Taxation Primer
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INTRODUCTION

This Primer will introduce you to the Income Tax Act (ITA) and the taxation laws in Canada. You will look at income tax liability in Canada and sources of income that trigger income tax. The Primer discusses the taxation of employment, business and property income, including capital gains and losses, and miscellaneous income and deductions. Corporate income tax and GST/HST are also covered.

PART 1

The ITA

Federal tax on income is levied under the ITA. The Canada Revenue Agency (CRA) is the government agency that administers the filing of income tax returns and enforces income tax laws.

Common law

Another source of law in determining federal tax is the decisions made under the courts. For example, the tests for determining residency or the tests for determining whether individuals are employees or are self-employed are based on decisions made over time through the court system.

Liability for income tax

Canada levies income tax based on residence. This is unlike the United States, which uses citizenship as its basis for levying income tax. Individuals who are Canadian residents are taxed on their worldwide income for the entire fiscal year (January 1 to December 31 for individuals). Individuals can be “part year residents” if they enter Canada for the first time and meet the tests for determining residency (fresh start), or if they leave Canada and do not meet the residency tests (clean break).

Determining residency status

The rules for determining residency are for the most part based on common law, which looks at the primary and secondary ties individuals have in Canada.

Individuals are residents of Canada for tax purposes if they have significant residential ties with Canada. Individuals who have a home, spouse and dependents in Canada (primary residential ties) will generally be considered Canadian residents for tax purposes. If the primary tests are inconclusive, one must consider secondary ties such as location of assets, bank accounts, and memberships.
Individuals who lack significant residential ties but sojourn (that is, are temporarily present) in Canada for 183 days or more in a calendar year are deemed to be residents of Canada for the entire year.

Non-residents are also taxed if they are employed in Canada, carry on business in Canada or dispose of taxable Canadian property. They can also be taxed via withholding tax on property income earned in Canada (that is, if they earn interest, rent, royalties, or dividends).

**Determining Division B net income**

Section 3 of the ITA contains the aggregating formula for computing net income. There are five sources of income: employment income, business income, property income, capital gains and losses, and other sources of income deductions.

**Taxable income and tax rates**

Taxable income is calculated by reducing the sum of net income from each source by certain deductions, such as losses from other years, employee stock option deductions and capital gains deductions (in the case of individuals). Canada uses a progressive rate system for personal taxes, which means that the more taxpayers earn, the higher the tax rate that applies to each additional dollar of earnings. Income tax is calculated as a percentage of taxable income based on marginal tax rates set each year.
Aggregating formula under section 3

3(a) Income from employment (individuals only)
   Income from business
   Income from property
   Other income (individuals only)

3(b) Taxable capital gains in excess of allowable capital losses

3(c) Other deductions (individuals only)
   Moving expenses
   Child care expenses
   RRSP deductions
   Support payments

3(d) Loss from employment (individuals only)
   Loss from business
   Loss from property
   ABIL (allowable business investment loss)

Income for the year / Division B income / net income for tax purposes

Division C deductions

For individuals
   Stock option deduction
   Capital gains deductions
   Non-capital loss carryforward (20) / back (3)
   Net capital loss carryforward (indefinite) / back (3)
   Social assistance deduction
   Workers' Compensation deduction

For corporations
   Charitable donations
   Taxable dividends received from Canadian corporations
   Non-capital loss carryforward (20) / back (3)
   Net capital loss carryforward (indefinite) / back (3)

Taxable income
Employment income — inclusions

The most common source of income is employment income, which includes salary, wages, and taxable benefits. Section 6 of the ITA also states that “other benefits of any kind whatever received or enjoyed by the taxpayer … by virtue of the taxpayer’s … employment” are taxable. Some exclusions to this rule [found in the ITA in section 6(1)(a)(i)] and some specific calculations for certain benefits the CRA considers to be taxable or non-taxable as an administrative position are outlined in CRA guide T4130: Employers’ Guide – Taxable Benefits and Allowances. Below are some common taxable benefits.

Automobile benefits

One common type of taxable benefit is the use of a company car owned by an employer. The standby charge provides a calculation to tax the employee for the value of the car made available to employees for personal use. The standby charge is 2% of the cost of the automobile or two-thirds of the monthly lease cost, multiplied by the number of months in the year that the car was available to the employee. The standby charge is reduced if employment use is 50% or more (up to a maximum of 1,667 personal kilometres per month).

The operating expense benefit quantifies the value, received by an employee, of the operating costs of the car paid for by an employer but driven for personal use. In situations where there is a personal use of the car, the operating benefit is 28 cents per personal-use kilometre (in 2019) or, if advantageous, half of the standby charge can be used if employment use is 50% or more.

\[
\frac{A}{B} \times [2\% \times (C \times D) + \frac{2}{3}(E - F)]
\]

A* = lesser of:

a) Total personal-use kilometres driven during the time period, and
b) Value determined for B during the days the automobile is available.

\[
B = 1,667 \text{ km} \times (\text{total available days} / 30)
\]

C = full original cost of an employer-owned vehicle, including HST
D = total available days when employer owned the automobile / 30
E = lease payments, including HST, made by employer
F = portion of the lease payments that pertains to insurance for loss or damages

* Note that employment use must be > 50%; otherwise, A = B.
**Stock option benefits**

The taxable benefit for employee stock options is equal to:

- the fair market value (FMV) of the shares at the time of acquisition of the shares, less
- the exercise price, paid by the employee, of those shares

If the employer is a Canadian-controlled private corporation (CCPC), the employee includes the benefit in the year the shares are sold. If the employer is not a CCPC, the benefit inclusion occurs when the option is exercised.

The taxpayer may be able to claim a deduction equal to 50% of the stock option benefit (note that this deduction is part of Division C, not employment income under 3A of the aggregating formula above) when calculating taxable income. This is available if, at the time it was granted, the stock option was not in-the-money on the grant date (exercise price is less than the FMV).

Employees of CCPCs could also claim this deduction if the employees own the shares for at least two years after the date of exercise before selling.

**Imputed interest benefit**

If an employee receives a loan from the employer at interest rates below market, a taxable benefit is triggered. This benefit is calculated using prescribed interest rates found on the CRA website posted quarterly, less any interest that is actually paid on the loan. If the loan is to purchase a home, note that the prescribed rates used may differ slightly than a loan for other reasons.

**Allowances for personal or living expenses**

Amounts received by the taxpayer from the employer as an allowance for personal or living expenses are considered employment income. However, reasonable allowances for travel expenses and use of a motor vehicle while travelling for employment are non-taxable under certain conditions. For instance, an allowance for the use of a motor vehicle is reasonable only if it is based on the number of kilometres driven for employment purposes, and no higher than certain rates published by the CRA.
**Employment income — deductions**

The available employment income deductions are listed in section 8 of the ITA and are relatively few. The more notable ones are as follows:

- travel expenses including airfare, train fare and 50% of meals while travelling away from the metropolitan area of the employer for more than 12 hours in a day
- motor vehicle operating costs including lease costs, capital cost allowance (CCA) and interest within limits
- professional and union dues
- certain home office expenses

**Sales expenses of commission employees**

Employees who act in a selling capacity or who negotiate contracts for employers and earn commission income are allowed a broader range of deductions. Note that the expenses cannot exceed the amount of the commissions. However, a commissioned employee can choose instead to use the deductions allowed to regular employees and not be limited to commissions (though the deductions allowed are fewer). An analysis of both scenarios should be done in order to maximize the deduction.
Summary of deductions available to commissioned salespersons and regular employees

<table>
<thead>
<tr>
<th>Deduction</th>
<th>8(1)(f) limited to commissions. Only commissioned salespersons can claim under this paragraph.</th>
<th>8(1)(i)/(j) available to ALL employees.</th>
<th>8(1)(h)/(h.1) available to regular employees if required by contract and work away from main place of business.</th>
</tr>
</thead>
<tbody>
<tr>
<td>50% of meals (while taking out clients)</td>
<td>YES</td>
<td>YES</td>
<td>YES</td>
</tr>
<tr>
<td>50% of entertainment</td>
<td>YES</td>
<td>YES</td>
<td>YES</td>
</tr>
<tr>
<td>Promotion</td>
<td>YES</td>
<td>YES</td>
<td>YES</td>
</tr>
<tr>
<td>Travelling expenses (not auto)</td>
<td>Meals (50%)</td>
<td>YES</td>
<td>YES</td>
</tr>
<tr>
<td></td>
<td>Hotel</td>
<td>YES</td>
<td>YES</td>
</tr>
<tr>
<td></td>
<td>Taxi</td>
<td>YES</td>
<td>YES</td>
</tr>
<tr>
<td></td>
<td>Airfare</td>
<td>YES</td>
<td>YES</td>
</tr>
<tr>
<td>Automobile expenses</td>
<td>Gas</td>
<td>YES</td>
<td>YES</td>
</tr>
<tr>
<td></td>
<td>Insurance</td>
<td>YES</td>
<td>YES</td>
</tr>
<tr>
<td></td>
<td>Licence</td>
<td>YES</td>
<td>YES</td>
</tr>
<tr>
<td></td>
<td>Minor repairs</td>
<td>YES</td>
<td>YES</td>
</tr>
<tr>
<td></td>
<td>Parking</td>
<td>YES</td>
<td>YES</td>
</tr>
<tr>
<td>Interest on car loan (8)(1)(j)</td>
<td>YES</td>
<td></td>
<td></td>
</tr>
<tr>
<td>CCA on car (8)(1)(j)</td>
<td>YES</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Home office expenses</td>
<td>Utilities</td>
<td>YES</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Light bulbs</td>
<td>YES</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Cleaning</td>
<td>YES</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Cleaning materials</td>
<td>YES</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Minor repairs</td>
<td>YES</td>
<td></td>
</tr>
<tr>
<td>Supplies (&quot;consumed&quot; entirely during the year)</td>
<td>YES</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Professional or union dues</td>
<td>YES</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Salary to assistant</td>
<td>YES</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Long distance telephone calls</td>
<td>YES</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Home office expenses</td>
<td>Property tax</td>
<td>YES</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Insurance</td>
<td>YES</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Rental of equipment (for example, computer, fax)</td>
<td>YES</td>
<td></td>
</tr>
<tr>
<td></td>
<td>CCA on purchased equipment other than car or airplane</td>
<td>NO</td>
<td>NO</td>
</tr>
</tbody>
</table>

CPA CHARtered PROFESSIONAL ACCOUNTANTS

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Practice questions

1. Multiple-choice questions:

i. Which of the following statements is true for tax purposes?

   a) Canadian residents are taxed on their Canadian income only.
   b) In any calendar year, spending less than 183 days in Canada makes an individual a non-resident.
   c) A non-resident may be considered to be a deemed resident of Canada by being physically present in Canada for 183 days or more in a calendar year.
   d) The tax treaty is the first reference source when examining the tax implications of cross-border transactions.

Solution

Option c) is correct. The sojourning deemed residency rules state an individual may be a deemed resident if they are present in Canada for 183 days or more.

