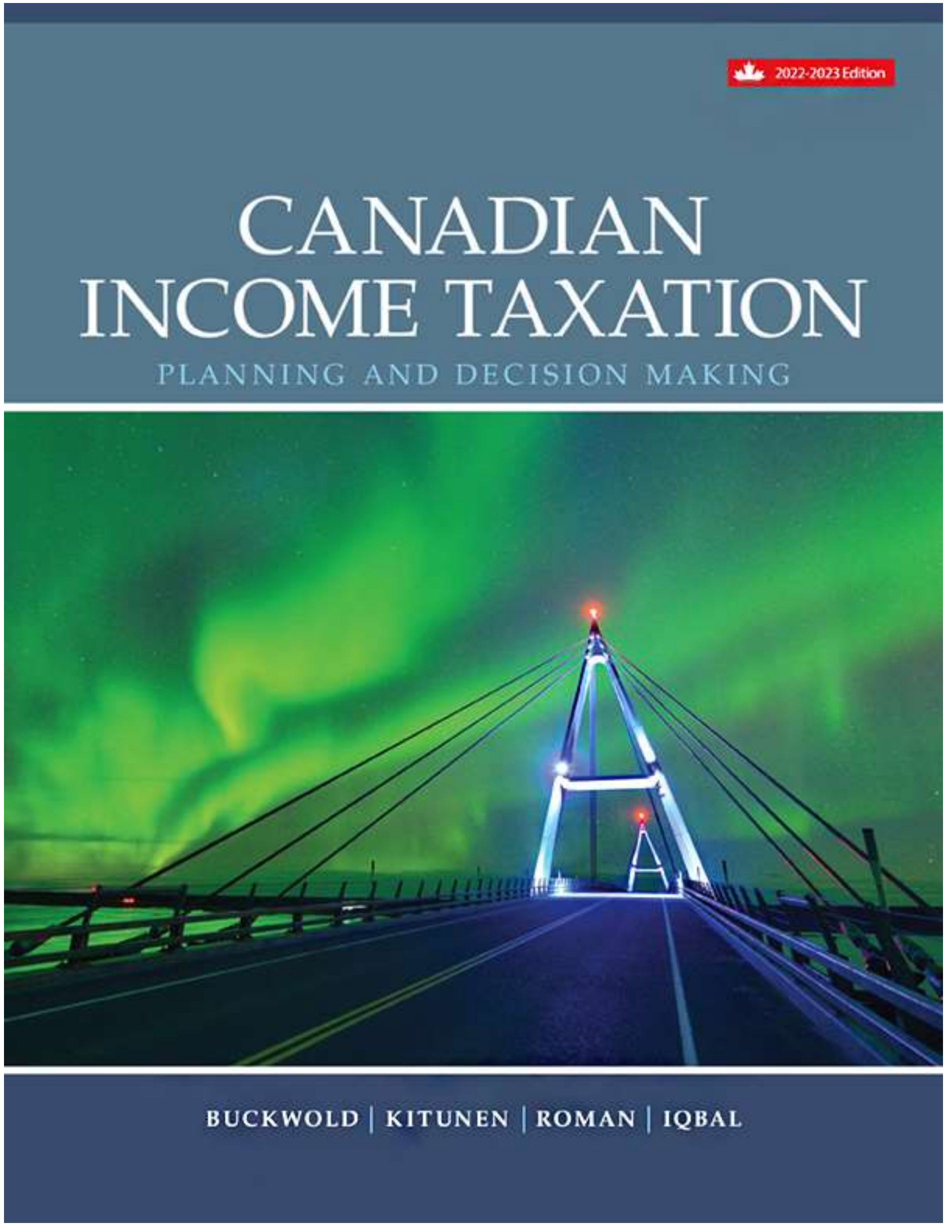


CHAPTER 1: Taxation – Its Role in Decision Making

Prepared by

Matthew Roman, CPA, MTax

KPMG, LLP

Electronic Presentations in Microsoft® PowerPoint®

Taxation – Its Role in Decision Making

I. Taxation and the Financial Decision Process

A. Taxation – a Controllable Cost

B. Cash Flow after Tax

II. The Fundamental Income Tax Structure and its Complexity

III. Conclusion

I. Taxation and the Financial Decision Process

- Businesses are subject to many forms of taxation from:
  - Municipal, provincial, federal governments
- Income tax is levied at the federal and provincial levels
  - It is the most significant form of taxation
  - Based on profits

I. Taxation and the Financial Decision Process[2]

- **Return on Investment** measured by cash-flows.
  - – Cash flows are after tax
  - – Every decision has a tax impact,
  - – That tax impact affects cash flows.

- **Ultimate Goal** – Maximization of shareholder wealth – decisions that:
  - **reduce,** or
  - **postpone (or defer)** the payment of tax.

will increase overall shareholder wealth.

I. Taxation and the Financial Decision Process[3]

- Decision-making process involves:
  - **Identifying alternative courses of action and analyzing:**
    - the short-range costs
    - long-range costs
    - benefits for each alternative

- Amount and timing of tax payable can vary significantly between alternatives.

I. Taxation and the Financial Decision Process[4]

Decision making process

Determine possible courses of action

Short-range Costs and benefits

Long-range Costs and benefits

Tax implications of each alternative.

Leads to improved cash flows and long-term maximization of value.

I. Taxation and the Financial Decision Process[5]

A. Taxation – A Controllable cost

- Considered a cost of doing business
  - Similar to other relevant costs
- Decision makers must
  - Attempt to understand and
  - Control tax costs
- Should be considered a Controllable cost

I. Taxation and the Financial Decision Process[6]

B. Cash Flow after Tax:

- All cash flow should be considered *after tax*
- **Analysis cannot be of value** without considering the tax impact
  - Positive after-tax cash flow is considered favourable
  - Managers should consider alternatives that will minimize tax
- **Failure** to take an after-tax approach:
  - May impose a permanently inefficient tax structure
  - May result in an unfavourable decisions that appeared favourable on a pre-tax basis.

I. Taxation and the Financial Decision Process[7]

Consider the cost of an 8% wage increase:

Employer:	**Employee:**
27% tax rate	50% tax rate
5.8% after tax cost	4% after tax value

The real cost to one party is different from the real benefit to the other.

II. Fundamental Income Tax Structure and its Complexity

Major variable in decision making:

1. **Taxpayer – three entities:**
    i. Individuals
    ii. Corporations
    iii. Trusts

2. **Types of income:**
    i. Business
    ii. Property
    iii. Employment
    iv. Capital Gains

II. Fundamental Income Tax Structure and its Complexity[2]

Major variable in decision making (cont'd):

3. **Business and Investment Structures:**
   i. Proprietorship
   ii. Corporation
   iii. Partnership
   iv. Limited Partnership
   v. Joint Arrangement
   vi. Income trust

4. **Tax Jurisdictions:**
   i. Provincial
   ii. Federal
   iii. Foreign

II. Fundamental Income Tax Structure and its Complexity[3]

Business Income

Alternative Structure

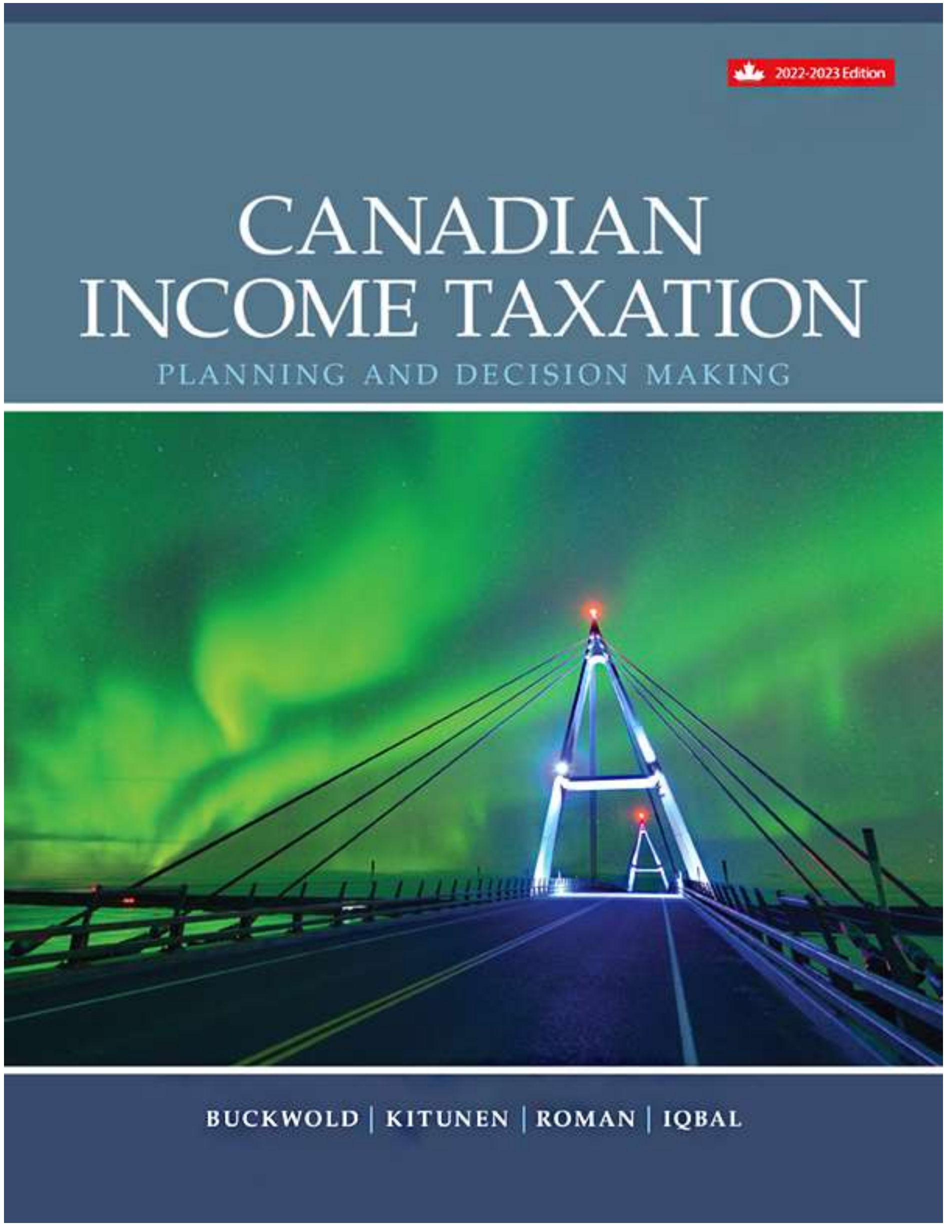
Partnership

Corporation

Joint Arrangement

Conclusion

- Taxation is a major variable that must be included in all financial decisions
  - **Cannot be ignored simply because it seems too complex.**
- Taxation as part of the formal decision making process will improve cash flows.



