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
- <u>Current Year Losses – Capital or Non-Capital</u>

- = 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,

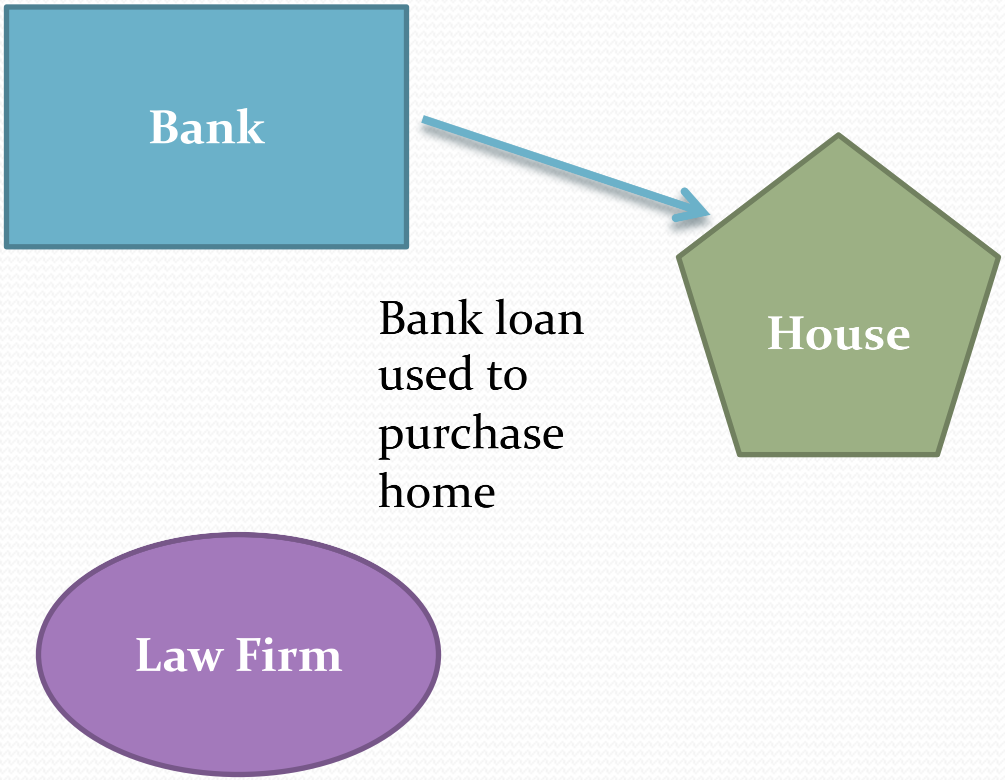
Interest Deductibility

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