Option a) is incorrect. Canadian residents are taxed on their worldwide income.

Option b) is incorrect. Spending less than 183 days may not necessarily make an individual a non-resident.

Option d) is incorrect. The first reference source is the ITA. The treaty does not apply unless an entity is a resident of each country. Therefore, you would determine if the entity is a resident first under the ITA’s own language and then under the code of the other country. Only then would you apply the treaty.

ii. Adrienne’s employer pays the following on her behalf:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Group life insurance premiums</td>
<td>$400</td>
</tr>
<tr>
<td>Extended health care premiums</td>
<td>$3,000</td>
</tr>
<tr>
<td>Counselling for employee’s retirement planning</td>
<td>$200</td>
</tr>
</tbody>
</table>

What is Adrienne’s taxable benefit amount?

a) $200
b) $400
c) $3,000
d) $3,600

Solution

Option b) is correct. Group life insurance premiums are a taxable benefit under subsection 6(4) of the ITA.
Option a) is incorrect. Counselling for employee’s retirement planning is not a taxable benefit [specifically excluded under clause 6(1)(a)(iv) of the ITA].

Option c) is incorrect. Extended health care premiums are not a taxable benefit [specifically excluded under clause 6(1)(a)(i) of the ITA].

Option d) is incorrect. Only group life insurance premiums are a taxable benefit.

2. Amal has the following income and loss (properly calculated) for the current tax year:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salary</td>
<td>$80,000</td>
</tr>
<tr>
<td>Interest income</td>
<td>2,000</td>
</tr>
<tr>
<td>Rental loss</td>
<td>(1,000)</td>
</tr>
<tr>
<td>Taxable capital gain</td>
<td>4,000</td>
</tr>
<tr>
<td>Allowable capital loss</td>
<td>(6,000)</td>
</tr>
<tr>
<td>RRSP contribution</td>
<td>4,000</td>
</tr>
</tbody>
</table>

**Required:**

Determine Amal's net income in accordance with the aggregating formula in section 3.

**Solution**

Section 3(a)
Employment income: salary $80,000
Property income: interest 2,000

Section 3(b)
Taxable capital gain $82,000

Section 3(c)
RRSP contribution (4,000)

Section 3(d)
Rental loss (1,000)**

Net income for tax purposes $77,000

* Section 3(b) cannot be negative. A negative balance carries over to other taxation years as a net capital loss.

** If the net income for tax purposes was a negative amount, the taxpayer would then have a non-capital loss that carries over to other taxation years.
3. Arlo’s employer provided him with a company car for all of 2019. He drives mostly for work. During the year, he drove 34,000 kilometres for work and 6,000 kilometres for personal use. The company leased the car on January 1, 2019, and the annual lease payment total is $11,340, which includes applicable taxes but excludes insurance. The car operating costs for the year paid directly by the employer are $4,000.

Required:

What is the taxable benefit for Arlo?

Solution

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Standby charge (reduction since used primarily for employment)</td>
<td>$2,268</td>
</tr>
<tr>
<td>(6,000 / 20,004) × 2/3 × $11,340</td>
<td></td>
</tr>
<tr>
<td>Operating cost benefit — lesser of:</td>
<td></td>
</tr>
<tr>
<td>a) $0.28 × 6,000 km = $1,680</td>
<td></td>
</tr>
<tr>
<td>b) 50% of standby charge $2,268 = $1,134</td>
<td></td>
</tr>
<tr>
<td>(available because used primarily for employment)</td>
<td></td>
</tr>
<tr>
<td>Total taxable benefit</td>
<td>$3,402</td>
</tr>
</tbody>
</table>

4. Arica sold 100 shares that she acquired under the employee stock option plan three years ago. Her employer is a CCPC. The following are the details:

- Proceeds received for 100 shares at $15 per share = $1,500.
- FMV at option grant date was $12 per share; FMV on exercise date was $13 per share.
- Option price was $10 per share.

Required:

What are the tax consequences for the current tax year for Arica? Ignore taxable capital gains (covered in Part 3).

Solution

Tax consequences:

- Employment income (stock option benefit) 100 × ($13 − $10) = $300
- Stock option deduction (Division C deduction) $300 × ½ = ($150)
Although the shares are worth more than the option price at the time they were issued, the 50% stock option deduction is still available because the shares are those of a CCPC and were held for more than two years. Since the shares were CCPC shares, the employment income is taxed in the year the shares were disposed of (rather than in the year exercised). If the company was not a CCPC, the employment income and stock option deduction would have been included in income three years ago when exercised, and Arica would only include the taxable capital gain in the year sold.

Taxable capital gain \[ 100 \times (\$15 - \$13) = \$200 \times 50\% = \$100 \] (covered in Part 3)

5. Assume Annie is a commissioned salesperson with a salary of \$80,000 and commission of \$5,000 in the current year. She incurs the following expenses to earn commission:

<table>
<thead>
<tr>
<th>Expenses</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Advertising</td>
<td>$1,000</td>
</tr>
<tr>
<td>Meals with clients</td>
<td>$10,000</td>
</tr>
<tr>
<td>Allowable automobile costs — CCA and interest (employment portion)</td>
<td>$2,500</td>
</tr>
</tbody>
</table>

**Required:**

What is the maximum amount of employment expenses Annie can deduct?

**Solution**

Salesperson expenses:

<table>
<thead>
<tr>
<th>Expenses</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Advertising</td>
<td>$1,000</td>
</tr>
<tr>
<td>Meals with clients (1/2 \times $10,000)</td>
<td>5,000</td>
</tr>
<tr>
<td>Total</td>
<td>$6,000</td>
</tr>
</tbody>
</table>

Deduction is limited to commission income $5,000

Allowable automobile costs* $2,500

Total employment expenses $7,500

* The CCA on an automobile, along with any related financing costs, is not subject to the commission limitation and can be deducted over and above commissions earned in a year.
PART 2

CCA

The ITA does not allow accounting depreciation to be deducted in computing net income for tax purposes, as there is too much flexibility involved and companies would likely choose aggressive depreciation policies in order to minimize tax.

A deduction may be claimed for CCA on depreciable capital assets used to earn income. This is similar to accounting depreciation but provides for a standardized method for all.

Similar assets are pooled together (with some exceptions discussed below) into various CCA classes, and the deduction is calculated as a percentage of undepreciated capital cost (UCC) of each class, usually on a declining balance basis.

Previously, a half-year rule applied to CCA; it restricted the first year’s amount of CCA to be claimed to one-half the calculated amount. Now, in the year the asset is available for use, the CCA deduction on net additions is 150% the normal rate for most CCA classes. This accelerated investment incentive property (AIIP) rule applies when additions exceed disposals in any given year. It does not apply to some assets added to Class 12 (for example, small tools, kitchen utensils, and linens). The AIIP rule gives businesses an incentive to invest in depreciable capital assets, as the amount of CCA that can be written off will be higher in the initial year in which the asset has been made available for use. Not all assets are eligible for this incentive, but most are. This Taxation Primer will demonstrate the calculations using the AIIP rule, as it is most relevant.

For businesses with a fiscal year of less than 365 days (either in the first year of business or with a short year end due to an acquisition of control or amalgamation), the CCA is prorated by the number of days in the taxation year (in addition to the half-year or AIIP rule for net additions).
**Example**

The opening UCC balance for Class 8 (20%) is $50,000. During 2019, ABC Ltd. buys furniture for $20,000 and sells office equipment for $8,000. The office equipment originally cost $10,000.

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>UCC, beginning of year</td>
<td>$ 50,000</td>
</tr>
<tr>
<td>Additions</td>
<td>20,000</td>
</tr>
<tr>
<td>Disposals (lower of cost and proceeds)</td>
<td>(8,000)</td>
</tr>
<tr>
<td>Net additions</td>
<td>12,000</td>
</tr>
<tr>
<td>Subtotal</td>
<td>62,000</td>
</tr>
<tr>
<td>AIIP adjustment ($12,000 × 0.5)</td>
<td>6,000</td>
</tr>
<tr>
<td>Total before CCA</td>
<td>68,000</td>
</tr>
<tr>
<td>CCA (20%)</td>
<td>(13,600)</td>
</tr>
<tr>
<td>AIIP adjustment</td>
<td>(6,000)</td>
</tr>
<tr>
<td>UCC, end of year</td>
<td>$ 48,400</td>
</tr>
</tbody>
</table>

**Sale of assets**

When assets are sold, the UCC pool is reduced by the lesser of proceeds and original cost. If the selling price exceeds the cost, that excess is taxed as capital gain. It is not possible to have a capital loss on the sale of depreciable property. At the end of the year, if all assets have been disposed of in a particular class, but a positive balance remains in the UCC pool, this balance is written off against income as a terminal loss. If the balance is negative, this balance is taxable as income as a recapture of CCA.

**CCA classes**

The more common classes, their percentage, and the applicable assets can be found in the Income Tax Regulations and on the CRA website. Classes with special treatment are discussed below.

**Specific CCA classes**

**Class 10.1 — Passenger vehicles**

All vehicles costing $30,000 or less are pooled in Class 10 with a CCA rate of 30%. For passenger vehicles that cost more than $30,000, each vehicle is placed in a separate Class 10.1 (not pooled), and is limited to maximum capital cost of $30,000 plus tax if the company is not an HST registrant. Instead of calculating recapture or terminal loss, only half of the CCA normally allowed is deductible as CCA in the year of sale, with the remaining balance being lost as a deduction. There is no adjustment for the lesser of proceeds or original cost in the year of sale.
**Class 13 — Leasehold improvements**

When tenants lease premises, the renovation costs qualify as Class 13 depreciable property. CCA is on a straight-line basis over the original or remaining lease term plus one renewable-option period (minimum of five years and maximum of 40 years). Each leasehold addition should be calculated according to the number of years remaining in the lease term at the time of the addition plus one renewal.

**Class 14 — Franchises, concessions, and licences**

Class 14 includes franchises, concessions, patents, and licences with a limited life. CCA is determined separately for each item, on a straight-line basis, multiplying the cost by the number of days owned in the year divided by the total days in the asset life. Patents are included Class 44 (25% declining balance CCA rate) but a taxpayer can elect to have a patent allocated to Class 14 if the asset is nearing the end of its useful life.

**Class 14.1 (5% CCA) — Goodwill and other intangibles**

Intangible assets with no specific legal life are pooled in CCA Class 14.1. Examples include goodwill, franchises and licences of an unlimited life, trademarks, customer lists and incorporation costs over $3,000. Normal CCA rules apply with allowable CCA at 5% declining balance basis.

**Business income**

The term “business” is defined in the ITA to include “a profession, calling, trade, manufacture, or undertaking of any kind whatsoever and an adventure or concern in the nature of trade.” The taxation year for individuals earning business income is the calendar year; for a corporation, it is its fiscal period.

**Inclusions**

The starting point for computing business income is usually GAAP profit. Adjustments are made to GAAP profit to determine the net income for tax purposes. Any accounting adjustments that are not GAAP should be adjusted for in computing net income for tax purposes.

