Capital Cost Allowance (CCA)

Capital Cost Allowance (CCA)

CCA

A method of reporting a decline in value

Retrieved October 6, 2014 from: http://uygarr.blogspot.ca/2012/10/new-ford-mondeo-release-date.html

Retrieved October 6, 2014 from: http://myfinancialjourney.com/archive/my-financial-journeys-pimp-ride

Accounting Vs. Tax

Amortization vs. CCA

Cost vs. Capital Cost

Net Book Value vs. Un-depreciated Capital Cost (UCC)

Individual Assets vs. Asset Pools by Class

Accounting Amortization:

$100,000	Purchased equipment with 5 year useful life (Cost)
(20,000)	Amortization in Year 1 (1/5)
80,000	Remaining useful life after year 1 (NBV)
(20,000)	Amortization in Year 2 (1/5)
60,000	Remaining useful life after year 2 (NBV)
(20,000)	Amortization in Year 3 (1/5)
40,000	Remaining useful life after year 3 (NBV)

Tax Depreciation:

$50,000	Equipment A purchased (Cost)
$50,000	Equipment B purchased (Cost)
100,000	Total Equipment
(20,000)	Depreciation (CCA) in Yr 1 (20%)
80,000	Remaining tax cost after year 1 (UCC)
(16,000)	Depreciation (CCA) in Yr 2 (20%)
64,000	Remaining tax cost after year 2 (UCC)
(12,800)	Depreciation (CCA) in Yr 3 (20%)
51,200	Remaining tax cost after year 3 (UCC)

Additions of Property

For Tax Purposes:

An addition to the capital cost of a property includes everything required to bring it to it's useable state:

Legal, Accounting, and Appraisal fees to acquire

Realtor Fees

Shipping, Duties, Installation

Ie. Mr. Smallman purchased a $15,000 tractor. He incurred a $2,000 legal fee and it cost $1,500 to ship it to his home.

The Capital Addition is: $18,500 added to CCA Class.

Additions of Property

Restrictions

Government assistance received is deducted from the cost of an asset for tax.

Mr. Smallman purchased a manufacturing plant for $1.5 million. The government gave him a grant for $500,000 to use towards the purchase.

Total addition to manufacturing assets: $1,000,000
($1,500,000 cost - $500,000 reimbursed grant)

What is Capital?

Remember our test for Rental/Home Office Deduction Purposes?

	Capital	**Current**
Does it add to the value of a property	New Roof	Fix 1 Shingle
Is it expected to have a useful life longer than a year	New Siding	Paint
Is it material	Freezer	Frying Pan

What is Depreciable Property?

Can't be Inventory

- What is inventory depends on nature of the business
- Printers are inventory to a company that sells and distributes printers
- Printers are capital to a legal firm

Can't be Land

- Land is a non-depreciable asset
- It's value lasts forever

CCA Terminology

- Capital Cost Allowance "Classes"
  - All assets of a particular class are lumped together

Example: Vehicles – Class 10,
Equipment – Class 8,
Software – Class 12, etc

Class 10

Retrieved Oct 1, 2014 from: http://www.homepower.com/articles/vehicles/basics/what-types-vehicles

Class 8

Retrieved Oct 1, 2014 from: http://www.oaklease.co.uk/Office-Equipment-Leasing

Class 12

Retrieved Oct 1, 2014 from: http://www.webopedia.com/DidYouKnow/Hardware_Software/types_of_software.asp

CCA Terminology

- Capital Cost Allowance "Pools"
  - The particular balance of a CCA Class is called it's "Pool". When you purchase an addition to a CCA Class you are adding to that Class's pool of UCC to depreciate.

WHOO HOO!!!

Retrieved Oct 1, 2014 from: http://www.vehiclepassion.com/2012/11/15/watch-2013-ford-fusion-jumping-off-a-cliff-in-commercial-video/

Retrieved Oct 1, 2014 from: http://www.forbes.com/fdc/welcome_mjx.shtml

Retrieved Oct 1, 2014 from: http://www.commentarymagazine.com/2009/05/01/an-inconsistent-car-company-goes-bankrupt/

Exceptions

- Separate Pools of the same "Class" of asset when:

  Multiple businesses. Example: a knitting supplies business and a legal advice business. Equipment related to each should be kept separate even though it is all equipment

  Rental Properties in excess of $50,000

  Luxury vehicles (Class 10.1) costing more than $30,000

Calculating CCA

- Capital Cost Allowance (CCA)
  - Annual CCA reduces the capital cost of a property and the remaining balance is UCC.
    - Opening UCC Pool
      - Add in additions
      - Subtract disposals (lesser of cost or proceeds)
      - Less: CCA
    - Closing UCC Pool
- Methods
  - Declining Balance – Most Classes
  - Straight Line – Leaseholds (Class 13)

Declining Balance - Example

- Stats
  - Original Cost = 500,000
  - Opening UCC Pool = 100,000
  - Rate 10%

Declining Balance Year 1: 100,000 x 10% = 10,000.

100,000 opening UCC – 10,000 CCA = 90,000 Ending UCC

Declining Balance Year 2: 90,000 x 10% = 9,000.

90,000 opening UCC – 9,000 CCA = 81,000 Ending UCC

Declining Balance - Practice

- Stats
  - Original Cost = 100,000
  - Opening UCC Pool = 60,000
  - Rate 30%

Declining Balance Year 1: 60,000 UCC x 30% = 18,000 CCA

60,000 opening UCC – 18,000 CCA = 42,000 Ending UCC

Declining Balance Year 2: 42,000 UCC x 30% = 12,600 CCA

42,000 opening UCC – 12,600 CCA = 29,400 Ending UCC

Straight Line - Example

- Stats
  - Original Cost = 500,000
  - Opening UCC Pool = 200,000
  - Straight line over 5 years.

Straight Line Year 1: 500,000 / 5 years = 100,000 each year

200,000 opening UCC – 100,000 CCA = 100,000 Ending UCC

Straight Line Year 2: 500,000 / 5 years = 100,000 each year

100,000 opening UCC – 100,000 CCA = 0 Ending UCC

Straight Line - Practice

- Stats
  - Original Cost = 400,000
  - Opening UCC Pool = 250,000
  - Straight line over 8 years.

Straight Line Year 1: 400,000 / 8 years = 50,000 each year

250,000 opening UCC – 50,000 CCA = 200,000 Ending UCC

Straight Line Year 2: 400,000 / 8 years = 50,000 each year

200,000 opening UCC – 50,000 CCA = 150,000 Ending UCC

Accelerated First Year Rule

In the Year of Acquisition (purchase), 150% of the CCA on the additions can be taken

Declining Balance Example:

Opening UCC	$10,000 x 10% =	1,000
Additions	$5,000 x 10% x 150% =	750
Rate 10%	---------	------
Total Pool:	15,000	1,750 Total CCA

10,000 Opening UCC + 5,000 Additions – 1,750 CCA = 13,250 Ending UCC

First Year Rule - Practice

Steve purchased a $15,000 vehicle during the year for his business. The balance in his vehicle UCC pool at the beginning of this year is $30,000 and the declining balance rate of CCA is 30%. Calculate his current year CCA and Closing UCC Balance.

Opening UCC	$30,000 x 30% =	9,000
Additions	$15,000 x 30% x 150% =	6,750
Rate 10%	---------	------
Total Pool:	45,000	15,750 Total CCA

30,000 Opening UCC + 15,000 Additions – 15,750 CCA = 29,250 Ending UCC

Short Fiscal Periods

- When a fiscal year is short you prorate the CCA
- Suppose the business only started in December CCA is 1/12 what it normally would be.

- <u>Application</u>
  - First or last year of the business
  - 150% first year rule still applies if it is the year of purchase
  - Length of business year determines proration, not length of ownership of the asset
  - Only applicable to business income. No proration on property income producing assets.

Short Fiscal Periods

When a fiscal year is short (suppose the business only started in December) you prorate the CCA

Facts: 10% Class, Cost $100,000, Year of purchase

Declining Balance Year 1: 100,000 x 10% x 150% = 15,000 x 1/12 (1 month out of 12 months) = 1,250.

100,000 opening UCC – 1,250 CCA = 98,750 Ending UCC

Declining Balance Year 2: 98,750 x 10% = 9,875

98,750 opening UCC – 9,875 CCA = 88,875 Ending UCC

Short Fiscal Periods - Practice

Clovis decided to start a business September 1, 2012 and his fiscal year end will be Dec 31, 2012. He purchased a small office building for $90,000 in October in order to open a Quiznos franchise. Calculate his CCA in year 1 and 2 assuming a 6% rate.

Declining Balance Year 1: 90,000 x 6% x 150% = $8,100 CCA x 4/12 (4 months out of 12 months) = $2,700 Prorated CCA

90,000 opening UCC – 2,700 CCA = 87,300 Ending UCC

Declining Balance Year 2: 87,300 x 6% = 5,238

87,300 opening UCC – 5,238 CCA = 82,062 Ending UCC

Important Rates

- Class 1 - Buildings
  - 4% - If not included in one of the other %'s.
  - 6% - After 2007 >90% Non-residential buildings (offices, malls)
  - 10% - After 2007 >90% Buildings used in Manufacturing & Processing (M&P)

Cannot use CCA to create or increase a rental loss

Important Rates

- Class 8 – Miscellaneous/Equipment
  - 20%
  - Furniture
  - Equipment
  - Machinery
  - Photocopiers
  - Telephone Equipment
  - If something doesn't have a prescribed class, it usually goes here.

Important Rates

- Class 10 - Vehicles
  - 30% - Non-luxury cars, motorcycles, trucks, trailers, or special purpose vehicles like a cube van to fill with tools for a contractor

- Class 10.1 – Luxury Vehicles
  - 30% - But limited to a CCA addition of $30,000 regardless of the vehicles cost.
  - Each luxury vehicles gets it's own Class 10.1
  - When you dispose of it, you still get a half year's CCA and then there is no terminal loss or recapture.

Important Rates

- Class 12 – Small Items & Software
  - 100%
  - Computer Software (no systems software -Microsoft 10)
  - Various Tools.
  - Books to be lent
  - Cutlery/China
  - Uniforms
  - Kitchen Utensils under $500

Important Rates

- Class 13 – Leasehold Improvements
  - Straight line – over the lease term + first renewal period. (minimum of 5 years if short term)
  - What is a Leasehold: you rent a unit in an office building but improve it with new walls, painting, electrical, plumbing. Pretty much anything not part of the structure that a renter adds.
  - Ex: Purchased leaseholds worth $70,000 in the second year of a 5 year lease (so 4 remaining). There is a renewal option on the lease of 3 years.

70,000 / (4 + 3) = 10,000 depreciated per year with 150% = $15,000 first year depreciation, 10k each year after

Important Rates

- Class 53 – Manufacturing & Processing Equipment
  - 50%
  - Purchased after 2015 and before 2026
  - Only for M&P Equipment, not general purpose

M&P includes the creation of things – food, other machinery, vehicles, medication, etc.

Important Rates

- Class 50– Computers
  - 55%
  - Computer Hardware – laptops/Desktops
  - System Software – Not Class 12 assets like Microsoft Office, more like what a computer needs to operate. (Think Microsoft 10)
  - Computer Classes change a lot. In recent years has been 45, 52, 55. Current additions go to 50, but older ones may not (purchased in 2007 for example)

Know Your Rates

- For each of the following depreciable assets, indicate the appropriate CCA Class.

Printer	8
Machine for cutting out vehicle parts	53
BMW Costing $50,000	10.1
New dividing wall in a rented office	13
Manufacturing Plant	1 (10%)
Microsoft excel	12

Leaseholds

150% first Year Rule Applies

Straight Line

Remainder of the lease term + first renewal period.

Leasehold improvements purchased in 2008 for $400,000. Lease term is 7 years + two 3 year renewal periods.

CCA in 2008 is 400,000 / (7+3) x 150% = **$60,000**

400,000 / 5 x 150% = $120,000

CCA in 2012 is 400,000 / (7+3) = $40,000

Leaseholds

60,000
40,000
40,000
40,000
40,000
40,000
40,000
40,000
40,000
40,000
20,000

Leasehold improvements purchased in 2008 for $400,000. Lease term is 7 years + two 3 year renewal periods.

CCA in 2008 is 400,000 / (7+3) x 150% = $60,000

CCA in 2013 is 400,000 / (7+3) = $40,000

Leasehold improvements purchased in 2010 for $60,000 on the same building. (2 years have passed since lease started)

CCA in 2010 is 60,000 / (5+3) x 150% = **$11,250**

60,000 / 5 x 150% = 18,000

CCA in 2012 is 60,000 / (5+3) = $7,500

Class 10.1

Each one goes in a separate CCA pool

Additions are capped at $30,000 + tax:

- $40,000 car purchase = $30,000 added to UCC
- $20,000 car purchase = goes in Class 10.
- $60,000 car purchase = $30,000 added to UCC

Class 10.1

On Sale

-No Terminal Losses

-No Recapture

-1/2 year's CCA

10,000 UCC x 30% = $3,000 x 50% = $1,500 CCA deduction
10,000 UCC – 1,500 CCA = $0 Ending UCC.

Class 10.1

Sold the car for $12,000. UCC pool of $15,000

$15,000 Opening UCC
- No impact for sale proceeds

$15,000 Remaining UCC in a class with no assets
($2,250) $15,000 x 30% x ½ Half year's CCA claimed.
- Resets UCC - No tax impact

CCA is based on UCC before disposals.

Class 10.1

Sold the car for $19,000. UCC pool of $15,000

$15,000 Opening UCC
 - No impact for sale proceeds

15,000 Negative UCC in a class with no assets
($2,250) $15,000 x 30% x ½ Half year's CCA claimed.
- Resets UCC - No tax impact

CCA is based on UCC before disposals.

Disposing of Depreciable Property

- Accounting (Not tax)
  - Proceeds less Net Book Value (NBV) (original cost less amortization) = Gain or Loss

Example:

Gerald operates a business and owns several delivery trucks which are capital assets. He purchased them for $40,000 and has taken $25,000 in amortization since purchase. He sold them during the year for $60,000.

40,000 Cost – 25,000 Amort. = 15,000 NBV

60,000 Proceeds – 15,000 NBV = 45,000 Gain on Disposal

Accounting Disposition:

$100,000	Purchased equipment with 5 year useful life (Cost)
(20,000)	Amortization in Year 1 (1/5)
80,000	Remaining useful life after year 1 (NBV)

Equipment sold in year two for $120,000

$120,000	Proceeds
(80,000)	Net Book Value (Cost less Amortization)
40,000	Gain on Disposition

Disposing of Depreciable Property

Key to Know: No Capital Losses on Depreciable Property

- Tax Treatment
  - Lesser of: original cost or proceeds deducted from the pool.
    - IF: Still assets in the pool and a balance of UCC in the pool, then nothing special happens – CCA as normal.
    - IF: No assets in the pool and a UCC balance remaining, then terminal loss (less CCA taken than should have been)
    - IF: UCC is negative, then recapture results (more CCA taken than should have been)

Disposing of Depreciable Property

Proceeds in excess of cost trigger capital gains.

Original Cost

Proceeds in excess of UCC trigger recapture of negative UCC created.

UCC Balance of Pool

Proceeds less than UCC do nothing special if other assets left in the pool – CCA as normal.

Proceeds less than UCC trigger terminal loss of remaining UCC balance if no assets are left.

Example A – No Special Tax Impact

Mr. Sykes bought a piece of equipment for 100,000 and claimed CCA over time. His opening UCC balance for the current year was $150,000 and he sold the equipment for $60,000. He has several pieces of equipment left.

UCC Opening Balance	$150,000
Disposals	(60,000) (less of 100k and 60k)

UCC Ending Balance	$90,000
	x 20%
	(18,000) CCA deduction
	72,000 Ending UCC

Reduces the pool, but does not deplete it (less than zero) and there are still assets to depreciate. Therefore, no special tax impact (terminal loss or recapture, etc).

Example B – Terminal Loss

Mr. Sykes bought a piece of equipment for 100,000 and claimed CCA over time. His opening UCC balance for the current year was $150,000 and he sold the equipment for $60,000. He has no equipment left.

