>20X3</td>
<td>200,000</td>
<td>50,000</td>
</tr>
<tr>
<td>20X4</td>
<td>100,000</td>
<td>25,000</td>
</tr>
<tr>
<td></td>
<td>$600,000</td>
<td>$200,000</td>
</tr>
</tbody>
</table>

Therefore, both the amount and timing of the resulting tax savings are better than the corporate structure in part 1. The real loss from a branch structure would have been as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Cash Flow</th>
<th>NPV</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X1 (beginning)</td>
<td>$700,000</td>
<td>$700,000</td>
</tr>
<tr>
<td>20X1 (end) tax saving</td>
<td>(75,000)</td>
<td>(65,000)</td>
</tr>
<tr>
<td>20X2 (beginning)</td>
<td>100,000</td>
<td>87,000</td>
</tr>
<tr>
<td>20X2 (end) tax saving</td>
<td>(50,000)</td>
<td>(38,000)</td>
</tr>
<tr>
<td>20X3 (beginning)</td>
<td>200,000</td>
<td>152,000</td>
</tr>
<tr>
<td>20X3 (end) tax saving</td>
<td>(50,000)</td>
<td>(33,000)</td>
</tr>
<tr>
<td>20X4 (end) cash recovered</td>
<td>(200,000)</td>
<td>(114,000)</td>
</tr>
<tr>
<td>20X4 (end) tax saving</td>
<td>(25,000)</td>
<td>(14,000)</td>
</tr>
<tr>
<td>Net cost</td>
<td>$600,000</td>
<td>$675,000</td>
</tr>
</tbody>
</table>

Comparative Summary:

<table>
<thead>
<tr>
<th></th>
<th>Actual Loss</th>
<th>NPV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign branch</td>
<td>$600,000</td>
<td>$675,000</td>
</tr>
<tr>
<td>Foreign corporation:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Worst case</td>
<td>$800,000</td>
<td>$825,000</td>
</tr>
<tr>
<td>Best case</td>
<td>$700,000</td>
<td>$768,000</td>
</tr>
</tbody>
</table>
PROBLEM TWO

Kronston Ltd. is a Canadian-controlled private corporation that imports irrigation equipment from Taiwan for distribution in southwestern Ontario. Last year, the company achieved a profit of $600,000 after tax.

Kronston is interested in expanding its operations to the Okanagan region of British Columbia. It recognizes that to be successful, it will require a committed manager who is familiar with the area and understands the special problems of irrigation in that region.

The Okanagan region is capable of generating profits of $250,000 annually. Sonia Harapiuk lives in Vernon, B.C., and has been active in the irrigation business for many years. She is interested in managing the Okanagan expansion, provided that she can have an equity interest in the venture. Kronston is not averse to this, as Harapiuk has proven expertise in the industry and her equity participation would ensure a long-term commitment.

She has requested 50% equity in the venture and has sufficient funds to provide her share of the capital required to start the venture. Kronston had been thinking of allowing Harapiuk to purchase a 25% interest in the Okanagan activity. The company feels that her participation is important but also sees other alternatives. Before making a decision, the president of Kronston has asked his financial manager to determine the financial cost of allowing Harapiuk to own 50% instead of 25% of the new venture. The project will require a total capital investment by the owners of $800,000. Kronston has other opportunities for investing its funds, and these opportunities can yield pre-tax returns of 25% annually.

Required:

What would be the financial cost to Kronston of permitting Harapiuk to have the equity interest in the new venture that she has requested? Assume corporate tax rates are 15% on income subject to the small-business deduction and 25% on other business income.
Solution to P 20-2

The expansion project in this problem involves the participation of a new equity investor who will be active in managing the project. The primary issue is to establish the impact on Kronston of giving up 50% of the equity versus the intended 25%. While there are a number of administrative factors that must be considered, the problem is restricted to measuring the cash flow implications to Kronston. In doing this, it must be noted that increasing the new participant’s equity interest to 50% results in a reduced cash investment for Kronston as the new investor has sufficient funds to meet the capital requirements. Therefore, the potential return for Kronston from investing the reduced cash requirement in other investment opportunities becomes an integral part of the analysis.

A second issue involves the choice of an expansion structure. The basic alternatives are a separate corporation or a standard partnership. The analysis explores both with an emphasis on the corporate structure.

The Corporate Structure

If Kronston offers the new investor a 25% interest in the venture, Kronston will own 75% of the equity causing the new corporation to be associated with Kronston. As a result, the new entity will not have the small business deduction available. Kronston could, of course, allocate the annual small business deduction limit to the new corporation but that would substantially increase their own taxes which would have to be considered as a relevant cost. Assuming that Kronston will retain its SBD limit, its share of the new venture profits would be as follows:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Profits</td>
<td>$250,000</td>
</tr>
<tr>
<td>Less tax @ 25%</td>
<td>(62,500)</td>
</tr>
<tr>
<td>After-tax profits</td>
<td>$187,500</td>
</tr>
<tr>
<td>Kronston's share (75%)</td>
<td>$140,625</td>
</tr>
</tbody>
</table>

Any future dividend distributions to Kronston would be tax free. The resulting return on investment would be:

Investment (75% of $800,000) $600,000
ROI $140,625 = 23%
$600,000

If the new investor is given 50% of equity, two changes occur:

- The cash requirement is reduced by $200,000 (from $600,000 to $400,000). This freed-up cash can be invested by Kronston to provide a pre-tax return of 25%.
- Because Kronston will not control the new corporation, it will not be associated for tax purposes and will be entitled to its own annual small business deduction on $500,000 of income (tax rate - 15%).
Therefore, Kronston’s after-tax returns would be as follows:

**From new venture:**

- Profits: $250,000
- Less tax - $250,000 @ 15%: (37,500)
- After-tax profit: $212,500

Kronston's share (50%): $106,250

**From investment of incremental cash:**

- Pre-tax return ($200,000 @ 25%): $50,000
- Less tax @ 44 2/3% (22,334): 27,666

Total after-tax profits: $133,916

ROI: $133,916 = 22%

Therefore, giving up additional equity in the new venture reduces Kronston's profits by $6,709 ($133,916 - $140,625) primarily due to the expanded small business deduction limit.

**Partnership Structure**

If the expansion project was organized as a partnership, there would be no opportunity to expand the small business deduction limit. Kronston’s share of the partnership profits is simply included in Kronston’s income and would be taxed at the high rate of 25%. Giving up 50% of the equity would result in the following:

Share of partnership profits
(50% of $250,000): $125,000
Less tax @ 25%: (31,250)

Income from investment of additional funds:
- $200,000 @ 25%: $50,000
- Less tax @ 44 2/3% (22,334): 27,666
Total profits: $121,416

ROI: $121,416 = 20%

A 75% partnership interest for Kronston would provide the same profits as the corporate structure:

Share of partnership profits
(75% of $250,000): $187,500
(Less tax @ 25%): (46,875)

$140,625

Therefore, using a partnership structure, the cost to Kronston of giving up 50% equity versus 25% equity is $19,209 per year of after-tax profits.
PROBLEM THREE

Jean Dumenil is a senior executive for Dentex Ltd., a Canadian company operating a national chain of retail stores. His colleague and friend, George Watson, recently gave up his job as marketing manager with Dentex and has moved to the United States to start his own chain of retail stores.

Watson is trying to raise equity capital by selling shares of his new American corporation. He has approached Dumenil and offered him a 25% interest in that corporation in exchange for a $250,000 cash investment. Dumenil has confidence in Watson’s abilities and has agreed to the investment. Watson has assured Dumenil that the American corporation will pay regular dividends of $20,000 to Dumenil annually as soon as adequate cash flows permit.

Dumenil is subject to a personal marginal tax rate of 45% on income, except on Canadian dividends, which are taxed at a rate of 28% on eligible dividends and 33% on non-eligible dividends. Watson has informed Dumenil that the American corporation will pay tax at a rate of 40% on its business income. American withholding tax on dividends is 15% if paid to an individual and 5% if paid to a Canadian corporation owning more than 10% of the shares.

Required:

1. Determine the amount of tax that Dumenil will be required to pay if annual dividends of $20,000 are paid.

2. What is the combined rate of foreign tax and Canadian tax that will be paid on Dumenil’s share of the American business profits after they are distributed to him as dividends?

3. Would you advise Dumenil to create a Canadian holding corporation to own the shares of the American corporation? Explain, and provide supporting calculations.

4. If Dumenil uses a holding corporation but is going to require the annual dividends of $20,000 for personal use, how should he capitalize the holding corporation with his $250,000? Explain.
Solution to P 20-3

1. The $20,000 foreign dividend is fully taxable in Canada as property income. It is also subject to a U.S. withholding tax of 15% (for individuals). The foreign tax credit would reduce Canadian taxes by the withholding tax paid. The total tax to Dumenil is:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign dividend (expressed in Canadian dollars)</td>
<td>$20,000</td>
</tr>
<tr>
<td>Foreign withholding tax (15%)</td>
<td>$3,000</td>
</tr>
<tr>
<td>Canadian tax:</td>
<td></td>
</tr>
<tr>
<td>$20,000 @ 45%</td>
<td>$9,000</td>
</tr>
<tr>
<td>Less foreign tax credit</td>
<td>(3,000)</td>
</tr>
<tr>
<td>Total tax</td>
<td>$9,000</td>
</tr>
</tbody>
</table>

2. The combined Canadian and foreign rate of tax on Dumenil's share of the foreign venture profits is calculated as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assumed income of new venture</td>
<td>$1,000</td>
</tr>
<tr>
<td>Foreign corporate tax (40%)</td>
<td>(400)</td>
</tr>
<tr>
<td>Available for dividend</td>
<td>600</td>
</tr>
<tr>
<td>Personal tax on dividend:</td>
<td></td>
</tr>
<tr>
<td>Foreign withholding tax (15%)</td>
<td>$90</td>
</tr>
<tr>
<td>Canadian tax (45% of $600)</td>
<td>270</td>
</tr>
<tr>
<td>Canadian foreign tax credit</td>
<td>(90)</td>
</tr>
<tr>
<td>Net proceeds</td>
<td>$330</td>
</tr>
<tr>
<td>Combined tax:</td>
<td></td>
</tr>
<tr>
<td>Foreign</td>
<td>$400</td>
</tr>
<tr>
<td>Canadian</td>
<td>270</td>
</tr>
<tr>
<td>Combined rate</td>
<td>67%</td>
</tr>
</tbody>
</table>

3. If Dumenil used a Canadian holding corporation to own the U.S. corporate shares, the foreign corporation would qualify as a foreign affiliate (due to its 25% equity interest). Dividends from the foreign corporation would, therefore, not be subject to Canadian corporate tax. A 5% U.S. withholding tax would be applicable on the dividend and no Canadian foreign tax credit would be available, because there is no Canadian corporate tax on the dividend. The net proceeds from a $20,000 dividend to the Canadian corporation would be $19,000 ($20,000 - 5% of $20,000) compared to the net proceeds in part 1 of $11,000 ($20,000 - $9,000 = $11,000).