Section 12 of the ITA discusses amounts that shall be included in computing net income for tax purposes, such as unearned revenue and prior year reserves. For example, paragraph 12(1)(a) states that amounts received in advance of services being rendered or goods delivered (unearned revenue) are included in income. Paragraph 20(1)(m) allows an optional deduction of the same amount. In the following taxation year, paragraph 12(1)(e) requires that any reserve for unearned revenue claimed in the prior year has to be included in net income for tax purposes.
Deductions and the “reasonableness” test
For expenses to be deductible, they must be reasonable. The following are specifically explained as being “reasonable.” For other scenarios, common sense prevails:

- For food/beverage or entertainment expense, only 50% of the amount of the expense is deductible in most cases.
- For interest on loans for passenger vehicles, the lesser of actual interest and $10 a day is allowed to be deducted.
- The cost of leasing a passenger vehicle is limited to $800 plus HST/GST per 30-day period.
- Accrued unpaid bonuses or other compensation owing 180 days after year end is not allowed as a deduction until the actual payment is made.

General limitations on deductions
There are three general provisions in the ITA with respect to deductions, with the rest being specific:

1. No deduction should be allowed unless the outlay or expense was incurred for the purpose of earning income;
2. No deduction should be allowed for a capital outlay (that is, buying a building), or payment on account of capital (that is, financing fees or interest on a loan), or an allowance in respect of depreciation, obsolescence, or depletion, except if expressly permitted (this is the provision denying accounting depreciation mentioned above);
3. No deduction should be allowed for personal or living expenses.

Specific limitations on deductions

Reserves, contingencies, and so on
Amounts that are contingent or estimates in nature are not permitted to be deducted unless expressly permitted.

Use of recreational facilities and club dues
Expenses for the use or maintenance of a yacht, camp, lodge, or golf course are not deductible.

Political contributions and charitable donations
Political contributions are available as tax credits. For individuals, donations are available as tax credits; however, for corporations, they are deducted in computing taxable income.
Automobile allowances
For 2019, the maximum deductible is $0.58 per kilometre for the first 5,000 kilometres, and $0.52 thereafter (an additional $0.04 per kilometre is permitted in Yukon, Nunavut, and the Northwest Territories).

Fines, penalties, and illegal payments
Fines or penalties including CRA interest and late filing penalties are not deductible. Bribes and illegal payments made are also not deductible.

Interest and property taxes on vacant land
Interest costs and property taxes are normally deductible; however, a restriction applies for vacant land where the deduction is capped at the income that is generated from the land (that is, using the vacant land as a parking lot).

Home office expenses
Expenses for a home office used for business are deductible proportionate to its square footage (mortgage interest, property taxes, utilities, insurance, and maintenance and repairs). The deduction cannot exceed the business income. Any excess is claimable in the following year. A similar method of calculation applies when calculating home office expenses used in generating employment income, but additional restrictions apply.

Deductions specifically permitted
Section 20 of the ITA allows the optional deduction of certain amounts that would otherwise not be deducted under the three general provisions mentioned above.

Capital cost of property
As previously discussed, CCA is allowed to be taken on capital assets as a result of paragraph 20(1)(a).

Interest
Paragraph 20(1)(c) permits the deduction of interest on borrowed money used for the purpose of earned income.

Expenses to arrange financing
Since expenses with respect to financing may be considered long term in nature, these are typically expenses on account of capital and would be denied under the general provisions mentioned above. However, under paragraph 20(1)(e), costs for obtaining long-term financing (debt or shares) are deductible at one-fifth per year starting in the year paid. They include registering a mortgage, appraisal fees, and commissions.
Reserve for doubtful debts

Where accounts receivables are considered “doubtful,” a reserve may be taken to deduct this amount in computing net income for tax purposes. As discussed earlier, a tax reserve (deduction) taken in a year is required to be included (added) in computing net income for tax purposes in the subsequent year.

Bad debts

Where accounts receivables are considered “bad debts,” the full amount can be deducted in the year.

Reserve for unpaid amounts

A reserve may be deducted when inventory has been sold and all or part of the payment is not due until after two years from the date of sale (maximum three-year reserve). Reserves taken in one year will be included as income in the following year. The reserve is calculated as follows:

\[
\text{(Proceeds due after the end of the year/Total proceeds)} \times \text{Gross profit}
\]

Landscaping of grounds and utility service connection

Landscaping costs are deductible when paid. Service connection for gas, hydro, water, or sewers is also deductible as an expense.

Convention expenses

A deduction is permitted for the costs of attending up to two conventions in a year, where they are reasonable and in the “territorial scope” of the organizing party.

Practice questions

1. Multiple-choice questions:

i. Shady Co. signs a five-year office space lease agreement in 2019 with the option of renewing the lease for an additional five years. On June 1, 2019, the tenant spends $60,000 on leasehold improvements. On October 1, 2019, Shady acquires a limited-life 10-year licence for $36,500. Which of the following is the correct allowable CCA claim in 2019? (Assume a December 31 year end and ignore leap years.)

   a) $6,920
   b) $9,920
   c) $10,380
   d) $19,380
Solution

Option c) is correct.
Leasehold: Class 13 \[60,000 / (5 \text{ lease term} + 5 \text{ first renewal period}) \times 1.5 \text{ AIIP adjustment} = \$9,000\]
Licence: Class 14 \[36,500 \times 92 \text{ days in the year} / (365 \text{ days per year} \times 10 \text{ years}) \times 1.5 \text{ AIIP adjustment} = \$1,380\]
\[\$9,000 + \$1,380 = \$10,380\]

Option a) is incorrect. The AIIP rule was not applied to either asset.
\[(60,000/10) + (36,500 \times 92)/3,650 = \$6,920\]

Option b) is incorrect. The AIIP rule was applied to the leasehold improvement but not to the licence.
\[([60,000/10] \times 1.5] + (36,500 \times 92)/3,650 = \$9,920\]

Option d) is incorrect. The CCA on the leasehold improvements was based on five years instead of 10.
\[([60,000/5] \times 1.5] + [(36,500 \times 92)/3,650 \times 1.5] = \$19,380\]

ii. At the beginning of the year, Beta Co. had a Class 10 UCC balance of $3,120. During the year, Beta sold its delivery truck, its only Class 10 asset, for $4,000. The original cost of the truck was $18,000. What are the tax consequences of the sale?

a) Recapture of $880
b) Terminal loss of $880
c) Recapture of $880 and capital loss of $14,000
d) Terminal loss of $880 and capital loss of $14,000

Solution

Option a) is correct.

Options b), c) and d) are incorrect. This is a recapture (over-depreciation). No capital loss is allowable for depreciable property.

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening UCC</td>
<td>$ 3,120</td>
</tr>
<tr>
<td>Disposals — lesser of:</td>
<td></td>
</tr>
<tr>
<td>i) cost: $18,000</td>
<td></td>
</tr>
<tr>
<td>ii) proceeds: $4,000</td>
<td>(4,000)</td>
</tr>
<tr>
<td>Remaining UCC</td>
<td>(880)</td>
</tr>
<tr>
<td>Recapture (included in income)</td>
<td>880</td>
</tr>
<tr>
<td>Ending UCC</td>
<td>$ 0</td>
</tr>
</tbody>
</table>
2. South Seas is a new startup business. On September 1, the first day of operations, the company purchased a truck for $20,000. Its year end is December 31.

**Required:**

What is the allowable claim for the first year of business?

**Solution**

\[
\$20,000 \times 30\% \times 1.5 \times 122/365 \text{ days} = \$3,008
\]

3. Surfer Ltd., a CCPC, operates an active surfboard retail and wholesale business. Financial statements for the year ended December 31, 2019, report a net income before tax of $170,000. Surfer's income statement for the year included the following items:

- $1,500 in interest expense on late payment of tax instalment
- $3,000 paid for yacht maintenance and $1,000 for hockey tickets for entertainment of clients
- $5,000 in legal expenses for negotiating a long-term loan

**Required:**

a) What is the net income for tax purposes for the year ended December 31, 2019?

b) If Surfer purchases a new car for $60,000 on February 1, 2020, for the vice-president of sales, what is the amount of CCA that can be claimed for 2020? (ignore GST/HST).

**Solution**

a) Net income for tax purposes

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net income per financial statements</td>
<td>$170,000</td>
</tr>
<tr>
<td>Add back:</td>
<td></td>
</tr>
<tr>
<td>Interest on late payment of tax instalment</td>
<td>1,500</td>
</tr>
<tr>
<td>Yacht maintenance</td>
<td>3,000</td>
</tr>
<tr>
<td>Hockey tickets (1,000 x 50%)</td>
<td>500</td>
</tr>
<tr>
<td>Financing expenses (4/5 x 5,000, since only 1/5 deductible the first year)</td>
<td>4,000</td>
</tr>
<tr>
<td>Net income for tax purposes</td>
<td>$179,000</td>
</tr>
</tbody>
</table>

b) CCA — Class 10.1 = $30,000 (max. capital cost) (30%) × 1.5 = $13,500
PART 3

Property income

Property income includes income sources such as interest, dividends, rental income, and royalties. Property income is included in paragraph 3(a) of the aggregating formula learned in Week 1, and losses are included in paragraph 3(d). There are specific rules in the ITA that apply to property income only.

Interest income

Corporations, partnerships, and certain trusts report accrued interest on a fiscal-year basis. Individual taxpayers report interest as it is received. If no interest is received, individuals report accrued interest each anniversary of the investment. If an individual invests in a GIC on June 1 of Year 1, the anniversary date is May 31 of Year 2. This forces an individual to pay tax on the interest earned annually even if no payments have been received.

Dividend income

For individuals, the taxation of dividend income depends on the type of dividend received. Generally, eligible dividends are from public companies or income subject to the higher tax rates by a CCPC, and non-eligible dividends are from income of a CCPC taxed at low rates. Understanding whether a dividend is ineligible or non-eligible is important because in order to include it in net income for tax purposes, an individual has to "gross up" the dividend. The gross-up is necessary to bring the dividend amount to the pre-tax income that was originally earned in the corporation that paid out the dividend. Since the corporation paid tax on this income, the individual will get a dividend tax credit for the taxes paid by the corporation, to prevent double taxation. This mechanism makes the concept of integration work for Canadian tax purposes and is discussed in Week 6.

Dividend income for individuals

Cash dividends

The taxable amount of dividends is equal to the grossed-up amount of dividends received. There is a corresponding dividend tax credit that reduces your taxes payable. The following table shows the rates in effect for 2019.

<table>
<thead>
<tr>
<th>Item</th>
<th>Eligible dividends</th>
<th>Non-eligible dividends</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividend gross-up</td>
<td>38%</td>
<td>15%</td>
</tr>
<tr>
<td>Federal dividend tax credit as a fraction of the gross-up</td>
<td>6/11</td>
<td>9/13</td>
</tr>
<tr>
<td>Federal dividend tax credit as percentage of the actual dividend</td>
<td>20.727%</td>
<td>10.38%</td>
</tr>
</tbody>
</table>
For example, an eligible cash dividend of $100 received by an individual would result in $138 of taxable income. An individual would pay tax at their marginal rates on the $138 (assume 25% for this example), which would result in taxes of $34.50. The dividend tax credit would reduce these taxes by $20.73 such that the amount of taxes owing would be $13.77.