UCC Opening Balance	$150,000
Disposals	(60,000) (less of 100k and 60k)

Terminal Loss	$90,000 Reduction of Income

Reduces the pool, but does not deplete it (less than zero) but no assets left to depreciate. Should have depreciated faster.

Example C - Recapture

Mr. Sykes bought equipment for 100,000 and claimed CCA over time. His opening UCC balance for the current year was $50,000 and he sold the equipment for $60,000.

UCC Opening Balance	$50,000
Disposals	(60,000) (less of 100k and 60k)

Recapture of CCA	(10,000) Included in income

Reduces the pool to less than zero. Assets were depreciated too quickly. Need to recover some CCA taken by reporting income.

Example D - Gain

Mr. Sykes bought equipment for 100,000 and claimed CCA over time. His opening UCC balance for the current year was $50,000 and he sold the equipment for $120,000.

UCC Opening Balance	$50,000
Disposals	(100,000) (less of 100k and 120k)

Recapture of CCA	(50,000) Included in income

Reduces the pool to less than zero. Assets were depreciated too quickly. Need to recover some CCA taken by reporting income.

Proceeds also more than cost. An absolute gain has occurred. Must treat as a capital gain.

$120,000 Proceeds – 100,000 Cost = 20,000 Capital Gain 50% taxable = $10,000 included into income.

Practice - A

Mr. Sykes bought a piece of equipment for 80,000 and claimed CCA over time. His opening UCC balance for the current year was $170,000 and he sold the equipment for $90,000. He has one other piece of equipment left.

UCC Opening Balance	$170,000
Disposals	(80,000) (less of cost and proceeds)
UCC Ending Balance	$90,000 Assets left to depreciate

- Reduces the pool, but does not deplete it (less than zero) and there are still assets left to depreciate. No Income Impacts
- Capital gain triggered as proceeds exceed cost

  $90,000-80,000 = $10,000 capital gain 50% taxable = $5,000 inclusion

Practice - B

Mr. Sykes bought a piece of equipment for 150,000 and claimed CCA over time. His opening UCC balance for the current year was $60,000 and he sold the equipment for $120,000. He has no other equipment left

UCC Opening Balance	$60,000
Disposals	(120,000) (less of cost and proceeds)
UCC Ending Balance	$(60,000) Recapture (100% income)

Reduces the pool to less than zero. Assets were depreciated too quickly. Need to recover some CCA taken by reporting income.

Next year's Opening UCC Balance will be zero. Recapture resets the UCC to zero.

Income from Business

What is Business Income?

Net Income for Tax Purposes

- Net Employment Income
- Net Business Income
- Net Property Income
- Capital Gains and Losses
- Other Income
- Other Deductions
- Current Year Losses – Capital or Non-Capital

- = Net Income For Tax Purposes

Differences so far

- Net Employment Income
  - Can only be earned by individuals
  - Taxed on the cash basis
- Net Business Income
- Net Property Income
- Capital Gains and Losses
  - Can be reported by any taxable entity (corporation, trust, individual)
  - Taxed on the accrual basis

Income Over Time

- Important Reminder:
  - This determination occurs on the income that is earned over time. Business vs. Property income on property that is held.
- Why is this important?
  - Individuals – Only important in determining what deductions are available against the income.
  - Corporations – Property income is taxed as a significantly higher rate within a corporation.

Business vs. Property

- Property Income
  - Less effort to earn
  - "Passive" income
  - No large commitment of time, labour or attention
- Business Income
  - Actively Earned
  - "An adventure in the nature of trade"
  - Not employment income

Business vs. Property

- Property Income
  - Interest
  - Dividends
  - Rental Income
  - Royalties
- Business Income
  - Plumbing business
  - Starbucks Franchise
  - Providing legal consultations

Business vs. Property - Example

- An individual operates a 2 unit rental building (duplex) and has no employees. Would these rents be considered business or property income?

This income would be considered property, no significant commitment of time is required to earn income from a duplex unit.

- An individual operates a 50 unit rental building (complex) and has 8 employees to do bookkeeping, perform maintenance, and sit at reception. Would these rents be considered business or property income?

This income would be considered business income. Managing 8 employees for this number of units would require active work

Business vs. Property - Example

- An individual investments $20,000 in GIC's which bear interest at 6% annually. Is this interest business or property income?

This income would be considered property. Passive income that Involves only holding the GIC until interest is paid.

- An individual invests $300,000 in a McDonald's franchise and regularly checks in on the progress of the manager to make sure things are on track. Would income earned be business or property income?

This income would be considered business income. The individual Is monitoring and regularly managing their business. (Management Fees)

Gain on Sale

(business/cap gains)
(inventory/capital property)

- Important Reminder:
  - This determination occurs when an asset is sold.
- Why is this important?
  - Because capital gains are only 50% taxable, can be incentive to argue that income is capital and not business income.
  - Because capital losses are restricted and only 50% claimable, can be incentive to argue that losses are business losses and not capital

Business vs. Capital Gains

- Tests for Capital vs. Inventory
  - Did you buy the item to resell?
  - Length of ownership period (2 weeks vs. 5 years)
  - Is your normal business buying & reselling?
  - Number & frequency of transactions
  - Supplemental work on the property

- Capital Assets - Acquired to earn income through their use. Capital Gain on sale
- Inventory – Acquired to be resold for profit. Business Income on sale

Business vs. Capital Gains

- Inclusion Rate
  - **Business income** included in taxable income 100%
    - Dispose of an investment:
    - $10 FMV - $5 cost = $5 gain x 100% = $5.00 taxable
  - **Capital Gains** included in income 50%
    - Dispose of an investment:
    - $10 FMV – $5 cost = $5 gain x 50% = $2.50 taxable
- Application
  - Capital losses only deductible against capital gains

Business vs. Capital Gains

- Regularly performing an activity with a view to profit can result in business income, where it might otherwise be considered property income.

- Example:
- House Flippers Vs. Selling the Family Cottage

Ordinarily, the sale of a cottage is considered capital gains. It is Not purchased to earn income and occurs over a long period of time. However, house flippers buy homes with the intent to improve and Resell them. The trades occur frequently. This recharacterizes the Gains on sale as busines income.

Business vs. Capital Gains

- Regularly performing an activity with a view to profit can result in business income, where it might otherwise be considered property income.

- Example:
- Day Trading Vs. Passing Investing

Ordinarily, the sale of investments is considered capital gains. Generally, investments are purchased with the intent that their Value will increase over time. However, day traders intend to make Profits over a very short period of time. They purchase stocks with The intent to resell them shortly at a profit. This changes their nature To Business income.

Examples:

Ostrich Producers of Ontario, 2012

Business Income Calculation

Calculation of Business Income

START

Income for Accounting Purposes	$100,000
Adjust for items restricted in the act	
Adjust for items permitted in the act	
Example:	
Amortization (not deductible for tax)	$20,000
CCA (not included in accounting income)	(16,000)
Business Income for Tax	$104,000

Calculating Business Income

- Start with Accounting Income (Financial Statements)
  - Add Items Back
    - Accounting Depreciation
    - Accounting losses
    - Taxable Capital Gains
    - Income Tax Expense
    - Interest & Penalties on Taxes
    - 50% of meals & entertainment
    - Current year financing fees
    - Non-deductibles (Yacht, Golf)
    - Unreasonable expenses (high income to spouse)

Calculating Business Income

- Less Items
  - Capital Cost Allowance (CCA-Tax depreciation)
  - Financing Costs (over 5 years)
  - Accounting Gains
  - Landscaping Costs (if capitalized for accounting)

=Net Income for Tax Purposes

Calculating Business Income

- Adjusting Items
  - Accounting Gains removed, Capital Gains added
    - Example, sale of land purchased for $10, sold for $30.
    - Accounting gain = $20 ($30-$10)
    - Taxable Capital Gain = $10 ((30-10) x 50%)

Adjusting accounting income to taxable income

Deduct: accounting gain	(20)
Add: taxable capital gain	10
Adjusted Income	(10)

Calculating Business Income

- Adjusting Items
  - Unreasonable Expenses
    - Amounts paid to related entities must be reasonable to be deductible
    - Salary for wife who does bookkeeping $150,000
    - Arms length individual would be paid $40,000

Adjusting accounting income to taxable income	
Add: unreasonable amount	150,000
Deduct: reasonable amount	(40,000)
Adjusted Income	110,000

Calculating Business Income

Meals & Entertainment

- 50% Deductible in ordinary circumstances
- 80% Deductible for long haul truck drivers traveling away from home at least 24 hours.
- No restriction if:
  - Meals provided to customers (hotels, airlines)
  - Meals for a charitable fundraising event
  - When reported as a taxable benefit
  - When for meals in a remote work site
  - **When made available to all employees (office meetings or Holiday parties).**
  - Meals billed to clients who reimburse

Calculating Business Income

- Adjusting Items
  - Meals
    - Example assumes ordinary 50% meals of $1,000

Adjusting accounting income to taxable income	
Add: 50% of meals	500
Deduct: no offset	0
Adjusted Income	500

Calculating Business Income

- Adjusting Items
  - Financing Fees
    - Costs of refinancing debt.
    - Deductible over 5 years – straight line
    - Assume current year fee paid of $1,000

Adjusting accounting income to taxable income

Add: any current year fee	1,000
Deduct: 1/5 of current year	(200)
Adjusted Income	800

Income reduction in year 2, 3, 4, 5 = $200 in each year

Calculating Business Income

- Adjusting Items
  - Reorganization Fees
    - Legal and accounting fees paid to perform a reorganization or incorporation
    - Non-deductible but then added to Class 14.1

Adjusting accounting income to taxable income

Add: accounting deduction	1,500
Deduct: no offset	(0)
Adjusted Income	1,500

CCA deduction calculated separately. And CCA deduction taken.

Calculating Business Income

- Adjusting Items
  - Landscaping Fees
    - Landscaping fees are capitalized to the cost of land for accounting purposes
    - They are deductible for tax purposes

Adjusting accounting income to taxable income	
Add: no offset	0
Deduct: landscaping fees	(2,000)
Adjusted Income	(2,000)

Calculating Business Income

- Adjusting Items
  - Interest & Penalties
    - Can't deduct interest and penalties owing because of the tax act (on late filing, late payment, late installments, etc.)
    - Must add it back to calculate business income
  - Taxes Owing per Financial Statements
    - Financial Statement income is ordinarily shown net of tax (tax already deducted).
    - Must add it back to calculate the business income we want to apply tax to.

Business Income Inclusions

Business Income Inclusions

- Damages
  - For example, a subcontractor defaults on the contract and you are awarded damages
- Gambling Profits
  - Only when earning it constitutes a business (a professional gambler). Otherwise, gambling and lottery winnings are tax free.
- Inducement Payments
  - For example, receipt of a lease inducement from tenant who wants special terms included in a lease.

Business Income Inclusions

- Profits from Illegal Businesses
  - Drugs, Bribery, and Prostitution Income is Taxable

- Government Assistance
  - When received to purchase capital assets, it reduces the cost of the assets.
  - When received for an income earning purpose, it is included in taxable income.

- Restrictive Covenants
  - Includes non-compete clauses received other than by employment. Example, from the person who purchases your business

Restrictions on Business Deductions

Business Deduction Restrictions

- Capital Costs
  - Non-deductible, only CCA can be taken.
  - If deducted for accounting, must be added back.

- Personal or living expenses
  - Personal housing, travel, meals, clothing, etc.

- Must be Incurred to Earn Taxable Income
  - Expenses to earn exempt income aren't deductible
  - Must be incurred with the intent to earn income

Business Deduction Restrictions

- Interest & Property Taxes on Vacant Land
  - Since not technically incurred to earn income it isn't deductible. These amounts are capitalized to the cost of the land.
- Illegal Payments
  - Bribes, Fines, Tickets
- Political Donations
  - Not deductible but able to receive a credit for them.

Business Deduction Restrictions

- Yacht, Camp, Lodge, or Golf Dues
  - Never deductible to businesses

- Expenses of Personal Services Business
  - What is a PSB? Acting as an employee through a corp.
  - Restricted to employment expenses

Business Deduction Restrictions

- Life Insurance
  - Cannot be deducted unless:
    - Required by the lender
    - Lender is a financial institution (bank)
    - Used as collateral for a loan
    - Interest on that loan is deductible

Life Insurance Example:

Andy borrows $50,000 from the bank to buy new vending machines for his snack business. He's getting on in years so the bank asks for life insurance against the balance of the loan. Andy thought he'd probably like extra life insurance too so bought a policy for $150,000.

The annual premiums were $6,000

Can Andy deduct the life insurance against business income?

Yes – it is a requirement of lending

How much can he deduct?

$2,000 the proportion the premiums are to the required insurance
$6,000 premiums x ($50,000 required / $150,000 obtained)

Comprehensive Examples

Example A:

Financial Statements of Harpco:	
Revenues from sale of widgets	$60,000
Salaries	$10,000
Depreciation/Amortization (CCA $10k)	$6,000
Legal fees	$2,000
Accounting fees	$2,000
Meals & Entertainment	$1,800
Interest ($100 from CRA)	$1,500
Parking Tickets	$200
Net Income before tax	$36,500
Tax Expense	$5,840
Net Income	$30,660

Example A: Solution

Accounting Income	**30,660**
Tax Expense for Accounting	5,840
Salary (no adjust if reasonable)	-
Accounting Amortization	6,000
CCA (assumed)	(10,000)
Legal (no adjust if not reorg/finance)	-
Accounting (no adjust if not reorg/finance)	-
Meals (50% deductible)	900
Interest & penalties from CRA	100
Parking Tickets (illegal)	200
Net income for tax purposes:	**33,700**

Example B:

Financial Statements of Harpco:

Revenues from sale of widgets	$500,000
Salaries	$170,000
Depreciation	4,000
Financing Fees	2,000
Life Insurance (no debt)	3,000
Net Income before tax	$321,000
Tax Expense	$50,000
Net Income	$271,000

CCA $6,000 & Bribes accepted $3,000 (unreported)
Plays the lottery once a week at work, and won $50,000 (unreported)
Husband earns $130,000 as bookkeeper, would cost $40,000 to replace.

Example B: Solution

Accounting Income	**$271,000**
Tax Expense (Added back to calc pre-tax income)	50,000
Salaries (add unreasonable)	$130,000
Salaries (deduct reasonable)	(40,000)
Depreciation (add accounting)	4,000
CCA (deduct for tax)	(6,000)
Financing Fees (deductible over 5 yrs)	2000
Financing Fees (Deduct year 1)	(400)
Life Insurance (deductible if required for debt)	3,000
Bribes not included in accounting income	3,000
Lottery winnings (not business income)	-
Net income for tax purposes:	**416,600**

Example C:

Jim operates a welding business. He doesn't maintain records but wants you to calculate his taxable income. He believes he earned $50,000 from sale of his services and received $15,000 in government grants to get started. He paid his employees $7,000 in salaries (unrelated to Jim) and paid for $400 in meals while they were on the job. He used some welding profits to pay for a new lawn mower which cost $500.

Calculate Jim's Net Income for Tax Purposes from Business Income.

Example C: Solution

Accounting Income (N/A)	**0**
Revenue	50,000
Government Assistance	15,000
Salaries (all reasonable)	(7,000)
Meals (no exceptions-50% deductible)	(200)
Lawn mower (personal)	-
Net income for tax purposes:	**57,800**

Income from Property

What is Property Income?

Net Income for Tax Purposes

- Net Employment Income
- Net Business Income
- Net Property Income
- Capital Gains and Losses
- Other Income
- Other Deductions
- Current Year Losses – Capital or Non-Capital

- = Net Income For Tax Purposes

Differences so far

- Net Employment Income
  - Can only be earned by individuals
  - Taxed on the cash basis
- Net Business Income

  Net Property Income

  Capital Gains and Losses
  - Can be reported by any taxable entity (corporation, trust, individual)
  - Taxed on the accrual basis (some exceptions)

Business vs. Property

- Property Income
  - Less effort to earn
  - Interest
  - Dividends
  - Rental
  - Royalties
- Business Income
  - Actively Earned
  - "An adventure in the nature of trade"
  - Not employment income

Definition

- Difference from Business Income covered in great detail in Session 6.
- Return on invested capital where little or no effort is required by the investor to produce the return.
- Doesn't include capital gains, as these are included elsewhere as income under the tax act.