CHAPTER 2: Fundamentals of Tax Planning

Prepared by
Matthew Roman, CPA, MTax
KPMG, LLP

Electronic Presentations in Microsoft® PowerPoint®

Fundamentals of Tax Planning

I. What Is Tax Planning?

II. Types of Tax Planning

III. Skills Required for Tax Planning

IV. Restrictions to Tax Planning

A. Shifting Income from One Time Period to Another

- In most cases, there is little opportunity to choose between discretionary alternatives.

- Can sometimes choose between alternatives:
  - i.e. Reserves - can choose to claim a deduction from income in a different time period.

- Must consider future tax rates in the decision to shift income.

A. Shifting Income from One Time Period to Another2

Future tax rates may be greater than, less than, or the same as current tax rates.

Current tax rate lower than future tax rate	Current tax rate higher than future tax rate
↓	↓
Tax savings to recognize income now vs. later	Tax cost to recognize income now vs. later

Also consider finance costs to pay tax now rather than later

Shifting Income Example

The following is tax information for ABC Corp.

- Tax rate on income < $500,000 13%
- Tax rate on income > $500,000 27%
- Year 1 income after reserve = $150,000

  ($20,000 reserve can be delayed to Year 2)
- Year 2 income is estimated to be $550,000
- Cash is being used to take advantage of 2% early payment discounts (assume equivalent to an annual rate of 36%)

Determine the ultimate tax savings from shifting the reserve to Year 2.

Shifting Income Solution

If the $20,000 reserve is deducted in Year 2 instead of Year 1, income is shifted from Year 2 to Year 1.

Increase in Year 1 tax ($20,000 x 13%)	$ 2,600
Decrease in Year 2 tax ($20,000 x 27%)	(5,400)
Tax reduction	$(2,800)

Shifting Income Solution2

- Must also consider the financing cost of prepaying $2,600 tax one year in advance
- Purchasing costs would increase by $936 ($2,600 x 36%)
- These costs would be deductible and save tax of $253 ($936 x 27%)
- Therefore, the net cost, after-tax is $683
- Overall savings:

Tax savings	$2,800
Finance cost of prepaying tax	(683)
	$2,117

A. Shifting Income from One Time Period to Another

In making a decision to shift income, must determine:

- Future tax rates
- Discretionary opportunities within the Tax Act (i.e. reserves)
- Time value of money

B. Transferring Income to Another Entity

- **Individuals can accumulate wealth by using one or more different entities:**
    - Corporations, proprietorship, partnerships, trusts, etc.
- The tax treatment varies with the entity chosen.
- Ultimately, the wealth leads back to the individual or family members.
- Shifting income to a different structure

  may reduce or significantly delay tax payable.

B. Transferring Income to Another Entity[2]

For example:

- An individual may run a business through a corporation or as a sole-proprietor.
- Individual needs $40,000 after-tax
- Corporate tax rates – 13% on first $500,000; 27% on excess
- **Personal tax rates:**

First $50,000	20%
Next $50,000	30%
Next $56,000	40%
Next $66,000	45%
Income over $222,000	50%

B. Transferring Income to Another Entity[3]

	Unincorporated		**Incorporated**
Business profits	$100,000	Bus. Profits Less Salary	$100,000 (50,00)
Taxes (20% of 50,000; 30% of 50000)	(25,000)	Corporate Taxes (13%)	(6,500)
Personal expenses	(40,000)		
After-tax cash flows	$35,000		$ 43,500

Incorporation provides an extra $8,500 available for expansion

B. Transferring Income to Another Entity[4]

Other factors to consider:

- Future requirements for cash distributions from corporation
- Corporate profits in excess of $500,000 incur higher rates of tax
- Losses incurred in corporation
- Business failure, Sale of business, etc.
- Shareholder dies or leaves the country

Tax planning involves anticipating possible future events.

C. Converting Income from One Type to Another

Four basic types of income:

1. Employment (Chapter 4)
2. Business (Chapter 5)
3. Property (Chapter 7)
4. Capital gains (Chapter 8)

Amount & timing of taxable income to be reported depends on the type of income.

C. Converting Income from One Type to Another[2]

- Can alter the amount of tax and its timing by adjusting a financial transaction to generate a different type of income.
- **It is not always simple to convert one type of income to another.**
  - converting income may also involve shifting that income from one entity to another.
- May also consider converting costs to acquire goods or services from one type of expenditure to another

III. Skills Required for Tax Planning

- **Anticipation** – envision the complete cycle
- **Flexibility** – seek out alternative methods
- **Speculation** – anticipate tax effects
- **Application of compound interest**
- **Perspective** – common sense must prevail
- **Global approach** – consider all sides

IV. Restrictions to Tax Planning

- Tax planning is divided between acceptable and unacceptable activities.
- The *Income Tax Act* specifically prohibits a number of activities.

anti-avoidance rules

IV. Restrictions to Tax Planning[2]

A. Specific Anti-Avoidance Rules:

- Two general types of financial transactions:
  - Between parties with a close relationship (not at arm's length), and
  - Between parties completely independent of each other
- Authorities are more concerned with those not at arm's length
  - Several provisions have been designed to limit tax avoidance activities

IV. Restrictions to Tax Planning[3]

B. The General Anti-Avoidance Rule (GAAR)

- When a person is involved in a tax "avoidance transaction";
- Receives a "tax benefit"; and
- There has been a "misuse or abuse" of the Income Tax Act,

the tax will be adjusted to deny the benefit. [245(2)]

Not an avoidance transaction if,

– Its primary objective is other than to obtain a tax benefit.

– Undertaken primarily for bona fide business, investment or family purposes. [245(3)]

Establishes a business purpose or economic reality test

– Helps distinguish between unacceptable and acceptable planning activities.

IV. Restrictions to Tax Planning[4]

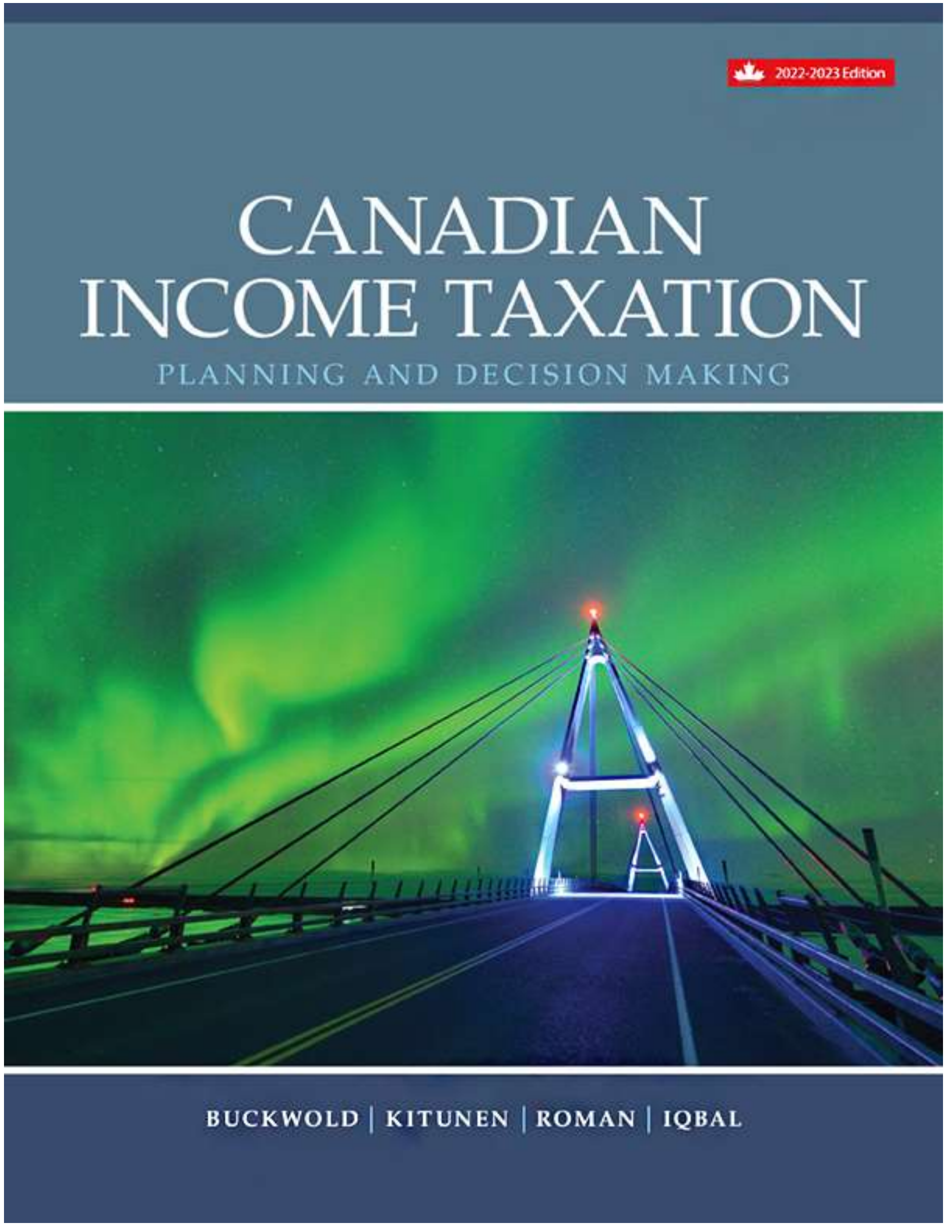
For a tax plan to be rejected it must:

- Fail the business purpose test and,
- Must be extreme - that it is not within the "spirit" of the tax system. [245(4)]

Conclusion

- **Tax Planning** – conscious effort to direct financial activities to eliminate, reduce, or defer tax
  - There is some flexibility in the tax system
  - Planning activities must be consistent with prudent business activities.