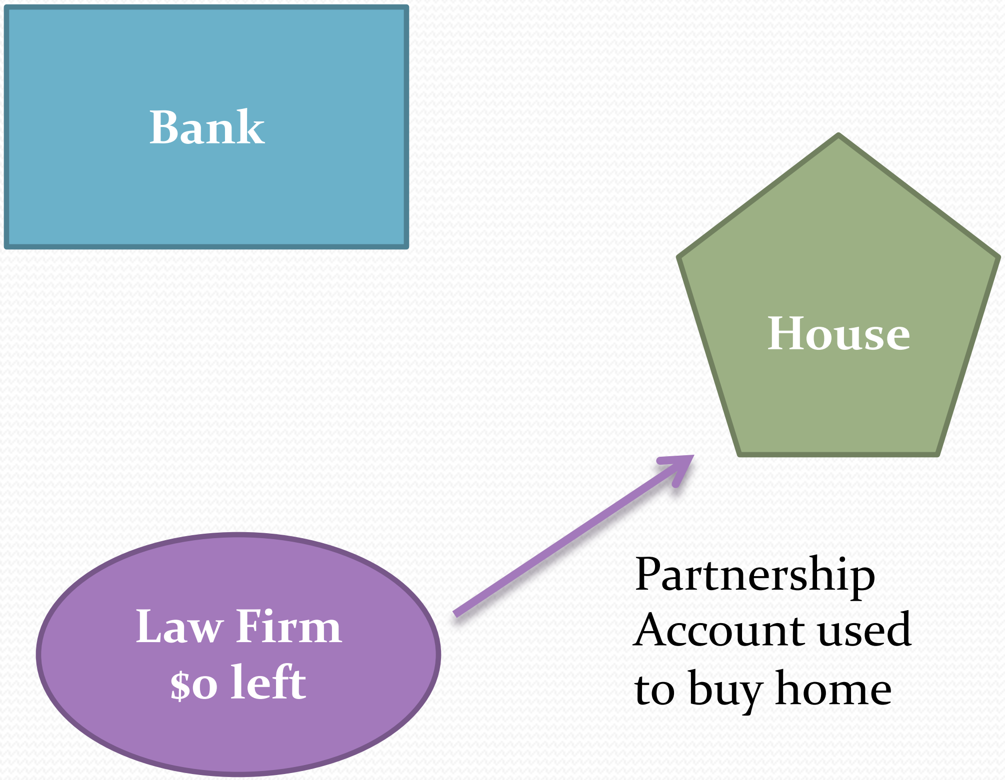
Typical Home Buying Transaction

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



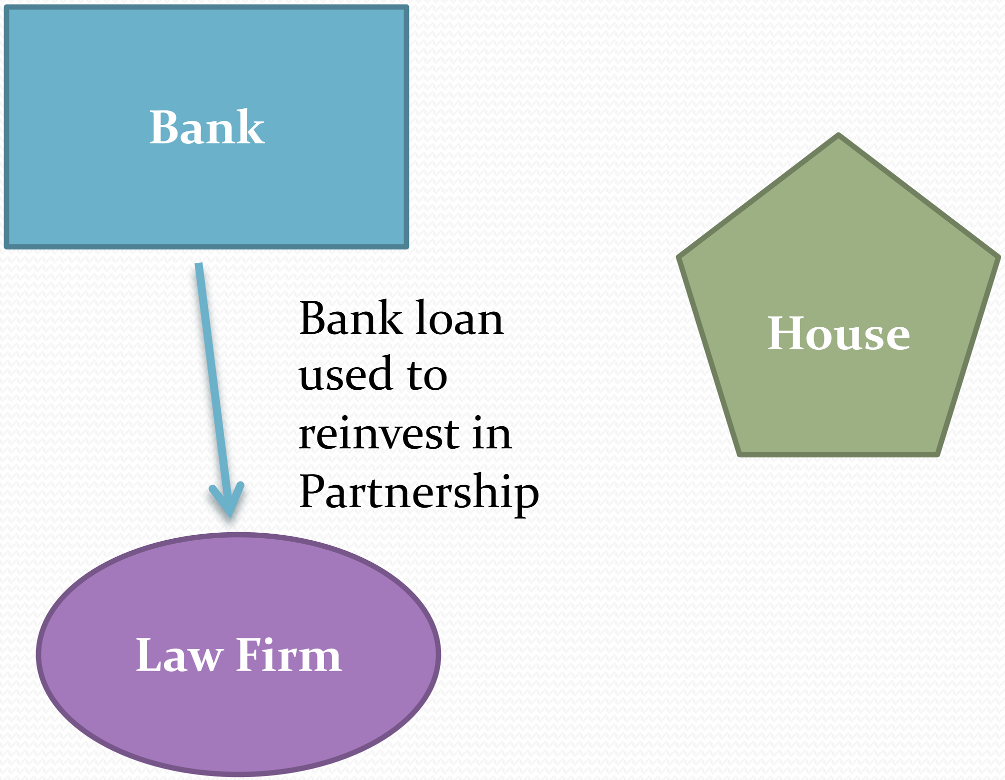
Singleton Case – Step 1

- 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.