Important Because

- CCA cannot be used to increase or create a loss on property income.
- No requirement to prorate CCA on assets used to produce property income for short year ends.
- Limited deductions for property income – No CEC, convention expenses,

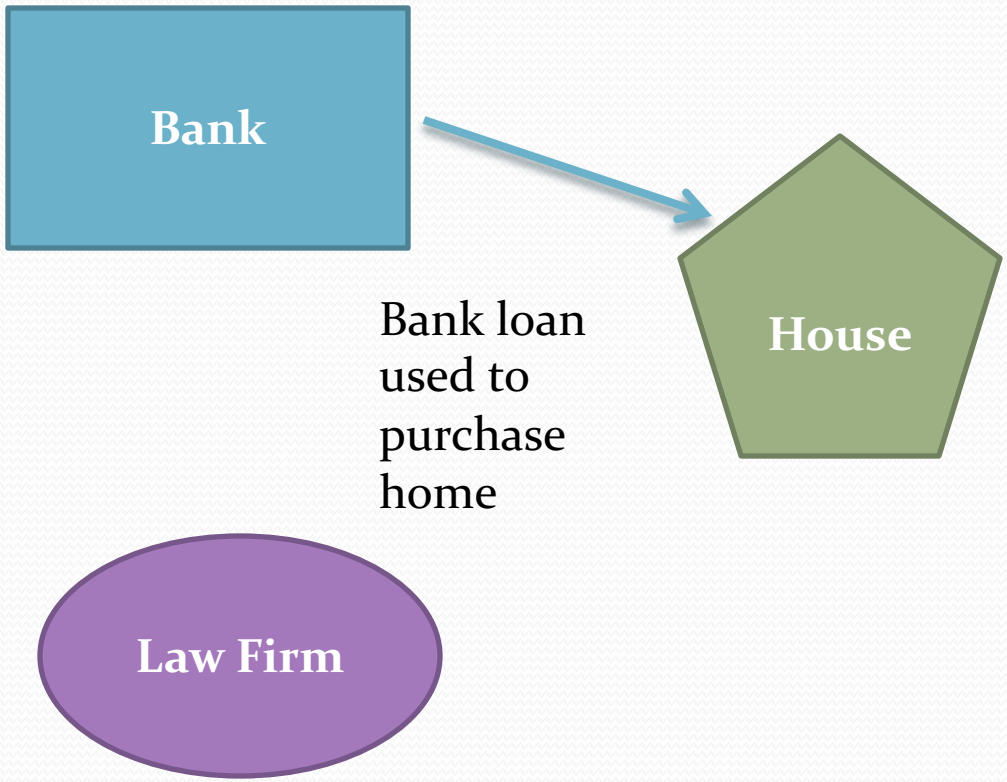
Interest Deductibility

Restrictions

- Deductible only to the extent it is incurred to earn business or property income.
  - Capital gains do not qualify
  - Employment Income does not qualify
  - Cannot be interest for personal purchases

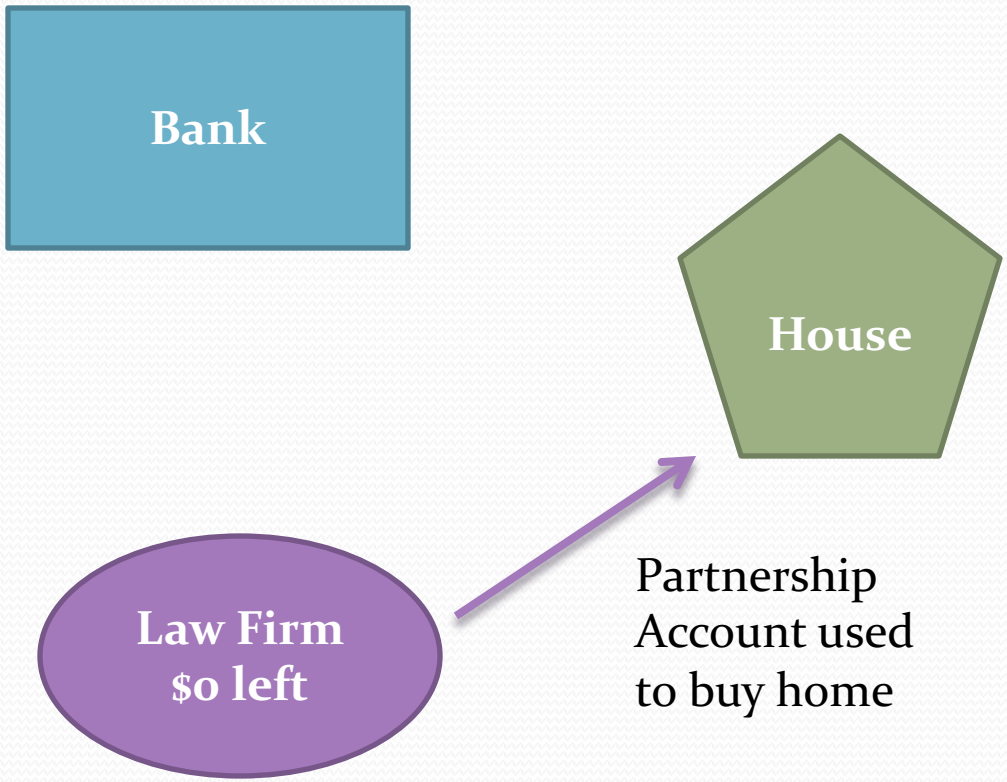
Typical Home Buying Transaction

- Ordinarily a taxpayer will loan funds from a bank to buy a home.
  - Personal Transaction
  - No deduction if there is interest paid



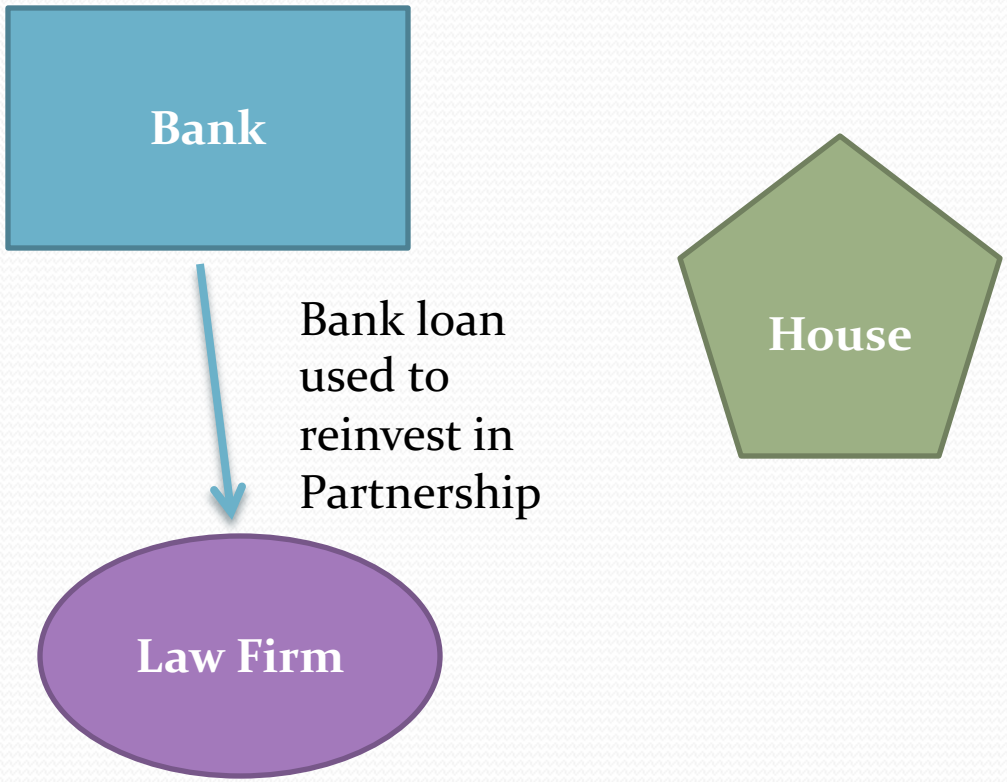
Singleton Case – Step 1

- Withdrew funds from his law firm to purchase a personal home.
  - Personal Transaction
  - No deduction if there is interest paid



Singleton Case – Step 2

- THEN, received a commercial loan and reinvested in the law firm.
  - Interest on this debt, used to invest in business income earning asset, is deductible.

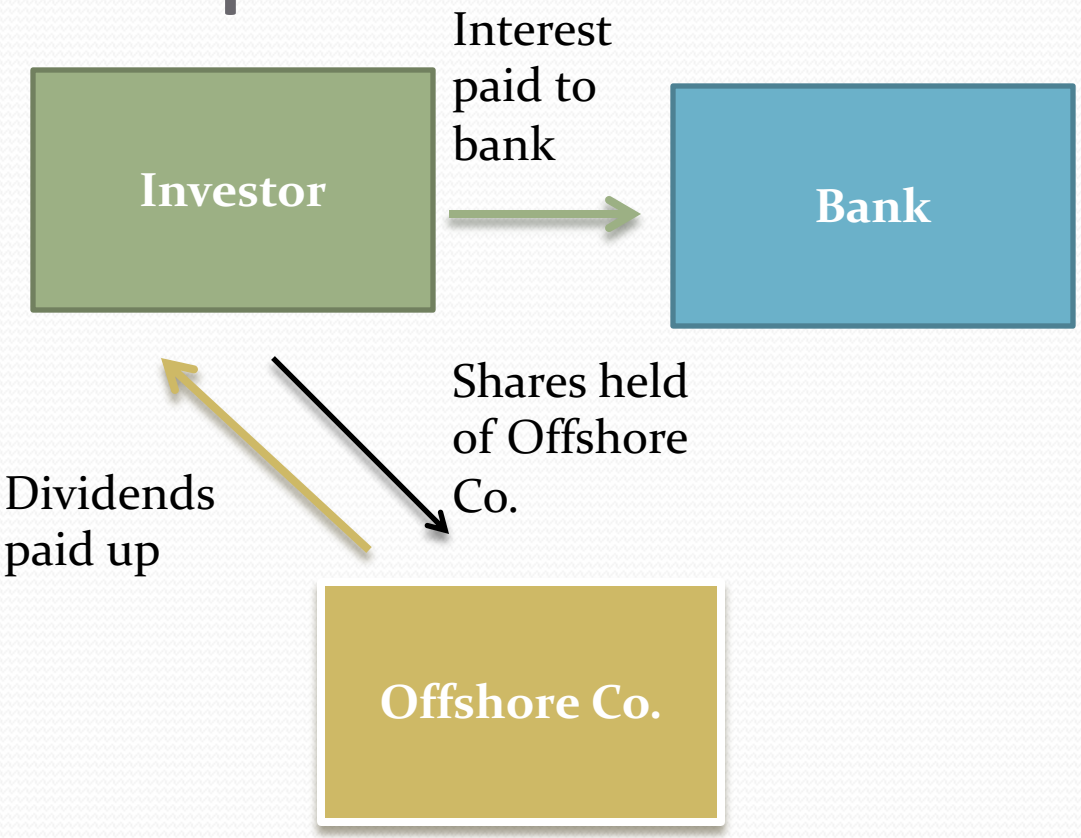


Singleton - Result

- The "shuffle of cheques" created legal relationships.
- The interest paid by the taxpayer was on debt used to earn income (by being contributed to the law firm)
- Therefore, the interest was deductible. (ie. Taxpayer WIN!)
- No debt existed for the purchase of the home, therefore the structure is the most tax advantageous (no lost deduction for interest paid)

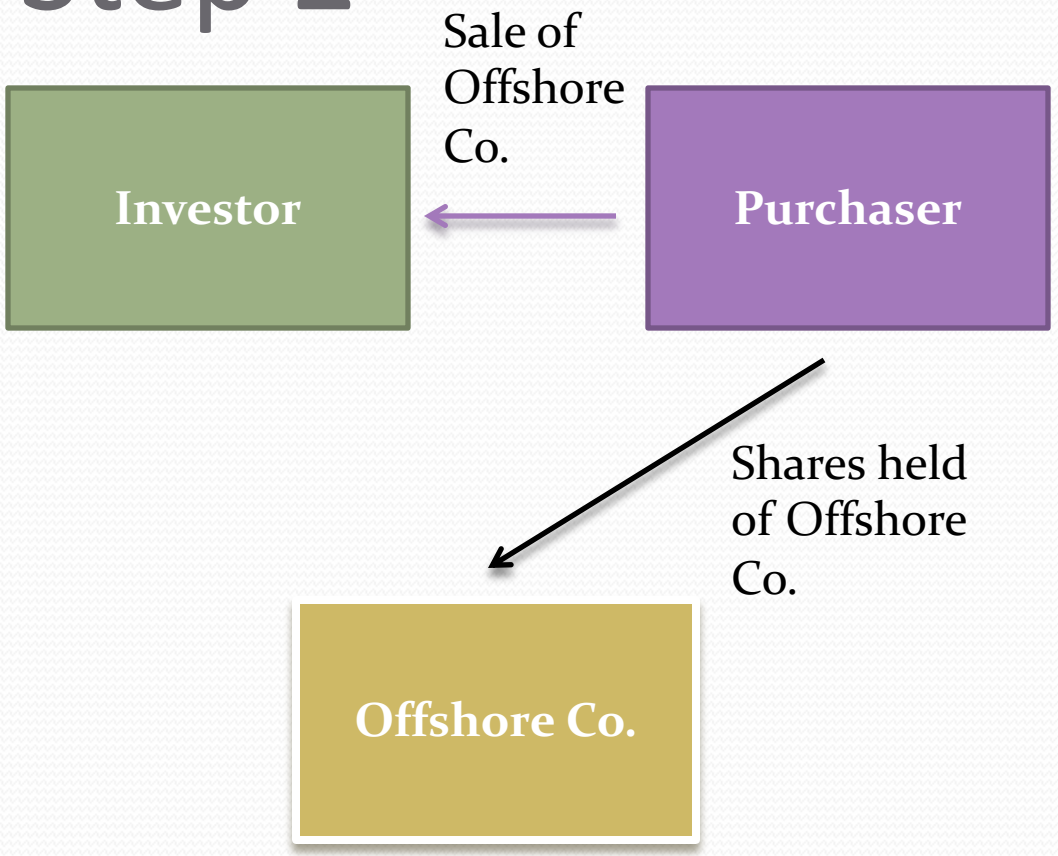
Ludco Case – Step 1

- Borrowed funds to invest in an offshore company
  - $6,000,000 in interest paid
  - $600,000 in dividends received



Ludco Case – Step 2

- Shares of Offshore Co. sold to a purchaser
  - $9,200,000 capital gain incurred.
  - CRA's position that purchase was to earn gains, not income.



Ludco - Result

- Earning business or property income doesn't have to be the ONLY purpose of the transaction.
- An investment can have multiple purposes.
- Therefore, the interest was deductible. (ie. Taxpayer WIN!)
- This case is further complicated by the size of income ($600,000) to interest paid ($6 million). Although approved in this case, there is some dispute over whether it would fall prey to the proposed Reasonable Expectation of Profit Rules (REOP)

Interest

- What is interest?
  - It must be accrued on a continuous basis (able to be calculated at any point in time)
  - It must be calculated based on a principal amount
  - It must be compensation for the use of the principal amount.

Direct or In-Direct Use

Requirement is that the funds borrowed must be used to earn income from Business or Property.

- Remember Singleton – The use of the loan on which the interest is paid is the important one. Economically was to purchase a home, directly was to invest in law firm.