- Good tax planning involves applying business basics.



CHAPTER 3:
Liability for Tax, Income Determination, and Administration of the Income Tax System

Prepared by
Matthew Roman, CPA, MTax
KPMG, LLP

Electronic Presentations in Microsoft® PowerPoint®

Liability for Tax and Income Determination

I. Sources of Canadian Tax Law

II. Liability for Tax

III. Determination of Income

IV. Administration of the Income Tax System

I. Sources of Canadian Tax Law

Three sources that govern tax law in Canada:

1. Statute law:
    - Federal income tax system – The *Income Tax Act*
    - Separate provincial *Income Tax Act*
    - GST/HST - *Excise Tax Act*

2. Common law:
    - Supreme Court of Canada
    - Federal Court of Appeal
    - Tax Court of Canada

3. International tax treaties

Common Law

- **Is an integral source of tax law.**
  - Disputes regarding the application and interpretation of the *Income Tax Act* are often settled in the Canadian court system.

- **Sufficient jurisprudence helps define and interpret tax laws.**
  - Jurisprudence is now the primary source of definitions and interpretations.

International Tax Conventions

- Canadian taxpayers often earn income in foreign jurisdictions that also impose income tax
- Foreign entities also engage in income earning in Canada
- Reciprocal tax treaties with foreign countries exist in order to:
  a) rationalize and define the jurisdictional authority; and,
  b) avoid the incidence of double taxation.
- Treaties takes precedence over *Income Tax Act*

I. Sources of Canadian Tax Law 2)

- Federal tax law is the responsibility of the Department of Finance.
- Assessing and collecting tax is the responsibility of Canada Revenue Agency ("CRA").

Interpretation Bulletins, Income Tax Folios and Information Circulars

- In order to assess tax, CRA must interpret the law.
- CRA publishes its interpretation of the tax laws in two forms:
  - Interpretation Bulletins (being replaced by **Income Tax Folios)**
  - Information Circulars
- The interpretations/folios published by CRA are not law and can be disputed through the court system.

II. Liability for Tax

A. The Entities

- Federal and provincial income taxes are imposed on:
  - Individuals
  - Corporation
  - Trusts

- Other forms of business such as proprietorships, partnerships and joint ventures are not directly taxed.

Corporations

- An artificial person
- Has same legal rights and responsibilities as an individual.
- Its affairs are formally separate from its owners (i.e.. shareholders).
- For tax purposes, corporate profits earned or losses incurred belong to the corporation.

Corporations[2]

- Individual shareholders will realize profits by receiving dividends and/or selling shares

- Individual and corporations are separate taxable entities
  - Ultimate recipient of profit and cash flow is the individual

- Separate taxation of the two entities is temporary and ultimately will be integrated

B. Resident Individuals and Corporations

- Residency is the primary factor in determining how an entity is taxed in Canada.
- Subject to tax if considered resident in Canada.
- Residents subject to tax on worldwide income. [2(1)]
- Non-resident entities are only taxable on income earned in Canada. [2(3)]

1. Individuals

- The concept of "residency" is not defined in the *Act*.
  - must maintain a "continuing state of relationship" with the country.
- "Residence" for tax purposes is not:
  - the same as domicile, or
  - citizenship.

Individuals - Residency

- Being present in the country indicates a state of relationship, but it is only one of a number of factors that are considered (next slide).
    - question of fact whether one is resident or not, and
    - each case is judged on its own special circumstances.

Individuals – Residency[2]

- **Factors to consider in determining residency:**
  - ➢Amount of time spent in Canada on a regular basis
  - ➢Motives for being present or absent
  - ➢Maintenance of a dwelling place in Canada
  - ➢Origin and background of the individual
  - ➢General mode and routine of one’s life
  - ➢Existence of social and financial connections with Canada.

Individuals – Residency[3]

“Sojourner”

- An Individual who is not resident (no continuing state of relationship), but
- Spends more than 182 days in Canada in a calendar year is deemed resident for the entire year. [250(1)]

- Residency is determined on a year-to-year basis.

Individuals – Residency[4]

- Exceptions to being resident for the entire year are:
  - If at some time in the year, an individual severs all ties (emigrates), or
  - When a non-resident establishes new ties with the country (immigrates)

- Resident only for the relevant part of the year

- Taxed on world income for that part of the year [114]

2. Corporations

- **Corporations incorporated in Canada are residents of Canada** [250(4)]
  - – subject to tax on world income [2(1)]
- Foreign corporation may be Canadian resident if “central management and control” is exercised from within Canada.

3. Dual Jurisdictions

- May be subject to tax in a foreign jurisdiction if carry on business outside of Canada.
- The treaty may limit Canada's right to tax.
- May be subject to taxation in both jurisdictions; if so, the *Income Tax Act* generally allows a foreign tax credit.

C. Non-Resident Individuals and Corporations

- Non-residents of Canada are taxable on specific activities.
  1. Income reportable on a Canadian tax return, and
  2. Income subject to withholding tax

1. Income reportable on a Canadian tax return

- **Taxed in Canada on net income arising while non-resident if:** [2(3)]
  - carries on business in Canada (through a Permanent Establishment);
  - disposes of Taxable Canadian property; or,
  - is employed in Canada.

2. Income Subject To Withholding Tax

“Withholding Tax”

- Tax on amounts originating in Canada but paid to a non-resident.
- General rate is set at 25% by the *Act*. [212(1),(2)]
- Most tax treaties have reduced the rate to 5%, 10%, or 15% on most types of revenues.

2. Tax on Canadian Source Income

- **Major types of payments subject to withholding tax are:**
  - Dividends [212(2)]
  - Rents [212(1)(d)]
  - Royalties [212(1)(d)]
  - Pension benefits [212(1)(h)]
  - Certain management and administration fees [212(1)(a)]
  - Interest (only if paid to non-arms length (related) party) [212(1)(b)]

D. Decision Making and the Residence Issue

- Determining who is liable for tax in Canada impacts decisions about investing abroad or expanding to international markets

- **Create a structure that will**
  - meet business objectives with minimum cash, and
  - permit maximum repatriation of funds for reinvestment

III. Determination of Income

- Each entity is required to pay tax on its taxable income in each taxation year.

- What is taxable income?
  - The *Act* does not specifically provide a single definition of income
  - Instead, it more closely resembles a framework

A. The Taxation Year

- Corporate taxpayers can choose the taxation year.
  - Regarded as its fiscal period [249(1)(a)]
  - A taxation year cannot exceed 53 weeks [249.1(1)(a)]
  - Once chosen, it must continue with that same period unless concurrence is given by CRA [249.1(7)]
  - May be less than 12 months in particular situations.
  - Exception is Professional Corps carrying on business as a member of a professional partnership – fiscal year must coincide with calendar year [249.1(1)(b)]

- Individual taxpayers
  - Tax year = calendar year [249(1)(c)]

B. Types of Income

- **An entity's world income is derived from five basic sources:**
    1. Employment income
    2. Business income
    3. Property income
    4. Capital gains
    5. Other specific sources

- Income is determined by applying basic principles specific to the particular category.

C. Net Income for Tax Purposes

- Aggregating the five types of income included
  - Often referred to as the “statutory scheme”
  - Referenced to *section 3* of the *Income Tax Act*
  - The same formula is used by both individuals and corporations

Formula - Net Income for Tax Purposes

3(a) Income from all sources	+
3(b) Taxable capital gains	+
3(c) Other deductions	-
3(d) Losses from all sources	-
Net income	+ or 0
Division C deductions	-
Taxable Income	+ or 0

Paragraph 3(a)

3(a) Employment income	+
Business income	+
Property income	+
Other items of income	<u>+</u>
Income from all sources	+ or 0

Paragraph 3(a) [2]

- The reference to income is for *net income* from each source
  - Example:

Business Income = Gross Revenue – Expenses

- Each category of income may have more than one source within it.

- Includes only positive net income.
  - Any source resulting in net loss is included later in the formula at paragraph 3(d)

Paragraph 3(b)

This section deals exclusively with capital property

Taxable Capital Gains	+	
Taxable Net Gains from listed personal property (chapter 8)	+	
exceed		
Allowable Capital Losses	-	<u>+ or 0</u>
Subtotal must be positive or Zero		+ or 0

Paragraph 3(b) 2

- **This segment applies only when total capital gains for a year exceed total capital losses for that year**
  - Capital losses cannot be used to offset any other source of income included in paragraph 3(a)
  - Unused capital losses are available in other years if other capital gains are realized

- Only one-half of the actual capital gains and losses are applicable for tax purposes

Paragraph 3(c)

- **"Other items of deduction" are subtracted at this point:**
  - RRSP contributions
  - Moving expenses
  - etc.
- These items can be offset against any form of income.
- These deductions cannot exceed the total of income included to this point.