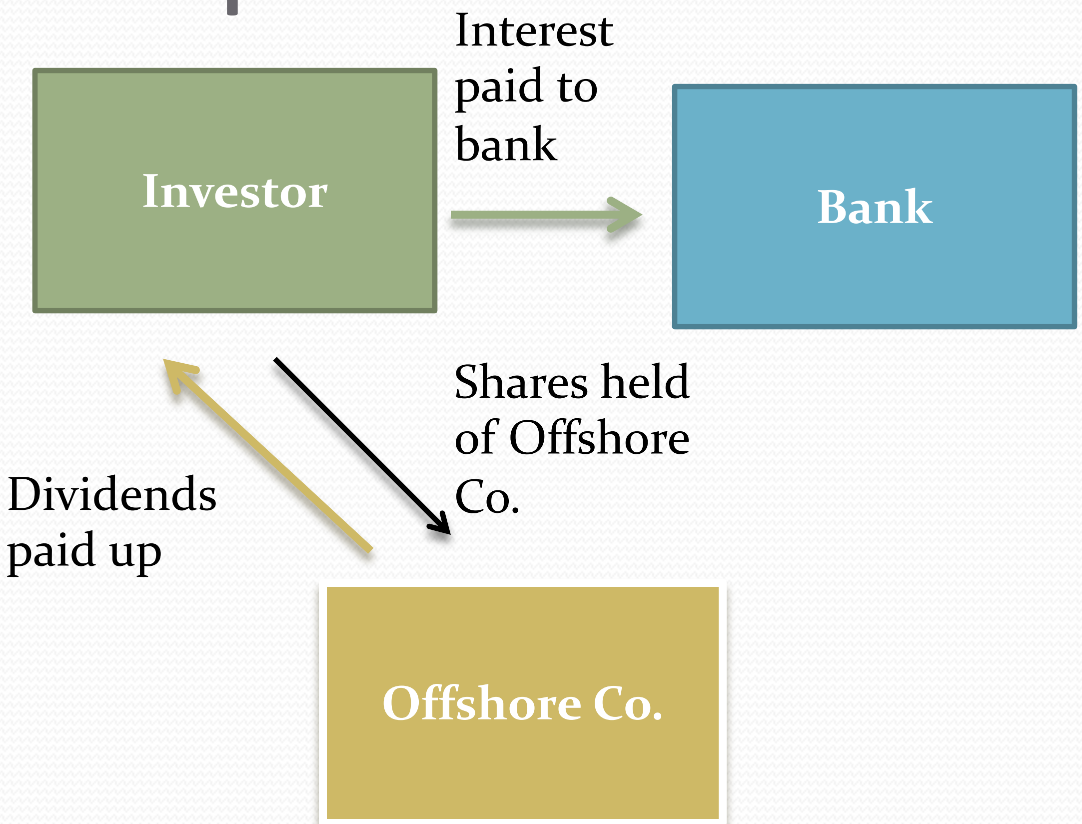


Singleton - Result

- The "<u>shuffle of cheques</u>" 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)