Therefore, the holding corporation would provide a tax deferral provided that the dividend returns are reinvested within the corporation. If the holding corporation distributed its earnings as Canadian dividends to Dumenil, such dividends would qualify for the dividend tax credit and an effective tax rate of 28%. His after tax proceeds from the $20,000 would be as follows:
Holding corporation:
  Dividend income $20,000
  Less withholding tax (5%) (1,000)
  Available for distribution 19,000

Dumenil:
  Tax on Canadian dividend – Eligible (28%) (5,320)
  Net after-tax proceeds $13,680

Therefore, Dumenil's ultimate rate of tax on his share of the U.S. profits is as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. corporate income</td>
<td>$1,000</td>
</tr>
<tr>
<td>Less U.S. tax (40%)</td>
<td>(400)</td>
</tr>
<tr>
<td>Available for dividend</td>
<td>600</td>
</tr>
<tr>
<td>U.S. withholding tax (5%)</td>
<td>30</td>
</tr>
<tr>
<td>Net to Canadian corporation</td>
<td>570</td>
</tr>
<tr>
<td>Personal tax (28% of $570)</td>
<td>(160)</td>
</tr>
<tr>
<td>Total</td>
<td>$410</td>
</tr>
</tbody>
</table>

Combined tax:
  U.S. Corporate tax $400
  U.S. withholding tax 30
  Canadian tax on personal dividend 160
  Total $590

Therefore, the holding corporation structure can create a tax deferral and also reduce the overall tax on Dumenil's share of the U.S. profits to 59% from 67%. This results from the conversion of the foreign dividend into a Canadian dividend (gaining the dividend tax credit) by passing it through the Canadian holding corporation.

4. If Dumenil used a holding corporation but required the annual dividend for personal use, he should capitalize the holding corporation with a nominal amount of share capital and the balance as a non-interest bearing shareholders loan. The holding corporation's balance sheet would be as follows:

Asset:
  Investment in U.S. shares $250,000

Liabilities and Shareholder Equity:
  Due to Dumenil $249,999
  Share capital 1
  Total $250,000

As a dividend from the U.S. corporation to the Canadian holding corporation would be subject to a 5% foreign withholding tax only, it would leave an annual amount of $19,000 ($20,000 - $1,000) available for distribution to Dumenil. Rather than distribute the $19,000 as a taxable dividend to Dumenil, the holding company could simply repay a portion of the $249,999 shareholder loan which would not result in any tax to Dumenil. This enables Dumenil to obtain his needed cash and still maintain the tax deferral from the benefit of the holding company.
CASES

Klondike Carpets Ltd.

Klondike Carpets Ltd. is a large Winnipeg retailer of home and office flooring. The company is a success because it keeps abreast of market changes and provides personalized service to its customers.

The company is owned by three brothers, each of whom plays a major role in the business operations. George, a CA, handles financing. Walter heads the buying department and travels extensively. Ken is the primary marketing person, the one who instills the concept of “personal service” in the sales organization.

Klondike’s profits for the last fiscal year amounted to $550,000 after reasonable salaries to the three managing shareholders. The company has accumulated large cash reserves.

Recently, the brothers have been discussing what to do next in their successful business. They have listened to offers to sell the company that, if accepted, would give them sufficient net capital to live a comfortable life. But they have also considered just staying the way they are (that is, a successful local business) and letting their wealth accumulate.

This sounds attractive, but they are all young enough to seriously entertain expansion possibilities. Recently, Ken completed a tour of Canada and targeted 10 cities that he thought could support a successful operation like the one in Winnipeg. The Winnipeg operation has two locations—the main store on Portage Avenue and a branch in Polo Park. The branch is managed by Shirley Friesen, who is exceptional in that she runs the business as if she owns it. In the previous year, she was rewarded with a bonus of 10% of profits.

Walter has expressed concern that Shirley, with her expertise and personality, may soon open her own store in competition. Although she does not currently have any substantial amount of capital, Walter is aware that she saves her entire bonus as well as a portion of her regular salary.

The brothers plan to meet to discuss these current issues. In preparation, George has assembled the following information:

Winnipeg branch store

<table>
<thead>
<tr>
<th>Current profits</th>
<th>$120,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Major assets:</td>
<td></td>
</tr>
<tr>
<td>Working capital and inventory</td>
<td>300,000</td>
</tr>
<tr>
<td>Fixtures and leaseholds</td>
<td>nominal</td>
</tr>
</tbody>
</table>
Expansion stores

• New stores would be in rented premises.
• Possible good locations: 10.
• Capital required per store:

<table>
<thead>
<tr>
<th>Description</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Working capital</td>
<td>$300,000</td>
</tr>
<tr>
<td>Leasehold improvements and fixtures</td>
<td>$250,000</td>
</tr>
<tr>
<td>Start-up costs (opening advertising giveaways etc.)</td>
<td>$50,000</td>
</tr>
<tr>
<td>Available bank financing on new store</td>
<td>$200,000</td>
</tr>
<tr>
<td>Net capital required</td>
<td>$400,000</td>
</tr>
</tbody>
</table>

- Profits are expected to be 30% of capital invested, or $120,000 per store (after amortization and so on).
- Klondike can raise about $2,000,000 for expansion by combining its cash reserves with a small amount of bank financing. The required bank financing is separate from the bank financing for each new store described above.
- Corporate tax rates are 15% on income subject to the small-business deduction, 25% on other business income, and 44 2/3% of investment income.

Required:

Recommend a course of action for:

(a) the Polo Park branch operations; and
(b) a possible expansion to the target cities.
Solution to Case - Klondike Carpets Ltd.

This case forces students to analyze the after-tax cost resulting from sharing a portion of the equity of a venture and the impact of choosing alternative organization structures. The student is also required to apply fundamental business valuation and corporate reorganization concepts.

The Polo Park Branch Issue

Klondike is concerned that they may lose Friesen's outstanding management abilities and also that she may become an effective competitor. Therefore, they must explore alternatives that would ensure Shirley's continued commitment.

One method would be to simply increase Friesen's bonus to 20%, 30%, or even 50% of the pre-tax profits. As this would result in a deductible expense to Klondike, the after-tax cost of this alternative can be easily measured. Klondike may be concerned that increasing cash bonuses will simply mean that Friesen's cash reserves will continue to grow and increase her opportunity to start up her own store in competition. They should, therefore, explore the possibility of permitting Friesen to acquire an equity interest. This raises a number of issues:

- How much equity should she acquire?
- What price should she pay?
- How can the branch be separated from the existing corporation?
- What is the cost to Klondike of giving up an equity interest?
- What organization structure should be used?

Often students begin by suggesting that Friesen acquire a portion of the shares of Klondike Carpets Ltd. from either the existing shareholders or directly from the corporate treasury. While this is a viable alternative, it means that she would participate in the entire organization rather than just the Polo Park operation. The discussion that follows assumes that she will participate only in the Polo Park operation. It is also assumed that the reported branch profit of $120,000 is before her existing 10% bonus and that if she acquires an equity interest, no future bonus will be paid beyond her fair management salary.

In order for Friesen to acquire a part ownership in the branch, Klondike will have to sell the branch assets to a separate entity which could be either a separate corporation or a partnership.

Value of the Polo Park Branch:

The book value of the branch is $300,000. This consists of working capital (assets minus liabilities) and includes inventory. The fixtures and leaseholds, although useful to the business, likely do not have any significant resale value. Therefore, any additional value of the branch would relate to a goodwill factor.

An examination of the expansion information provides information regarding expected returns. Each new expansion store is expected to generate profits of $120,000 from a net investment of $400,000 (30% return). The net value of the Polo Park branch could be determined using a capitalization rate of 30%. As its profits are the same as the proposed expansion stores, its value would be $400,000 ($120,000/.30). This would consist of the following:

- Net working capital (including inventory) $300,000
- Goodwill 100,000

$400,000
Transfer of Branch Assets:

The assets would be sold to the new entity (corporation or partnership) at fair market value ($400,000). However, for tax purposes, the transfer price could be at an elected price to eliminate the creation of taxable income to Klondike. If the election is not made, Klondike would be subject to a tax of $12,500 from the sale of goodwill (25% of (2/3)(3/4) [$100,000]). This assumes that Klondike has a zero balance in its cumulative eligible capital account.

Before deciding on whether or not the election option should be used, it is necessary to establish whether or not Friesen will obtain an equity interest by contributing her percentage ownership in the new entity. It is possible that she could obtain an equity interest with only a nominal contribution. For example, if Klondike permitted the new entity to owe the full balance of the purchase price ($400,000) in the form of debt and/or preferred shares, the remaining equity would have a nominal value. Friesen could then acquire an equity interest for a nominal cost. She would then share in the entity’s growth only to the extent that it exceeded $400,000.