Stock dividends
Stock dividends are taxed like cash dividends. In addition, the actual dividend amount increases the shares’ adjusted cost base (ACB), which affects gains and losses when sold. This gives the same outcome as if you were given a cash dividend, and then immediately took that cash and purchased more shares. Without adjusting the ACB, there would be double tax.

Capital dividends
Capital dividends are paid out of the capital dividend account (CDA) of a CCPC and are tax-free for the recipient. The CDA tracks certain non-taxable transactions within a corporation and allows these non-taxable transactions to flow through to an individual via a dividend, tax-free. This is a second mechanism necessary for integration to be successful. Examples of non-taxable transactions are the 50% non-taxed portions of capital gains, as well as life insurance proceeds.

Foreign dividends
The gross amount of foreign dividends, before withholding tax, is included in taxable income. Foreign tax credits may be available for the tax withheld. There is no gross-up or dividend tax credit on foreign dividends since the CRA did not receive any tax from the foreign corporation.

Dividend income for corporations
Recall that corporations create journal entries for all their transactions. Dividends received by corporations are included in accounting net income and are not adjusted for under Division B of the ITA. Under Division C, dividends from taxable Canadian corporations are deducted in arriving at taxable income. This is because the dividends are paid out of after-tax dollars from the paying corporation. Without this deduction, there would be double taxation. Dividends are allowed to pass through Canadian corporations tax-free until they reach the individual shareholder, who is required to follow the previously mentioned gross-up rules.
**Rental income**

Net rental income is calculated as rental revenue minus rental expenses. Rental revenue is reported on an accrual basis per the CRA guide T4036 *Rental Income*. The following are special rules for CCA on a rental property or a group of properties:

- Each rental building costing $50,000 or more is included in a separate CCA Class 1 pool.
- A CCA claim may not create or increase a net rental loss.
- Any recapture or terminal loss increases or decreases rental income, respectively.

**Capital gains and losses**

Sale of capital property results in a capital gain when proceeds are greater than the ACB of the capital property. A capital loss occurs when proceeds are less than the ACB. Expenses of disposition may be deducted when calculating the capital gain or loss. Taxable capital gains are 50% of capital gains. An allowable capital loss is 50% of a capital loss.

The taxable capital gains in excess of allowable capital losses are included in paragraph 3(b) of the aggregating formula. This amount cannot be negative. If allowable capital losses exceed taxable capital gains, 3(b) is 0 and the balance can be carried back three years or forward indefinitely to be applied against taxable capital gains. This carryforward balance is called a net capital loss and is subtracted in Division C. This is discussed in Week 4.

**Principal residence**

A taxpayer’s principal residence is exempt from tax. Only one designation of principal residence for a family unit is allowed for a given year. The formula for calculating the exempt portion of the gain is as follows:

\[
\text{Total gain} \times \frac{1 + \text{years designated}}{\text{Years the property was owned}}
\]

The “1 +” is used in the formula because individuals may buy and sell a house in the same calendar year. If two or more properties are owned, a taxpayer should designate the property with the highest gain per year of ownership as the principal residence.

**Personal-use property**

PUP includes property for the taxpayer’s personal use, such as furniture, a boat, or a house if it cannot use the principal residence exemption above. There is a $1,000-minimum rule in calculating the capital gain. If proceeds are less than $1,000, they are deemed to be $1,000. Similarly, if the cost is less than a $1,000, the cost is deemed to be $1,000. Capital losses are not allowed and are deemed to be nil.
**Listed personal property**

LPP is a subset of PUP and includes prints, etchings, drawings, paintings, sculptures, jewelry, stamps, coins, and rare books. Similar to PUP, the $1,000-minimum rule applies to LPP. Unlike PUP, capital losses are deductible, but only against capital gains from disposition of LPP. Unused losses can be carried back three years and forward seven years to be applied against LPP gains. Unlike regular capital losses, the application of the carryforward of LPP losses occurs in 3(b) of the aggregating formula, and the loss is tracked at the gross amount rather than the 50% taxable amount.

**Identical properties**

If you own a block of a particular class of a company’s shares, it is treated as an identical property. The ACB of identical property is calculated on a weighted average cost (WAC) basis, and the capital gain or loss on sale is determined based on WAC.

**Business investment loss**

A special type of capital loss is the business investment loss (BIL) from the sale of small business corporation (SBC) shares or a loss on debt invested in an SBC. An SBC is a CCPC whose assets are used primarily to generate active business in Canada. Half of a BIL is an ABIL. An ABIL can be deducted against any source of income in the year it is realized, which is why it is applied in paragraph 3(d) of the aggregating formula. An ABIL can be carried back three years and forward 10 years. After the 10 years, any unused amount converts to a net capital loss-carryover balance and can be carried forward indefinitely to offset capital gains only. If you have previously used some of your capital gains exemption (discussed in Part 4), some of your BIL will be converted to a capital loss.

**Capital gains reserves**

A capital gains reserve may be set up if all or some of the sale proceeds on the disposition of an asset are not payable until after the end of a taxation year. The capital gains are reduced by the reserve amount. This is fair as you may not have the funds to pay your taxes on the capital gain if you aren’t receiving all the funds up front. The second part of the formula ensures that the full capital gains tax will be paid within five years of the sale.

The capital gains reserve is the lesser of:

(Proceeds payable after year end/Total proceeds) × Capital gain

and

(1/5 of capital gain) × (4 – number of years that have ended after the year of disposition)

Each year the prior year’s reserve is included in income, and a new reserve is calculated.
Other sources of income

Other sources of income for individual taxpayers include items not included in employment, business, or property income. These are added in paragraph 3(a) of the aggregating formula. Some of these are briefly described below:

- pension benefits, including Old Age Security and Canada Pension Plan (CPP)
- a retiring allowance paid by an employer for long service or as severance
- spousal support or maintenance payments paid pursuant to a written legal agreement
- scholarships, fellowships, and bursaries above the exemption threshold
- social assistance payments and workers’ compensation, which are included in income and then deducted in calculating taxable income, and thus are non-taxable

Non-taxable benefits

Non-taxable benefits include the Canada child benefit, child support payments, lottery winnings, gifts, inheritances, and life insurance benefits.

Other deductions

The following select deductions are available in sections 60 through 64 of the ITA. Other deductions are paragraph 3(c) of the aggregating formula. Remember that paragraph 3(c) and Division C are different; students commonly confuse the two. Refer to the Week 1 material for a summary of the calculation of taxable income.

Support payments

There is a deduction for a taxpayer who makes support payments. Support payment are periodic amounts paid pursuant to a divorce or separation agreement, as support to a spouse or common-law partner or former spouse or common-law partner. There is no deduction for child support payments.

Moving expenses

Eligible moving expenses may be deducted to the extent of the employment income, business income, or scholarship income earned at the new location. Moving expenses that are not deductible in the year of the move can be carried forward to the following year.
**Child care expenses**

A taxpayer may claim the cost of caring for a child who is 16 years old or under in order to earn income. In a two-parent situation, the lower-income spouse claims the deduction, limited to the lesser of:

i) 2/3 of earned income of that parent (employment, business, scholarships, CPP, or provincial disability pension)

ii) the expense paid

iii) a combined family limit that includes $8,000 per child aged six or under and $5,000 per child aged seven to 16, or if the child has a disability, $11,000 per child with no age restrictions

Actual expenses paid (part of limit (iii)) for boarding school or overnight camp expenses are limited to $200 per week for a child aged six or under and $125 per week for a child aged seven to 16. Higher deductible limits apply for a disabled child, regardless of age.

The higher-income spouse can claim child care expenses under certain circumstances, such as when:

- The lower-income spouse is enrolled as a student for a minimum of three weeks.
- The lower-income spouse has a mental or physical infirmity.
- The spouses are living apart for at least 90 days due to marriage breakdown.

**Deferred income plans**

The following are the more common deferred income plans:

- **Registered Retirement Savings Plan (RRSP):** This is based on the available contribution room to a maximum annual limit. The contributions are tax-deductible and income grows tax-free within the plan. The withdrawals are taxable in the year they are withdrawn. For 2019, the maximum annual contribution to an RRSP is $26,500, and for 2020 it is $27,230.

- **Tax-Free Savings Account (TFSA):** The contributions are not tax-deductible; however, the income earned in the plan and withdrawals from the plan are not taxable. Any portion of the limit not used in one year will carry forward to the next year, similar to an RRSP. The limit for 2019 and 2020 is $6,000.

- **Registered Education Savings Plan (RESP):** A contribution to an RESP to fund a child’s education is not tax-deductible, nor are withdrawals of contributions taxable in the future. Income earned within an RESP is taxed in the hands of the beneficiary when withdrawn for post-secondary education. There is a lifetime maximum of $50,000 per beneficiary.
Practice questions

1. Multiple-choice questions:

i. Samantha buys a $10,000, two-year GIC investment on April 1, 2019. The interest accrued at December 31, 2019, is $225, and at March 31, 2020, it is $300. She receives eligible dividends from Rapid Inc. in the amount of $200. What is the minimum property income included in Samantha’s 2019 income tax return?

   a) $230
   b) $276
   c) $501
   d) $576

Solution

Option b) is correct. 200 × 1.38 = $276. Interest of $525 would be included on an anniversary-day basis in 2020.

Option a) is incorrect. It uses the gross-up rate for non-eligible dividends.

Option c) is incorrect. It includes $225 of interest.

Option d) is incorrect. It includes $300 of interest.

ii. Jack had a garage sale in the summer of this year. He sold dining room furniture that originally cost $1,700 for $1,200 and a coin collection that originally cost $800 for $2,300. In addition, he sold shares of Pumpkin Inc., which cost $2,000, for $3,000. What is the minimum taxable capital gain for Jack this year?

   a) $900
   b) $1,000
   c) $1,150
   d) $1,250

Solution

Option c) is correct. The minimum taxable capital gain is $1,150. The LPP gain on the coin collection is $2,300 – $1,000 = $1,300 plus the gain on shares of $3,000 – $2,000 = $1,000 = $2,300 multiplied by the 50% capital gains rate = $1,150.

Option a) is incorrect. It includes the $500 capital loss from the furniture, which is PUP, with the correct capital gain on the coin collection, multiplied by the 50% capital gains rate.
Option b) is incorrect. It includes the $500 capital loss from the furniture and calculates the LPP gain as $2,300 – $800 = $1,500, multiplied by the 50% capital gains rate.

Option d) is incorrect. It includes an LPP gain of $1,500 ($2,300 – $800) with the correct capital gain on shares, multiplied by the 50% capital gains rate.