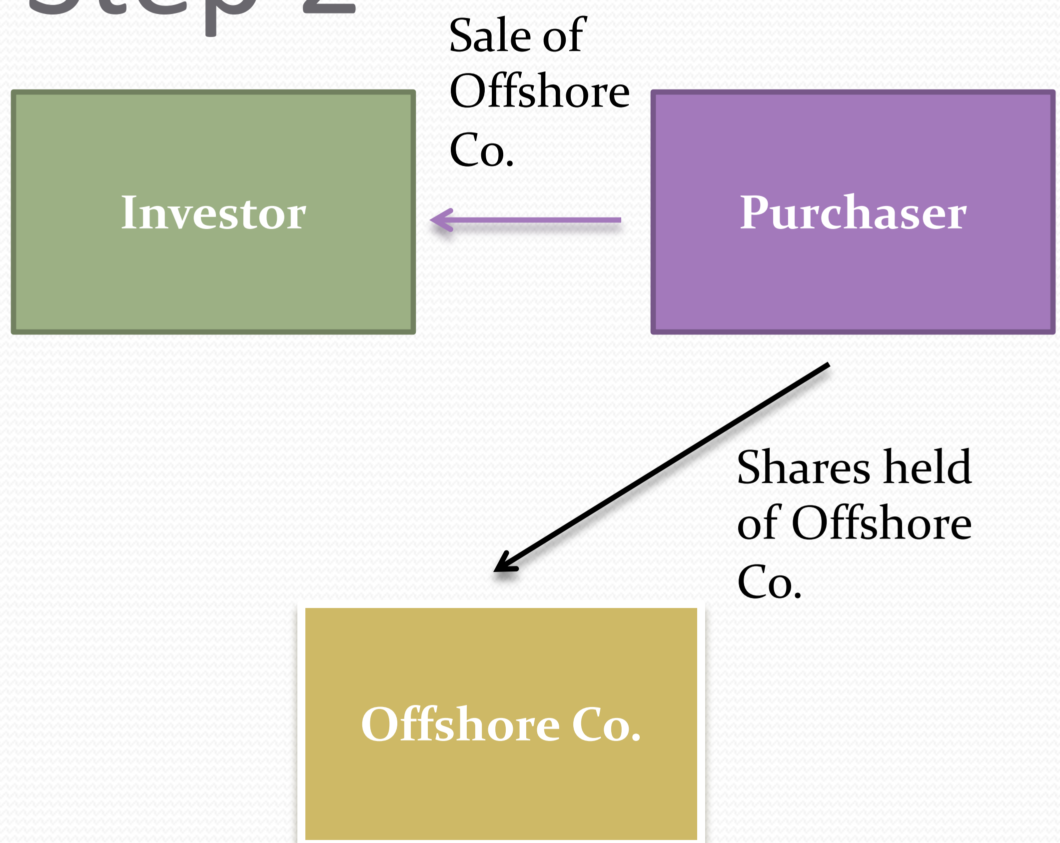
Ludco Case – Step 1

- 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

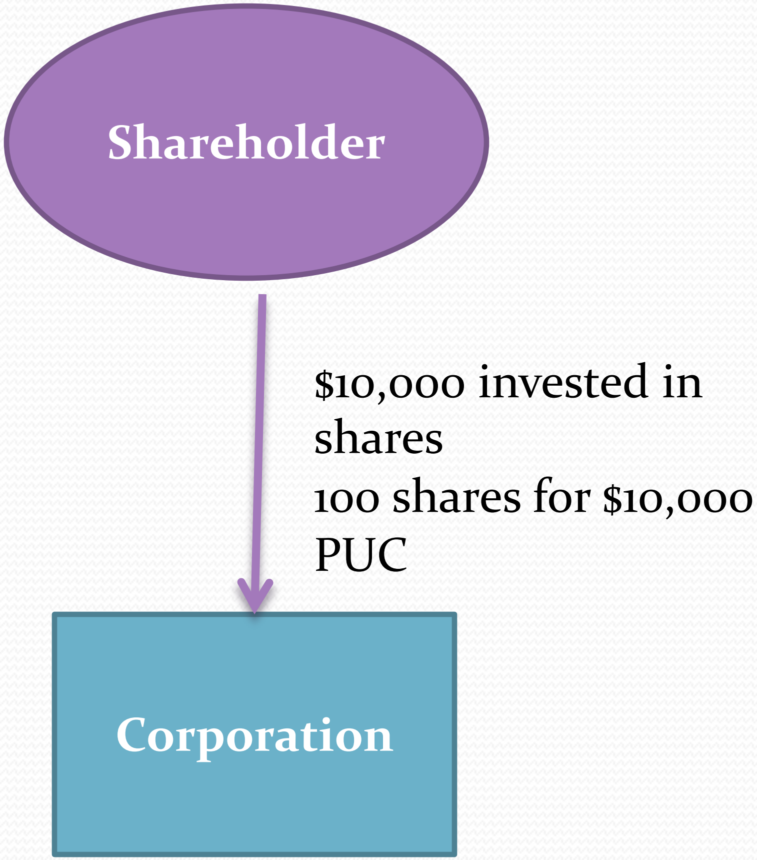
  - Return of capital limited to paid up capital of shares.
  - Redemptions and dividends limited to retained earnings left in the company

Filling the Hole – ROC Step 1

- Step 1 :