Permitting Friesen to obtain an equity interest at a nominal cost is consistent with her ability to raise capital. However, as she has no risk, it may not achieve the desired result of ensuring her long-term commitment to the success of the operation. Most students argue that she should be required to contribute her percentage share of the $400,000. If this is done, it may be unreasonable for Klondike to use the election option for the goodwill as that would not permit the new entity to deduct the cost of the goodwill over future years to the detriment of Friesen who contributed a fair value for her interest. Further analysis assumes that Klondike will incur a tax of $12,500 (assuming Klondike has made no CEC deductions in the past years) on the sale of the branch to the new entity. The issue of how Friesen can obtain the funds to acquire her interest is discussed later.

Equity Percentage and Organization Structure:

Students will suggest a variety of equity percentages for Friesen that usually range from 10% to 50%. Regardless of the percentage chosen, it is important to translate its impact on Klondike's share of after-tax profits by comparing before and after scenarios. This should also be considered for both a corporate and partnership structure. The following analysis is made for each structure assuming that Friesen will acquire a 50% interest.

Profits before the transfer are as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual pre-tax profit</td>
<td>$120,000</td>
</tr>
<tr>
<td>Less bonus to Friesen (10%)</td>
<td>(12,000)</td>
</tr>
<tr>
<td>108,000</td>
<td></td>
</tr>
<tr>
<td>Less corporate tax @ 25%</td>
<td>(27,000)</td>
</tr>
<tr>
<td>After-tax profits</td>
<td>$ 81,000</td>
</tr>
</tbody>
</table>

Regardless of the structure chosen, Friesen will have to obtain financing to make her required $200,000 contribution to the new entity (50% of $400,000). If she has difficulty obtaining independent financing, Klondike could act as a guarantor for the loan or could lend the funds to Friesen with interest. It is first assumed that Klondike will act as a guarantor of the Friesen loan. Therefore, the following would occur:

- Friesen borrows $200,000 and contributes the cash to the new entity for a 50% equity interest.
- Klondike sells the assets to the new entity in exchange for cash of $200,000 and a 50% equity interest of $200,000. The cash contributed by Friesen is used to pay Klondike.
- Klondike pays tax of $12,500 from the asset sale and, therefore, has additional cash to invest of $187,500 ($200,000 - $12,500).
The additional cash can be used by Klondike for the new store expansion project which should provide a pre-tax return of 30%.

**Partnership** - If a partnership structure is used, Klondike’s after-tax revised profits will be:

- Partnership income (no bonus) $120,000
- Klondike’s share (50%) $60,000
- Less tax @ 25% (15,000)
- Partnership profits 45,000

Return on additional cash from sale:
- 30% of $187,500 $56,250
- Less tax @ 25% (14,063) 42,187

- After-tax profits $87,187

Therefore, Klondike's after-tax profits are actually increased slightly ($87,187 vs. $81,000) because of their alternative investment opportunities (even after paying tax of $12,500).

A second scenario can be considered. Klondike could have used the additional cash of $187,500 for providing a loan to Friesen with interest. Assuming a fair rate of interest to be 10%, the above results would be changed as follows:

- Share of partnership profits (after-tax) $45,000
- Add: Interest earned from Friesen:
  - $187,500 @ 10% $18,750
  - Less tax @ 44 2/3% (8,375) 10,375
- After-tax profits $55,375

Under this scenario Klondike would lose annual profits of approximately $25,625 ($81,000 - $55,375) for giving up a 50% interest in the branch. This is equivalent to paying Friesen a deductible bonus of approximately $34,167 ($34,167 – tax saving @ 25% = $25,625).

**Corporation** - If a corporate structure was used, it would not be associated with Klondike because Klondike would not have control (greater than 50% of the voting equity). Therefore, the new corporation would be entitled to its own $500,000 small business deduction limit resulting in an assumed corporate tax rate of only 15%. Klondike’s share of these profits could be returned as a tax-free dividend. Therefore, Klondike's revised position would be as follows:

- Corporate profits (no bonus) $120,000
- Less tax @ 15% (18,000)
- Klondike’s share (50%) $51,000
- Return from investment of additional cash from sale
  - 30% of $187,500 $56,250
  - Less tax @ 25% * (14,063) 42,187
- After-tax profits $93,187
* Assumes the additional cash is invested in the Klondike business.

Using this structure, Klondike's profits increase by $12,187 annually ($93,187 - $81,000) as a result of selling 50% of the branch to Friesen.

If Friesen were to acquire less than a 50% interest, the corporate results would be the same as the partnership results as a new SBD would not be created.

Recommendation:

It is difficult to make a recommendation regarding an equity interest for Friesen because there are a number of other administrative factors that must also be considered. However, based only on the cash flow analysis, it would seem appropriate to provide Friesen with a 50% interest using a corporate structure, subject to the risks associated with giving up voting control of the operation. This will have the greatest chance of securing Friesen's long-term participation in the operation and may even increase her efforts due to the substantial ownership interest.

Expansion Program

The decision to expand the number of retail stores involves significant strategy issues beyond the tax considerations. First of all, they must decide if they want to fund the expansion solely with internal resources or if they want to involve additional equity investors.

If Klondike decides to complete the expansion on its own, it can expect the following:

- **Funds available** $2,000,000
- **Funds required for each store** $400,000
- **Expansion limitation** ($2,000,000/$400,000) 5 stores
- **Expected Profits (5 x $120,000)** $600,000
  - **Less tax @ 25%** (150,000)
  - **After-tax profits** $450,000

  **ROI** $450,000 = 22.5%
  $2,000,000

Each expansion store could be operated as a division of Klondike or as a separate subsidiary corporation. The division structure would permit any losses incurred during the start up phase, or thereafter, to be offset against Klondike's other profitable operations, creating additional cash flow from tax savings that could be used for the further expansion requirements. In a corporate structure such losses would be locked into each separate corporation and would remain unused until the particular store became profitable or a reorganization took place. Therefore, if any start-up losses are anticipated, the corporate structure will result in a greater cash requirement thereby impairing the expansion capability.

The expansion stores are located in different provinces and, therefore, the impact of varying rates of provincial taxes should be considered. The division structure will allocate the total profits of Klondike (which includes the existing operations) to each province by the ratio of wages and sales in each
province to the total wages and sales of the entire organization. This may result in a favorable or unfavorable allocation. Under the corporate structure the actual profits of each store will be subject to the provincial taxes applicable in the province in which it is located. The extent of the potential tax difference from these alternatives should be determined for consideration.

Maintaining 100% ownership of the expansion program means that 5 potential locations must be left out. These may be able to be completed later as cash resources expand unless the void is filled by competitors. To expand to all of the target cities will require additional equity from outside investors of $2,000,000 (being 50% of $4,000,000 required—10 stores @ $400,000). If this is to be done, Klondike could do any of the following:

- expand the capital of Klondike by issuing share capital to new investors permitting them to participate in the entire organization.
- organize a single new entity to house the 10 expansion stores permitting the new investors to participate in all of the expansion.
- organize separate entities for each new store and attract separate investors for each.

If the first option above is chosen, the expansion stores can be organized as divisions or corporations with the same implications as discussed previously.

If the second or third option is chosen, the structures can include a separate corporation, standard partnership or limited partnership. With respect to the impact of possible start-up losses and provincial taxes, the results are similar to the division versus corporation comparison.

It appears that obtaining effective management of each new expansion store is crucial to the program's success as evidenced by the activities of the existing Polo Park branch store. This provides a possible strategy that would seek out a separate investor for each location who would also provide strong management. This provides the opportunity of organizing 10 separate corporations owned 50% by Klondike ($200,000 contribution) and 50% by the local manager ($200,000 contribution). By not having voting control, the new corporation would not be associated with Klondike thereby generating a separate $500,000 small business deduction limit for each corporation. If the profit potential is achieved, Klondike’s position would be as follows:

<table>
<thead>
<tr>
<th>Investment required ($10 x $200,000)</th>
<th>$2,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit for each store</td>
<td>$120,000</td>
</tr>
<tr>
<td>Less tax @ 15%</td>
<td>(18,000)</td>
</tr>
<tr>
<td>After-tax profits</td>
<td>$102,000</td>
</tr>
<tr>
<td>Klondike's share</td>
<td>$510,000</td>
</tr>
<tr>
<td>50% of $102,000 = $51,000 x 10 stores</td>
<td>$510,000</td>
</tr>
<tr>
<td>ROI $510,000/2,000,000 = 25.5%</td>
<td></td>
</tr>
</tbody>
</table>

If a partnership structure were used, Klondike’s profits share would be only $450,000 as all profits would be subject to a 25% tax rate ($120,000 x 10 = $1,200,000 - tax @25% = $900,000; Klondike’s share, 50% of $900,000 = $450,000).

Therefore, expanding to 10 stores using separate corporations with 50% ownership increases their ROI to 25.5% from 22.5%. Klondike should, however, keep in mind that if any of the stores should suffer substantial losses and fail, those losses would be difficult to use, as any reorganization options are restricted because of the lack of equity control. They would, therefore, have to recognize
their loss as an allowable business investment loss at the time the shares are disposed. This means that only 1/2 of the loss can be used.
CASE TWO

Cargill Transport Ltd.

Cargill Transport operates a Canada-wide trucking operation hauling commercial freight. In the past several years, a number of Canadian customers have had requirements involving shipments to their American operations. Cargill does not have operating facilities or licences to operate in the United States and so, until now, has basically ignored this potential market.

Cargill’s Winnipeg operation, however, has had so many requests for foreign hauling that it has set up an arrangement with a Minneapolis-based hauler. The arrangement is that Cargill hauls Canadian freight to the American border and leaves the trailer at the border to be picked up by the American hauler. Likewise, the American hauler brings American freight to the Canadian border and leaves the trailer to be picked up by a Cargill truck.