Paragraph 3(d)

Employment losses	-	
Business losses	-	
Property losses	-	
Allowable business investment losses	-	<u>- or 0</u>

Allowable Business Investment Loss

- A loss on the sale of shares of a small business corporation

  or

- A loss on a loan to a small business corporation [39(1)(c)]

- Although capital in nature, it is given a special category

- Inclusion in paragraph 3(d) means that this type of loss **can be offset against all other sources of income**
  - Capital losses in 3(b) can only be used against capital gains.

D. Taxable Income

- Net income for tax purposes is reduced by limited number of Division C deductions to arrive at taxable income.

- The items that reduce net income for tax purposes to taxable income are different for individuals and corporations.

Division C Deductions Applicable to Individuals

- Unused losses of other years [111(1)]
- Employee stock option deductions [110(1)(d), (d.1)]
- Capital gains deduction on certain property [110.6]

Division C Deductions Applicable to Corporations[2]

- Charitable donations [110.1]
- Unused losses of other years [111(1)]
- Dividends from Canadian corporations [112(1)]
- Dividends from foreign affiliates [113(1)]

IV. Administration of the Income Tax System

A. Tax Returns – filing due date:

1. Corporations – 6 months after taxation year ends [150(1(a)]

2. Individuals:
   - April 30
   - June 15 – if individual (or spouse) carries on a business [150(1)(d)]

   Deceased Individuals due the later of:
   - 6 months from date of death, or
   - Normal filing deadline (April 30 or June 15) [150(1)(b)]

3. Trusts – 90 days after taxation year ends [150(1)(c)]

Tax Returns Filed Electronically – not filed until CRA acknowledges receipt

B. Assessment

- After receiving a return, CRA is required to assess it within a reasonable time.

  - usually means within two weeks to four months of the date the return was filed

  - Means CRA may scrutinize the calculations later

B. Assessment[2]

CRA has the right to reassess returns at a later time, subject to limitations:

- individuals, trusts and CCPCs - within three years of original assessment [152(3.1)(b)]
- For public corporations & mutual funds extended to four years [152(3.1)(a)]

Reassessment period extended where:

- taxpayer has made any:
  - misrepresentation that is attributable to neglect, carelessness, or wilful default, or has committed any fraud in filing the return or supplying information. [152(4)]

OR

- taxpayer has signed a waiver. [152(4)]

C. Objection and Appeal

- **Taxpayers can appeal an assessment they do not agree with:**
  - The first step is to request a formal review of the items in dispute by filing a **notice of objection** with the CRA.
  - The objection must be filed within 90 days of the mailing date on the Notice of Assessment or Reassessment. [165(1)(b)]
  - For individuals, the deadline is extended to one year after the filing-due date for the year, (whichever is later). [165(1)(a)]

C. Objection and Appeal[2]

- Unsatisfactory results of this first appeal (notice of objection) may be appealed to the Tax Court of Canada.
- **Still not satisfied then appeal to:**
  - the Federal Court of Canada, and
  - perhaps to the Supreme Court of Canada.

D. Payment of Tax – Individuals

- Pay tax on certain income when received:
  - E.g.: Employers are required to withhold and remit tax to CRA on employee's behalf. [153(1)]
- Other types of income, tax payments must be made on an instalment basis.

D. Payment of Tax – Individuals[2]

- Instalments are required when tax owing exceeds $3,000 for both:
  - – the current year and
  - – one of the past two taxation years. [156.1(1)]

- Instalments are due quarterly: [156(1)]
  - March 15
  - June 15
  - September 15
  - December 15
- The balance of taxes payable is due on April 30. [248(1) – *balance-due day* definition]

D. Payment of Tax – Individuals[3]

Instalment alternatives: [156(1)]

1) 4 instalments of ¼ of estimated tax payable for the current year

2) 4 instalments of ¼ of tax payable for the preceding year

3) 2 instalments of ¼ of tax payable for the 2nd preceding year +
   2 instalments of ½ of (tax payable for the preceding year – 1st two instalments)

D. Payment of Tax - Corporations

- Instalments are required when federal tax owing exceeds $3,000 for both:
  – the current year and
  – preceding year. [157(2.1)]
- A corporation must make 12 instalments per year
  - Due on the last day of each month. [157(1)]
- Monthly instalments are equal to 1/12 of prior year's tax owing.
  - Can choose to base first two monthly instalments on the tax for the 2nd prior year, and make up the difference in the following 10 instalments. [157(1)]

D. Payment of Tax – Corporations[2]

- Balance owing is due **two** months after taxation year-end. [157(1)(b); 248(1) – *balance-due day* definition]
- Extended to **three** months for a **CCPC** if:
  - the small business deduction was claimed for the current or preceding year, and
  - taxable income does not exceed the $500,000 annual business limit for the preceding year. [157(1)(b); 248(1) – *balance-due day* definition]

D. Payment of Tax - Payroll Taxes

- Employers are required to deduct CPP, EI and income tax from remuneration
  - Must remit to CRA (depending on average monthly remittances)
    - *Less than $3,000* (and perfect compliance history): due 15th of month following each quarter
      - New employer without a compliance history can also pay quarterly
    - *Less than $25,000*: 15th of the following month
    - *$25,000 – 100,000*:
      - 25th for remuneration paid in month before 16th
      - 10th of the following month for remuneration paid on the 16th to the end of the month
    - *$100,000 or more*: 3 workings days following the 7th, 14th, 21st and last day of the month.

D. Payment of Tax – Interest on Overdue Taxes

- CRA charges interest on any tax that is due and payable but not paid.
- Interest is charged on late or deficient tax instalments.
- Interest rate is prescribed by the regulations and is adjusted quarterly. [161(1)]
  - The rate for the first two quarters of 2021 was **5%**
  - Not deductible for tax purposes. [18(1)(t)]

D. Payment of Tax - Refund Interest

- CRA pays corporations refund interest calculated at the prescribed rate for taxable benefits.
  - Interest starts accruing 120 days after the corporation’s year end (if the tax return is filed on time).
  - Rate is **1%** compounded daily for first quarter of 2022

- CRA pays individuals refund interest calculated at the prescribed rate for taxable benefits + 2%.
  - Interest starts accruing May 31st (if the tax return is filed on time).
  - Rate is **3%** compounded daily for first quarter of 2022

E. Penalties and Offences

- Failure to file an annual return:
  - **5%** of the tax unpaid for the year, **plus 1%** for each complete month after the due date, to a maximum of 12 months. [162(1)]
- Repeated failures to file an annual return:
  - 10% on a second or further late filing.
  - increased by 2% for each complete month after the due date, for a maximum of 20 months. [162(2)]

E. Penalties and Offences[2]

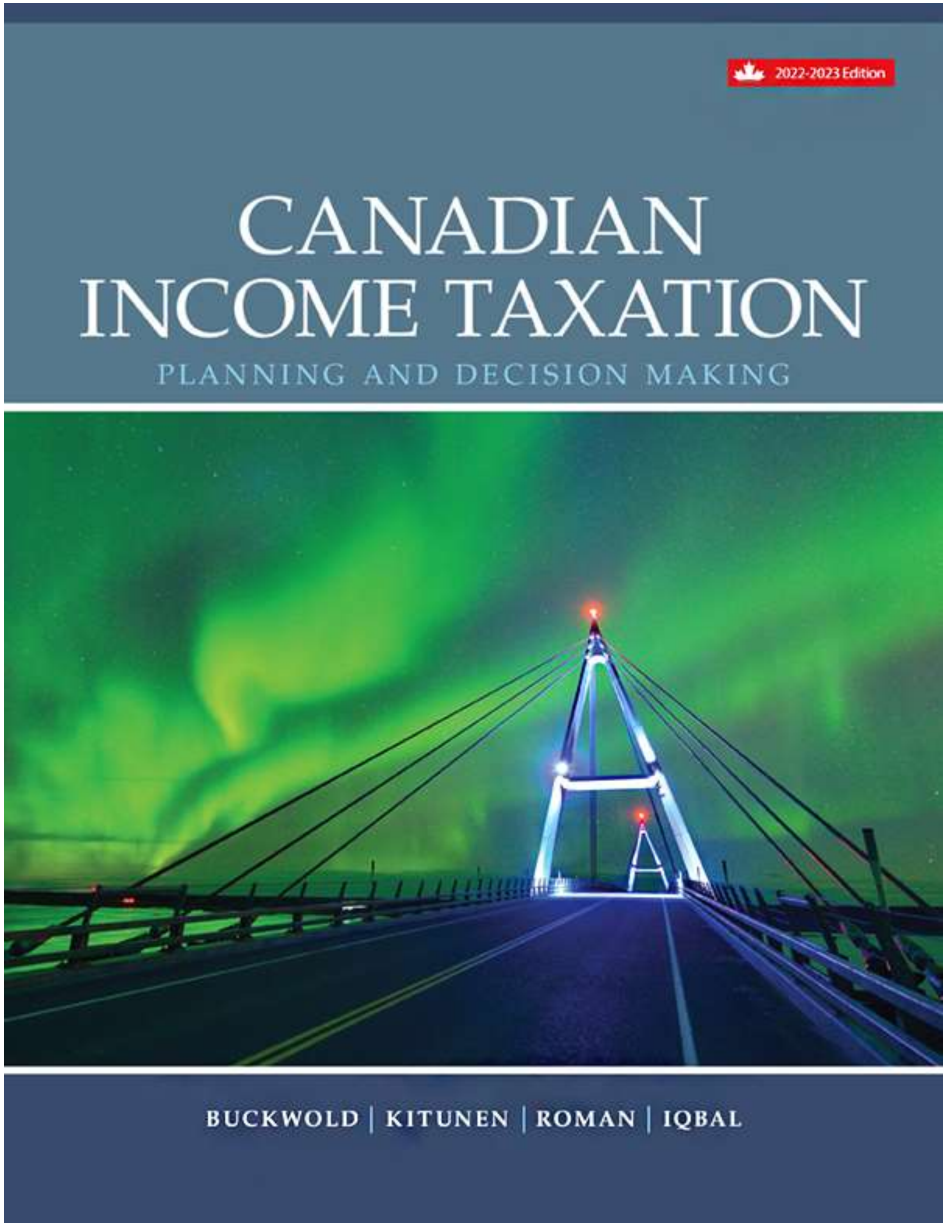
- Failure to report an item of income:
  - Lessor of:
    - 10% of the unreported income and
    - 50 percent of the difference between the understatement of tax related to the omission and tax paid in respect of the unreported income [163(1),(2)]
- Knowingly making a false statement or omission:
  - 50% of the tax owing on the excluded or understated amount [163(2)]