Direct or In-Direct Use

Direct Use is the general use, with Two Exceptions

- Exception 1: FILLING THE HOLE

  Interest on loans made to Pay Dividends, Redeem Shares, or Return Capital can be deductible where:

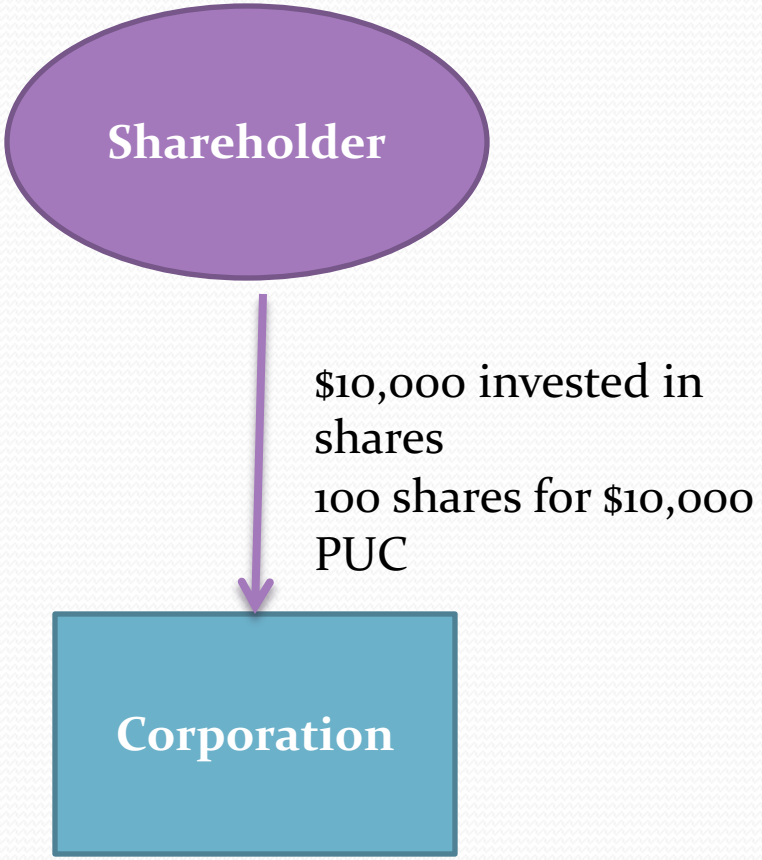
  The loan takes the place of capital already invested in the company
  - Return of capital limited to paid up capital of shares.
  - Redemptions and dividends limited to retained earnings left in the company

Filling the Hole – ROC Step 1

- Step 1 :

  Individual invests $10,000 of his own money in a company.

  Invested capital is $10,000



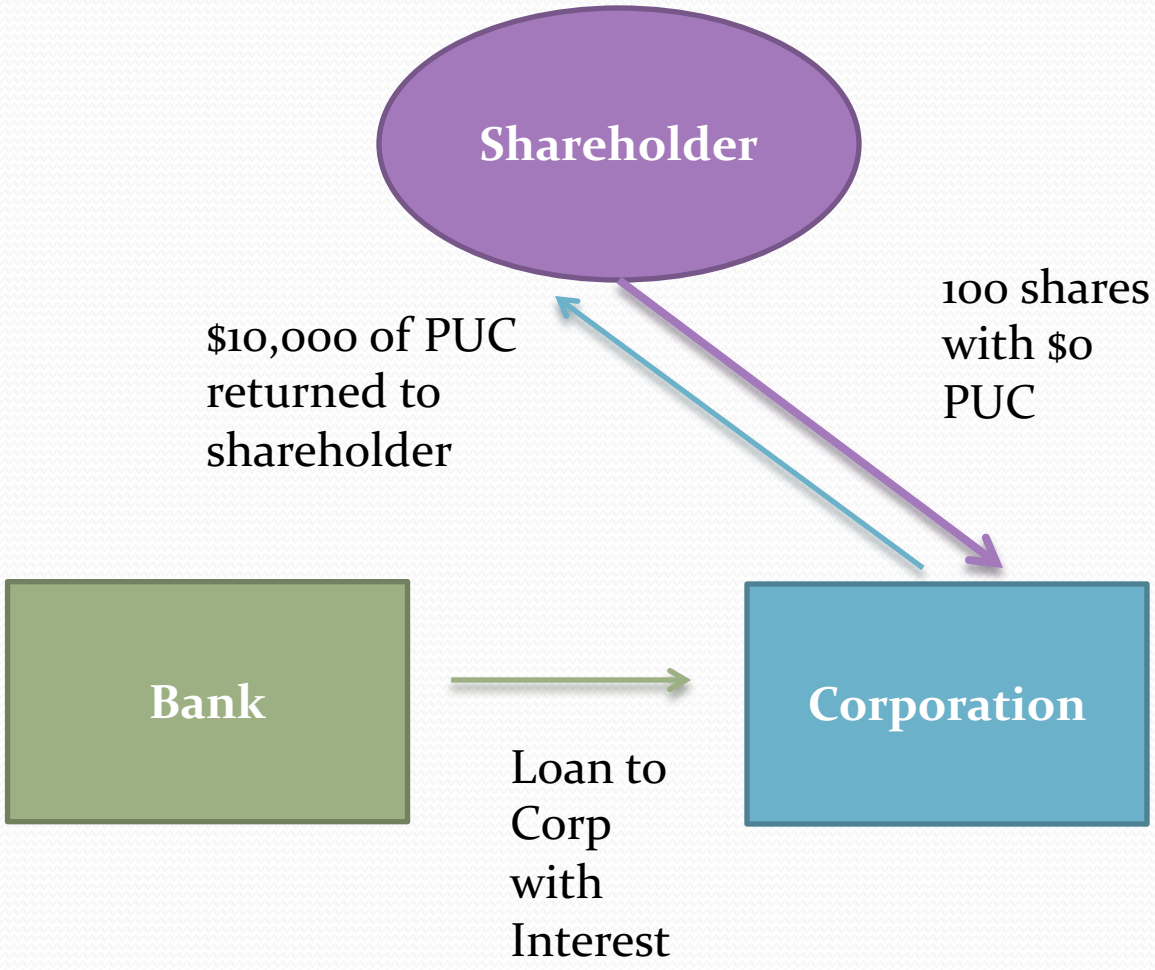
Filling the Hole – ROC Step 2

- Step 2 :

  Corporation borrows $10,000 from the bank and repays the Shareholder

  Invested capital remaining is $0

  Corporation pays interest to bank



Filling the Hole – ROC Result

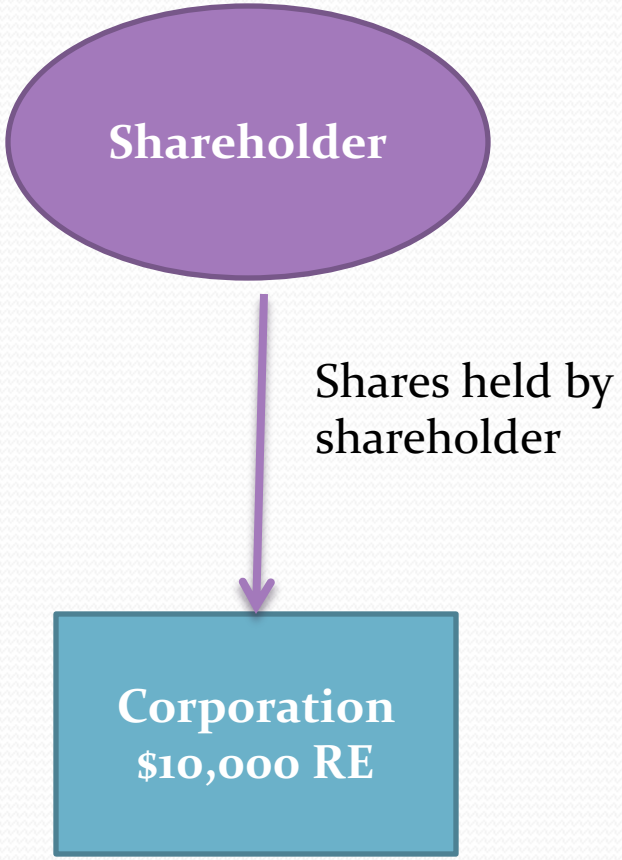
- Direct use of the money was to return capital to the shareholder.
- In-direct use of money was to replace money the shareholder invested to earn income from business or property.
- Hence why it is called the "Fill the hole" concept. Based on replacing money, that was originally used for purposes that would cause interest to be deductible.

Filling the Hole – Dividend Step 1

- Step 1 :

  Corporation earns $10,000 after tax and never pays a dividend.

  Retained Earnings of company is $10,000



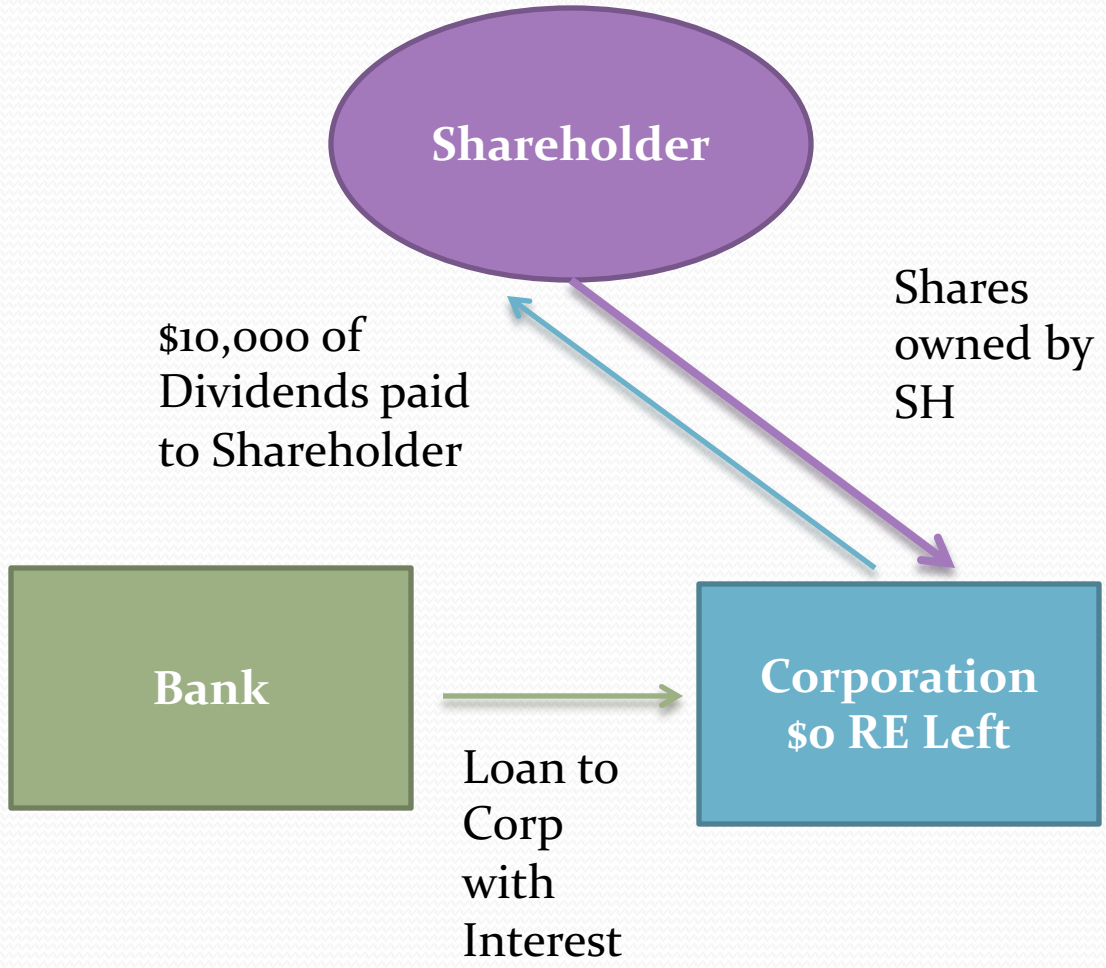
Filling the Hole – Dividend Step 2

- Step 2 :

  Corporation borrows $10,000 from the bank and pays a dividend to the shareholder

  Retained Earnings is $0

  Corporation pays interest to bank



Filling the Hole – Dividend Result

- Direct use of the money was to pay a dividend to the shareholder.

- In-direct use of money was to replace money the shareholder invested to earn income from business or property.
  - shareholder "invested" the retained earnings of the corporation, by not distributing them previously.
  - By leaving them within the corporation the shareholder made the choice to invest them.

- Hence why it is called the "Fill the hole" concept. Based on replacing money, that was originally used for purposes that would cause interest to be deductible.

Interest Free Loans

Interest paid on loans used to make interest free loans are not deductible

- Exception 1: INTEREST FREE LOANS

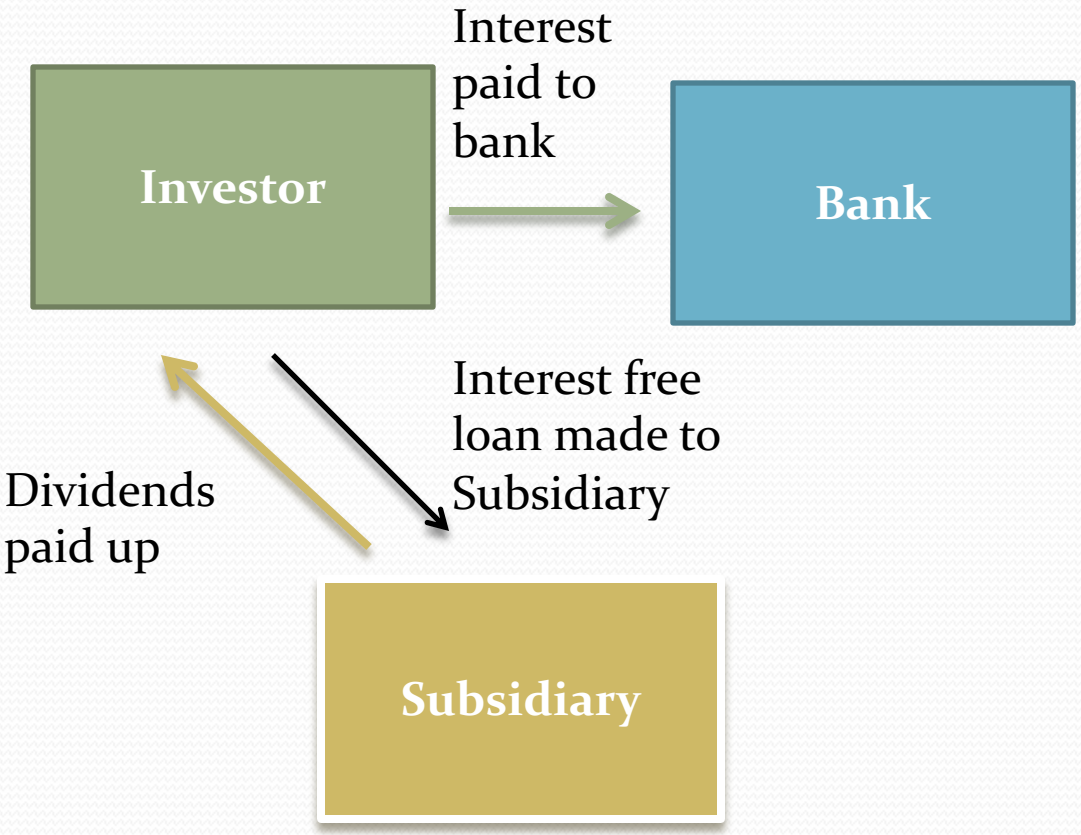
  Interest on money borrowed to make interest free loans can be deductible if income is expected to be earned another way than by interest because that loan was made

  Example:

  - Interest free loan to a corporate subsidiary, who then pays dividends to the lender.

Interest Free Loans

- Borrowed funds to invest in a subsidiary
  - Loan to sub allows them to earn income, which they distribute as dividends
  - Investor has earned dividend income (property) from the loan



Linking to Current Use

The current use of the borrowed funds must be to earn income.