The arrangement is cumbersome for two reasons:

1. It is difficult to coordinate freight loads to match delivery deadlines, and often, the trucks are returned from the border without a trailer.

2. It is difficult to accurately allocate the fee between the two carriers, as the distance travelled by each is different and operating costs also vary.

Cargill wants to expand its operations into the entire United States. This will have to be done gradually, as Cargill’s resources for expansion are limited. Cargill is owned 50% by a British corporation and 50% by Turnbull Holdings Ltd., a Canadian investment corporation. Turnbull is entirely owned by the Pickle family of Toronto.

Cargill’s executives in Toronto have recently decided to begin expanding into the United States. Winnipeg has been chosen to spearhead the expansion because it is the only location that has any foreign activity and connections. Obtaining a licence to operate in the United States is rather complicated, especially in the highly regulated transportation industry. It is necessary to obtain both state and federal licences. One option, of course, is to acquire a major existing American company that is already licensed throughout the United States, but this is not practical because of Cargill’s financial limitations.

Charles Wheeler, the vice-president (finance), is given the task of developing the American expansion. He wants to establish a base in Minneapolis and obtain a licence permitting hauls from there to Winnipeg. The Winnipeg division of Cargill has 12 vehicles and trailers that are not being fully utilized, and Wheeler decides to relocate these to the United States to establish the company’s presence there. The American base will require a small freight depot as well as parking and repair facilities; however, all major administration, such as accounting and payroll, will still be carried out at the administration office in Winnipeg. An American bank account will be established to collect American fees and pay American expenses.

Wheeler does not know how long it will take for the operations to become profitable, although he is reasonably certain that the route will eventually be lucrative. Wheeler is certain that as the operation grows and experience is gained, more American personnel will be hired to assist in the expansion program. In the meantime, market studies are to be carried out to determine where the next thrust should be.
Before investigating the expansion, Wheeler gathers together what limited information the company has on international taxation and on business organizations in foreign countries (see below).

CARGILL TRANSPORT LTD.

1. Canadian tax rate for Cargill (assumed) 25%
2. American tax rates for American corporation*
   - First $40,000 profit 20
   - Next $60,000 profit 35
   - Profit over $100,000 43
3. American withholding tax on dividends 5
4. Canadian withholding tax on dividends to the United Kingdom 10

* The American tax rates are not actual American rates. They have been arbitrarily chosen to demonstrate various levels of foreign tax that may occur.

**Required:**

How should Wheeler proceed with the expansion so as to maximize the profits and returns for the entire organization?
Solution to Case Two - Cargill Transport Ltd.

The initial expansion into the U.S. can be structured as either a foreign branch or a foreign subsidiary corporation. In evaluating these two basic alternatives, Wheeler must address the following:

- The company has limited resources and, therefore, the cash requirements for the expansion are critical.
- The initial expansion is part of a longer term plan to develop a U.S. hauling enterprise that will operate within the U.S. and it is important to maximize the amount of after-tax profits from the expansion operations for reinvestment in the U.S.
- Ultimately the rewards of the U.S. expansion will be repatriated to Cargill for Canadian reinvestment or distribution to its shareholders. Minimizing tax on this activity is also a factor.

Before deciding on the initial structure, Wheeler must chart the path along which cash will flow and identify the points on that path when a tax cost will occur as a result of the alternative structures available. The existing structure is diagrammed below.

The tax points along the cash flow path are analyzed below for a branch and corporate expansion structure. As the foreign tax rates vary depending on the level of income, the calculation is based on an arbitrary income amount of $1,000 in each foreign tax bracket. The calculation traces the funds from the U.S. all the way back to the Pickle family (Canadian shareholders) and then refers to the British shareholders.
### Branch Option:

<table>
<thead>
<tr>
<th></th>
<th>1st $40,000</th>
<th>Next $60,000</th>
<th>over $100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign tax rate</td>
<td>20%</td>
<td>35%</td>
<td>43%</td>
</tr>
<tr>
<td>Foreign income</td>
<td>$1,000</td>
<td>$1,000</td>
<td>$1,000</td>
</tr>
<tr>
<td>U.S. tax</td>
<td>(200)</td>
<td>(350)</td>
<td>(430)</td>
</tr>
<tr>
<td>Canadian corporate tax</td>
<td>(25%)(assumed)</td>
<td>(250)</td>
<td>(250)</td>
</tr>
<tr>
<td>Foreign tax credit</td>
<td>200</td>
<td>250</td>
<td>250</td>
</tr>
<tr>
<td>Net to Branch and Cargill</td>
<td>750</td>
<td>650</td>
<td>570</td>
</tr>
<tr>
<td>Tax on dividend to Turnbull</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Net to Turnbull</td>
<td>750</td>
<td>650</td>
<td>570</td>
</tr>
<tr>
<td>Tax on dividend to Pickle family (28%)</td>
<td>(210)</td>
<td>(182)</td>
<td>(160)</td>
</tr>
<tr>
<td>Net to Pickle family</td>
<td>$540</td>
<td>$468</td>
<td>$410</td>
</tr>
<tr>
<td>Total tax rate</td>
<td>46%</td>
<td>53.2%</td>
<td>59%</td>
</tr>
</tbody>
</table>

Profits of the US branch may be subject to a special *branch tax* similar to the withholding tax on dividend distributions. The Canada/US Tax Treaty limits the branch tax to 5% of branch profits that are not reinvested in the US. Also, the first $500,000 of branch profits is exempt. When the branch tax is imposed, it is normally eliminated by the Canadian foreign tax credit and, therefore, has no effect.

Dividends paid from Cargill to the British corporation are subject to a Canadian withholding tax of 10%. There is not sufficient information to trace the ultimate tax cost to the British corporation and its shareholders. From their perspective, the existing structure is fixed and they are primarily concerned with maximizing Cargill's profits.
**Corporation Option:**

<table>
<thead>
<tr>
<th>Foreign tax rate</th>
<th>1st $40,000</th>
<th>next $60,000</th>
<th>Over $100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign income</td>
<td>$1,000</td>
<td>$1,000</td>
<td>$1,000</td>
</tr>
<tr>
<td>U.S. corporate tax</td>
<td>(200)</td>
<td>(350)</td>
<td>(430)</td>
</tr>
<tr>
<td>Net to U.S. corporation</td>
<td>800</td>
<td>650</td>
<td>570</td>
</tr>
<tr>
<td>U.S. withholding tax on dividend to Canada (5%)</td>
<td>(40)</td>
<td>(33)</td>
<td>(29)</td>
</tr>
<tr>
<td>Tax on dividend to Cargill</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Foreign tax credit</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Net to Cargill</td>
<td>760</td>
<td>617</td>
<td>541</td>
</tr>
<tr>
<td>Tax on dividend to Turnbull</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Net to Turnbull</td>
<td>760</td>
<td>617</td>
<td>541</td>
</tr>
<tr>
<td>Tax on dividend to Pickle family (28%)</td>
<td>(213)</td>
<td>(173)</td>
<td>(151)</td>
</tr>
<tr>
<td>Net to Pickle family</td>
<td>$547</td>
<td>$444</td>
<td>$390</td>
</tr>
<tr>
<td>Total tax rate</td>
<td>45.3%</td>
<td>55.6%</td>
<td>61%</td>
</tr>
</tbody>
</table>

**Evaluation of Primary Issues**

*Initial Cash Requirements* - The expansion project will suffer losses in the early years although the amount and for how long has not been identified. The branch structure permits those losses to be offset against Cargill's other income and will generate cash flow from tax savings at 25% of the losses. This is not available in the corporate structure. As Cargill's resources are limited, the additional cash flow from the branch structure may be vital to the success of the U.S. expansion and this indicates a strong preference for the branch structure.

*Reinvestment of Expansion Profits* - The long-term success of the project depends on the reinvestment of the project's profits in the U.S. and, therefore, repatriation will be delayed. The corporation structure provides the lowest immediate tax costs at two of the three levels of income. The percentage of after-tax profits available for U.S. reinvestment is compared below at each level of income:

<table>
<thead>
<tr>
<th>1st $40,000</th>
<th>next $60,000</th>
<th>Over $100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Branch</td>
<td>75%</td>
<td>65%</td>
</tr>
<tr>
<td>Corporation</td>
<td>80%</td>
<td>65%</td>
</tr>
<tr>
<td>Corporate advantage</td>
<td>5%</td>
<td>0%</td>
</tr>
</tbody>
</table>

Therefore, the corporate structure is preferred to maximize reinvestment cash flow by taking advantage of the lower U.S. tax rates on the first $40,000 of annual income. On profits in excess of $40,000 the return is the same.
Repatriation of Profits - The potential transfer of profits from the U.S. operation to Cargill for reinvestment in Canada is a less pressing issue but, nevertheless, of long-term importance. Upon repatriation, the percentage of after-tax foreign profits available to Cargill under both structure are compared below:

<table>
<thead>
<tr>
<th></th>
<th>1st</th>
<th>next</th>
<th>over</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$40,000</td>
<td>$60,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Branch</td>
<td>75%</td>
<td>65%</td>
<td>57%</td>
</tr>
<tr>
<td>Corporation</td>
<td>76%</td>
<td>62%</td>
<td>54%</td>
</tr>
</tbody>
</table>

The above indicates that the corporation structure is preferred only to the extent of the first $40,000 of annual foreign profits. On profits in excess of $40,000 the branch is preferred. Similar results occur when comparing repatriation to the Pickle family.

Recommendation:

Wheeler’s primary concern should be the success of the expansion program. Therefore, he should attempt to have the maximum resources available for the project. This would suggest the following:

- An initial branch structure to obtain the tax savings from loss utilization.
- At a point in time when losses decline and profits are reasonably anticipated, the branch is converted to a corporation to obtain advantage of the low corporate tax rates.