E. Penalties and Offences[3]

- Late or insufficient instalments:
  - Penalty applies to deficient installments greater than $1,000 [163.1]
- Misrepresentations of a tax matter by a third party:
  - Third parties includes tax preparers, advisors, etc.
  - Civil penalties where third parties cause or assist to cause others to misrepresent their tax owing
  - Range from $1,000 to $100,000 plus the preparer’s fee [163.2(2) & (4)]

Retention of Books & Records

- Books and records must be kept for **six years** from the end of the taxation year to which they relate. [230(4)]



CHAPTER 4: Income from Employment

Prepared by
Matthew Roman, CPA, MTax
KPMG, LLP

Electronic Presentations in Microsoft® PowerPoint®

Income from Employment

I. Scope and Structure of Employment Income.
II. Cash Basis.
III. Employee Benefits.
IV. Allowances.
V. Deductions from Employment Income.
VI. Employment Income and the GST/PST/HST.
VII. Efficient management of Employee Compensation

I. Scope and Structure of Employment Income

Definition of "Employed"

- not defined within the *Act* and therefore rests on common law decisions

Normally considered employed:

- ➢when agree to provide services,
- ➢at the full direction and control of the employer,
- ➢in return for a specific salary or wage.

Independent Contractor

- May provide services to another party as an independent contractor.
  - ➢ Not subject to same direction or control.
  - ➢ Paid in the form of a fee.
  - ➢ Considered Business income (not Employment)

- Distinction is important
  - ➢ Rules for determining income for tax differ for an employee and an independent businessperson

A. Employed – Defined

- **When the relationship is not clear, the courts consider four factors:**
  - ➢Control test
  - ➢Ownership of tools test
  - ➢Chance of profit or loss test
  - ➢Integration test

Control Test

- **Who determines what is done, where, when, and how?**

Employer-employee relationship → **Employer decides**

Independent contractor → **Contractor decides**

Ownership of Tools Test

Employer-employee relationship

Employer provides tools and pays for repairs

Independent contractor

Contractor provides tools and pays for repairs

Chance of Profit or Loss Test

Employer-employee relationship

Employer takes the risk and rewards

Independent contractor

Contractor takes the risk and rewards

Integration Test

- A worker whose work is an integral part of the business is probably an employee.
- Evidence of the worker receiving the economic rights, privileges, and benefits normally enjoyed by employees would be facts supporting employment status.
- If the worker is an accessory to the business, he/she is probably an independent contractor.

These tests may provide conflicting indicators.

- When that occurs, all four tests are considered and weighed against each other.
  - No one test is more important.

The Statutory Formula

Employment

Business

Property

Other

3(a) Income from all sources

3(b) + Taxable capital gains

3(c) - Other deductions

<u>3(d) - **Loss** from **Employ**, Bus, Prop, ABIL</u>

Division B net income

<u>Division C deductions</u>

Taxable Income

B. Employment Income
Fundamental Rules and Basic Formula

These rules determine **what** is included in employment income, **when** they are **included,** and what **items** may be **deducted** against that income:

1. All compensation, with exceptions, is taxable when received.
2. All benefits, with exceptions, are taxable when received.
3. All allowances received, with exceptions, are taxable.
4. No deductions are permitted, except for a specific, limited list of items.

Fundamental Rules and Basic Formula

Employment income = (A + B + C) – D

Where:

A =	the salary, wages, commissions, gratuities, and other forms of remuneration received.
B =	the sum of the benefits received or enjoyed.
C =	the sum of the allowance received.
D =	deductions that are specifically permitted as exceptions to the general rule.

II. Cash Basis
A. Scope

- **First fundamental rule - inclusion of formal compensation arrangements, such as:**
  - Salary, wages and commissions
  - Gratuities
  - Bonuses
  - Honoraria
  - Director’s fees

- **Included on a Cash Basis**
  - when received, not necessarily when earned. [5(1)]

B. Salary Deferrals

- **Gap between the time** that employment income is **earned** and the time that it is **received** can influence the rate of tax payable.

- Delay may be beneficial to the employee if the tax rate in the future will be lower.

B. Salary Deferral

Significant abuses have led to **two anti-avoidance rules**:

1. If the employer wishes to deduct deferred compensation on an accrual basis, it must be **paid within 180 days** after the fiscal year end.
   - If it is not, employer delays deduction until the year paid [78(4)]

2. When an employer and employee enter into an arrangement, if the main purpose is to defer the receipt of remuneration, the employee is **deemed to** have **received** it in the **year** that it was **earned**. [6(11)]

III. Employee Benefits

- **Includes indirect forms of compensation such as:**
  - Employee pension plans
  - Insurance programs
  - Stock options
  - Automobile benefits

- Some are taxable in the year received;
- Others are taxable at some future time or are not taxable at all.

A. Taxable Benefits

- The general rule states that the value of all benefits received or enjoyed must be included in the employee’s income.
- Starting point is to assume all benefits are taxable unless part of the exceptions that are not.
- Exceptions are either specifically referenced in the ITA, or arise from CRA administrative policy [E.g. CRA T4130 guide]

A. Taxable Benefits[2]

Common forms of taxable benefits include:

[6(1)(a)]

- Rent-free or low-rent housing,
- Gifts in cash or in kind,
- Group term life insurance policies,
- Holiday trips, prizes, and incentive awards in recognition of job performance,
- Interest-free or low-interest loans,
- Fitness, gym, or health club memberships, even if part of an employee wellness program to increase job performance.

A. Taxable Benefits[3]

- **Amount of Benefit included is the lower of:**
  - Cost to employer of supplying the benefit, or
  - FMV of the benefit.

- **Special Benefit calculations apply to:**
  - Use of employer automobiles for personal use
  - Loans from employers
  - Relocation expenses
  - Stock option benefits

Automobiles

- To the extent that an automobile is available for personal use, a taxable benefit results.

- There are two components:
    1. Standby charge [6(1)(e) & 6(2)], and
    2. Operating cost benefit [6(1)(k) & (l)]

Automobiles - Operating Cost Benefit

- **Operating benefit** = Prescribed Rate x Personal kms

- Prescribed rate changes from time to time
  - For **2022**, the prescribed rate is **$0.29**.

- Driving between home and the employer's place of business is considered personal use.

Automobiles - Operating Benefit

- Alternative calculation is available where the vehicle is used more than 50% for employment:

  = ½ of the standby charge (coming up)

- If employer pays portion of operating cost for employee owned vehicle:
  - Personal portion is taxable benefit.

Automobiles - Standby Charge

Employer provided vehicle

- Removes the need to acquire a car personally.

↓

BENEFIT

- Benefit = the time period the automobile was **available** to the employee for personal use, not kms driven.

Automobiles - Standby Charge[2]

If the employer owns the automobile, standby charge =

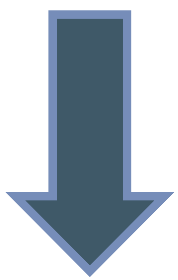
Original cost of the automobile x 2% x Number of months available

Value of the standby charge is substantial.

- For example, over a four-year period, **96% of the cost of the vehicle** would be added to the employee's income, regardless of actual personal usage.

Automobiles - Reduced Standby Charge

- Can be reduced to reflect a low amount of personal use.
- Reduced when the distance travelled is primarily for employment duties.



More than 50%

- Personal use must be less than 20,000 kilometres for the year.

Automobiles - Reduced Standby Charge[2]

- Multiply the basic standby charge for an owned or a leased vehicle by the following fraction:

$$\frac{\textbf{Personal Kilometres}}{\textbf{1,667 Kilometres x Months Available}}$$

Example – Reduced Standby Charge

An employee drives 30,000 km in a year, 18,000 km (60%) is for employment and 12,000 km (40%) is for personal use. The original cost for the vehicle is $25,000 (including taxes).

The **standby charge** is calculated as follows:

$25,000 x 2% x 12month x [**12,000 / (1,667 x 12)**]

= $3,600

Standby Charge

Employer leased automobile, standby charge =

Monthly Lease Cost	**x**	**2/3**	**x**	**Number Of Months Available**

Employee Loans

- Low-interest or interest-free loans provided by employers are a taxable benefit. [6(9), 80.4(1)]

- Taxable Benefit (determined quarterly)=
  - Prescribed rate for the quarter – interest rate paid by the employee × number of days outstanding ÷ 365 × amount of the loan outstanding.
  - Actual interest paid must be paid by Jan 30 of the following year.