- Step 1: An individual borrows $100,000 to buy shares of a corporation that pays dividends.
  - Interest on the loan is deductible.
- Step 2: The individual sells the shares of the corporation for $100,000 and uses those funds to buy a yacht. The loan is still outstanding
  - The interest on the loan is no longer deductible. The current use of funds is to buy a yacht

Linking to Current Use

The current use of the borrowed funds must be to earn income.

- Step 1: An individual borrows $100,000 to buy shares of a corporation that pays dividends.
  - Interest on the loan is deductible.
- Step 2: The individual sells the shares of the corporation for $100,000 and uses those funds to invest in a copyright that earns royalties. The loan is still outstanding
  - The interest on the loan remains deductible. The new use is to earn royalties, which is property income.

Linking to Current Use

What happens if sold for more or less than the purchase price?

- Step 1: An individual borrows $100,000 to buy shares of a corporation that pays dividends.
  - Interest on the loan is deductible.
- Step 2: The individual sells the shares of the corporation for $60,000 (less) and uses $20,000 to invest in a new car and $40,000 to invest in another corporation.
  - The interest on the loan is prorated. 2/3 will be deductible, 1/3 will not be.
  - This is the ratio of the current use of the funds ($40,000 income earning/$60,000 total proceeds = 2/3 deductible)

Linking to Current Use

What happens if sold for more or less than the purchase price?

- Step 1: An individual borrows $100,000 to buy shares of a corporation that pays dividends.
  - Interest on the loan is deductible.
- Step 2: The individual sells the shares of the corporation for $120,000 (More) and uses $20,000 to invest in a new car and $100,000 to invest in another corporation.
  - Option 1 – the interest on the loan is allocated 100% to the most beneficial use ($100,000 of loan allocated to $100,000 investment)
  - Option 2 – the interest is prorated based on the % of the proceeds is used to earn income
    - $20,000 / $120,000 = 16.67% of the interest will be non-deductible.

Disappearing Source Rules

If loan proceeds disappear, borrower isn't penalized.

- Step 1: An individual borrows $100,000 to buy shares of a corporation that pays dividends.
  - Interest on the loan is deductible.
- Step 2: The individual sells the shares of the corporation for $60,000 and uses those funds to repay the loan. $40,000 of the loan is outstanding
  - The interest on the loan is still deductible.
  - The asset's decline in value shouldn't unfairly penalize the taxpayer

Common vs. Preferred Shares

- Preferred shares typically have set dividend rates (ex. 5% per year)
  - Purpose of earning income is easy to observe. Dividends received regularly
- Common shares do not ordinarily have a mandatory dividend on them. They are "participating" in that they can share in the growth of the company by receiving dividends when and if there is income in the company.
  - Purpose of earning income is still present, if it could be expected that dividends will be paid.
  - Not there if explicitly state in their terms that no dividends will be paid.

Interest Income

Interest

- Taxed when earned by corporations and trusts (Accrual method)
- Taxed on the anniversary date for individuals or when cash is received if earlier.

Bond Cash Flow

This is a $10,000 5% bond

Date	Cash Flow	Income
Feb 1, 2016	($10,000) Issued	-
Dec 31, 2016	Year end	-
Feb 1, 2017	$0	$500 Accrued
March 15, 2017	$700	$200 (Cash is taxable, less accrued amount already reported
Dec 31, 2017	Year End	-
Feb 1, 2018	$0	$300 2nd year accrual (2 years x $500 per year, less excess cash already reported)

Taxation of Dividends

Definition

- Dividends are payments of corporate earnings to shareholders.
- Paid out of after tax retained earnings
- Not deductible to the corporation

Example:

$100,000 Revenue

($20,000) Supplies Expense

$80,000 Net Income

(12,400) Tax on Net Income

$67,600 After Tax Income

$30,000 Opening RE

$67,600 Current Year Income

(40,000) Dividends Paid

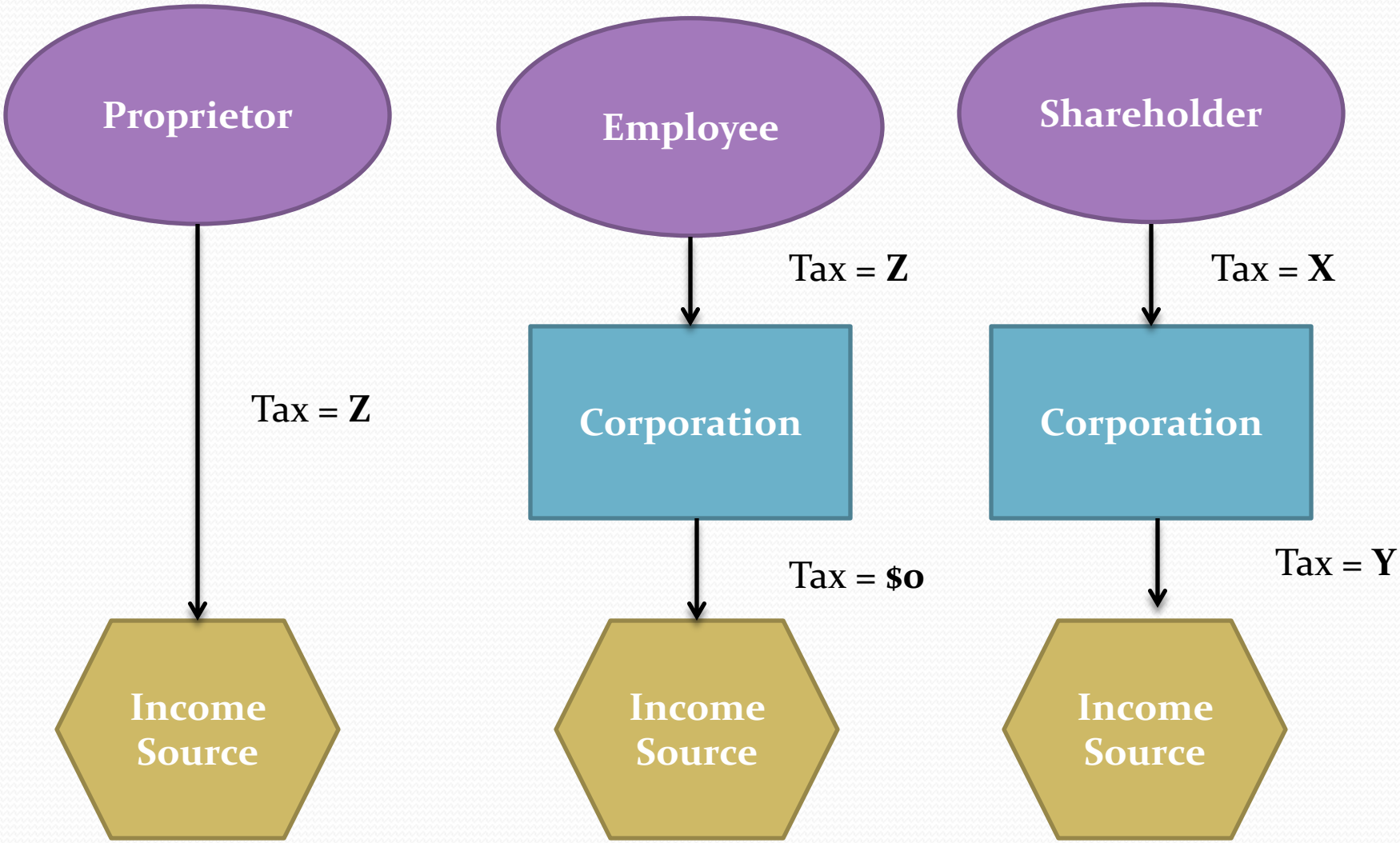
$57,600 Ending RE

Concept of Integration

- Theory that regardless of how a specific type of income is earned, the same overall tax should be levied.
  - Ie. earned through corporation, partnership, sole-proprietor, etc.
  - Eligible and Non-Eligible Dividends help create this "integration"
  - Will be covered more thoroughly in ECON3205 when discussing corporate taxation.

Integration

X + Y = Z



Dividends – Non-Eligible

- Non-Eligible
  - Grossed up 1.25 x Actual
  - Credit 16 2/3% of Actual
  - Applies to dividends from small corporations who pay the low rate of tax.

Example

$1,000 non-eligible dividend.

$1,250 Taxable Dividend included in income ($1k x 1.25)

$167 Dividend Tax Credit ($1,000 actual dividend x 16.67%)

Dividends – Non-Eligible

Calculate Tax Assuming $50,000 in salary as well as this $1,000 non-eligible dividend.

$51,250 Taxable Income

$13,176 Tax on income (10,363 + ((51,250-43,000)x.341))

$11,000 Personal Credit

(2,651) Reduces Tax ($11k x .241)

(167) Dividend Tax Credit

(2,818) Total Credits

$10,358 Net Tax (13176 – 2818)

Example

$1,000 non-eligible dividend.

$1,250 Taxable Dividend included in income ($10k x 1.25)

$167 Dividend Tax Credit ($1,000 actual dividend x 16.67%)

Dividends - Eligible

- Eligible
  - Grossed up 1.38 x Actual
  - Credit 20.75 of Actual
  - Applies to dividends from big corporations who pay a high rate of tax

Example

$1,000 eligible dividend.

$1,380 Taxable Dividend included in income ($1k x 1.38)

$207.5 Dividend Tax Credit ($1,000 actual dividend x 20.75%)

Dividends – Eligible

Calculate Tax Assuming $50,000 in salary as well as this $1,000 eligible dividend.

$51,380 Taxable Income

$13,221 Tax on income (10,363 + ((51,380-43,000)x.341))

$11,000 Personal Credit

(2,651) Reduces Tax ($11k x .241)

(207.5) Dividend Tax Credit

(2,858.5) Total Credits

$10,362.5 Net Tax (13221 – 2858.5)

Example

$1,000 eligible dividend.

$1,380 Taxable Dividend included in income ($10k x 1.38)

$207.5 Dividend Tax Credit ($1,000 actual dividend x 20.75%)

Dividend Example A

Murray received a dividend on his shares of TD Bank of $25,000. He wants to know how much tax he will pay.

Type:

Gross up:

Credit:

Tax Calculation:

Dividend Example A

Murray received a dividend on his shares of TD Bank of $25,000. He wants to know how much tax he will pay.

Type: From large public corp - Eligible

Taxable Income: $25,000 x 1.38 = $34,500 Taxable

Credit: $25,000 x 20.75% = $5,187.50 reduction of income tax

Tax Calc: $34,500 x 24.1% (first bracket) = $8,314.50 Tax
$11,000 (personal credit) x 24.1% = $2,651 + $5,187.50 DTC = $7,838.50 Reduction of Tax
$8,314.50 - $7,838.50 = $476 Net Tax Owing

Can't be negative tax owing

Dividend Example B

Murray received a dividend on his shares of Murray Co., which he owns, of $25,000. Murray Co. makes $250,000 in taxable income per year. He wants to know how much tax he will pay.

Type:

Gross up:

Credit:

Tax Calculation:

Dividend Example B

Murray received a dividend on his shares of Murray Co., which he owns, of $25,000. Murray Co. makes $250,000 in taxable income per year. He wants to know how much tax he will pay.

Type: From small corp & under $500,000 – Non-eligible

Taxable Income: $25,000 x 1.25 = $31,250 Taxable

Credit: $25,000 x 16.67% = $4,167.50
reduction of income tax

Tax Calc: $31,250 x 24.1% (first bracket) = $7,531.25 Tax
$11,000 (personal credit) x 24.1% = $2,651 + $4,167.50
DTC = $6,818.50 Reduction of Tax
$7,531.25 - $6,818.50 = $712.75 Net Tax Owing

Dividends Cont'd

- Capital Dividends
  - Non-taxable
  - Must be paid from a company's "Capital Dividend Account".
  - Will be covered in corporate tax.

Obtained Oct 22, 2013 from: http://www.etftrends.com/2010/09/how-etfs-pay-dividends/

Dividends Cont'd

- Stock Dividends
  - A distribution of corporate stock to an individual.
  - Actual dividend is the "paid up capital" amount of the stock.
  - Can have a set FMV or be a common share with floating value.

- Example
  - B Co. issues a stock dividend to its shareholder of 1,000 Class B preferred shares.
  - The shares have a PUC of $20 and a FMV of $1 million
  - Actual Dividend is $20. FMV has no impact until shares are sold or redeemed.
  - Eligible or non-eligible treatment applied to the $20

Other Property

Royalties

- Defined as: Payments based on production or use

- Calculated using the accrual method – royalties earned but not received during the year must be included in income.

Example: Jim purchases the right to a Post Malone song which earns $30,000 in the year after the date of his purchase. $5,000 of that amount was not received until the next year. How much must Jim include in income?

Royalties

- Defined as: Payments based on production or use

- Calculated using the accrual method – royalties earned but not received during the year must be included in income.

Example: Jim purchases the right to a Post Malone song which earns $30,000 in the year after the date of his purchase. $5,000 of that amount was not received until the next year. How much must Jim include in income?

Jim must include $30,000 in income; the amount earned.

Rental Property

- Calculated using the accrual method – can use cash method if net income would be effectively the same. It is rare for this method to be used.

- CCA can be claimed on rental properties.
  - Remember that each rental property costing more than $50,000 receives it's own CCA "pool".
  - CCA cannot be used to create or increase a rental loss that is property.

Rental Property - Example

Example:

Jerry has rental income of $40,000 in 2012. He calculates that his rental expenses are $36,000. His opening UCC balance on his rental building is $200,000 (4%). Calculate the maximum CCA Jerry can take.

Rental Property - Example

Example:

Jerry has rental income of $40,000 in 2012. He calculates that his rental expenses other than CCA are $36,000. His opening UCC balance on his rental building is $200,000 (4%). Calculate the maximum CCA Jerry can take.

$200,000 Opening UCC x 4% = $8,000 maximum CCA claim.

However, net income is currently $4,000 before CCA ($40,000 income - $36,000 expenses). Cannot use CCA to create or increase a loss.

Therefore, max CCA claimable is $4,000. Enough to bring income to zero.

Rental Property - Example

Example:

Jerry has rental income of $40,000 in 2012. He calculates that his rental expenses other than CCA are $36,000. His opening UCC balance on his rental building is $50,000 (4%). Calculate the maximum CCA Jerry can take.

Rental Property - Example

Example:

Jerry has rental income of $40,000 in 2012. He calculates that his rental expenses other than CCA are $36,000. His opening UCC balance on his rental building is $50,000 (4%). Calculate the maximum CCA Jerry can take.

$50,000 Opening UCC x 4% = $2,000 maximum CCA claim.

Jerry's net income is currently $4,000 before CCA ($40,000 income - $36,000 expenses). Cannot use CCA to create or increase a loss.

Therefore, max CCA claimable is $2,000. Net income after CCA is $2,000 ($4,000 before CCA less $2,000 CCA = $2,000). Not negative, so no reason to adjust CCA claimed.

Rental Property

- Rental Income
- Less:
  - Utilities
  - Repairs
  - Maintenance
  - Interest
  - Insurance
  - Property Taxes
  - CCA if not in your home

If in home:

Current expenses are pro-rata based on space used.

Always remember to separate out the current and capital expenses.

All expense deductible. This isn't employment income, which limits what can be deducted.

Mutual Funds

Teco Rodrigues/For the Toronto Star

- A “trust” where you pool your money with many other investors to buy a pool of investments
- Income of the pool gets flows out to you as:
  - Dividends
  - Capital Gains
  - Interest,
  - Foreign Income
  - Return of Capital (ROC)

Foreign Source Income

- Taxed as regular income regardless of type (US interest, dividends, etc.)
- Taxes withheld by foreign authorities (like the IRS) is used as a tax credit to reduce Canadian taxes paid.

- <u>Example:</u>

John received US dividends of $15,000. $1,000 in US taxes was withheld from the dividends so he received $14,000 in cash.

John includes $15,000 in his taxable income. His total taxes owing will be reduced by $1,000.