With this in mind, Wheeler should at least consider the following other relevant issues:

- The use of the existing trucks within an initial branch structure creates no immediate tax concerns as their ownership remains with Cargill. However, if the branch is converted to a U.S. corporation, the trucks will either have to be sold to the corporation at market value or leased to it. Leasing will result in U.S. withholding taxes on the rent payments but these should be offset by the foreign tax credit in Canada. The lease payments may have the effect of shifting a greater amount of U.S. profits to be taxed in Canada.

- Other assets of the branch, including an amount for goodwill, if any, would also have to be transferred to the branch on a fair market value basis as no election option is available for the sale of assets to a foreign corporation.
CHAPTER 21

TAX ASPECTS OF CORPORATE FINANCING

Review Questions

1. Why is it important to examine the corporate cost of financing alternatives in conjunction with the tax position of the potential investors?

2. If a corporation is subject to a 25% tax rate, why may it be advantageous for it to issue debt as opposed to preferred shares?

3. If the corporate tax rate is 15%, what difference does it make whether the corporation issues debt bearing 8% interest or preferred shares with a 6 3/4% dividend rate?

4. A corporation issues 7% bonds as well as preferred shares with an annual 5.5% dividend rate. Excluding the risk factor, what type of investor would prefer the bond and what type would prefer the shares? Explain.

5. An investor who is an individual could earn a 10% return either from shares that pay a low dividend and have high growth or from shares that pay a high dividend and have low growth. Assuming that the risk related to each is the same, which investment would the individual prefer?

6. If the cost of preferred share financing is so much greater than debt, why are such securities issued by public corporations?

7. Briefly describe the tax treatment applied to expenses incurred to issue shares or borrow money (the cost of a prospectus, commissions to brokerage firms, and the like). What impact does this tax treatment have on the after-tax cost of financing?

8. If a corporation issues a bond at a price less than the face value of the security, the discount is amortized, for accounting purposes, over the life of the bond. How does this treatment of the discount compare with the treatment for tax purposes?

9. If a corporation issues a bond at a discount, will the after-tax cost of financing to the issuing corporation be higher or lower than if it had issued the bond at its face value? Explain.

10. Is the after-tax return to a casual investor who purchases a bond at a discount greater than or less than the after-tax return on a bond purchased at its face value? Explain.

11. How does the issuing of a bond at a premium affect the after-tax cost of financing to the corporate issuer?

12. Explain the difference between a financial lease and an operating lease.

13. What is the difference, in tax terms, between leasing and owning?
Solutions to Review Questions

R21-1. The buyers of corporate securities include individuals, private corporations, other public corporations, and an array of pension and other investment funds. The tax treatment of investment returns for each type of investor may vary. Therefore, certain investors prefer certain types of securities because of the particular tax treatment, and may be prepared to pay a higher price than other investors for the same investment. In order to take advantage of a tax sensitive market, the corporation issuing securities must be familiar with investor tax concerns in order that a cost efficient financing structure is developed.

R21-2. Debt financing is serviced by the payment of interest that is fully deductible from corporate income for tax purposes. In comparison, preferred shares are serviced by the payment of dividends which are not deductible and, therefore, must be paid from after-tax corporate income.

For example, a corporation that incurs an interest cost of 10% on $100,000 of borrowed funds ($10,000) can fund the cost of the borrowed funds by investing them to provide a minimum return of 10%. If this occurs, the after-tax income available to the common shareholders remains the same. In comparison, issuing preferred shares with a dividend rate of 8% requires that the capital be invested by the corporation at a minimum rate of 10.67% in order that it would not affect the after-tax income available to common shareholders. A 10.67% return results in an 8% after-tax return (10.67% - 25% tax = 8%) that is required to make the dividend payments. Therefore, even though a dividend rate may be lower than an interest rate (8% versus 10%), the real cost of the dividend is significantly higher.

R21-3. If the corporate tax rate is 15%, the cost of issuing debt with interest at 8% or preferred shares with dividends of 6 3/4% is very similar. In both cases, the corporation will have to invest the acquired funds to return a minimum of 8% in order to service the debt or preferred shares.

This is demonstrated below assuming that $100,000 of funds are obtained from the financing arrangement and invested by the corporation to earn an 8% pre-tax return.

Debt:

| Corporate income earned | $8,000 |
| Less interest (8% of $100,000) | (8,000) |
| Net income to corporation | $ 0 |

Preferred shares:

| Corporate income earned | $8,000 |
| Less corporate tax (15%) | (1,200) |
| 6,800 |
| Less dividend (6 3/4% of $100,000) | 6,750 |
| Net to corporation | $ 50 |
R21-4. Each type of investor may be subject to different tax treatments on the returns provided by the two securities. Interest returns are fully taxable to each investor at their marginal rates of tax. However, dividend returns vary considerably. Public corporations are not taxable on the receipt of Canadian dividends, Canadian-controlled private corporations are subject to a special refundable tax of 33 1/3%, and individuals are eligible for the dividend tax credit. The approximate marginal tax rates and after-tax yields for each investor are summarized below:

<table>
<thead>
<tr>
<th></th>
<th>7% Bond</th>
<th></th>
<th>5.5% Shares</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Tax Rate</td>
<td>After-tax Yield</td>
<td>Tax Rate</td>
<td>After-tax Yield</td>
</tr>
<tr>
<td>Individual:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Low bracket</td>
<td>24%</td>
<td>5.3%</td>
<td>0%</td>
<td>5.5%</td>
</tr>
<tr>
<td>2nd bracket</td>
<td>32</td>
<td>4.8%</td>
<td>10</td>
<td>5.0%</td>
</tr>
<tr>
<td>3rd bracket</td>
<td>40</td>
<td>4.2%</td>
<td>21</td>
<td>4.3%</td>
</tr>
<tr>
<td>High bracket</td>
<td>45</td>
<td>3.9%</td>
<td>28</td>
<td>4.0%</td>
</tr>
<tr>
<td>Private Corporation</td>
<td>44 2/3</td>
<td>3.9%</td>
<td>33 1/3**</td>
<td>3.7%</td>
</tr>
<tr>
<td>Public Corporation</td>
<td>25</td>
<td>5.3%</td>
<td>0</td>
<td>5.5%</td>
</tr>
</tbody>
</table>

* Dividend assumed to be Eligible.

** 33 1/3% refundable part IV tax

Based on the above, individuals and public corporations prefer the 4% preferred shares over the 7% bonds; private corporations prefer the bond.

R21-5. The tax rates on capital gains and dividends vary by different amounts for individuals in the four applicable tax brackets. Therefore, the preference for obtaining returns as dividends versus capital gains also varies. The applicable tax rate and after-tax yields for each tax bracket are summarized below. The rates exclude provincial surtaxes and relate to an unspecified province. (See Chapter 10).

<table>
<thead>
<tr>
<th></th>
<th>Dividend (Eligible)</th>
<th>Capital Gain</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Tax Rate</td>
<td>After-tax Yield</td>
</tr>
<tr>
<td>Low bracket</td>
<td>.00</td>
<td>10.0%</td>
</tr>
<tr>
<td>2nd bracket</td>
<td>.10</td>
<td>9.0%</td>
</tr>
<tr>
<td>3rd bracket</td>
<td>.21</td>
<td>7.9%</td>
</tr>
<tr>
<td>High bracket</td>
<td>.28</td>
<td>7.2%</td>
</tr>
</tbody>
</table>

Based on the above, individuals in the first two tax brackets prefer the investment with high dividends and low growth. Individuals in the third tax bracket and the highest tax bracket prefer capital gains over dividends. The timing of the tax cost may also be a factor as dividends are taxed as they are received but capital gains are taxed only when the shares are sold.
R21-6. In spite of the fact that preferred share issues result in a higher cost than debt securities they are still considered viable when debt loads reach their maximum level. As long as the preferred share capital can be invested at a rate of return that is higher than the after-tax cost of the preferred share issue, common shareholders will benefit. In addition, the added equity base may relieve the pressure of current debt loads (especially if the preferred shares have no fixed redemption requirements) permitting future debt to be obtained at a lower interest cost.

R21-7. Expenses incurred to borrow money or issue shares are permitted to be deducted for tax purposes over a five year period at the rate of one-fifth of the total cost per year [S.20(1)(e)]. Therefore, the after-tax cost of financing must consider the timing of the tax savings that occur from such costs. While the costs associated with interest or dividends are spread out over the life of the security, the implementation costs create tax savings in the first five years.

R21-8. While the discount cost of issuing a bond at less than face value is amortized over the life of the bond for accounting purposes, the tax treatment is dramatically different. For tax purposes the cost is recognized only when the bond is repaid. In addition, the amount of the deduction may be limited. If the initial discount is a "shallow" discount (issued at 3% or less than its face value), the full discount cost is deductible when the debt is repaid. However, if the initial discount is greater than 3% ("deep" discount) only one-half of the discount is deductible when the loan is repaid [S.20(1)(f)]. Therefore, the primary difference is the timing of the deduction and the related tax savings, although the amount of the deduction may be different as well.

R21-9. Where it is anticipated that a bond with a stated interest rate will have to be issued at a discount, the discount can be eliminated by increasing the interest rate to the amount demanded by the marketplace. If this is done, the additional cost occurs in the form of an actual interest payment creating tax savings annually as payments are made. In comparison, if the interest rate is not adjusted and the discount remains, the cost of that discount, which reflects the higher required interest rate, is deductible for tax purposes when the loan is repaid rather than annually over the term of debt. Therefore, the timing of the tax savings from the cost deduction is later rather than sooner. Consequently, the after-tax cost of financing when measured on a time basis is greater under the discount approach. The discount approach may result in even greater costs if it is a "deep" discount and only one-half of the cost is deductible (see solution to question 8).