- Prescribed rate is set by the CRA every quarter. [Reg. 4301]

Employee Loans - Special Circumstance

Loan used to acquire a house or to repay existing house loan:

- Rate used to determine the taxable benefit will NOT be greater than the **prescribed rate** in effect at the time the **loan** was **received** (for a maximum of five years). [80.4(4), (6)]
- If the prescribed rate declines, the lower rate is used.

Relocation Expenses

- Employers may reimburse employees for costs to relocate
- Generally the reimbursement of moving expense is not taxable.
- Reimbursement of two specific types of relocation expenses *is* taxable:
    1. Reimbursement of costs to finance a residence
    2. Reimbursement of loss on sale of home: [6(20)]
        - First $15,000 - not taxable, but
        - one-half of any amount above $15,000 is taxable.

Benefits – Stock Options

- Employee given opportunity to purchase ownership in company at a set price.
- No cash outlay required by employer
- Employee contributes cash but receives a benefit because the employee will have acquired an asset with a market value higher than the price paid

Benefits – Stock Options[2]

Categories of Stock Options

- **In-The-Money Options:** Stock options of **public companies** with an **option price below FMV** of the shares at the date the option is granted.

- **Not-In-The-Money Options:** Stock options of **public companies** with an **option price equal to or greater than the FMV** of the shares at the date the option is granted.

- **Stock options of a CCPC**.

1. In-The-Money Options

- A taxable benefit must be included in income at the time the option is **exercised.** [7(1)]

Benefit = FMV at Exercise Date – Option Price

- Any increase (or decrease) in value subsequent to purchase date is a capital gain or loss.

2. Not In-The-Money Options

- Employment benefit is calculated when the shares are purchased in the same way as the first category (In-The-Money Options). [7(1)]
- One-half of the amount is deducted as a *stock option deduction* under Division C in determining *taxable income*. [110(1)(d)]
- This leaves one-half of the benefit taxable, similar to a capital gain.

Stock Option Summary

	Public company	CCPC
Date option is granted	No tax implications	No tax implications
Date option is exercised	Employment benefit = (fair market value on exercise date – exercise price) × the number of shares acquired under the option plan	No tax implications
Date shares are sold	Taxable capital gain = 50% × number of shares sold × (proceeds of disposition – fair market value on exercise date)	Employment benefit = (fair market value on exercise date – exercise price) × number of shares sold in the year that were acquired under the option plan Taxable capital gain = 50% × number of shares sold × (proceeds of disposition – fair market value on exercise date)
Stock Option Deduction Criteria	Fair market value of the share on the grant date is equal to or less than the exercise price (i.e. option is not in the money on the grant date).	Fair market value of the share on the grant date is equal to or less than the exercise price (i.e. option is not in the money on the grant date). **OR** The shares acquired under the option plan are held for at least two years after the option is exercised (use first-in-first-out to determine two year period if shares acquired at different times).
Stock Option Deduction Timing	Year the option is exercised (same year as the employment income inclusion).	Year the shares are sold (same year as the employment income inclusion).

3. Canadian Controlled Private Corporation ("CCPC")

- The employment benefit is not taxable until the *shares are sold* [7(1.1)]
- One-half of the amount is deducted as a *stock option deduction* under Division C in determining *taxable income*

***If*:**

- Employee held the shares for *two years* after acquisition, [110(1)(d.1)] *or*
- The options were *not in-the-money* when granted. [110(1)(d)]

B. Non-Taxable and Tax-Deferred Benefits

- **The *Act* specifically allows certain benefits to be excluded from income.**
  - Some are taxable at a later time (deferral).
  - Other benefits are permanently not taxable.

B. Non-Taxable and Tax-Deferred Benefits[2]

- The following benefits are excluded on a deferred or permanent basis: [6(1)(a)]
  - Employer contributions to a (or for)
    - registered pension plan (“RPP”)
    - deferred profit-sharing plan (“DPSP”)
    - pooled registered pension plan (“PRPP”)
    - group sickness or accident plans
    - private health service plan
    - supplementary unemployment benefit plan
    - counseling services.
    - Scholarships, bursaries, and free tuition provided to employee family members

Tax-exempt Benefits

CRA has arbitrarily chosen to consider some benefits non-taxable, including:

- Discounts on merchandise
- Subsidized meals
- Cell phones and computers if primarily for business purpose
- Uniforms and special clothing needed for the job
- In house recreational facilities
- Club dues, when it is clearly to the employer’s advantage for the employee to be a member of the club
- Internet at home if primarily to benefit the employer
- Tuition/Training costs reimbursed if course primarily benefits the employer

Tax-exempt Benefits[2]

- Transportation passes for bus, rail & airline employees travelling on standby
- Free or discounted public transit passes provided to public transit employees
- Employer-provided child care (managed by employer & available to employees, only
- Moving allowance up to $650
- Frequent-flyer points collected on personal credit cards when travelling on employer reimbursed business trips
- Overtime meals & allowances
- Non-cash gifts with a value of $500 or less annually
- Non-cash long service/anniversary award of $500 of less

IV. Allowances

- All allowances are taxable, subject to specific exceptions. [6(1)(b)]
- **Allowance refers to:**
  - a fixed, specified amount that is paid on a regular basis,
  - over and above a normal salary,
  - to cover certain expenses incurred.
  - Employee does not have to account for or provide details of how it was spent.

B. Exceptions

- Nine specific allowances are excepted from the general rule and considered not taxable.

- Only three of the exceptions have broad application:
  1. Overtime meals and allowances
  2. Employees selling property or negotiating contracts.
  3. Employees other than salespeople.

Overtime Meals and Allowances

1. **Reasonable overtime meal allowances are not taxable if:**
   - Employee works two or more hours of overtime right after scheduled hours.
   - The overtime is infrequent and occasional (less than three times a week).
   - Up to **$23** per meal will generally be considered reasonable

Otherwise, the allowance is a taxable benefit.

Employees selling property or negotiating contracts

- Entitled to a non-taxable allowance for travel expenses include transportation, car, meals, lodging, and other incidental costs. [6(1)(b)(v)]
- The allowance must be reasonable:
  - if unreasonably high or low in relation to the actual costs incurred, the allowance is taxable.
- Tax-free allowances are not always beneficial.

Employees Other Than Salespeople

Also entitled to receive a tax-free allowance for travel expenses. [6(1)(b)(vii)]

- **Travel allowance that does not relate to the use of an automobile is considered tax-free only if:**
  - The allowance is a reasonable amount; and,
  - The employee travels outside the municipality or metropolitan area in which the employer is located.

Employees Other Than Salespeople[2]

- **Automobile allowances are considered tax-free if:**
  - The allowance is for the purpose of travelling in the performance of their duties as employees; **and,**
  - The allowance is reasonable and [6(1)(b)(vii.1)]
    - **based solely on the number of kilometres used to conduct employment duties.** [6(1)(b)(x)]
- CRA's new administrative policy is to consider a per kilometre allowance of $0.61 for the first 5,000 kilometres and $0.55 for the remainder (**2022**) as a guideline for reasonableness.

V. Deductions from Employment Income

- **No deductions** are permitted **unless** specifically **listed**. [8(2)]
- **Most common deductions:**
  1. Legal expenses paid to collect salary or wages [8(1)(b)]
  2. Sales expenses [8(1)(f)]
  3. Traveling expenses [8(1)(h)]
  4. Car expenses [8(1)(h.1)]
  5. Professional and union dues [8(1)(i)]
  6. Supplies consumed [8(1)(i)]
  7. Office rent or workspace in home [8(1)(i) and/or (f)]
  8. Interest & CCA on a car [8(1)(j)]
  9. RPP Contributions [8(1)(m)]
  10. Tradesperson's Tools - $500 maximum [8(1)(s)]

Travel Expenses

- An employee can deduct travel expenses incurred in the course of work-related duties provided that the following circumstances exist:
  - Employee is ordinarily **required** to carry on employment duties away from the employer's place of business or in different places.
  - Employee is required to pay the travel costs, and
  - Employee has not received a non-taxable allowance designed to cover such costs. [8(1)(h)]

Travel Expenses[2]

- **Travel expenses include:**
  - Transportation, includes all methods including automobile costs,
  - Meals – limited to 50%,
  - Lodging, and
  - All other expenses created by the travel activity.

Travel Expenses[3]

- Vehicle cost, subject to limitations, include:
  - Gas and oil
  - General repairs
  - Insurance
  - Financing costs (interest)
  - Capital cost or lease costs

- Limitations to Vehicle Costs
  - Vehicle cost limited to $34,000 plus federal and provincial/territorial sales tax [13(7)(g), Reg. 7307(1)]
  - Lease cost limited to $900 plus federal and provincial/territorial sales tax per month [67.3, Reg. 7307(3)]
  - Interest cost limited to $300 per month [67.2, Reg. 7307(2)]

Travel Expenses[4]

- No requirement that the travel costs be incurred away from the metropolitan area of the employer.
  - Exception is meals – must be away from the metropolitan area for at least **12 hours**. [8(4)]

- To the extent the employee has been reimbursed, expenses deducted must be reduced accordingly.

B. Cost of Supplies Consumed

- Can be deducted if:
  - ➢Employment contract requires to pay for supplies,
  - ➢Only if they are *fully consumed* when used.
- Supplies consumed would include such items as postage, stationery, and writing materials.
- Includes utilities and maintenance, where home office expenses are deductible.

C. Salespeople's Expenses

- Employees who act in a selling capacity or who negotiate contracts are permitted a broad range of deductions.
  - Remuneration includes some amount of commission or other similar amount that is a function of sales volume
  - Can deduct all amounts expended to earn employment income,
  - Limited to commission earned. [8(1)(f)]
- Items **not** limited to commission:
  - CCA on an automobile,
  - Automobile financing costs.