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

  Invested capital is $10,000



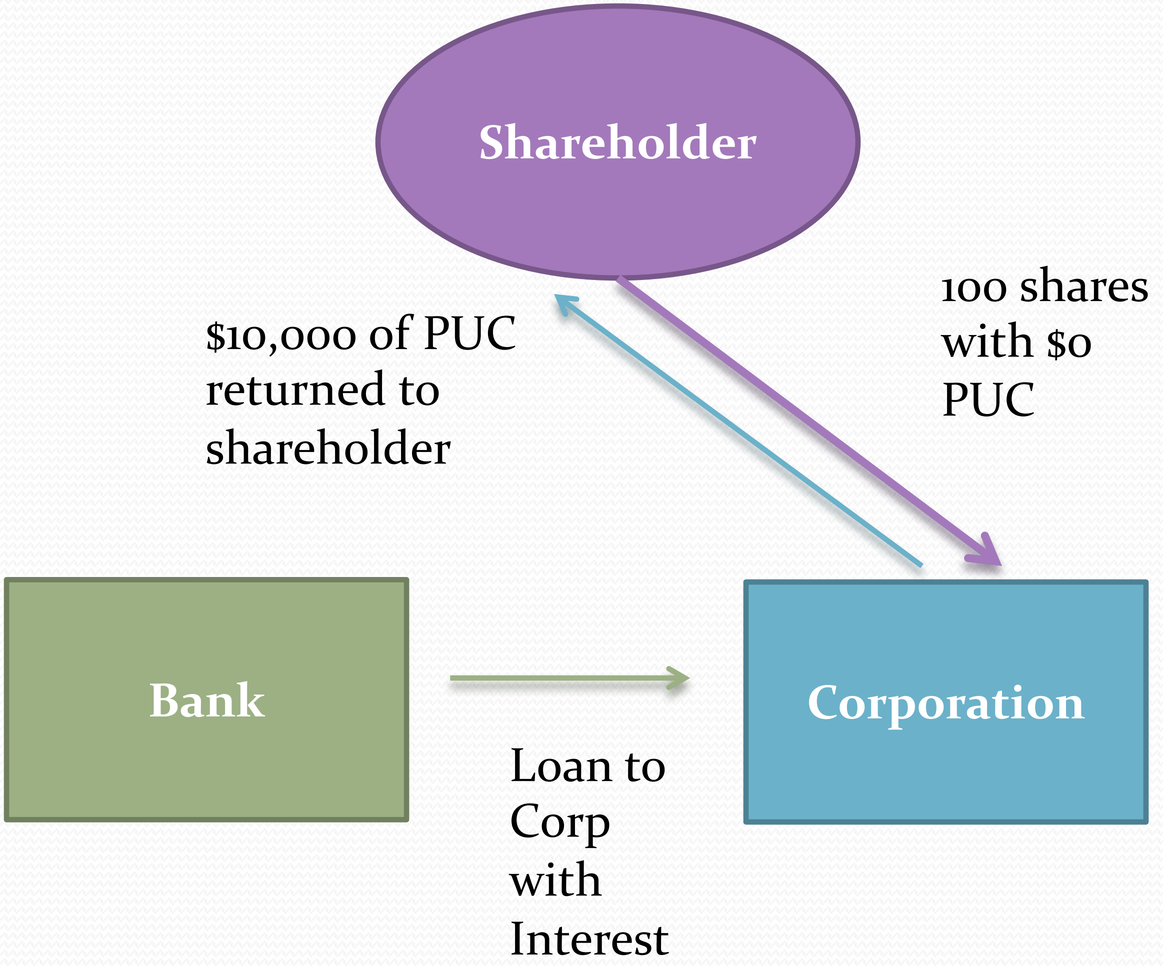
Filling the Hole – ROC Step 2

- 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.