R21-10. An investor who purchases a bond at a discount will receive a lower than normal annual interest return but will receive a gain when the debt is repaid (difference between the discount price and face value) such that the combined pre-tax yield is the same. The tax treatment of the investor’s gain from the discount is, therefore, important in establishing an after-tax yield comparison.

Where the purchasing of bonds is part of the investor’s business, the gain from the discount is fully taxable. However, where the investor is not in the business of buying and selling securities but rather is investing savings from time to time, the gain may be considered as a capital gain for tax purposes of which only one-half is taxable. For this type of investor acquiring discounted bonds will provide greater after-tax returns.

R21-11. Issuing a bond at a premium means that the security is issued at a price greater than the face amount but the annual interest cost is equal to the stated rate of interest on the face value. This premium reflects the fact that the stated interest rate is too high. Consequently, the issuer incurs a higher annual interest cost in exchange for a premium gain because they must repay only the face value of the bond rather than the higher amount received on issuance.
The premium gain is not taxable to the issuing corporation (unless it is in the business of lending money) but the actual higher interest costs remain deductible for tax purposes even though that higher cost is recovered from the premium. In comparison, if the corporation reduced the interest rate to eliminate the premium, only the lower interest would be deductible even though the pre-tax cost is the same. Therefore, issuing debt securities at a premium normally results in lower after-tax financing costs.

R21-12. A financial lease is one that provides the lessee with the right to use an asset for a long period of time, normally for most of its useful life. In most cases, the lessee will be the only user of the property. The lease payments are usually structured to permit the leasing company to recover the full cost of the property plus a reasonable return on their investment. Financial leases are a direct alternative to purchasing assets with debt financing as the payment terms are based on similar variables.

In comparison, an operating lease normally has a short term and is used to obtain the use of assets that have a lower cost and short-term life such as furniture and small office equipment.

R21-13. Annual rent payments under a leasing arrangement are deductible for tax purposes annually as they occur. Therefore, provided that the business entity has taxable income, the rental payments directly reduce income taxes in proportion to the lease payments. If assets are purchased, the timing of the related tax savings may be significantly different. Cash payments are required for the down payment as well as the principal and interest on a loan. However, the tax deductions occur in accordance with the applicable capital cost allowance rate and the payment of interest. Therefore, the timing of cash payments and the tax savings that occur are not in proportion as is the cash under a lease arrangement.
Problems

PROBLEM ONE

The Canadian Queen’s Bank of Industry Ltd. is a large national Canadian bank. It has significant expansion opportunities. However, its ability to raise additional debt capital from bonds or debentures is restricted because of the debt/equity regulations of Canada’s Bank Act.

The bank has decided to issue preferred shares. The financial highlights of the prospectus are as follows:

*Proposed issue*
4,000,000 floating rate, class A preferred shares (cumulative, redeemable, and without par value).

*Price*
$100 per share.

*Dividends*
Dividends will be payable monthly. The dividend rate will float in relation to changes in the prime interest rate as set by the bank. The initial annual dividend rate will be equal to 2/3 prime plus 1/2% per annum. As dividends will accrue and be payable monthly, the normal dividend payment will be 1/12 of the annual rate.

*Redemption*
The shares will be redeemable at the option of the bank in whole or in part from time to time.

At the time the prospectus was issued, the bank published the following interest rates for its customers:

- Prime lending rate: 7.5%
- Savings account (interest monthly): 3.0%
- One-year term deposits: 6.0%
- 30-day term deposits: 4.0%

The bank is subject to an income tax rate of 25%.

**Required:**

1. Assume that the bank will issue all of the preferred shares proposed in the prospectus. What amount of additional income must the bank earn in order to service the preferred shares without diminishing the amount of earnings currently available to the common shareholders?

2. How would your answer to 1 be different if the bank could issue bonds with an interest rate equal to 1.5% less than the prime rate?

3. Are the preferred shares attractive to investors? Explain.
Solution to P 21-1

1. Based on the current interest rate, the annual dividend rate on the preferred shares is:

\[ \frac{2}{3} \text{ of } 7.5\% \text{ (prime rate)} = \frac{5.0\%}{ \text{ Plus } \frac{0.5}{5.5\%} } \]

If all of the preferred shares are issued, the total dividend payments will be:

- Issue price \( (4,000,000 \times $100) \) $400,000,000
- Annual dividend (5.5%) $22,000,000

In order that the cost of the preferred share dividends does not diminish the earnings currently available to the common shareholders the bank will have to invest the $400,000,000 to earn $32,836,000 calculated as follows:

\[ \frac{x - \cdot22x}{x} = \$22,000,000 \]

\[ x = \$29,333,000 \]

In other words, the bank will have to invest the preferred share funds to yield 7.3% ($29,333,000/$400,000,000) in order to have sufficient after-tax profits to service the 5.5% preferred share dividend. Because the dividend rate floats with the prime rate, the required returns to service the dividend will also fluctuate.

2. If the bank could issue bonds at an interest rate that is 1.5% less than the prime rate, the required profits from investing the funds to meet the interest obligation would be only $24,000,000 calculated as follows:

\[ \text{Current prime rate} \quad 7.5\% \]
\[ \text{Less} \quad 1.5\% \]
\[ \text{Bond rate} \quad 6.0\% \]

\[ \text{Total interest cost} \quad \$400,000,000 \times 6.0\% \quad \$24,000,000 \]

Because interest costs are deductible for tax purposes, the funds from the bond issue have to be invested to yield the bank $24,000,000 or 6.0% in order that the common shareholder profits would not be diminished.
3. The after-tax return for investors on a 5.5% preferred share dividend is summarized below for each type of investor:

<table>
<thead>
<tr>
<th></th>
<th>Dividend Rate</th>
<th>Tax* Rate</th>
<th>After-tax Yield</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Individuals:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Low bracket</td>
<td>5.5%</td>
<td>.00</td>
<td>5.5%</td>
</tr>
<tr>
<td>2nd bracket</td>
<td>5.5</td>
<td>.10</td>
<td>5.0</td>
</tr>
<tr>
<td>3rd bracket</td>
<td>5.5</td>
<td>.21</td>
<td>4.4</td>
</tr>
<tr>
<td>High bracket</td>
<td>5.5</td>
<td>.28</td>
<td>4.0</td>
</tr>
<tr>
<td>Public corporation</td>
<td>5.5</td>
<td>0</td>
<td>5.5</td>
</tr>
<tr>
<td>Private corporate</td>
<td>5.5</td>
<td>.33</td>
<td>3.7</td>
</tr>
<tr>
<td>Registered funds (RRSP)</td>
<td>5.5</td>
<td>0</td>
<td>5.5</td>
</tr>
</tbody>
</table>

* Based on general rates determined for dividends (eligible) in Chapters 10, 11 & 13.

In comparison, the maximum after-tax interest yield for each type of investor (assuming they choose a one year term deposit investment of 6.0%) is:

<table>
<thead>
<tr>
<th></th>
<th>Interest Rate</th>
<th>Tax Rate</th>
<th>After-tax Yield</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Individual:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Low bracket</td>
<td>6%</td>
<td>.24</td>
<td>4.6%</td>
</tr>
<tr>
<td>2nd bracket</td>
<td>6</td>
<td>.32</td>
<td>4.1</td>
</tr>
<tr>
<td>3rd bracket</td>
<td>6</td>
<td>.40</td>
<td>3.6</td>
</tr>
<tr>
<td>High bracket</td>
<td>6</td>
<td>.45</td>
<td>3.3</td>
</tr>
<tr>
<td>Public corporation</td>
<td>6</td>
<td>.25</td>
<td>4.5</td>
</tr>
<tr>
<td>Private corporations</td>
<td>6</td>
<td>.44 2/3</td>
<td>3.3</td>
</tr>
<tr>
<td>Registered funds (RRSP)</td>
<td>6</td>
<td>0</td>
<td>6.0</td>
</tr>
</tbody>
</table>

All investors, except the registered funds, earn a higher after-tax return from the preferred shares as a result of the preferential tax treatment of the dividends.

In addition, because the dividend rate fluctuates with the prime rate of interest, the market value of the preferred shares should remain constant. This eliminates the risk of loss and ensures the ability for the investor to sell the shares at any time. Provided that the overall risk of owning preferred shares in a large bank is not a major factor, the investment is attractive to investors.
PROBLEM TWO

Orpin Industries Ltd. is about to make its first bond issue in the public market. Orpin is a small but growing company, and its shares are starting to be recognized. For the past two years, they have consistently traded at a price equal to 12 times the after-tax earnings per share.

The proposed bond issue will raise $20,000,000, which will be used to expand the corporation’s retail operations into western Canada. The expanded operations should provide a minimum return on investment of 22%.

After receiving financial advice, the company decides to issue the bonds in units of $1,000 with an annual interest rate of 10% (interest payable annually). The financial advisor indicates that at this interest rate, the bonds can be sold (with a 10-year term) at their par value. Just before the issue date, long-term interest rates in the market increase by half a percent.

Orpin realizes that it will have to issue its bonds at a discount in order to obtain the full $20,000,000. Alternatively, the company could delay the issue for a short time, revise the prospectus, and print new bonds to reflect the higher interest rate. This would, of course, create additional costs. Before making the decision, Orpin wants to know if there would be any benefit to revising the interest rates.

Orpin is subject to a 25% tax rate.

Required:

1. If Orpin issues the bonds as originally proposed (that is, with an interest rate of 10%), how much will it have to discount them? Ignore any tax implications to the potential investors.

2. Based on your answer to 1, determine the after-tax cost of financing the bond issue under both the discount option and the revised interest rate option.

3. Assuming that the interest rate on the bond is revised, how may this affect the trading value of Orpin’s common shares?