C. Salespeople's Expenses[2]

The following items are specifically not deductible:

1. Payments for the use of a yacht, camp, lodge, or golf course. [8(1)(f)(vi), 18(1)(l)(i)]

2. Membership fees or dues in a club,
   1. main purpose to provide dining, recreational, or sporting facilities to its members. [8(1)(f)(vi), 18(1)(l)(ii)]

3. Expenditures of a capital nature that have a long-term benefit. [8(1)(f)(v)]

Salespeople's Expenses[3]

Deductible items include:

- Advertising and promotion
- Telephone (extra costs for your business – long distance, message center, call waiting)
- Parking
- Automobile
- Supplies
- Fees paid to assistants
- Work space in home
- Travel expenses

D. Work Space in Home

Permitted if the work space is either:

- The place the individual primarily performs duties of employment (more than 50% of time),

  or

- If first condition not met, then:
  - Used exclusively for earning employment income, **and**
  - Used on a regular/continuous basis for meeting customers or clients. [8(13)]

Work Space in Home - Allowable Costs

- **Employees – non salespeople:**
  - Appropriate portion of maintenance and utility costs. [8(1)(i)]
- **Salespersons:**
  - The preceding items, plus an appropriate percentage of *property taxes* and *house insurance* premiums. [8(1)(f)]

Employees cannot deduct mortgage interest as a work space in the home expense

E. Registered Pension Plan Contributions

- Employers often contribute amounts to a registered pension plan on behalf of an employee.
- Most RPPs permit (or require) the employee to contribute an annual amount to the plan.
- Within specified limits, contributions made by an employee are deductible. [8(1)(m)]
  - For **2022** – The maximum RPP dollar limit is **$30,780**
    [147.1(1) *money purchase limit* definition]

VI. Employment Income and the GST/PST/HST

- An employer must include the value of GST/PST/HST when calculating the amount of a taxable benefit for an employee.
- Any employee who has expenses that are deductible for tax purposes can claim a GST rebate on those expenses.
- GST rebate is **5/105 x Employment deductions** that are not zero-rated or GST exempt.
- In the year received, the GST rebate is included in income or reduces the UCC if relates to CCA deductions. [6(8)]

VII. Efficient Management of Employee Compensation

A. Basic Objectives and General Tax Principles

B. Indirect Compensation

1. Taxable Indirect Compensation
2. Non-taxable Indirect Compensation

C. Deferred Compensation

1. Registered Plans
2. Non-Registered Plans
3. Stock-Based Plans

A. Basic Objectives and General Tax Principles

- Objective is to provide maximum satisfaction to the employees at the least possible cost.
- **In general terms:**
  - Compensation expenses are fully deductible by employer when incurred
  - Fully taxable to the employee when received.

A. Basic Objectives and General Tax Principles[2]

- Employer can offer non-taxable or tax-deferred compensation.
- The employer can achieve further cost savings from economies of scale.
- Different forms of compensation may have different values to different employees.

A. Basic Objectives and General Tax Principles[3]

Compensation categories:

I. **Direct**
- Salaries, hourly wages, commissions, bonuses
- Fully taxable (employee) and deductible (employer)

II. **Indirect**

III. **Deferred**

B. Indirect Compensation

- Indirect forms of compensation provide employees with specific benefits.
- Usually fully deductible by the employer.
- Taxation to the employee varies:
    - some benefits are fully taxable;
    - others are tax-free.

1. Taxable Indirect Compensation

- Personal use of employer’s automobile
- Holidays trips, other prizes and incentive awards
- Tuition fees paid be an employer
- Life Insurance
- Interest-free of low-interest loans

1. Taxable Indirect Compensation[2]

- Assume all benefits are taxable unless specifically exempt.
- The question arises: What value is gained by the employer and by the employee from such types of compensation?

Overall Cash Savings If:

1. Employee needs the benefit and would acquire it from after-tax disposable income
2. Employer can acquire the benefit at a lower cost than the employee.

2. Non-Taxable Indirect Compensation

- Certain benefits can be received tax-free.
- Common tax-free benefits:
  - Private Health Services plans
  - Supplementary unemployment benefits
  - Counselling fees
  - Discount on merchandise
- Not taxable to the employee, but
- Fully deductible by the employer as compensation expenses.

2. Non-Taxable Indirect Compensation[2]

Can create additional cash flow in two ways:

1. Eliminating tax on benefits received by the employee.
2. Reducing costs resulting from economies of scale when services are purchased for a large number of employees.

C. Deferred Compensation

Two advantages from the employee's perspective:

1. Taxing income later may result in lower tax rates
   - especially if payments are delayed until retirement.
2. If delayed payments are invested, investment returns will be achieved on pre-tax income.

C. Deferred Compensation[2]

Three categories of deferred plans:

1. Registered Plans
2. Non-Registered Plans
3. Stock-Based Plans

1. Registered Plans

Three specific registered deferred compensation plans that provide preferential tax treatment:

1. Registered pension plan (RPP)
2. Pooled registered pension plan (PRPP)
3. Deferred profit sharing plan (DPSP)

1. Registered Plans[2]

- **Contributions are deductible to employer:**

  - After-tax cost is the same as normal compensations, i.e. salaries.

- **Compensation as a registered plan makes a vast difference to the employee:**
  - Value of the benefit is not taxed until the funds are removed from the plan.
  - Investment returns on contributions are not taxable until they are distributed to the employee.

1. Registered Plans – An Example

Compensation – Salary $3,500

Tax Rate – 45%

After-tax compound interest – 5.5%

Invest every year for 30 years

Salary	$ 3,500
Tax	(1,575)
After-tax cash	$ 1,925

Total wealth after 30 years

after tax = $ 147,000

Compensation – RRP $3,500

Tax Rate – 45%

Before tax Compound Int. – 10%

Invest every year for 30 years

RPP Contribution	$ 3,500
Tax	(0)
After-tax cash - Invest	$ 3,500

Total wealth after 30 years

after tax = $ 348,000

2. Non-Registered Plans

Non-registered deferred compensation plans:

- Employee profit sharing plans
- Employee trusts
- Salary deferral arrangements
- Retirement compensation arrangements

2. Non-Registered Plans[2]

- Seldom used because there is no tax relief for the amounts deferred.
  - Payments to the plan are deductible from the employer’s income but
  - Are taxable, along with any investment returns, in the employees’ income in the year in which they are received by the plan.

3. Stock-Based Plans

- Compensation plans that give employees opportunities to purchase shares
  - Stock options (tax treatment discussed earlier in this chapter)
  - Stock purchase plans
    - Employer lends funds to employee to purchase shares
    - Loan is returned to the employer in exchange for shares
    - If shares are not purchased at a discount, there is no taxable benefit

3. Stock-Based Plans[2]

Stock Options

- **Employee:** taxation from stock option benefits was described earlier.
  - Taxation depends on type of corporation
- **Employer:** this form of incentive is attractive because it does not involve a cash payment
  - Does result in dilution of ownership.

3. Stock-Based Plans[3]

Stock Purchase Plans

- Permits employees to purchase shares from the corporate treasury at FMV using funds loaned by the employer.
- Funds loaned to the employees come back to the company in exchange for the shares,
  - No cash cost to the employer.