2. Molly is a single mother with two children, aged five and seven. She earns an annual salary of $80,000. She also earned $10,000 in 2019 as a self-employed, part-time bookkeeper. Molly paid her babysitter $7,340 in 2019 for looking after both children. In addition, Molly paid $250 for one week at an overnight summer camp for the seven-year-old child.

**Required:**

What is the maximum child care expense that Molly can claim in 2019?

**Solution**


**Least of:**

1) **Expenses incurred**
   - Babysitting for both children $ 7,340
   - Overnight summer camp ($250 × 1 week) child under 7 (limited to $125 per week) 125 $ 7,465

2) **Child care expense**
   - $8,000 × one child (under 7 years old) $ 8,000
   - $5,000 × one child (aged 7–16) 5,000 $ 13,000

3) ⅓ earned income — income from employment $ 80,000
   - — part-time bookkeeping business 10,000 $ 90,000
   - × ⅓ $ 60,000
3. Cary sold land (capital property) to Kalinda in 2019 for $100,000. The original cost of the land was $40,000. As part of the terms of the purchase agreement, Kalinda made a $30,000 initial payment, and the balance will be paid in two equal instalments over the next two years.

**Required:**

a) What is Cary’s minimum taxable capital gain in 2019?

b) What is Cary’s minimum taxable capital gain in 2020?

**Solution**

a) The minimum taxable capital gain for Cary in 2019 is $24,500 (see below).

b) The minimum taxable capital gain for Cary in 2020 is $5,250 (see below).

<table>
<thead>
<tr>
<th></th>
<th>2019</th>
<th>2020</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital gain</td>
<td>$60,000</td>
<td>Capital gain (prior year reserve)</td>
</tr>
<tr>
<td>Less reserve*:</td>
<td></td>
<td>Less reserve*:</td>
</tr>
<tr>
<td>Lesser of:</td>
<td></td>
<td>Lesser of:</td>
</tr>
<tr>
<td>70,000/100,000 × 60,000</td>
<td>(42,000)</td>
<td>35,000/100,000 × 60,000</td>
</tr>
<tr>
<td>4/5 × 60,000 = 48,000</td>
<td>(42,000)</td>
<td>3/5 × 60,000 = 36,000</td>
</tr>
<tr>
<td>Capital gain 2019</td>
<td>$18,000</td>
<td>Capital gain 2020</td>
</tr>
<tr>
<td>Taxable capital gain (50%)</td>
<td>$9,000</td>
<td>Taxable capital gain (50%)</td>
</tr>
</tbody>
</table>

* (Proceeds payable after year end/Total proceeds) × Capital gain, and

(1/5 of capital gain) × (4 – number of years that have ended after the year of disposition)
PART 4

Related persons

Various sections in the ITA — such as the association rules discussed below and guidance about connected corporations (discussed in Week 5), acquisition of control, and attribution rules — make reference to the concept of “related persons” or “persons not dealing at arm’s length.” It is thus important to understand who are related persons for purposes of the ITA in order to determine whether these rules apply.

Related persons are deemed not to be at arm’s length. Individuals connected by blood relationship, marriage or common-law partnership, or adoption are considered related persons. This includes a taxpayer’s parents, grandparents, parents-in-law, grandparents-in-law, spouse or common-law partner, siblings, siblings of the taxpayer’s spouse, spouses of the taxpayer’s siblings, children (including those adopted or born outside of marriage) and their spouses and children. For tax purposes, aunts, uncles, nieces, and nephews are not considered to be related.

An individual and a corporation controlled by that individual are related to one another for tax purposes. Two corporations are related to each other if they are controlled by the same person or group of persons. In general, control means legal control (ownership of more than 50% of the voting shares). The meaning of control is important in determining the association of corporations, which is discussed below.

Inadequate consideration rules

Inadequate consideration occurs when there is a transfer of property for no proceeds or at a price other than FMV. Inadequate consideration rules apply to all related entities, including corporations. The rules for transactions involving inadequate consideration between non-arm’s-length parties are summarized below:

<table>
<thead>
<tr>
<th>ITA reference</th>
<th>Transaction</th>
<th>Proceeds to seller</th>
<th>ACB to purchaser</th>
</tr>
</thead>
<tbody>
<tr>
<td>69(1)(a)</td>
<td>Transfer for proceeds &gt; FMV</td>
<td>Actual proceeds</td>
<td>FMV</td>
</tr>
<tr>
<td>69(1)(b)</td>
<td>Transfer for proceeds &lt; FMV Gift</td>
<td>FMV</td>
<td>Actual price paid</td>
</tr>
<tr>
<td>69(1)(c)</td>
<td>Bequest, inheritance</td>
<td>FMV</td>
<td>FMV</td>
</tr>
</tbody>
</table>

As a result of the one-sided tax adjustments to either the purchaser or the seller in the above transactions, there will be double taxation. If a capital gain is created as a result of a transaction noted above, it will be taxed twice. If a capital loss is created, it will be denied.

Other specific provisions apply for transfers to spouses or common-law partners and minors.
Associated corporations
There are a few situations that result in corporations being associated. For example, two corporations are associated if one corporation controls the other or if two corporations are controlled by the same person or group of persons. Corporations controlled by two different persons would be associated if the persons were related to each other and one of the persons owned at least 25% of the other corporation that he or she did not control.

Numerous rules in the ITA apply when companies are considered associated. One example is that associated corporations must share the small business deduction.

Taxable income for individuals
Division C deductions reduce net income in order to compute taxable income. These deductions include the employee stock option deduction, the deduction for workers’ compensation and social assistance payments, loss carryovers from other years and the capital gains deduction. Be sure to revisit the aggregating formula from Week 1 to refresh your understanding of the components of taxable income.

Overview of loss-carryover system
A non-capital loss arises where the total of losses from employment, business, property and allowable business investment losses exceeds the net income computed under paragraph 3(c). It can be carried back three years, carried forward 20 years, and applied against any type of income. A net capital loss arises when allowable capital losses exceed taxable capital gains. It can be carried back three years and carried forward indefinitely. A net capital loss can be applied against taxable capital gains only.

Capital gains deduction
The capital gains deduction applies to the sale of shares of a qualified small business corporation (QSBC) or qualified farm or fishing property (QFFP). QSBC shares are CCPC shares, where 50% or more of the FMV of the assets is used principally in an active business in Canada for at least 24 months prior to the disposition. At the time of sale, at least 90% of the FMV of the assets must be used in active business. There is one lifetime maximum per individual for both QSBCs ($433,456 limit for 2019) and QFFPs (limit is $500,000). The entitlement is the least of the qualifying taxable capital gain or net gain, the unused lifetime deduction, the annual gain limit, and the cumulative gains limit.

Tax payable for an individual
Gross federal tax is determined by applying marginal tax rates to taxable income. The 2019 rates vary from 15% in the lowest tax bracket ($0 to $47,630) to 33% in the highest bracket (> $210,371). See the Appendix.
Non-refundable and refundable tax credits

The 15% non-refundable federal tax credits reduce the amount of federal tax payable, if any. The GST/HST credit is an example of a refundable tax credit. The taxpayer will receive this even if there is no tax payable. The working income tax benefit and the refundable medical expense supplement are other examples.

Completion of tax payable calculation

Net federal tax is gross federal tax reduced by applicable tax credits. The balance of tax payable or refundable is net federal tax reduced by income tax deducted at source, any tax instalments paid and refunds of CPP or Employment Insurance (EI) overpayments. If the amount is negative, there is a refund. A positive amount means there is tax owing to the CRA.
# APPENDIX — 2019 individual tax rates and non-refundable tax credits

## 2019 tax brackets — taxable income is between

<table>
<thead>
<tr>
<th>Taxable Income Range</th>
<th>Tax on Base Amount</th>
<th>Tax on Excess</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0 and $47,630</td>
<td>$0</td>
<td>15.0%</td>
</tr>
<tr>
<td>$47,631 and $95,259</td>
<td>$7,145</td>
<td>20.5%</td>
</tr>
<tr>
<td>$95,260 and $147,667</td>
<td>$16,908</td>
<td>26.0%</td>
</tr>
<tr>
<td>$147,668 and $210,371</td>
<td>$30,535</td>
<td>29.0%</td>
</tr>
<tr>
<td>$210,372 and any amount</td>
<td>$48,719</td>
<td>33.0%</td>
</tr>
</tbody>
</table>

## 2019 common non-refundable tax credits

<table>
<thead>
<tr>
<th>Credit Description</th>
<th>ITA Reference</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Personal</td>
<td>118(1)(a) or (c)</td>
<td>$12,069</td>
</tr>
<tr>
<td>Married (reduced by spouse’s net income)</td>
<td>118(1)(a)</td>
<td>12,069</td>
</tr>
<tr>
<td>Wholly dependent person (equivalent to spouse) (reduced by dependant’s net income)</td>
<td>118(1)(b)</td>
<td>12,069</td>
</tr>
<tr>
<td>Canada caregiver (reduced for net income over $17,766)</td>
<td>118(1)(d)</td>
<td>7,140</td>
</tr>
<tr>
<td>Additional amount for taxpayers who claim spouse, common-law partner or eligible dependant credit, or have an infirm child under 18 (reduced by dependant’s net income)</td>
<td>118(1)(e)</td>
<td>2,230</td>
</tr>
<tr>
<td>Age 65 and older (reduced for net income over $37,789)</td>
<td>118(2)</td>
<td>7,494</td>
</tr>
<tr>
<td>Pension income</td>
<td>118(3)</td>
<td>2,000</td>
</tr>
<tr>
<td>Canada employment</td>
<td>118(10)</td>
<td>1,222</td>
</tr>
<tr>
<td>Adoption expense</td>
<td>118.01</td>
<td>16,255</td>
</tr>
<tr>
<td>First-time home buyers</td>
<td>118.05</td>
<td>5,000</td>
</tr>
<tr>
<td>Charitable donations at 15% and balance at 29%</td>
<td>118.1</td>
<td>200</td>
</tr>
<tr>
<td>Medical expense (in excess of the lesser of 3% of income and $2,352)</td>
<td>118.2</td>
<td>—</td>
</tr>
<tr>
<td>Disability (medical or physical impairment)</td>
<td>118.3</td>
<td>8,416</td>
</tr>
<tr>
<td>Disabled child</td>
<td>—</td>
<td>4,910</td>
</tr>
<tr>
<td>Tuition</td>
<td>118.5</td>
<td>actual cost</td>
</tr>
<tr>
<td>Interest on student loan</td>
<td>118.62</td>
<td>actual cost</td>
</tr>
<tr>
<td>EI (amount deducted from income to EI maximum of $860.22)</td>
<td>118.7</td>
<td>—</td>
</tr>
<tr>
<td>CPP (amount deducted from income to CPP maximum of $2,748.90)</td>
<td>118.7</td>
<td>—</td>
</tr>
<tr>
<td>Transfer of unused credits to spouse (age, disability)</td>
<td>118.8</td>
<td>—</td>
</tr>
<tr>
<td>Transfer of unused tuition credits (maximum of $5,000 per year)</td>
<td>118.81</td>
<td>—</td>
</tr>
</tbody>
</table>
Practice questions

1. Multiple-choice questions:

   i. Ralph owns 80% of Lauren Ltd., a Canadian wholesaler corporation. Ralph also owns 100% of Russo Ltd., a Canadian retail business. Lauren Ltd. sells shirts to Russo Ltd. at a cost of $20 per shirt; the price charged to other Canadian retailers is $30. Which of the following reflects the correct proceeds to be recognized by Lauren Ltd. and cost for Russo Ltd. per shirt?

      a) Proceeds of $30; cost of $30
      b) Proceeds of $30; cost of $20
      c) Proceeds of $20; cost of $20
      d) Proceeds of $20; cost of $30

   Solution

   Option b) is correct. Lauren Ltd. and Russo Ltd. are related and not dealing at arm’s length. They are both controlled by Ralph, and the inadequate consideration rules apply. The sale price for Lauren Ltd. is deemed to be FMV, which is $30, and the cost for Russo Ltd. will be the actual price paid of $20.