4. If the company chooses to issue the bonds at a discount, could the amount of the discount be affected by the tax treatment to the potential investor? Explain.
Solutions Manual Chapter Twenty-One

Solution to P 21-2

1. The discount can be established by determining the present value of a bond with the following values:

   Future value $1,000
   Periodic payment (10% of $1,000) 100
   Required interest rate 10.5%
   Number of payments per year 1
   Time period 10 years

   Issue price $969.90

   Discount per $1,000 bond:
   
   | Face value | $1,000.00 |
   | Issue price | (969.90) |
   | Discount | $ 30.10 |

2. If the interest rate is revised to 10.5%, the company will incur an annual interest cost of 10.5% on the bond that is deductible for tax purposes. Therefore, the after-tax cost of financing the bond is:

   Annual interest payment 10.50%
   Less tax savings (2%) 2.62%
   7.88%

   If the interest rate is not revised, the annual interest cost (deductible for tax purposes) will be 10% of the $1,000.00 face value of the bond. However, the bond will be issued at a discount price of $969.90. The discount of $30.10 ($1,000.00 - $969.90) is only one-half deductible for tax purposes at the end of year 10 when the bond is repaid at its face amount of $1,000.00. This discount is only one-half deductible because it is greater than 3% of bond amount [S.20(1)(f)].

   The after-tax cost in year 10 from the bond redemption is, therefore, $995.33 calculated as follows:

   Redemption price (year 10) $1,000.00
   Less tax savings on bond discount 3.76
   25% of (1/2)$30.10 $ 996.24

   The after-tax cost of financing can be determined by calculating a yield to maturity on the bond using the after-tax cash flows for the company:

   Present value of bond $969.90
   Future value of bond $996.24

   Periodic payment:
   Annual cost ($1,000 @ 10%) $100.00
   Less tax savings @ 25% (25.00)
   $ 75.00
Payment periods per year                          1  
Time period                                        10 years
After tax cost of bond                             7.92%

Therefore, issuing the bond at a discount results in a slightly higher after-tax cost of financing of 7.92% compared to 7.88% if the interest rate is adjusted (7.92% - 7.88% = 0.04%). Based on a $20,000,000 bond issue the annual additional cost of the discount method is $8,000 ($20,000,000 x 0.02%). The present value of this annual cost for 10 years is approximately $54,960 (discount rate 10% - 25% tax = 7.5%) and this should be compared to the after-tax costs that would be incurred for reprinting the bonds.

3. Revising the interest rate on the bonds will increase the after-tax income of the company by $8,000 annually. As the common shares normally trade at 12 times after-tax earnings, the trading value of the shares may be increased. However, the amount is very small and may have no noticeable impact.

4. If the bonds were issued at a discount, the investors would obtain a pre-tax yield of 10.5%. However, for those investors who are not in the business of lending money and are not traders in securities, the portion of the yield pertaining to the discount would be a capital gain of which only one-half would be taxable. Therefore, the after-tax yield from a discount bond yielding 10.5% would be higher than the after-tax return from a par value bond yielding 10.5% which requires that the full amount of the yield be taxed annually as earned.

The preferential tax treatment to the investor on the discounted bond may create a higher demand for that security which, in turn, may have the effect of increasing the price. This increased price (or reduced discount) would lower the related financing cost to the issuing corporation.
PROBLEM THREE

Anderson Enterprises Ltd. is a Canadian corporation wholesaling auto parts in eastern Canada. The company has decided to begin manufacturing a product that it currently wholesales.

The expansion will require manufacturing equipment costing $80,000. Anderson's bank has agreed to provide a term loan to finance the entire purchase. The terms of the loan call for monthly payments of $1,235 for eight years. Due to the high risk, the payment includes interest at 10 1/2%. The bank provides the company with a payment schedule, which is roughly summarized on an annual basis in the table below.

<table>
<thead>
<tr>
<th>Year</th>
<th>Principal</th>
<th>Interest</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$7,000</td>
<td>$7,820</td>
<td>$14,820</td>
</tr>
<tr>
<td>2</td>
<td>7,500</td>
<td>7,320</td>
<td>14,820</td>
</tr>
<tr>
<td>3</td>
<td>8,500</td>
<td>6,320</td>
<td>14,820</td>
</tr>
<tr>
<td>4</td>
<td>9,000</td>
<td>5,820</td>
<td>14,820</td>
</tr>
<tr>
<td>5</td>
<td>10,000</td>
<td>4,820</td>
<td>14,820</td>
</tr>
<tr>
<td>6</td>
<td>11,000</td>
<td>3,820</td>
<td>14,820</td>
</tr>
<tr>
<td>7</td>
<td>13,000</td>
<td>1,820</td>
<td>14,820</td>
</tr>
<tr>
<td>8</td>
<td>14,000</td>
<td>820</td>
<td>14,820</td>
</tr>
</tbody>
</table>

It is estimated that the equipment will have a useful life of 10 years and will be scrapped at the end of that time. Anderson has also obtained some quotes for leasing the equipment. The quote with the most favourable terms involves a six-year lease with monthly payments of $1,565 and an option to renew on an annual basis for a mere $2,000 per year. Anderson likes this alternative because his company would not have to renew after six years if it wanted to acquire more modern equipment.

However, at this point, the company anticipates that it will use the equipment for its useful life of 10 years, at which time it will acquire replacement equipment. Assume the company is subject to a 25% tax rate. It has expansion opportunities that can yield a minimum before-tax return of 22%.

Required:

1. Determine the financial cost to Anderson of leasing rather than owning the manufacturing equipment. Assume that at the end of 10 years, the company will scrap the equipment and purchase new equipment.

2. How would your answer to 1 change if, after 10 years, Anderson Ltd. leased, rather than purchased, the equipment?

3. What other factors, if any, should the company consider when making the decision?
Solution to P 21-3

1. The after-tax cost of obtaining the use of the equipment is calculated below in terms of actual cash flow and its present value for both owning and leasing. As the corporation normally earns a pre-tax return on investments of 22% an after-tax discount rate of 17% (22% - 25% tax = 17% rounded) is used for determining present values.

Owning
If the equipment is purchased, tax savings will result from the payment of interest and from CCA. As new equipment will be acquired at the end of year 10, the undepreciated capital cost of the equipment in question will not be eligible for a terminal loss as it will simply remain in the pool for continued CCA. The impact of this continued CCA beyond year 10 is determined separately in the calculations which follow.

The equipment will be used for manufacturing and qualifies as a Class 43 property - CCA rate of 30%. Note that Manufacturing and processing equipment acquired between March 19, 2007 and December 31, 2013 has a 50% straight-line CCA rate (Class 29). A CCA rate of 30% has been used for this solution.

The annual tax savings from CCA and interest on the loan (as specified in the problem) is determined below.

<table>
<thead>
<tr>
<th>Year</th>
<th>CCA</th>
<th>Interest</th>
<th>Total</th>
<th>Tax Savings 25%</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$12,000</td>
<td>$7,820</td>
<td>$19,820</td>
<td>$4,955</td>
</tr>
<tr>
<td>2</td>
<td>20,400</td>
<td>7,320</td>
<td>27,720</td>
<td>6,930</td>
</tr>
<tr>
<td>3</td>
<td>14,280</td>
<td>6,320</td>
<td>20,600</td>
<td>5,150</td>
</tr>
<tr>
<td>4</td>
<td>9,996</td>
<td>5,820</td>
<td>15,816</td>
<td>3,954</td>
</tr>
<tr>
<td>5</td>
<td>6,997</td>
<td>4,820</td>
<td>11,817</td>
<td>2,954</td>
</tr>
<tr>
<td>6</td>
<td>4,898</td>
<td>3,820</td>
<td>8,718</td>
<td>2,180</td>
</tr>
<tr>
<td>7</td>
<td>3,429</td>
<td>1,820</td>
<td>5,249</td>
<td>1,312</td>
</tr>
<tr>
<td>8</td>
<td>2,400</td>
<td>820</td>
<td>3,220</td>
<td>805</td>
</tr>
<tr>
<td>9</td>
<td>1,680</td>
<td>--</td>
<td>1,680</td>
<td>420</td>
</tr>
<tr>
<td>10</td>
<td>1,176</td>
<td>--</td>
<td>1,176</td>
<td>294</td>
</tr>
<tr>
<td>10 From continued CCA (note 1)</td>
<td></td>
<td></td>
<td></td>
<td>$438</td>
</tr>
</tbody>
</table>

Note 1 - The tax savings in year 10 from continued CCA is the PV of the future CCA at that time determined by the formula:

\[
\frac{C \times T \times R}{R + I}
\]

The cost amount used in the formula is the UCC of the equipment after year 10 which is $2,744 ($80,000 - total CCA above of $77,256).

\[
\frac{2,744 \times .25 \times .30}{.30 + .17} = $438
\]

The PV of this amount in year 1 is $200.
The after-tax cash flow from purchasing the equipment is summarized below:

<table>
<thead>
<tr>
<th>Year</th>
<th>Cash Payments</th>
<th>Tax Savings</th>
<th>After-tax Cost</th>
<th>NPV</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>14,820</td>
<td>4,955</td>
<td>9,865</td>
<td>8,432</td>
</tr>
<tr>
<td>2</td>
<td>14,820</td>
<td>6,930</td>
<td>7,890</td>
<td>5,764</td>
</tr>
<tr>
<td>3</td>
<td>14,820</td>
<td>5,150</td>
<td>9,670</td>
<td>6,038</td>
</tr>
<tr>
<td>4</td>
<td>14,820</td>
<td>3,954</td>
<td>10,866</td>
<td>5,799</td>
</tr>
<tr>
<td>5</td>
<td>14,820</td>
<td>2,954</td>
<td>11,866</td>
<td>5,412</td>
</tr>
<tr>
<td>6</td>
<td>14,820</td>
<td>2,180</td>
<td>12,640</td>
<td>4,927</td>
</tr>
<tr>
<td>7</td>
<td>14,820</td>
<td>1,312</td>
<td>13,508</td>
<td>4,501</td>
</tr>
<tr>
<td>8</td>
<td>14,820</td>
<td>805</td>
<td>14,015</td>
<td>3,991</td>
</tr>
<tr>
<td>9</td>
<td>--</td>
<td>420</td>
<td>(420)</td>
<td>(102)</td>
</tr>
<tr>
<td>10</td>
<td>--</td>
<td>294</td>
<td>(294)</td>
<td>(61)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>438</td>
<td>(438)</td>
<td>(91)</td>
</tr>
<tr>
<td></td>
<td><strong>$118,560</strong></td>
<td><strong>$29,392</strong></td>
<td><strong>$89,168</strong></td>
<td><strong>$44,610</strong></td>
</tr>
</tbody>
</table>