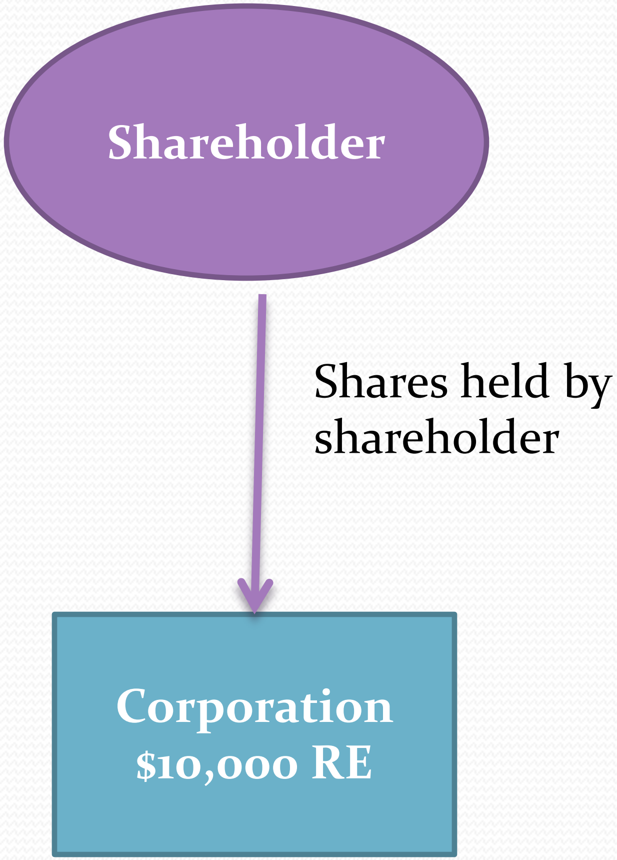
- Hence why it is called the “Fill the hole” concept. Based on replacing money, that was originally used for purposes that would cause interest to be deductible.