   Option a) is incorrect. Because Lauren Ltd. and Russo Ltd. are non-arm’s-length parties, the cost to Russo Ltd. should be the actual price paid of $20, not FMV of $30.

   Option c) is incorrect. Because Lauren Ltd. and Russo Ltd. are non-arm’s-length parties, the deemed proceeds for Lauren Ltd. should be the FMV of $30, not the actual proceeds received of $20.

   Option d) is incorrect. Because Lauren Ltd. and Russo Ltd. are non-arm’s-length parties, the deemed proceeds for Lauren Ltd. should be the FMV of $30, not the actual proceeds received of $20. The cost to Russo Ltd. should be the actual price paid of $20, not FMV of $30.

   ii. In 2019, Emily had employment income of $80,000 and a taxable capital gain from the sale of shares of $7,000. She had net capital loss of $17,000 and non-capital loss of $2,000 from the prior year. What was Emily’s minimum taxable income for tax purposes?

      a) $68,000
      b) $70,000
      c) $78,000
      d) $87,000
Solution

Option c) is correct. \[80,000 + 7,000 - 7,000 \text{ (limit net capital losses to taxable capital gain)} - 2,000 \] = $78,000.

Option a) is incorrect. The full amount of net capital loss is deducted.

Option b) is incorrect. The full amount of net capital loss is deducted, and non-capital loss is not included in the calculation.

Option d) is incorrect. This is net income, which is before the application of loss carryovers.

2. In 2019, Ben earned employment income of $160,000. His employer withheld $2,748 in CPP premiums and $860 in EI premiums. Ben received $10,000 in eligible dividends from Knotworth Inc., a Canadian company. As in prior years, he donated $1,000 to a Canadian charity. He has $20,000 non-capital loss carried over from the prior year.

Required:

a) Determine Ben’s minimum taxable income for 2019.

b) Determine Ben’s minimum federal tax payable for 2019.

Solution

a)

<table>
<thead>
<tr>
<th>Calculation of taxable income</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employment income</td>
<td>$160,000</td>
</tr>
<tr>
<td>Dividend income ($10,000 \times 138%)</td>
<td>13,800</td>
</tr>
<tr>
<td>Net income</td>
<td>173,800</td>
</tr>
<tr>
<td>Division C deduction: non-capital loss</td>
<td>(20,000)</td>
</tr>
<tr>
<td>Net income and taxable income</td>
<td>$153,800</td>
</tr>
</tbody>
</table>
b) Federal tax payable

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employment income</td>
<td>$50,000</td>
</tr>
<tr>
<td>Stock option benefit [1,000 \times ($7 – $6)]</td>
<td>1,000</td>
</tr>
<tr>
<td>Taxable capital gain {½ × [1,000 shares \times ($10 – $7)]}</td>
<td>1,500</td>
</tr>
<tr>
<td>Net income</td>
<td>52,500</td>
</tr>
<tr>
<td>Stock option deduction (½ × $1,000)</td>
<td>(500)</td>
</tr>
<tr>
<td>Taxable income</td>
<td>$52,000</td>
</tr>
</tbody>
</table>

The stock option benefit for a CCPC is included in income in the year of sale. The stock option benefit is eligible for the Division C deduction because the shares were held for more than two years.
PART 5

Computation of taxable income

Corporate tax liability begins with determining net income for tax purposes based on financial statement income and applying adjustments as part of the reconciliation process, similar to computing business income for tax purposes. Once net income is determined, a corporation is able to take the following deductions from net income to compute taxable income under Division C: charitable donations (limited to 75% of net income; unused donations have a five-year carryforward period), dividends received from taxable Canadian corporations and losses carried forward or back from other years.

Types of corporations and income categories

The rate of corporate tax depends on the type of corporation and on the type of income. For public companies and for private companies that are not CCPCs, the federal tax rate is 15%. For CCPCs, the federal tax rate will vary depending on the type of income earned.

Active business income

The ITA states that business income is active by default if it is not specified investment business (SIB) income or personal-services business (PSB) income. This distinction is important, as the small business deduction (SBD) is available only for active business income (ABI).

The principal purpose of an SIB is to derive income from property (including interest, dividends, rents, or royalties). A PSB is a business that is an “incorporated employee;” that is, it would be regarded as an “employee” of the person to whom the services were provided had the business not been incorporated. Neither SIBs nor PSBs are entitled to the SBD unless the SIB or PSB has more than five full-time employees, in which case it would be considered an active business.

Aggregate investment income and dividend income

To discourage passive income investments being held within a corporation for CCPCs, an additional refundable tax applies on aggregate investment income (AII), which is the total of Canadian and foreign property income (interest, rent, royalties, dividends) plus net taxable capital gains less Division C dividends and Division C net capital losses deducted. In other words, the corporation pays an additional tax in the year the AII is earned, which will be refundable in the future when a taxable dividend is paid to the shareholder. Note that dividends net to 0, which is why there is the Part IV tax discussed below.

For any private corporation (including a CCPC), dividends received from taxable Canadian corporations are deducted from taxable income under Division C and so are not taxed under Part I of the ITA. This is necessary or else there would be double
Taxation in an organization with more than one corporate shareholder. If tax had to be paid on each dividend received (which would be paid out of after-tax profits), there would be nothing left for the top shareholder after taxes were paid. Similar to the above with AII, in order to prevent dividend income on widely held shares to be sheltered within a corporation, there is a special tax called Part IV tax. Part IV tax essentially taxes the dividend within a corporation at a rate similar to that of an individual earning the dividend income directly. This Part IV tax, along with the refundable portion of Part I tax discussed above, are both refundable in the future as part of the dividend-refund mechanism and the system of integration.

### Overall tax calculation

<table>
<thead>
<tr>
<th>Item</th>
<th>ABI ≤ $500,000</th>
<th>ABI &gt; $500,000</th>
<th>All</th>
<th>PSB income</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Taxable income</strong></td>
<td>XXX</td>
<td>XXX</td>
<td>$ XXX</td>
<td>$ XXX</td>
</tr>
<tr>
<td><strong>Basic tax @ 38% × taxable income</strong></td>
<td>38.0</td>
<td>38</td>
<td>38.00</td>
<td>38</td>
</tr>
<tr>
<td>Less: <strong>federal abatement for</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>provincial tax</td>
<td>(10.0)</td>
<td>(10)</td>
<td>(10.00)</td>
<td>(10)</td>
</tr>
<tr>
<td><strong>Subtotal</strong></td>
<td>28.0</td>
<td>28</td>
<td>28.00</td>
<td>28</td>
</tr>
<tr>
<td>Add: <strong>refundable tax on CCPC All</strong></td>
<td></td>
<td></td>
<td>10.67</td>
<td></td>
</tr>
<tr>
<td><strong>Subtotal</strong></td>
<td>28.0</td>
<td>28</td>
<td>38.67</td>
<td>28</td>
</tr>
<tr>
<td>Less: <strong>general rate reduction</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>small business deduction</td>
<td>(19)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>dividend refund</td>
<td></td>
<td></td>
<td>(30.67)</td>
<td></td>
</tr>
<tr>
<td><strong>Additional 5% for PSB income</strong></td>
<td></td>
<td></td>
<td></td>
<td>5</td>
</tr>
<tr>
<td>Federal rate of tax</td>
<td>9</td>
<td>15</td>
<td>8.00</td>
<td>33</td>
</tr>
<tr>
<td>Hypothetical provincial rate of tax</td>
<td>4.0</td>
<td>10</td>
<td>10.00</td>
<td>10</td>
</tr>
<tr>
<td>Hypothetical combined rate</td>
<td>13</td>
<td>25</td>
<td>18.00</td>
<td>43</td>
</tr>
</tbody>
</table>

### Part I tax

As you can see above, public and private (non-CCPC) taxable income and ABI over the small business limit (CCPC) are taxed at 15%, active business income under the small business limit (CCPC) is taxed at 9% and AII (CCPC) is taxed at 38.67%.

The formula in the ITA starts by multiplying total taxable income by 38%, regardless of its source.

Next, the federal abatement is a deduction from Part I tax equal to 10% of taxable income earned in the year in a province or territory, to help offset provincial taxes levied. If a portion of the income is earned through a permanent establishment in a foreign country, the abatement is reduced.

At this point, a 28% (assuming full abatement) tax has been applied to the total taxable income. Then different tax rates are applied to the different components of taxable income.
The SBD

Canadian ABI earned by a corporation that is a CCPC throughout the entire taxation year is eligible for the 19% SBD. The SBD is based on the least of:

- ABI
- taxable income
- the business limit of $500,000, unless it is being shared with an associated corporation

The small business limit of $500,000 can be reduced based on two additional considerations. The first is based on the size of the corporation. The reduction comes into effect if share capital plus debt, known as taxable capital, exceeds $10 million. The second consideration comes into effect if the corporation has passive income, called adjusted aggregate investment income, in excess of $50,000. The $50,000 limit is calculated by adding together the adjusted aggregate investment income amounts for each taxation year of the group of associated corporations that ended in the preceding calendar year.

Additional refundable tax on CCPC investment income

There is an additional refundable tax (ART) assessed on AII for CCPCs consisting of 10⅔% of the lesser of:

- AII
- taxable income minus the SBD qualifying base

The general rate reduction

The 13% general rate reduction applies only to income that is not eligible for the SBD or the manufacturing and processing (M&P) deduction, and to income that is not AII. Basically, whatever is left over from taxable income that has not been taxed at the low SBD rate, or the high AII rate, is given the 13% general rate reduction. Note that the M&P deduction is the same as the general rate reduction, so the M&P deduction is not typically calculated anymore.
Taxation of dividend income — Part IV tax

Part IV tax is applied on dividends received that were deductible in the calculation of taxable income. It is calculated as the total of the following:

- 38½% of dividends received from non-connected corporations
- A prorated share (equal to the connected corporations’ percentage of ownership in the payer corporation) of the payer corporation’s non-eligible dividend refund for assessable dividends received from connected corporations
- A prorated share (equal to the connected corporations’ percentage of ownership in the payer corporation) of the payer corporation’s eligible dividend refund for assessable dividends received from connected corporations

A payer corporation is connected to the recipient corporation if the payer is controlled by the recipient or if the recipient owns shares of the payer with greater than 10% of the votes and greater than 10% of the FMV of total issued shares.