Leasing:

If the equipment is leased, the annual lease payments will be $18,780 per year ($1,565 x 12) for six years and only $2,000 per year for the remaining four years. All lease payments are deductible for tax purposes in the year paid. The after-tax cost of leasing is, therefore, $14,085 per year ($18,780 - 25% tax saving = $14,085) for the first six years and $1,500 ($2,000 - 25% tax saving = $1,500) for the remaining years. The total costs are summarized below:

<table>
<thead>
<tr>
<th>Year</th>
<th>After-tax Cost</th>
<th>NPV</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>14,085</td>
<td>12,038</td>
</tr>
<tr>
<td>2</td>
<td>14,085</td>
<td>10,289</td>
</tr>
<tr>
<td>3</td>
<td>14,085</td>
<td>8,794</td>
</tr>
<tr>
<td>4</td>
<td>14,085</td>
<td>7,510</td>
</tr>
<tr>
<td>5</td>
<td>14,085</td>
<td>6,425</td>
</tr>
<tr>
<td>6</td>
<td>14,085</td>
<td>5,490</td>
</tr>
<tr>
<td>7</td>
<td>1,500</td>
<td>500</td>
</tr>
<tr>
<td>8</td>
<td>1,500</td>
<td>427</td>
</tr>
<tr>
<td>9</td>
<td>1,500</td>
<td>365</td>
</tr>
<tr>
<td>10</td>
<td>1,500</td>
<td>312</td>
</tr>
<tr>
<td></td>
<td><strong>$90,510</strong></td>
<td><strong>$52,150</strong></td>
</tr>
</tbody>
</table>

The after-tax costs of each alternative are compared below:

<table>
<thead>
<tr>
<th></th>
<th>Leasing</th>
<th>Owning</th>
</tr>
</thead>
<tbody>
<tr>
<td>Absolute costs</td>
<td>$90,510</td>
<td>$89,168</td>
</tr>
<tr>
<td>Net present value</td>
<td>$52,150</td>
<td>$44,610</td>
</tr>
</tbody>
</table>

While the absolute costs of each alternative are only marginally different, the net present value of those costs is significantly higher for leasing ($52,150) compared to owning ($44,610). Owning will result in an overall cost reduction of $7,540.
2. If, after the ten year period, the replacement equipment was leased rather than purchased, the costs associated with the leasing option in part 1 (above) would not be affected. However, the costs associated with owning may be altered.

As the expansion is the company’s only manufacturing activity, the purchased equipment is the only equipment that qualifies for Class 43. Consequently, if the equipment was scrapped and sold for a nominal value, a terminal loss would occur in year 10 if the replacement equipment was leased. The terminal loss would be $3,920 being the UCC of the equipment at the end of year nine.

The impact of this would be as follows:

\[
\begin{align*}
\text{PV of owning in part 1 (above)} & \quad \$44,610 \\
\text{Add:} & \\
\text{Taxing savings in year 10 from} & \\
\text{normal CCA (PV)} & \quad 61 \\
\text{From continued CCA on Class 43} & \\
\text{after year 10 (PV)} & \quad 200 \\
\text{Deduct:} & \\
\text{Taxing savings from terminal loss} & \\
25\% \text{ of } $3,920 = $980 & \quad 203 \\
\text{Revised after-tax cost} & \quad \$44,668
\end{align*}
\]

In this particular case, only a marginal cost reduction will occur as a result of the terminal loss in year 10.

3. The above analysis emphasized the comparison of the net present value of after-tax costs over the useful life of the asset. While this is an important factor, consideration should also be given to the absolute after-tax costs, especially in the early years after obtaining the property for use in the business.

Every business expansion involves risk and that risk is normally highest in the early years. This risk can be reduced if cash flow is maximized in the early years when it is most needed. The advantage of this is difficult to quantify but is an important consideration when choosing between the two alternatives.

In this particular case, the absolute after-tax costs in the early years are lower when the equipment is purchased as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Owning</th>
<th>Leasing</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$ 9,865</td>
<td>$14,085</td>
<td>$ 4,220</td>
</tr>
<tr>
<td>2</td>
<td>7,890</td>
<td>14,085</td>
<td>6,195</td>
</tr>
<tr>
<td>3</td>
<td>9,670</td>
<td>14,085</td>
<td>4,415</td>
</tr>
<tr>
<td>4</td>
<td>10,866</td>
<td>14,085</td>
<td>3,219</td>
</tr>
<tr>
<td>5</td>
<td>11,866</td>
<td>14,085</td>
<td>2,219</td>
</tr>
<tr>
<td></td>
<td>$50,157</td>
<td>$70,425</td>
<td>$20,268</td>
</tr>
</tbody>
</table>

The additional cash flow of $20,268 in the first five years may be an important factor in the funding requirements of the expansion and increases its chance of success. The results here are consistent with the present value costs which also favour the purchase option. However,
in some cases, the present value comparison may result in preference for one option but the absolute cash flows in the early years favour the other in which case the importance of the early cash flow must be weighed against the long-term reduced cost.
PROBLEM FOUR

Brandi Manufacturing Ltd. has decided to expand. To raise additional capital, the company is considering selling $300,000 of its present manufacturing equipment to an insurance company and leasing it back for eight years, which is the estimated useful life of the equipment. The equipment will have no residual value after eight years. The annual rent on the lease-back would be $54,000.

The equipment to be sold under the sale-and-lease-back arrangement is not all of the equipment owned by the company. The undepreciated capital cost of all of the company’s manufacturing equipment (class 43) was $800,000 at the end of the previous year. Of this $800,000, approximately $100,000 relates to the equipment that the company is thinking of selling.

The equipment that would be sold is used to manufacture a single specialized product. The equipment generates annual pre-tax revenues of $60,000 and is expected to continue to do so in the future.

Brandi is interested in the sale-and-lease-back arrangement because it will enable the company to obtain $300,000 of immediate funds with a related annual payment of $54,000, which appears to be equivalent to a low rate of interest. Assume the company is subject to a corporate tax rate of 25%. The company considers 12% to be a reasonable after-tax rate of return.

Required:

1. If Anderson does not sell the equipment, how much cash flow will be generated, in net present value terms, from the ownership and operation of that equipment?

2. What rate of interest is reflected in the lease arrangement?

3. What net present value cash flow would be obtained as a result of the sale-and-leaseback arrangement?
Solution to P 21-4

1. If the equipment is not sold, the annual cash flows relating to the equipment are identified as follows:
   - Annual revenues = $60,000
   - Tax savings from continued capital cost allowance on the equipment based upon its share of the undepreciated capital cost of the Class 43 pool of assets - $100,000.

   The net present values of the above cash flows are as follows:

   Revenues:
   - Annual revenue $60,000
   - Less tax @ 25% 15,000
   - After-tax cash $45,000

   PV of an annual amount of $45,000 for 8 years @ 12% $223,543

   Tax saving from CCA:
   - The present value of tax savings can be determined by the formula:
     \[
     \frac{C \times T \times R}{R + I}
     \]
   - \[
     = \frac{100,000 \times .25 \times .30}{.30 + .12} = 17,857
     \]
     \[
     \frac{17,857}{1} = 178,570
     \]
     \[
     \frac{178,570}{1} = 178,570
     \]

2. The sale of equipment for $300,000 and its lease back for its remaining useful life is similar to obtaining a $300,000 loan to be repaid with interest over an eight year amortization. In effect, the company receives $300,000 in exchange for annual payments of $54,000 for eight years. The implicit interest rate in the lease arrangement can be determined from finance tables that designate the interest rate required for installment loans as follows:

   Initial amount of loan $300,000
   Periodic payment $54,000
   Periods per year 1
   Time period 8 years
   Interest rate 8.9%

   The above assumes the lease payments are made annually ($54,000). If monthly payments are required ($54,000/12 = $4,500), the interest rate reflected in the arrangement would increase to 9.7%. 

3. If the equipment is sold for $300,000 and leased back at an annual cost of $54,000 for eight years, the following would occur:

- The sale price of $300,000 would reduce the Class 43 CCA pool. No recapture would occur because there are other assets in the class and its UCC is $800,000. This reduces the amount of CCA that can be claimed in future years resulting in higher annual tax costs. The present value of this can be determined from the formula:

\[
\frac{C \times T \times R}{R + I}
\]

- The annual lease payments of $54,000 are fully deductible from income for tax purposes and create tax savings of 25%.

- Annual revenues from the use of the equipment remain at $60,000.

The net present value of the above cash flows is as follows:

Inflows:
- Proceeds from sale of equipment $300,000
- Annual net income
  - Revenue $60,000
  - Lease cost (54,000)
  - Net income 6,000
  - Less tax @ 25% (1,500)
  - Net cash $ 4,500

\[\text{PV of } $4,500 \text{ annual for 8 years (12\%)} = 22,354\]

Outflows:
- Loss of tax savings from reduction of CCA pool by $300,000

\[
\frac{300,000 \times 0.25 \times 0.30}{0.30 + 0.12} = (53,571)
\]

\[\text{Total outflow} = $268,783\]

The sale and lease-back arrangement is beneficial to the company because it provides positive cash flow (NPV) of $268,783 compared to $241,400 if ownership of the equipment is retained.