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



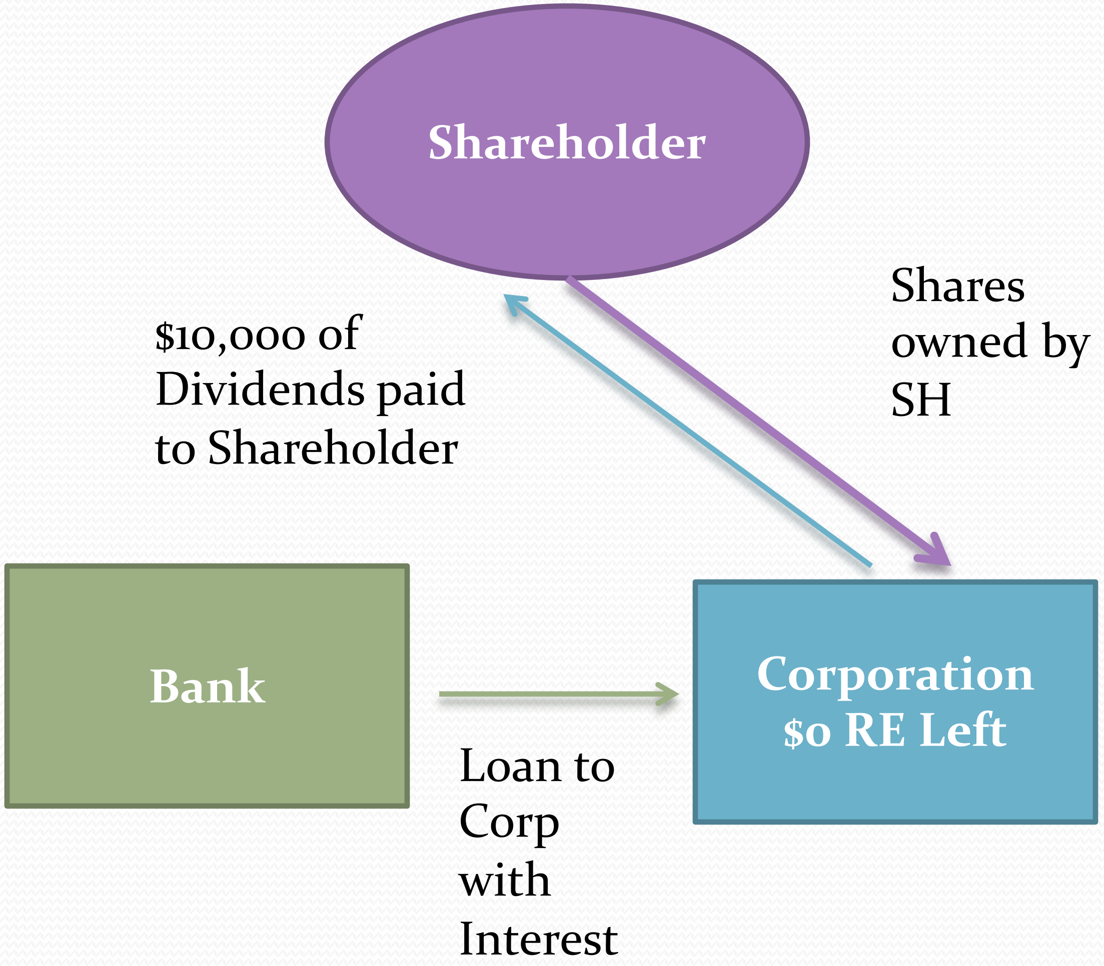
Filling the Hole – Dividend Step 2

- 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

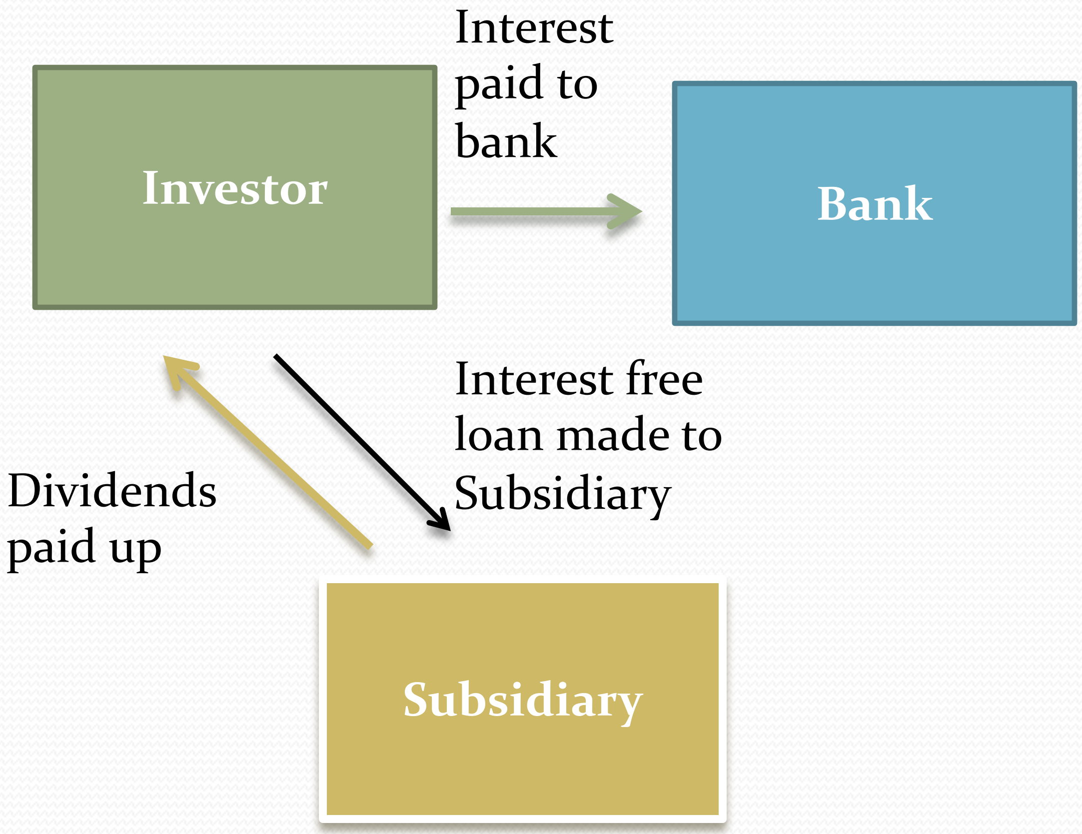
  Interest on money borrowed to make interest free loans can be deductible if income is expected to be earned another way than by interest because that loan was made