Eligible and non-eligible refundable dividend tax on hand accounts (ERDTOH and NERDTOH)

The ERDTOH and NERDTOH accounts are pools of previously paid tax that are available for refund when taxable dividends are paid. There are two separate accounts — one that is refundable when non-eligible dividends are paid (NERDTOH), and a second that is refundable when eligible dividends are paid (ERDTOH). Two taxes build these pools.

The resulting balance is used to determine the amount of any dividend refund. There are separate dividend refunds calculated for non-eligible dividends and eligible dividends paid during the year.

Refundable Part I tax

For CCPCs only, the RDTOH is increased by the refundable Part I tax, which is the least of:

- 30½% × All for the year
- 30½% × [taxable income less SBD base]
- Part I tax
Dividend refund

A corporation can pay two types of dividends (eligible and non-eligible RDTOH), which track the amount of tax that is refundable for each type of dividend payment. Therefore, a corporation's dividend refund has two components.

The eligible dividend refund is the lesser of:
- \(38\frac{1}{3}\% \times\) taxable eligible dividends paid in the year
- the balance of ERDTOH at the end of the year

The non-eligible dividend refund is the sum of the following two components:
Component 1 — the lesser of:
- \(38\frac{1}{3}\%\) of the total of all non-eligible dividends paid during the year; and
- the year-end balance in the NERDTOH account.
Component 2 — the lesser of:
- The amount of the excess of \(38\frac{1}{3}\%\) of the total of all non-eligible dividends paid during the year over the year-end balance in the NERDTOH account; and
- The amount by which the corporation’s ERDTOH at the end of the year exceeds the eligible dividend refund for the year.

The total dividend refund for the year will be the total of the eligible dividend refund and the non-eligible dividend refund.

Practice questions

1. Multiple-choice questions:

   i. Olive Corp., a CCPC, owns 40% of the voting shares (which equals 40% of the FMV of total issued shares) of Green Inc., another CCPC. Green earns ABI that is subject to the SBD and paid taxable dividends of $30,000 in the current taxation year, of which Olive receives $12,000. Because of this dividend payment, Green is entitled to a non-eligible dividend refund of $5,000. Which of the following statements is correct?

      a) Olive is connected to Green and will have Part IV tax of $2,000.
      b) Olive is connected to Green and will have Part IV tax of $4,800.
      c) Olive is associated with Green and will have Part IV tax of $2,000.
      d) Olive is associated with Green and will have Part IV tax of $4,800.
Solution

Option a) is correct. Olive owns more than 10% of the voting shares of Green, so the corporations are connected. The Part IV tax would be Olive’s ownership percentage of 40% multiplied by the total dividend refund for Green. 

\[ 40\% \times $5,000 = $2,000 \]

Option b) is incorrect. You calculated the dividend refund as 40% of the dividends received. 

\[ 40\% \times $12,000 = $4,800 \]

Options c) and d) are incorrect. Olive and Green are connected, not associated, and the Part IV tax is 40% of Green’s dividend refund.

ii. Harper, a CCPC, owns 80% of voting shares of Bazaar, also a CCPC. Harper earns ABI and taxable income of $400,000 in the current taxation year. Bazaar earns ABI and taxable income of $200,000 and claims an SBD of $38,000 in the current taxation year. Both Harper and Bazaar have a December 31 year end. Which of the following statements is true?

a) Harper is associated with Bazaar and is entitled to claim an SBD of $76,000.
b) Harper is associated with Bazaar and is entitled to claim an SBD of $57,000.
c) Harper is associated with Bazaar and is not entitled to claim an SBD.
d) Harper is not associated with Bazaar and is entitled to claim an SBD of $76,000.

Solution

Option b) is correct. As Harper controls Bazaar, the two corporations are associated. They will share the $500,000 small business limit. Because Bazaar has claimed $200,000 (38,000/0.19) of the small business limit, the balance of $300,000 is available to Harper. 

\[ $300,000 \times 19\% = $57,000 \]

Option a) is incorrect. $300,000 of the small business limit is available to Harper. $400,000 \times 19\% = $76,000

Option c) is incorrect. Harper is entitled to claim an SBD, but must share the small business limit with Bazaar.

Option d) is incorrect. Harper is associated with Bazaar.

2. Salsa Co. is a wholesaler and a public company based in Cobourg, Ontario. The following is its financial information for the year ended December 31, 2019:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income from wholesaling operation</td>
<td>$610,000</td>
</tr>
<tr>
<td>+ Canadian taxable dividends</td>
<td>30,000</td>
</tr>
<tr>
<td>– Charitable donations</td>
<td>(10,000)</td>
</tr>
<tr>
<td>Net income</td>
<td>$630,000</td>
</tr>
</tbody>
</table>
Required:

a) Calculate net income for tax purposes and taxable income for Salsa.

b) Compute Part I federal tax payable.

Solution

a) The net income and taxable income for 2019 is as follows:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net income</td>
<td>$630,000</td>
</tr>
<tr>
<td>+ Charitable donations</td>
<td>10,000</td>
</tr>
<tr>
<td><strong>Net income for tax purposes</strong></td>
<td><strong>$640,000</strong></td>
</tr>
<tr>
<td>Division C deductions</td>
<td>(40,000)</td>
</tr>
<tr>
<td>Less: dividends and charitable donations</td>
<td></td>
</tr>
<tr>
<td><strong>Taxable income</strong></td>
<td><strong>$600,000</strong></td>
</tr>
</tbody>
</table>

b) Part I tax

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basic federal tax (38% × 600,000)</td>
<td>$228,000</td>
</tr>
<tr>
<td>Less: abatement (10% × 600,000)</td>
<td>(60,000)</td>
</tr>
<tr>
<td></td>
<td>168,000</td>
</tr>
<tr>
<td>Less: general rate reduction (13% × 600,000)</td>
<td>(78,000)</td>
</tr>
<tr>
<td><strong>Part I federal tax payable</strong></td>
<td><strong>$90,000</strong></td>
</tr>
</tbody>
</table>

3. Meringue Co. is a retailer and a CCPC in Ontario. There are no associated companies. The following is its financial information for the year ended December 31, 2019:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income from retailing operation</td>
<td>$600,000</td>
</tr>
<tr>
<td>+ Interest income from passive investments</td>
<td>30,000</td>
</tr>
<tr>
<td><strong>Net income</strong></td>
<td><strong>$630,000</strong></td>
</tr>
</tbody>
</table>

Required:

a) Determine Meringue’s federal Part I tax payable.

b) Determine Meringue’s Part IV tax payable.

c) Is Meringue entitled to receive a dividend refund?
Solution

a) Meringue’s net income and taxable income is $630,000.

<table>
<thead>
<tr>
<th>Part I tax payable</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basic federal tax (38% × 630,000)</td>
<td>$239,400</td>
</tr>
<tr>
<td>Less: abatement (10% × 630,000)</td>
<td>(63,000)</td>
</tr>
<tr>
<td>SBD: 19% of the least of:</td>
<td></td>
</tr>
<tr>
<td>i. ABI $600,000</td>
<td></td>
</tr>
<tr>
<td>ii. Taxable income $630,000</td>
<td></td>
</tr>
<tr>
<td>iii. Business limit $500,000</td>
<td></td>
</tr>
<tr>
<td>iv. 500,000 × 19%</td>
<td>(95,000)</td>
</tr>
<tr>
<td>ART: 10 2/3% of the lesser of:</td>
<td></td>
</tr>
<tr>
<td>i. All 30,000</td>
<td>3,200</td>
</tr>
<tr>
<td>ii. Taxable income less SBD base 630,000–500,000</td>
<td></td>
</tr>
<tr>
<td>General rate reduction:</td>
<td>(13,000)</td>
</tr>
<tr>
<td>Part I federal tax payable</td>
<td>$71,600</td>
</tr>
</tbody>
</table>

b) Part IV tax payable is nil as Meringue did not receive any taxable dividends.

c) Meringue is entitled to receive a dividend refund only if it declares and pays a dividend and has a balance in one of its RDTOH accounts.
PART 6

The need for integration

Income earned by a corporation is subject to two levels of taxation — corporate tax and personal tax. The goal of the integration system in the ITA is to ensure that the total of the corporate tax paid plus the personal tax paid on dividend distributions is equal to the tax that would be paid if that income were earned directly by an individual. The dividend gross-up and related dividend tax credit for individuals is one of the integration mechanisms. Another tool is the ART recovery through the dividend refund and RDTOH account for a CCPC’s investment income, as well as the CDA, which allows the cumulative balance to be distributed as a tax-free dividend to individuals.

Incorporating a business — tax deferral

One tax planning mechanism is the incorporation of a sole proprietorship. In 2019, the federal tax rate for a CCPC on income eligible for the SBD is 9%. The provincial rate varies depending on the province but results in perfect integration where the provincial rate is approximately 4%, giving a combined rate of 13.04%. The federal rate on business income subject to the general corporate tax rate is 15%. Again, the provincial rate varies, but perfect integration results where the provincial rate is approximately 12.5%, giving a combined rate of 27.54%. Both rates are generally below the marginal personal tax rates paid on business income through a proprietorship. Depending on the extent and duration that after-tax income is retained in the corporation and not paid out, the second tier of tax payable by the shareholder is deferred until there is an actual dividend payout. Thus, for example, if your personal tax rate was 40%, the corporation would pay 13.04% or 27.54% depending on the nature of the income, and 26.96%\(^1\) or 12.46%\(^2\) of the taxes would be deferred until the income is paid as a dividend to the shareholder. In theory, the total tax paid by the individual and corporation would be the 40% personal tax rate of the individual.

Non-tax issues including limited liability and additional administrative costs need to be considered when deciding to incorporate a business.

Owner-manager tax planning

One of the most important areas of practice for many accountants is assisting their owner-manager clients to determine the appropriate remuneration packages for the owners and their employees based on need and preference and applying other tax planning tools.

\(^1\) 40% personal rate – 13.04% corporate rate = 26.96%
\(^2\) 40% personal rate – 27.54% corporate rate = 12.46%
**Income splitting**

Income splitting (or income sprinkling) is a strategy used by high-income shareholders of private corporations to divert their income to family members with lower personal tax rates. The ITA has restrictive tax rules regarding moving income from one family member to another; however, there are some tax-savings opportunities; for example, paying a reasonable salary to family members who work for the company.

**Salary versus dividends**

Extracting the profits of the corporation (salary versus dividends) in the most tax-effective manner depends on the client’s current and future income needs. Points to consider include the following:

- Salary (not dividends) is tax-deductible by the corporation.
- Salary gives the opportunity to contribute to an RRSP or deduct child care expenses.
- Salary allows a taxpayer to contribute to the CPP program and receive CPP pension in retirement.
- Salary requires regular remittance of payroll deductions (including both the employer and employee portion of CPP as mentioned above). Dividends, on the other hand, are not subject to any source deductions or remittances.