Deferred Income Plans

Non-Deductible Contribution Types

Types

Registered Education Savings Plans (RESPs)

Registered Disability Savings Plans (RDSPs)

Tax Free Savings Accounts (TFSAs)

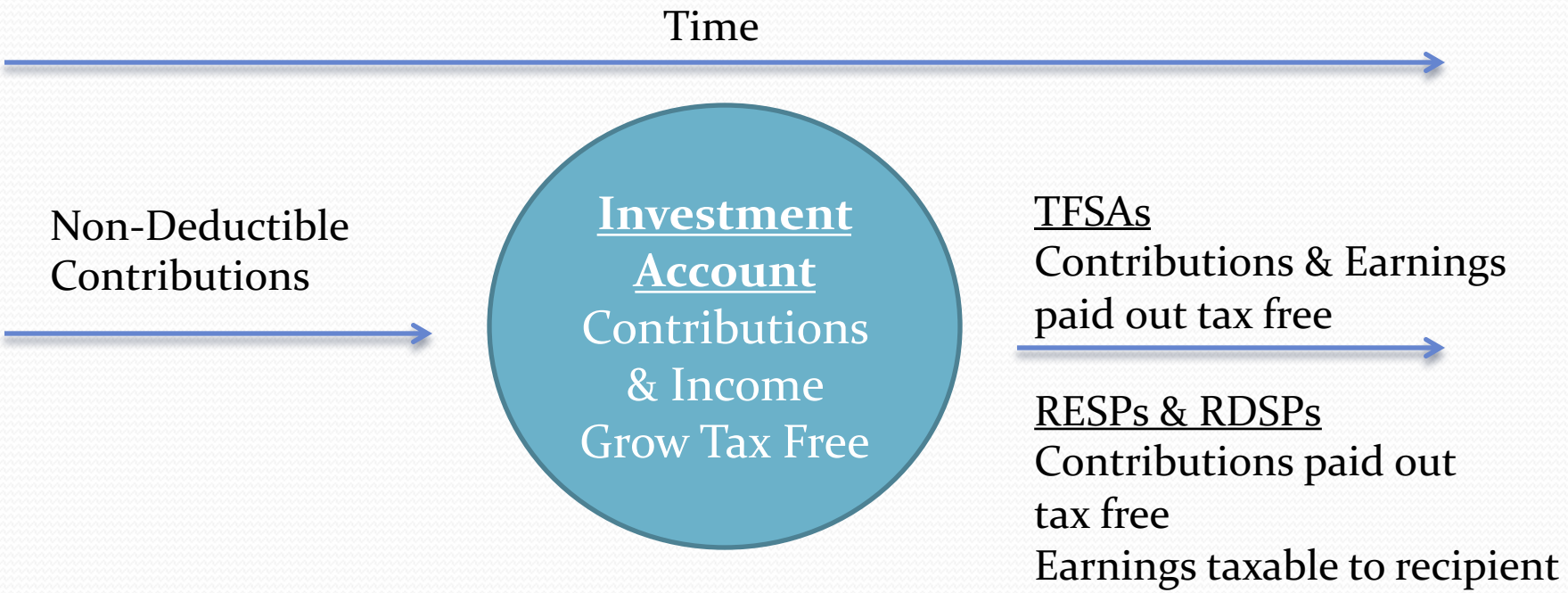
Benefits

Growth of Investment Earnings Tax Free

Tax Reduction – RESP/RDSP - Use of a low income individual's tax brackets

Tax Avoidance – TFSA Only – No tax on income earned within the account.

Structure


Time
Non-Deductible Contributions
Investment Account
Contributions & Income Grow Tax Free
TFSAs
Contributions & Earnings paid out tax free
RESPs & RDSPs
Contributions paid out tax free
Earnings taxable to recipient

RESPs

Registered Education Savings Plans

Image obtained November 1, 2013 from:
http://www.yummymummyclub.ca/life/money/your-resp-rulebook

Registered Education Savings Plans (RESPs) - Overview

- Intended to assist in saving for the education of a beneficiary (generally a child or grandchild)
- Contributions are made by the adult relative.
- Taxable withdrawals are taxed to the beneficiary (the child) if the beneficiary is in post-secondary study at the time of withdrawal.
- Otherwise taxable to the contributor.

Registered Education Savings Plans (RESPs) - CESGs

- CESGs – Canada Education Savings Grants
- 20% government grant deposited to the RESP
- Maximum of $500 per year on contributions of $2,500.
- If beneficiary not in post-secondary study when RESP withdrawn, the CESG and income on it is removed from RESP account.
- Can catch up if did not contribute or open a plan – max of $1,000 in any one year.

Registered Education Savings Plans (RESPs) – CESGs +

- For low income families, extra grant (on top of ordinary 20%) is available.

- On first $500
  - 20% if family income is $43,953 or less
  - 10% if family income is between 43,953 and 87,907
  - 0% if family income is greater than 87,907

Registered Education Savings Plans (RESPs) - CLBs

- CLB – Canada Learning Bond
- Government contributions to the RESP. $525 in the first year, $100 in each subsequent year.
- Not based on contributions made by others
- Made to a beneficiary's RESP when the family qualifies for the National Child Benefit supplement.
- Stops when the child turns 15, family income must be below $25,356.

Registered Education Savings Plans (RESPs) - Restrictions

- Tax free growth of earnings is limited to 35 years (40 years if beneficiary has a disability)
- Total contributions are limited to $50,000 for any one beneficiary
- Penalty of 1% per month on the excess over $50,000.
- Lifetime maximum CESG of $7,200.

Registered Education Savings Plans (RESPs) - Withdrawals

- Contributions can be withdrawn at any time by beneficiary or contributor unless restricted by the plan itself (the bank's terms)

- Education Assistance Payments
  - Paid from accumulated earnings, CESG amounts and CLB amounts.
  - Included in the income of the recipient if recipient qualifies due to enrollment in post-secondary education.

Registered Education Savings Plans (RESPs) - Withdrawals

- Accumulated Income to Subscribers
  - Paid after beneficiaries turn 21 & not eligible for EAP
  - CESG and CLB Repaid to the government
  - Extra 20% tax on remaining income to compensate for tax deferred growth

- Limits
  - Full time students can withdraw $5,000 in the first term, unlimited thereafter.
  - Part time students have lower limits.

Registered Education Savings Plans (RESPs) - Plans

- Single beneficiary plans – limits as we described

- Family plans – beneficiaries can be any child of the contributor.
  - Attractive if several children and not all pursue education.
  - Same contribution limits per beneficiary.
  - No restriction on which beneficiary can withdraw funds.

Practice Example A – 1 (Exam realistic)

Jeremy and his wife, Diane, have a 2 year old daughter. They make a $3,000 contribution to her RESP each year.

Calculate the amount of basic savings grants the government will contribute to the RESP.

Annual max is 20% x $2,500 = **CESG of $500 = amount contributed**

Practice Example A - Expanded

Jeremy and his wife, Diane, have a 2 year old daughter. They have made annual contributions of $3,000 to her RESP since she was born. Their family income is $120,000.

Calculate the amount the government will contribute to the RESP if the family contributes $3,000 in the current year.

No unused CESG carried forward since more than $2,500 has been contributed each year.

No Extra CESG as the family earns too much income.
No Canada Learning Bond as the family earns too much income.

Annual max is 20% x $2,500 = **CESG of $500 = amount contributed**

Practice Example B - Expanded

Jeremy and his wife, Diane, have a 2 year old daughter. Last year was the first year they opened her RESP and they contributed $1,000 to it. Their family income is $50,000.

Calculate the amount the government will contribute to the RESP if the family contributes $4,000 in the current year.

max $1,000 CESG over past lifetime (2 yrs x $500 per year), only $200 used to date = $800 max carry forward.

10% Extra CESG on first $500 as family earns between 43,953 and 87,907
No Canada Learning Bond as the family earns too much income.

$4,000 contributions x 20% = $800 ($500 cy + $300 py) + (500 x 10% extra) 50 = **850 CESG** (less than $500 + carryforward so ok)
Maxed at $1,000 per year = not relevant as did not reach

Practice Example C - Expanded

Jeremy and his wife, Diane, have a 1 year old daughter. This year was the first year they opened her RESP. Her grandparents opened an RESP for her last year and contributed $1,500 Their family income is $90,000.

Calculate the amount the government will contribute to the RESP if the family contributes $4,500 in the current year.

max $500 CESG over past lifetime (1 yrs x $500 per year), only $300 used to date by grandparents = $200 max carry forward.

No Extra CESG as family earns too much income
No Canada Learning Bond as the family earns too much income.

$4,500 contributions x 20% = $900 CESG (**Max #1 - maxed at $700. Carry forward of $200 + $500**)
Max #2 - Maxed at $1,000 per year = not relevant, did not reach

Practice Example D - Expanded

Jeremy and his wife, Diane, have a 21 year old daughter. She has an RESP worth $36,000 and is attending a Canadian university Full-time this Fall. She plans to withdraw $5,000 each term from her RESP.

Who will pay tax on the withdrawals? Which amounts will be taxable to them? Is the daughter permitted to take withdrawals as she has specified.

As a post-secondary student, daughter will pay tax on the withdrawals. They are considered Education Assistance Payments.

Daughter will be taxable on any earned income, CESGs, or CLBs included in her withdrawal. It will not be taxable to the extent that it is contributions made to the RESP.

Yes, as a full time student, is limited to $5,000 in her first term, and has no withdrawal limit after that point.

RDSPs

Registered Disability Savings Plan

Image obtained November 1, 2013 from: https://www.comsavings.com/Personal/ProductsAndServices/Investing/RDSP/

Registered Disability Savings Plans(RDSPs) - Overview

- Intended to assist in providing care to disabled individuals, particularly beyond the lifespan of the care providers.
- Contributions are made by the adult relative.
- Beneficiary is the disabled individual.
- No deduction on contributions, income grows tax free.
- Income portion is taxable to the beneficiary on withdrawal. Withdrawn contributions are tax free.

Registered Disability Savings Plans (RDSPs) - Restrictions

- Total contributions are limited to $200,000 over the beneficiary's lifetime.

- Similar to RESPs
  - Canada Disability Savings Grant
  - Canada Disability Savings Bond

- Additional information for those interested can be found online in CRA's guide: RC4460

TFSAs

Tax Free Savings Accounts

Image obtained November 1, 2013 from: http://www.financefox.ca/do-you-have-a-tfsa-account/

Tax Free Savings Plans (TFSAs) - Overview

- Resident individual's over 17 years old can establish a TFSA (since 2009)
- Total individual limit based on years since 2009 or over 17. No annual limit to contributions.
- No deduction on contribution, no tax on earnings, no tax on withdrawals.
- TFSA belongs to the contributor. Not established for the use of someone else.

Tax Free Savings Plans (TFSAs) – Contribution Room

- Annual Limits:
  - 2009 - $5,000
  - 2010 - $5,000
  - 2011 - $5,000
  - 2012 - $5,000
  - 2013 - $5,500
  - 2014 - $5,500
  - 2015 - $10,000
  - 2016-2018- $5,500
  - 2019 - $6,000
  - 2020 - $6,000
- As of 2020 the max an individual can contribute is $69,500 total

  ** this assumes they've been eligible since 2009.*

  ** the count begins once a taxpayer turns 18*

Tax Free Savings Plans (TFSAs) – Contribution Room

- Annual Limits:
  - 2009 - $5,000
  - 2010 - $5,000
  - 2011 - $5,000
  - 2012 - $5,000
  - 2013 - $5,500
  - 2014 - $5,500
  - 2015 - $10,000
  - 2016 & 2017 - $5,500
  - 2019 - $6,000
  - 2020 - $6,000
- An individual turns 18 in 2012. How much can they contribute in 2015 when they open a TFSA?
- $26,000 total ($5,000 for 2012 + $5,500 for 2013/2014 + $10,000 for 2015)

Tax Free Savings Plans (TFSAs) – Contribution Room

- No account needed to accumulate contribution room.
- Withdrawals are added back to contribution room the year AFTER withdrawal. (Do not treat it like a chequing account).
- Over-contributions taxed at 1% per month

Practice Example A

Francis has an starting contribution room of $13,000 in 2013. He contributed $4,000 in February, withdrew $6,000 in May, and contributed another $11,000 in September.

Calculate Francis' contribution room after the September contribution.

$13,000 Starting Balance
(4,000.00) Contribution – reduces balance
(11,000.00) Contribution – reduces balance

(2,000.00) Overcontribution (1% penalty per month).

Practice Example A

Francis has over-contributed by $2,000 at the end of 2013 and withdrew $6,000 in May 2013.

Calculate his contribution room in 2014.

(2,000.00) Over-contribution (ending balance)
5,500.00 New annual limit added to room
6,000.00 Prior year withdrawals added to balance.

$9,500.00 Contribution room in 2014.

Tax Free Savings Plans (TFSAs) – Miscellaneous

- TFSA's are investment accounts

  Some investments are restricted:

  - Investments in private companies which the TFSA owner or a related individual owns.

- On Death
  - A spouse named as a beneficiary can maintain the deceased spouses TFSA account or roll it into their own account without affecting their contribution room.

Deductible Contribution Types

Types

No Sponsor Required

Registered Retirement Savings Plans (RRSPs)

Registered Retirement Income Funds (RRIFs)

Employer Sponsored

Registered Pension Plans (RPPs)

Pooled Registered Pension Plans (PRPPs)

Deferred Profit Sharing Plans (DPSPs)

Motivations

Company pension plans disappearing
- Defined Benefit
- Defined Contribution

Aging Population

Government Funded Pensions
- CPP $12,000 max
- OAS $6,500 max
- Total $18,500.

Canadian low income cutoff line $21,359

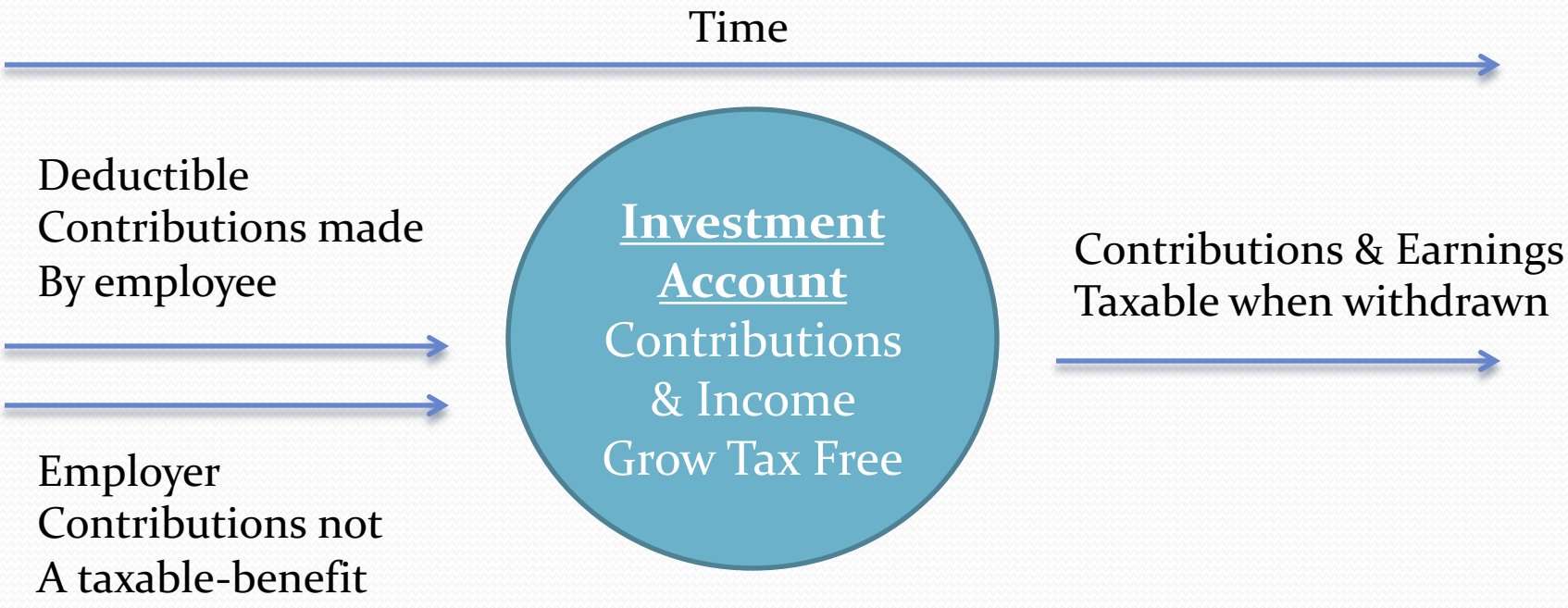
Benefits

Growth of Investment Earnings Tax Free

Tax Deferral – tax-deductible contributions eliminate current tax, and postpone it until retirements funds are needed.