  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

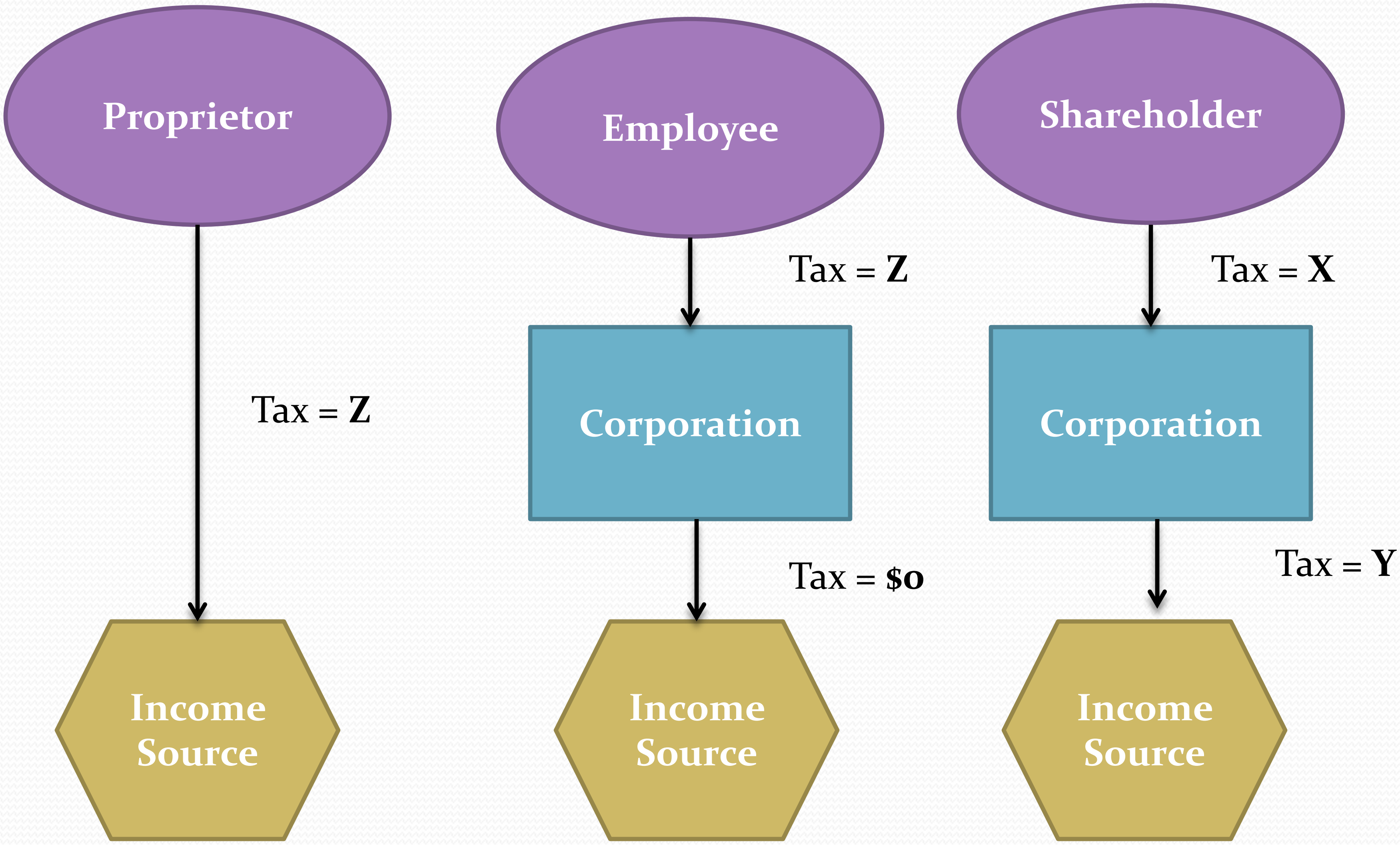
$57,600 Ending RE

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.