**Shareholder loans**

The owner-manager can borrow funds from the corporation without tax consequences under certain circumstances. To minimize tax avoidance, rules exist that will tax loans made to shareholders as income from property (the shares being the property) unless the loan is a legitimate lending arrangement or is in the nature of an advance.

If the loan is repaid by the end of the taxation year following the year in which the loan was made, the loan will not be included in income. Where the loan is a legitimate borrowing for three specific purposes, that is, to enable the employee to acquire a motor vehicle for employment, to acquire a dwelling for the employee’s habitation or to acquire fully paid treasury shares of the employer corporation, the loan will not be included in income as long as the loan was made to the shareholder in their capacity of being an employee for the company, and there are terms of repayment. If the criteria are not met and the amount is included in income, a deduction can be made in the future when the loan is repaid.
GST and HST

GST was introduced in Canada on January 1, 1991. The rate for the GST is 5%. In some provinces, the GST is combined with a similar provincial tax and called the harmonized sales tax, or HST. In Ontario, for example, the rate for the HST is 13%.

GST/HST remittance and input tax credits

GST/HST registrant businesses are required to charge and collect GST/HST on taxable supplies and file returns. Registration is mandatory for businesses with worldwide sales of taxable goods and services in excess of $30,000 for a single calendar quarter or over four consecutive calendar quarters.

A business with sales below the $30,000 threshold (referred to as a “small supplier”) is not required to register but can voluntarily register for GST/HST to claim input tax credits (ITCs). The credits represent the GST/HST that the business has paid on taxable supplies purchased in commercial activities. Zero-rated supplies are those supplies where no GST/HST is charged to customers. The net amount of tax collected minus ITCs is remitted to the government. Filing and reporting deadlines and frequency of reporting (annual, quarterly or monthly) depend on the amount of annual taxable supplies. A “quick method” and “simplified ITC method” are also available under certain situations.

General administrative requirements

Income tax filing requirements and deadlines

The table summarizes the CRA deadlines. Penalties apply for missed filing deadlines. Interest applies for missed payment deadlines.

<table>
<thead>
<tr>
<th>Item</th>
<th>Individual</th>
<th>Corporation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Form</td>
<td>T1</td>
<td>T2</td>
</tr>
<tr>
<td>Filing deadline</td>
<td>i) April 30</td>
<td>Six months after year end</td>
</tr>
<tr>
<td></td>
<td>ii) June 15 (self-employed</td>
<td></td>
</tr>
<tr>
<td></td>
<td>taxpayer or spouse)</td>
<td></td>
</tr>
<tr>
<td>Balance due date</td>
<td>April 30 (includes individuals</td>
<td>i) Two months after year</td>
</tr>
<tr>
<td></td>
<td>carrying on a business)</td>
<td>end (CCPCs)</td>
</tr>
<tr>
<td></td>
<td>ii) Three months after</td>
<td></td>
</tr>
<tr>
<td></td>
<td>year end (CCPCs)</td>
<td></td>
</tr>
</tbody>
</table>
**Instalments**

Taxpayers have income taxes deducted at the source by employers. An individual taxpayer who earns income through a business or from property or a corporation, can pay instalments to prepay estimated taxes owing for the year.

For individuals, if the balance due on filing is greater than $3,000 for the current year (estimated in advance) and one of the two previous years, instalments must be paid for the current year. Instalments are due on March 15, June 15, September 15 and December 15. The instalment amount would be the least of:

i) ¼ × estimated tax owing for the current year

ii) ¼ × tax owing for the immediately preceding year

iii) first two instalments calculated as: ¼ × tax owing for the second preceding year AND two instalments calculated as: ½ × tax owing for the preceding year minus first two instalments

**Notice of assessment**

Once a tax return is filed, the CRA will complete an initial assessment and provide the taxpayer with a notice of assessment. The CRA can reassess up to three years after the date on the original notice of assessment, for individuals and for CCPCs. The reassessment period for non-CCPCs is four years.

**Notice of objection and appeal process**

The taxpayer can file a notice of objection if they disagree with an assessment or reassessment. The deadline to file is the later of one year after the filing due date and 90 days after the mailing date of the notice of assessment (or reassessment) for individuals. For a corporation, the deadline is 90 days after the date of mailing of the notice of assessment (or reassessment). If the taxpayer is dissatisfied after the objection process, the taxpayer may appeal to the Tax Court of Canada and further to the Federal Court of Appeal.

**Approaches to combating offshore tax evasion and aggressive tax avoidance, and the use of data analytics**

**Combatting tax evasion and avoidance**

In recent years, the CRA has been cracking down on tax cheaters with a focus on offshore tax evasion and aggressive tax avoidance. There is a system in place that can tackle tax cheating on a domestic level as well as internationally. The CRA shares information with partners outside of Canada and develops new tools to analyze information. Experienced audit and investigations teams are at work to detect and track down offshore tax cheats to ensure that they face consequences for their actions.
Some of the steps\(^3\) that the CRA is taking to crack down on offshore tax evasion and aggressive tax avoidance are as follows:

- The Offshore Compliance Advisory Committee (OCAC) has offered five recommendations\(^4\) on the use of big data by the CRA to assist with compliance activities:
  
  1. Develop metrics and other evaluation criteria to measure the effectiveness of data mining techniques currently being used.
  2. Ensure the CRA’s data mining and analysis techniques remain among the most cutting-edge in the world by working with tax authorities in other countries.
  3. Measure the effectiveness of data mining techniques by comparing the additional cost of these techniques against the additional tax revenue they generate.
  4. Develop a risk analysis program for all taxpayers, not only large multinational corporations and associated high-net-worth individuals.
  5. Increase publicity of the data mining techniques to enhance public perception of the effectiveness of the tax system.\(^5\)

  Big data refers to “information flows containing large amounts of financial data relating to taxpayers, in volumes substantially larger than was available to the CRA using previous data sources and less sophisticated information systems.”\(^6\) The CRA fully supports these recommendations and is currently implementing them.\(^7\)

- Reviewing money transfers as they cross the border to and from Canada.
- Collaborating and sharing information with international and domestic partners.
- Identifying promoters of aggressive tax schemes.
- Identifying international non-compliance and abuses through the exchange of information within a large treaty network.

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\(^5\) Ibid.

\(^6\) Ibid.

Data analytics and administrative efficiency

Data analytics is used by the CRA in many ways to detect non-compliance. Patterns and abnormalities can be detected using data analytics in a cost-effective manner. The availability of low-cost data storage and analytical tools, combined with high-power computing, makes processing large amounts of data possible. Data lakes (repositories storing massive amounts of data) in large organizations are used as data sources for tax authorities. Tax authorities can allocate resources more effectively because they are able to better predict where non-compliance will arise. This is helpful at a time when government budgets put pressure on tax authorities to reduce costs. More precise targets result in fewer audits and a reduction of administration.

Reporting system requirements

For many businesses, the most common way to manage tax compliance is through the use of Excel spreadsheets that are stored and accessed on shared network drives. Issues with this type of reporting system are difficulties maintaining the data, which can be stored across multiple networks, the detection of potential errors, and incomplete data. Tax compliance may also require frequent adjustments due to changes in tax legislation.

Tax compliance technologies can assist, or even automate, preparing and filing tax returns accurately and efficiently. Tax software can also analyze tax data from various sources to identify errors or calculate tax liabilities. Adopting tax reporting systems and technology will help organizations meet their objectives of ensuring tax compliance, stronger controls, cost savings, and real-time reporting as well as enable measurement of key performance indicators within the tax function.9

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Practice questions

1. Multiple-choice questions

   i. Saul owns 100% of the shares of Bay Co., a CCPC. Bay’s year end is November 30, and Bay loans Saul $50,000 on March 15, 2019. Saul uses the money to buy a sailboat and did not pay back the loan until January 2021. Which of the following is correct?

   a) Include $50,000 in Saul’s 2021 income tax return.
   b) Include $50,000 in Saul’s 2020 income tax return.
   c) Include $50,000 in Saul’s 2019 income tax return.
   d) There is no need to include $50,000 in Saul’s income as he repaid the loan.

   Solution

   Option c) is correct. Because the loan is still outstanding on November 30, 2020, Saul would include this in income for the year the loan was received (2019).

   Options a) and b) are incorrect. Saul would not include this in income in either 2020 or 2021.

   Option d) is incorrect. The loan was repaid after the end of the taxation year following the year in which the loan was made.

   ii. Zi started a pool servicing business in Toronto. His revenues are $15,000 in 2019 ($5,000 each for the months of May, June, and July). Which of the following statements is true?

   a) Zi’s business cannot register to be an HST registrant as its taxable sales are below the $30,000 threshold (referred to as a “small supplier”).
   b) Zi’s business may register to be an HST registrant even if its taxable sales are below the $30,000 threshold (referred to as a “small supplier”).
   c) Zi’s business must register to be an HST registrant even if its taxable sales are below the $30,000 threshold (referred to as a “small supplier”).
   d) Zi’s business would not have any HST implications as this is a pool servicing business.
Solution

Option b) is correct. A business may still voluntarily register for GST/HST in order to use ITCs, even if it is a small supplier.

Option a) is incorrect. A business may still voluntarily register for GST/HST in order to use ITCs, even if it is small supplier.

Option c) is incorrect. Small suppliers are not required to register for GST/HST.

Option d) is incorrect. Zi would need to be an HST registrant if his business has worldwide sales of taxable goods and services in excess of $30,000 for a single calendar quarter or over four consecutive calendar quarters (in a calendar year).

2. Eddie will owe taxes of $5,000 at the end of 2020. He owed tax of $2,500 when his 2019 tax return was filed and $4,300 when his 2018 tax return was filed.

Required:

a) Will Eddie need to remit income tax instalments for the 2020 tax year? Why or why not?

b) What are the payment amount options available for instalments for 2020?

Solution

a) Eddie is required to remit instalments because his taxes owing for the current year (2020) and one of the two preceding years (2018) exceeded $3,000.

b) The choices available are as follows:

i) $5,000 \times \frac{1}{4} = 1,250

ii) $2,500 \times \frac{1}{4} = 625

iii) first two instalments: $4,300 \times \frac{1}{4} = 1,075

next two instalments: \( \frac{1}{2} \times (2,500 - 2 \times (1075)) = 175 \)

The lowest cost option would be either option ii) or iii). Eddie might prefer option ii) because the first two payments would be less than they would be under option iii). However, any of the three choices would be acceptable.

3. In 2019, Madison has employment income and revenues from her bookkeeping business.

Required:

a) What is the tax return filing deadline for Madison for the 2019 tax year?

b) Madison will owe taxes to the CRA when she files her 2019 return. What is the tax remittance deadline for the taxes owing?
Solution

a) Because Madison is self-employed, her 2019 tax return filing deadline is June 15, 2020.

b) Madison must remit taxes owing by April 30, 2020.