Tax Reduction – Deductions are taken in high income years, retirement funds may be taxable in low income years. Better use of marginal tax rates.

Structure


Time
Deductible
Contributions made
By employee
Employer
Contributions not
A taxable-benefit
Investment
Account
Contributions
& Income
Grow Tax Free
Contributions & Earnings
Taxable when withdrawn

RRSPs

Registered
Retirement
Savings Plans

Image obtained November 3, 2013 from: http://www.helpingyoubuyyourfirsthome.ca/blog/bid/78032/Can-I-use-my-RRSP-to-buy-a-home

Registered Retirement Savings Plan (RRSPs) - Characteristics

- Administered by a financial institution
  - Banks, Insurance Companies, Mutual Funds, etc.
- Professionally managed or self-directed investing
- Defined Contribution (set pay in)
- Contributions can be made in the year or 60 days after. Payments in January, 2020 can be deducted in 2019.

Registered Retirement Savings Plans – (RRSPs) Tax Treatment

- Individual – Deductible Payments
- Income Grows Tax Free
- Individual - Taxable Proceeds as ordinary income
  - Important to note that capital gains and dividend lose their nature in an RRSP.

Registered Retirement Savings Plans – (RRSP) Special Rules

- Contributing Investments to an RRSP
  - Deemed disposition of investments
  - Capital gains included in income
  - Losses not able to be realized

- Spousal RRSP
  - Can contribute to a spouse's plan
  - Deducted from contributor's income & room
  - 3 year time delay on withdrawals.

Spousal Example A - Solution

Harriet contributes $5,000 to a spousal RRSP for her husband, Jake, in each of 2010 and 2011.

In 2013, Jake withdraws $12,000 from his RRSP.

What is the impact on Jake and Harriet's income from this withdrawal?

$5,000 attributed to Harriet and taxable in her hands. (any spousal contributes in current year (2013) or two preceding years (2012 or 2011)).

$7,000 taxable to Jake (12,000 total withdrawn – 5,000 attributed).

RRSP Deduction Room

- Prior year's ending balance
  - Plus: Lesser of:
    - 18% of prior year earned income, or
    - 26,230 (2018), 26,500 (2019), 27,230 (2020)
  - Less: Prior year's RPP (pension) Adjustment
  - Less: Current year contributions for self
  - Less: Current year contributions for spouse
- Equals: Ending Balance

- Withdrawals do NOT increase the deduction room.

Components of Earned Income

Additions:

Net employment income

Income from a business

Net rental income from real property

Income earned as a partner

Royalties where received by the author, composer, etc.

Taxable support payments (spousal support)

Research Grants, net of expenses

Canada Pension Plan Benefits

Employment Insurance Benefits

Components of Earned Income

Deductions:

Deductible Support Payments (Spousal Support)

Losses from a business

Losses from being a partner

Loss from the rental of real property

Example A

Mr. Kelly had $12,000 in RRSP deduction room at the end of 2012. His employer says his pension adjustment for 2012 was $4,000 on his $50,000 salary.

Mrs. Kelly has no income so cannot save for her own retirement. **Mr.** Kelly contributes $500 per month toward her retirement from January 2013 – December 2013. Because of his pension, he doesn't make payments for himself

Mr. Kelly has never deducted RRSP contributions before.

What is the impact on his taxable income and what is his RRSP Deduction room?

Example A - Solution

$12,000 Ending RRSP Deduction Room end of 2012

$9,000 $50,000 earned income from 2012 x 18% = $9,000
(less than RRSP 2013 annual limit of $23,820.)

(4,000) Pension Adjustment from T4.

17,000 2013 RRSP Deduction Room

(6,000) Spousal Contributions made by Mr. Kelly

$11,000 Ending RRSP Deduction Room end of 2013

Deduction from Mr. Kelly's income = (6,000) for Spousal Contributions

Example B

Mr. Kelly had $8,000 in RRSP deduction room at the end of 2012. He does not participate in any other pension savings. He earns $3,000 from interest and $80,000 from his rental properties in 2012.

Mr. Kelly contributes $1,300 per month to his RRSPs in 2013

What is the impact on his taxable income and what is his RRSP deduction room?

Example B - Solution

$8,000 Ending RRSP Deduction Room end of 2012

$14,400 $80,000 earned income from 2012 x 18% = $14,400
(less than RRSP 2013 annual limit of $23,820.)

22,400 2013 RRSP Deduction Room

(15,600) Ordinary Contributions made by Mr. Kelly

$6,800 Ending RRSP Deduction Room end of 2013

Deduction from Mr. Kelly's income = (15,600) for RRSP Contributions Made

Registered Retirement Savings Plans (RRSPs) – Special Rules

- Un-deducted Contributions
  - So long as there is RRSP deduction room, an employee can contribute to their RRSP.
  - There is no requirement that the contributions actually be deducted in the year made.

- Excess Contributions
  - Amounts contributed in excess of the RRSP deduction room are penalized 1%/month
  - $2,000 “cushion” before penalties are applied

Registered Retirement Savings Plans – (RRSP) Withdrawals

- Lump sum payments
  - Subject to lump sum tax withholdings
  - Not eligible for pension splitting or pension credit
- Convert to an Annuity
    - Payments still taxable as received
- Convert to a RRIF
  - Like an annuity, with minimum withdrawal rates.

Registered Retirement Savings Plans – (RRSPs) Life Changes

- At Age 71 you must:
  - Transfer RRSP to an RRIF
  - Transfer the RRSP to an annuity
  - Withdraw the RRSP entirely
  - Can continue to make RRSP contributions to a spousal RRSP if the spouse is not yet 71.

- If you die the RRSP:
  - Can roll tax deferred to a spouse or dependant child
  - OR: Be fully taxed in the final return of the deceased

Registered Retirement Savings Plans (RRSPs) – Special Rules

- Home Buyers Plan
  - $35,000 limit per person for a home purchase
  - Non-taxable withdrawal from an RRSP
  - Non-deductible repayment over 15 years (straight line).
  - Repayment begins in the second year following the withdrawal.
  - Amounts not repaid are included in income each year.

Registered Retirement Savings Plans (RRSPs) – Special Rules

- Home Buyers Plan - Qualifying
  - Cannot have a HBP withdrawal outstanding when making a withdrawal.
  - Neither the individual taking the withdrawal or their spouse can have owned a home in the four years preceding the withdrawal.
  - Amounts deposited into RRSP within 90 days before purchase cannot be used.
  - Must have bought or built a qualifying home:
    - Housing unit located in Canada.

Registered Retirement Savings Plans (RRSPs) – Special Rules

- Lifelong Learners Plan
  - Maximum $10,000 per year, to a $20,000 max over four years.
  - Withdrawal to fund full-time post-secondary education for withdrawer or their spouse
  - Non-taxable withdrawal from an RRSP
  - Non-deductible repayment over 10 years (straight line).
  - Repayment begins in the fifth year following the withdrawal.
  - Amounts not repaid are included in income each year.

Registered Retirement Savings Plans (RRSPs) – Special Rules

- Lifelong Learners Plan - Qualifying
  - Cannot have a LLP withdrawal outstanding when making a withdrawal.
  - Amounts deposited into RRSP within 90 days before purchase cannot be used.

RPPs

Registered Pension Plans

Image obtained November 3, 2013 from: http://www.smallbizadvisor.ca/group-retirement/saskatchewan-pension-plan-to-apply-for-prpp-2093

Registered Pension Plans – (RPPs)

- Characteristics
  - Run by Employer
  - Defined Contribution (set pay in)
  - Defined Benefit (set pay out)

- Tax Treatment
  - Employer Contributions – No Taxable Benefit
  - Employee Contributions – Deductible Payments, Taxable Withdrawals
  - Income Grows Tax Free

Contribution Limit

- Same limit as for RRSP contributions (a single limit for all plans).
- Delay in impact means that RPP's can use the current years expected income to absorb the deduction.
- Recall: prior year pension adjustment reduces the deduction room.

Obtained November 3 from:
http://www.telegraph.co.uk/finance/personalfinance/pensions/9028142/How-to-manage-your-own-pension.html

Contribution Limit

- Key to remember:
  - If you have an employer run RPP, you must adjust your self-administered RRSP contributions accordingly.
  - Failure to do so is the most common source of over-contributing & penalties.

Registered Pension Plans – (RPP) Withdrawals

- Lump sum payments
  - Subject to lump sum tax withholdings
  - Not eligible for pension splitting or pension credit
- Paid Out Over Time
    - Employer generally administers a scheduled payout
- Convert to an RRIF or Annuity
  - If permitted by the plan terms

PRPPs

Pooled Registered Pension Plans

Image obtained November 3, 2013 from: http://www2.macleans.ca/2012/02/09/how-the-government-wants-to-trick-us-into-saving-more/

Pooled Registered Pension Plans (PRPPs)

- MacLean Magazine:

  "How the government wants to trick us into saving more".

- In 2011, only 24% of Canadians used RRSPs.

- The average contribution was $2,830.

Article obtained November 3, 2013 from: http://www2.macleans.ca/2012/02/09/how-the-government-wants-to-trick-us-into-saving-more/

Pooled Registered Pension Plans (PRPPs)

- Employer PRPP participation is optional.
- However, once chosen, employees of companies that opt in are automatically enrolled.
- Employees will have to opt-out to get out of the program.
- Similar to an RPP except many companies pool together to save administration costs.

Pooled Registered Pension Plans (PRPPs)

- Self-employed individuals and employees of company's that don't participate can still opt-in to a PRPP plan.
- Same contribution room as RRSPs/RPPs.
- Effective from January 1, 2013 onward federally.
- Participating requires the province of residence to have enacted legislation.

RRIFs

Registered
Retirement
Income Funds

Image obtained November 3, 2013 from:
http://www.advisor.ca/news/industry-news/are-you-getting-rrif%E2%80%99d-off-18788

Registered Retirement Income Funds – (RRIFs)

- Deductible contributions cannot be made to a RRIF
- A RRIF is another retirement plan that has been converted into an income stream.
- Ie. Stop depositing money in, start taking money out.
- Rollover of an RRSP or RPP into a RRIF is tax free, and begins the process of using the funds in retirement.

Registered Retirement Income Funds – (RRIFs)

- Withdrawals are taxed as ordinary income.
- Withdrawals from RRIFs are eligible for pension splitting and the pension credit.
- Minimum annual withdrawals are set by legislation and are based on the age of the recipient and the funds in the RRIF.
- No maximum withdrawal amount.

Registered Retirement Income Funds – (RRIFs) Life Changes

- If you die the RRIF:
  - Can roll tax deferred to a spouse or dependant child
  - OR: Be fully taxed in the final return of the deceased

DPSPs

Deferred Profit Sharing Plans

Image obtained November 3, 2013 from:
http://www.benplans.com/services/profit-sharing-plans.html

DPSP

- Characteristics
  - Payment made to plan by employer based on business profits
  - Not allowed for those related to those owning 10% or more of company
  - No specific payout schedule

- Tax Treatment
  - Employer Contributions – Payments not a taxable benefit, deductible
  - Employee Contributions – Not allowed to pay in
  - Income Grows Tax Free

Review

- Registered Education Savings Plans (RESP)
- Registered Disability Savings Plans (RDSP)
- Tax Free Savings Accounts (TFSA)
- Registered Retirement Savings Plans (RRSP)
- Registered Pension Plans (RPP)
- Pooled Registered Pension Plans (PRPP)
- Registered Retirement Income Funds (RRIF)
- Deferred Profit Sharing Plans (DPSP)

Capital Gains and Losses

Capital Gains

Occur on the disposition, or deemed disposition, of capital property

Remember to distinguish capital property from income earning property:

- Length of ownership
- Intention to resell
- Frequency of purchases/sales

Only since 1971 (V-Day) when capital gains became taxable

Calculating Gain or Loss

Proceeds	$10,000	
Adjusted Cost Basis (ACB)	(3,000)	
Disposition Costs	(1,500)	(ex. lawyer fees)

Capital Gain	$5,500	
Taxable Capital Gain 50%	2,750	

When A Disposition Occurs

Whenever Proceeds are Received and Assets Given Up:

- Sale of property
- Redemption of shares by a company
- Expropriations (property is taken from you)
- Exchanging one type of property for another

Transfers of Property – Change in 'beneficial' ownership

Deemed Dispositions

- Death, Change in Use, Ceasing to be a Resident
- Proceeds deemed to be FMV

Proceeds of Disposition

An Actual Disposition

- Sale Price
- Insurance or other compensation for property given up (destroyed, appropriated).

Deemed Dispositions & Related Party Sales

- Proceeds deemed to be FMV, or
- Greater of FMV or actual proceeds.

Capital Cost - Refresher

- Recall from Session 5 – CCA, how to calculate the cost of a capital asset acquired:

- Purchase price

  + Cost to bring the asset to the location of use (shipping & duties)

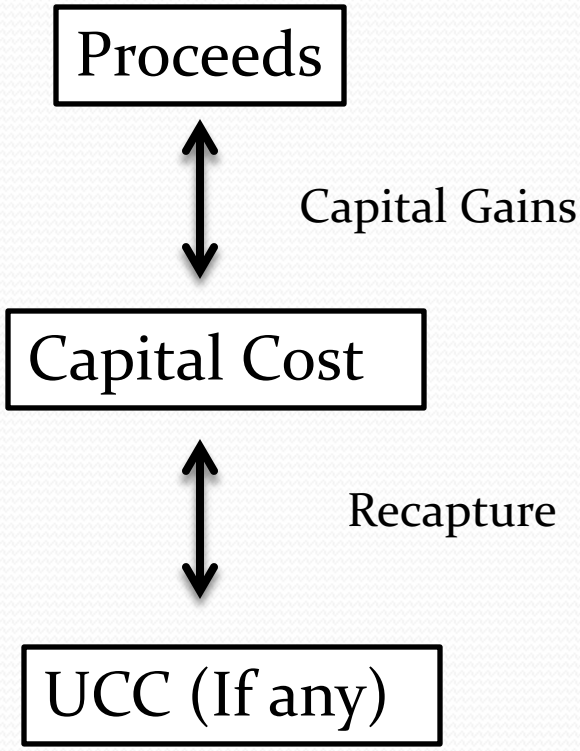
  + Cost to purchase the asset (legal/valuation fees)

  - Government assistance to purchase the asset

  + Superficial losses incurred on identical property (New)

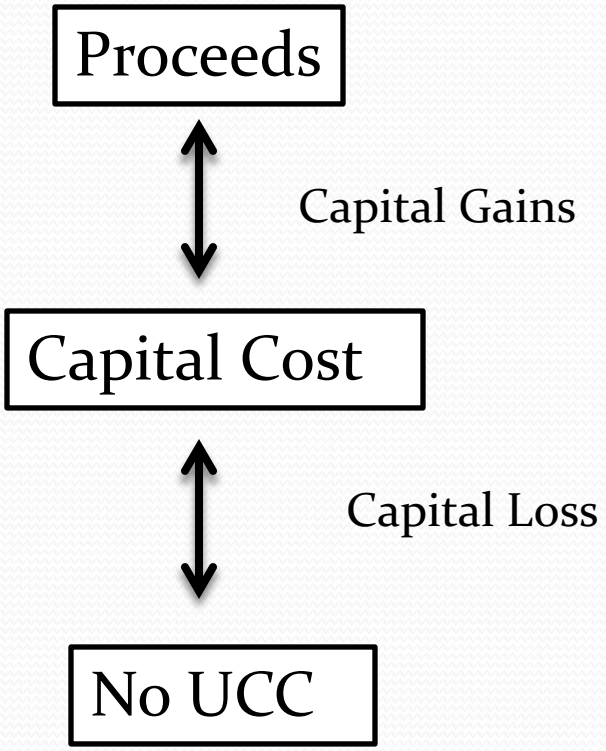
Adjusted Cost Base (ACB)

- Depreciable Property
  - Capital Cost (original cost).
  - NOT UCC



Adjusted Cost Base (ACB)

- Other Property (Land)
  - Capital Cost (original cost)



ACB Identical Properties

- Marketable Securities and other Liquid Assets

  - When you buy assets at different times you don't use a First In First Out (FIFO) method for ACB.
  - Instead, the ACB of the properties is the combined average cost of all the units you hold.

  This calculation must be redone after each purchase.

ACB Identical Properties

Ex. Dave purchases 100 shares for $25 in February, and 100 shares for $10 in March. In June he sells 100 shares. What is the ACB of the shares sold?

$2,500 Calculated as 100 shares x $25/share February purchase
$1,000 Calculated as 100 shares x $10/share March purchase

$3,500 Total ACB/ 200 shares = $17.50 per share

$1,750 Total ACB sold in June Calculated as 100 shares x 17.50 per share

ACB Identical Properties

After Dave sells his 100 shares in June, he purchases another 200 shares in September for $40 each. In December he sells 50 shares for $35. What is the gain on the shares he sells in December?

$3,500 Total ACB after purchases / 200 shares = $17,50 per share
(1,750) Total ACB of 100 shares sold in June

1,750 Remaining ACB for 100 shares Dave has left
8,000 Calculated as 200 shares x $40 each September purchase

9,750 Total ACB for 300 shares on hand = $32.50 per share

1,750 Proceeds of disposition of 50 shares sold
(1,625) ACB of 50 shares sold (50 shares x $32.50 ACB per share)
125 capital Gain x ½ = $62.50 taxable capital gain on sale.

Partial Dispositions

- Generally, partial dispositions involve prorating the cost based on a reasonable basis.
- Ex. 100 shares owned with ACB of $100,000. If selling 40 of these shares, ACB will be $40,000 (40%)
- Ex 2.
- 600 acres of land owned that has a cost of $500,000. If selling 300 acres of that land, cost of disposition is assumed to be $250,000 (50%).
- Exceptions: when reason to believe some part is not equal (ex. part of the land is waterfront property)

Reserves

- <u>If Proceeds Aren't All Received at Once</u>
  - Can defer gain over 5 years if normal sale.
  - Can defer gain over 10 years if QSBC shares sold to a child.

  (Qualified Small Business Corporation Shares)

- <u>Not Given to:</u>
  - Non-Residents
  - Exempt Entities (Charities)
  - When the sale is to a Corporation you own.
  - Deceased Individuals

Reserves - Calculated

- Deduction is Lesser of:

  1) Unpaid Proceeds / Total Proceeds ✖ Capital Gain

  and

  2) Year 1 – 4/5 of the gain
     Year 2 – 3/5 of the gain
     Year 3 – 2/5 of the gain
     Year 4 – 1/5 of the gain
     Year 5 – No reserve

& Prior year reserve is included in current year income

Example A

Mr. Anderson sold a piece of land for $150,000 during the year. He had purchased the land for $100,000 six years ago.

He is paid his proceeds in chunks of $25,000 in years 1-3 and then the remainder is paid off in year 4.

Calculate the impact on his income in each year.

Reserves – Calculated Year 1

- 150,000 Proceeds – 100,000 Cost = 50,000 Capital Gain

  Year 1: Reserve is the lesser of:

  $$\frac{\text{Unpaid Proceeds}}{\text{Total Proceeds}} = \frac{(150{,}000\text{-}25{,}000)}{150{,}000} = \frac{125{,}000}{150{,}000}$$

  =83.33% x 50,000 Capital Gain = 41,666.67

  OR

  4/5 Capital Gain = 40,000

Income Inclusion: 50,000 Gain – 40,000 Reserve = 10,000 Gain x 50% Capital Gains Rate = $5,000 income inclusion

Reserves – Calculated Year 2

- 150,000 Proceeds – 100,000 Cost = 50,000 Capital Gain

  Year 2: Reserve is the lesser of:

  Unpaid Proceeds / Total Proceeds = (150,000-50,000) / 150,000 = 100,000 / 150,000

  =66.67% x 50,000 Capital Gain = 33,333.33

  OR

  3/5 Capital Gain = 30,000

Income Inclusion: 40,000 P/Y Reserve – 30,000 C/Y Reserve = 10,000 Gain x 50% Capital Gains Rate = $5,000 income inclusion

Reserves – Calculated Year 3

- 150,000 Proceeds – 100,000 Cost = 50,000 Capital Gain

  Year 3: Reserve is the lesser of:

  $$\frac{\text{Unpaid Proceeds}}{\text{Total Proceeds}} = \frac{(150{,}000\text{-}75{,}000)}{150{,}000} = \frac{75{,}000}{150{,}000}$$

  =50% x 50,000 Capital Gain = 25,000

  OR

  2/5 Capital Gain = 20,000

Income Inclusion: 30,000 P/Y Reserve – 20,000 C/Y Reserve = 10,000 Gain x 50% Capital Gains Rate = $5,000 income inclusion

Reserves – Calculated Year 4

- 150,000 Proceeds – 100,000 Cost = 50,000 Capital Gain

  Year 4: Reserve is the lesser of:

  $$\frac{\text{Unpaid Proceeds}}{\text{Total Proceeds}} = \frac{(150{,}000-150{,}000)}{150{,}000} = \frac{0}{150{,}000}$$

  =0% x 50,000 Capital Gain = 0

  OR

  1/5 Capital Gain = 10,000

Income Inclusion: 20,000 P/Y Reserve – 0 C/Y Reserve = 20,000 Gain x 50% Capital Gains Rate = $10,000 income inclusion

Reserves – Calculated Year 5

- 150,000 Proceeds – 100,000 Cost = 50,000 Capital Gain

Year 5: Reserve is the lesser of:

Income Inclusion: 0 P/Y Reserve

Therefore, no reason to calculate reserve in year 5 since all proceeds collected and no p/y reserve to take into income.

Bad Debts on Loans Receivable

When an amount owed to a taxpayer becomes uncollectible, it is called a bad debt.

Taxpayers have the option to treat bad debts as though they were sold for $0 proceeds and reacquired for $0 (new ACB of $0).

This creates a capital loss for the taxpayer

Bad Debts - Example

Marley was owed $120,000 from a sale of land two years ago. The purchaser went bankrupt and Marley does not think she will ever be repaid.

What can she do and what are the tax implications to her?

Marley can elect under subsection 50(1) to dispose of her debt for $0 proceeds.

$0 proceeds - $120,000 ACB of debt = (120,000) loss x ½ = (60,000) taxable capital loss. Can be applied against capital gains in current, past, or future years, if any.

Sale of Land and Building

Land and Building are ordinarily sold together as a package, under a single purchase price.

Sale of land gives rise to capital gains, sale of building gives rise to recapture or terminal loss.

There is incentive to shift proceeds to land vs. building to take advantage of lower taxable income and higher terminal losses.

CRA reallocates proceeds under ITA 13(21.1)

Sale of Land & Building - $30,000 net income

Cannot have a terminal loss on a building and a capital gain on land where they are sold as part of one transaction. – proceeds gets reallocated until the terminal loss is eliminated or the loss has been, whichever comes first.

	Building	Land
Proceeds	30,000	220,000
Cost	60,000	120,000
UCC	50,000	

This would create a terminal loss of ($20,000) (50,000 – 30,000 = 20,000)

And taxable capital gain of $50,000 (220,000 – 120,000 = 100,000 x 50% = 50,000)

Sale of Land & Building - $40,000 net income

	Building		Land	
Proceeds	30,000	(50,000)	220,000	(200,000)
Cost	60,000		120,000	
UCC	50,000			

This would create a terminal loss of $0 (50,000 – 50,000 = 0)

And taxable capital gain of $40,000 (200,000 – 120,000 = 80,000 x 50% = 40,000)

Principle Residence Exemption

- Tax free residence with no gain on sale
- Available on 1 family home (per couple) per year.
- Can be claimed on any house that is “ordinarily inhabited” by the family (Cottage, regular home, etc.)

Principle Residence Exemption

$$\frac{1 + \text{Number of years after 1971 that the property was the principle residence of the taxpayer}}{\text{The number of years after 1971 that the taxpayer owned the property.}} \times \text{Capital Gain}$$

Principle Residence Example

Kimberley and her husband, Mark, have owned their family home since 2005 when they purchased it for $150,000. This home is worth $200,000

In 2003, they purchased a cottage for $100,000. It is currently worth $170,000.

They wish to sell both of these properties in 2015 for their FMV. Which property should the exemption be used on? What is the amount of income they will report?

Principle Residence Solution

Which property should the exemption be used on?

The decision should be based on the highest gain per year.

Cottage has a gain of $70,000 and was owned for 13 years = $5385 / year

Home has a gain of $50,000 and was owned for 11 years = $4,545 / year

Therefore, the family should use the exemption first against the gain on the cottage to minimize taxes.

Principle Residence Solution

What is the amount of income they will report?

Cottage: (12 years exempted + 1 from formula)/13 years of ownership = 100% exempt

$70,000 gain - $70,000 exempt = $0 gain to report

Home: (1 years exempted + 1 from formula)/11 years of ownership = 18% exempt

$50,000 gain – (50,000 x 18%) = $41,000 gain to report

$41,000 total gains x 50% taxable = $20,500 taxable income.

Principle Residence Example

Kimberley and her husband, Mark, have owned their family home since 2005 when they purchased it for $150,000. This home was sold in 2010 for $200,000 and the principle residence exemption was used on it for the 2006 to 2010 years.

In 2003, they purchased a cottage for $100,000. It is currently worth $170,000.

In 2013 the couple wish to give the cottage to their children for their use. The couple plans to move to Florida to retire.

Has a disposition occurred? Which property should have the principle residence exemption used on it? What is the taxable gain to the couple?

Principle Residence Solution

Has a disposition occurred?

Yes, a change in beneficial use has occurred. Kimberley and Mark have gifted the cottage to their children. Gifts to family members are deemed to occur at FMV.

What property should the principle residence exemption be used on?

In this case, the principle residence exemption from 2006-2010 was used on the home, therefore the exemption can only be used on the cottage for the other years that it was owned (2003, 2004, 2005, 2011, 2012, 2013).

Principle Residence Solution

What is the taxable gain to the couple?

1+ 6 (2003, 2004, 2005, 2011, 2012, 2013) Years since 1971 that the property was the principle residence of the taxpayers

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11 (number of years the taxpayer owned the property (2003-2013)

70,000 Ordinary gain on sale of cottage (170,000 FMV-100,000 Cost)

(44,545) Exempt gain on sale of cottage (170,000 FMV – 100,000 Cost = 70,000 Gain on cottage x (7/11 ratio from above)

25,455 Total Non-Exempt Gain on Sale

X 50% Taxable

12,728 taxable gain on sale to be included in income

Principle Residence - Rental

- When a portion of the principle residence is used to earn rental income, a partial disposition occurs and that portion is no longer a “principle residence”

- However, CRA will ignore this impact on the principle residence exemption where:
  - The income earning use is ancillary to the main purposes (not the major use).
  - There are no structural changes
  - No CCA is taken

Personal Use Property (PUP)

- Held for the personal use or enjoyment of the owner or related person
- No losses are allowed on this property
- When reporting gains, a deemed ACB and Proceeds of Disposition occurs of $1,000. Only proceeds higher than this will trigger a gain.

PUP - Example

- Michaela has several pieces of furniture that she no longer wants. She decides to sell them on eBay/Kijiji.
- Calculate the gain on sale she must report.

	Cost	FMV	Gain	Tax. Gain
Chair	500	300		
Loveseat	800	900		
Couch	2500	1500		
TV	800	1200		

PUP - Example

- Michaela has several pieces of furniture that she no longer wants. She decides to sell them on eBay.
- Calculate the gain on sale she must report.

	Cost	FMV	Gain	Tax. Gain
Chair	500	300	0	0
Loveseat	800	900	0	0
Couch	2500	1500	0	0
TV	800	1200	200	100

Listed Personal Property (LPP)

- Prints, drawings, sculptures, jewelry, rare books, stamps, coins
- Losses only deductible against LPP Gains.
- 3 year carry back, 7 year carry forward
- $1,000 floor on cost and FMV

LPP - Example

- Michaela has several collectibles that she no longer wants. She decides to sell them on eBay.
- Calculate the gain on sale she must report.

	Cost	FMV	Gain	Tax. Gain
Stamp	300	500		
Painting	15000	8000		
Sculpture	20000	23000		
Coin	900	1400		

LPP - Example

- Michaela has several collectibles that she no longer wants. She decides to sell them on eBay/kijiji.
- Calculate the gain on sale she must report.

	Cost	FMV	Gain	Tax. Gain
Stamp	300	500	0	0
Painting	15000	8000	(7,000)	(3,500)
Sculpture	20000	23000	3,000	1,500
Coin	900	1400	400	200

*Only 1,700 of taxable losses are able to be used (applied against current year gains). The remainder must be used in other years.

Superficial Losses

If a property is disposed of and 30 days before or after that disposal, an affiliated person held the same or an identical property any loss on the disposal is denied and added to the ACB of the purchaser.

<u>Examples:</u>

I sell shares of RBC, but then reacquire them in 5 days.

I sell shares of RBC but then my spouse buys some in 20 days.

I sell a piece of land to my spouse.

Superficial Losses - Example

I own shares of RBC which I bought for $1,000. I sell them for $500 on August 1. My spouse buys shares of RBC on August 20 for $2,000.

Superficial Losses - Example

I own shares of RBC which I bought for $1,000. I sell them for $500 on August 1. My spouse buys shares of RBC on August 20 for $2,000.

Someone affiliated with me (my spouse) owns identical property purchased within 30 days before or after my sale.

Therefore, my loss of $500 (1,000 cost – 500 sale price) is denied.

Spouses ACB gets increased for my denied loss $2,500 (2,000 amount paid + 500 denied loss).

Emigration/Immigration

When entering or leaving Canada permanently, an individual is deemed to dispose of all their assets at FMV except:

- Real Property (land or buildings)
- Deferred Income Plans (TFSA, RRSP, RESPs)
- Property used in active business carried on in Canada

Example

Stan is leaving Canada to work in France. He isn't certain he'll ever come back. He owns the following property when he leaves, what is his income inclusion on emigration?

	ACB	FMV	Gain	Tax Gain
Home	5,000	10,000		
Common Shares	2,000	10,000		
RRSP	3,000	7,000		
Land	10,000	25,000		

Example

Stan is leaving Canada to work in France. He isn't certain he'll ever come back. He owns the following property when he leaves, what is his income inclusion on emigration?

	ACB	FMV	Gain	Tax Gain
Home	5,000	10,000	0	0
Common Shares	2,000	10,000	8,000	4,000
RRSP	3,000	7,000	0	0
Land	10,000	25,000	0	0

Replacement Property – Real Property

Capital Gain on the disposition of property can be deferred if a similar property is purchased to replace the one disposed of.

Deferral is limited to the amount expended on the new property compared to the proceeds of the old (ie. If you spend less on the new building, you don't get to defer 100% of the old building's gain)

Replacement Property – Real Property

ACB of new property decreased by the deferral

Time limit to purchase:

Involuntary Dispositions – 24 months to buy replacement
Voluntary Dispositions – 12 months to buy replacement

Replacement Property - Shares

A similar deferral is available on the disposition of Eligible Small Business Corporation Shares (ESBC Shares) when the proceeds are invested in another ESBC.

A CCPC more than 90% of whose assets are used 50% of more of the time in active business carried on in Canada, and whose book value of assets is less than $50 million.

During the year of disposal or 120 days after year end to buy replacement shares

You must have held the shares for at least 185 days before the sale occurred.