3. Stock-Based Plans[4]

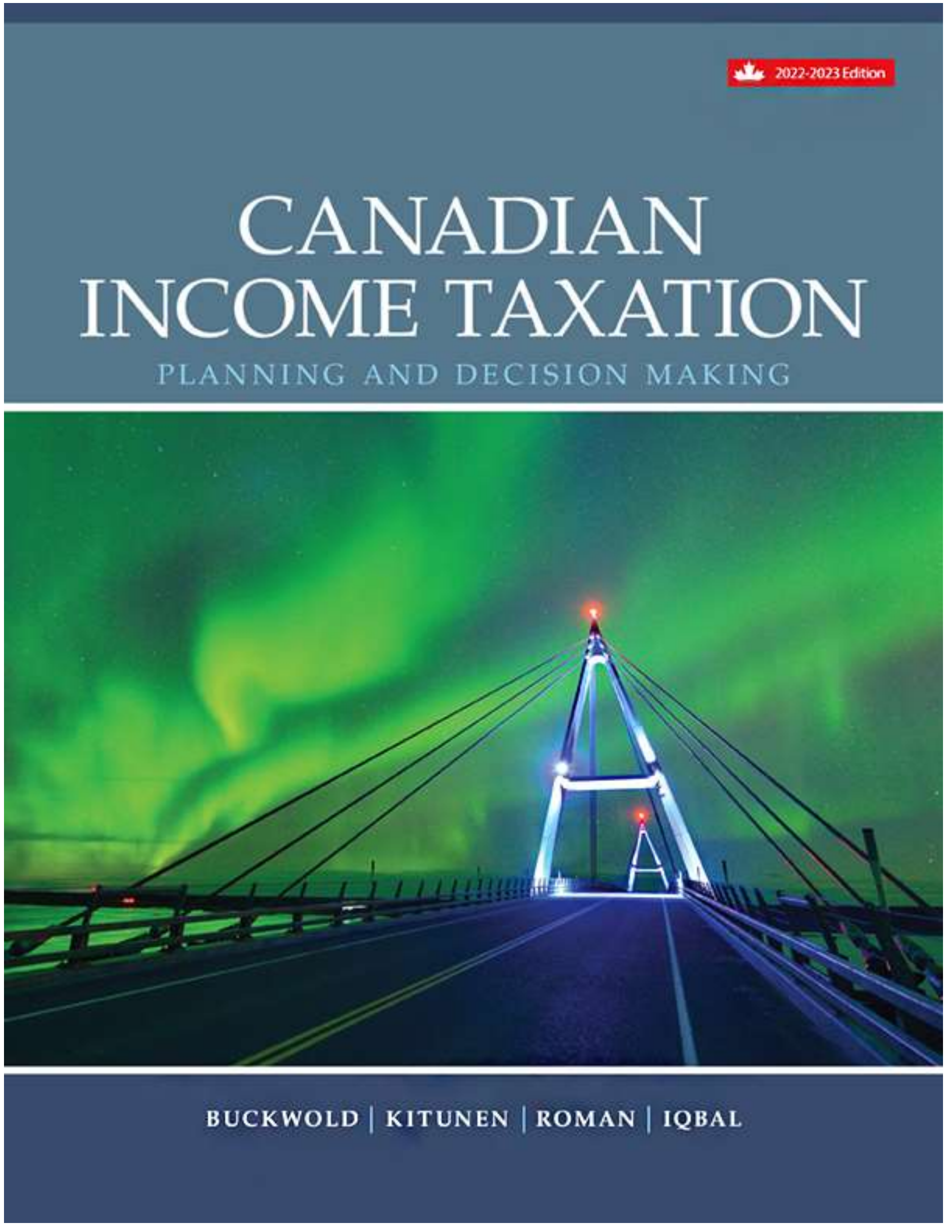
Stock Bonus Plans

- Employer issues shares in lieu of a cash bonus.
- Full value of shares received as a stock bonus is taxable:
  - As employment income in the year shares are issued.
- No cash cost to the employer
- Result is a tax cost to the employee.

3. Stock-Based Plan[5]

Phantom Stock Plan

- Does not actually provide shares;
  - it is an elaborate deferred bonus agreement.
- Bonus tied directly to changes in the value of the corporation's shares.
- **Benefit to Employer**: it preserves cash flow until the end of the vesting period.
- **Benefit to Employee**: The company shares its profits with them on a tax-deferred basis.



CHAPTER 5:
Income from Business

Prepared by

Matthew Roman, CPA, MTax

KPMG, LLP

Electronic Presentations in Microsoft® PowerPoint®

Income from Business

I. Business Income Defined

II. General Rules for Determining Business Income

III. Exceptions to the General Rules

IV. Business Income and the GST/HST

V. Summary, Conclusion, and Management Perspective

I. Business Income Defined

- Can be earned by all three of the taxable entities – **individuals, corporations, and trusts**.
- The *Income Tax Act* defines business broadly to include:
  - Profession, calling, trade, manufacturing
  - Adventure or concern in the nature of trade
- Definition does not consider size.
- Does not require that the activity be ongoing
  - Business income could exist even if activity is irregularly done

Adventure or Concern in the Nature of Trade

- Occurs when a taxpayer acquires property for resale even though not the normal business.
- The resulting profit or loss on sale is considered income or loss from business.

Business Income versus Capital

- Property, with ability to provide long-term benefit, may be considered **business** or **capital** in nature.

- Depending on the reason for acquisition & subsequent use, the gain or loss on the sale can be either
  - a business activity or
  - a capital transaction.

- Distinction between the two sources is important:
  - Capital transactions have preferential treatment.
  - Business income fully taxable.
  - Business losses can offset other income.

Intended Use

Capital treatment can be distinguished from business treatment by employing the following guidelines:

Acquired for Long-term Benefit → **Capital treatment**

Acquired for resale → **Business treatment**

Sometimes difficult to determine primary intention.

The Statutory Formula

Employment

Business

Property

Other

3(a) Income from all sources

3(b) + Taxable capital gains

3(c) - Other deductions

3(d) - **Loss** from Employ, **Bus**, Prop, ABIL

Division B net income

Division C deductions

Taxable Income

II. General Rules for Determining Business Income

A. Profit Defined

- The *Income Tax Act* states:

  "a taxpayer's income for a taxation year from a business is the profit therefrom for the year." [9(1)]

- Business income for tax purposes is the profit determined in accordance with well-established business principles (such as GAAP).
- GAAP is good starting point – adjustments are made where the Act specifies other requirements.

B. Generally Accepted Accounting Principles (GAAP)

Major Concepts:

1. Revenue Recognition – point of earning.
2. Concept of Accrual – recorded when incurred rather than paid.
3. Concept of Matching – cost and revenue recorded in same period.
4. Concept of Conservatism.

GAAP

- "Profit" is not precisely determinable
- There is room for unintended or intended misjudgment
- General limitations and exceptions in the ITA attempt to provide a more uniform standard

C. General Limitations to Business Income Determination

Expenses are deductible only if the following conditions are met:

1. Income-Earning-Purpose Test [18(1)(a)]
2. Capital Test [18(1)(b)]
3. Exempt Income Test [18(1)(c)]
4. Reserve Test [18(1)(e)]
5. Personal Expense Test [18(1)(h)]
6. Reasonableness Test [67]

1. Income-Earning Purpose Test

- Must be incurred for the purpose of gaining, producing, or maintaining income from business. [18(1)(a)]
  - Expenses incurred in carrying on a business activity with an expectation to profit
  - Primary test for the deductibility of expenses
  - If no reasonable expectation of profit, expenses are deductible only to the extent of related revenue

2. Capital Test

- Cannot deduct items of capital nature [18(1)(b)]
  - long-term or enduring benefit.

- **Main reason for limiting expenditures of capital nature:**
  - Remove flexibility and estimates from the calculation of accounting profit
  - Can deduct using uniform system – Capital Cost Allowance (“CCA”)

3. Exempt-Income Test

- An expense is **not deductible** even though it was incurred to earn income, if the income that is expected to be generated is itself **not taxable revenue**. [18(1)(c)]

4. Reserve Test

- No reserves are deductible for tax purposes. [18(1)(e)]
- However, exceptions are permitted.

5. Personal-Expense Test

- No deductions are permitted for a taxpayer's personal or living expenses *except* for those travel expenses incurred away from home in the course of carrying on business. [18(1)(h)]

6. Reasonableness Test

- An outlay or expense is deductible only to the extent it is reasonable in the circumstances. [67]
- Even if meets the other general criteria for deductibility, still subject to the reasonability test.
- Designed to combat abuse and confine business expenses to those incurred in the income-earning process.

III. Exceptions to the General Rules

- The *Act* responds to the general rules by listing specific exceptions.
- If a particular item is not listed as a specific exception, the general rules determine the outcome.

A. Specific Income and Expense Exceptions

Three items in s.12 of the ITA will be discussed here:

1. Inducement payments

- May be a grant, a subsidy, or a forgivable loan, and may come from another business or from a government.

- **Inducement payments may be:**
  - included in income in the year of receipt, [12(1)(x)] or
  - as a reduction of the cost of the property acquired – if so elect. [13(7.4)]

A. Specific Income and Expense Exceptions[2]

2. Insurance Proceeds:

- Destroyed property - the insurance proceeds are treated as proceeds of disposition. [13(21)]
- Damaged property – proceeds treated as taxable income, up to cost of repairs made. [12(1)(f)]
  - Effectively offset expenses.
  - Remaining proceeds are treated as proceeds of disposition.

A. Specific Income and Expense Exceptions[3]

3. Payments Based on Production or Use

- A payment based on the production or use of property is considered to be business or property income. [12(1)(g)]
  - Even when part of a sale price.

1. Expenses Denied

- Sections 18 and 19 of the *Act* list specific expenses that are not permitted as deductions even though they would otherwise qualify under the general rules.

- Provides negative guidance – what should not be deducted.

1. Expenses Denied[2]

Use of recreational facilities and club dues [18(1)(l)]

- No deduction permitted for the use or maintenance of a yacht, a camp, a lodge, or a golf course.

- No deduction permitted for membership fees or dues in any club, the main purpose of which is to provide dining, recreational, or sporting facilities to its members.

Political contributions [18(1)(n)]

- No political contributions are deductible.
- Tax Credit is received by individuals.
- Corporations are not permitted to make political donations.

1. Expenses Denied[3]

Advertising Expenses [19]

- Advertising in a **non-Canadian** newspaper or broadcasting undertaking **cannot** be deducted if the advertising is **directed primarily** at a Canadian market.

- This exception is designed to provide assistance to Canadian media enterprises.

1. Expenses Denied[4]

Allowance for an Automobile [18(1)(r), Reg. 7306]

- Limits the allowable amount to the prescribed amount.
- Maximum Allowance that can be deducted by an employer is **$0.61** for first 5,000 km, and **$0.55** for each additional km.
- Limitation applies only if allowance is tax-free.
- If allowance is taxable, the employer can deduct the full amount, provided that it is reasonable.

1. Expenses Denied[5]

Interest and property taxes on vacant, or idle, land: [18(2)]

- **Land is idle if:**
  - it is vacant and is not being used to generate income, or
  - if it is being held primarily for resale or development.
- **Related interest costs and property taxes are deductible**
  - to the extent that income is generated from that land.
- **Any unused balance is added to the cost of the land**
  - the amount initially denied can be deducted against the sale proceeds when sold.

1. Expenses Denied[6]

Certain costs during construction period may be denied as deductions: [18(3.1)]

- Legal and accounting fees,
- Interest costs,
- Mortgage costs,
- Property taxes, and
- Promotional expenses

that relate to the construction project.

- Rather than being deducted, these costs are added to the cost of the building and deducted through CCA.

1. Expenses Denied[7]

Work space in home [18(12)]

- Expenses applicable to such space are not permitted as a deduction unless **one** of the following conditions is met:
  - The space is "the individual's principal place of business." or
  - If first condition not met
    - used exclusively for the purpose of earning income from business, **and**
    - used on a regular or continuous basis for meeting clients, customers or patients of the individual."

1. Expenses Denied[8]

Work space in home2

- Permitted expenses include a proportionate amount of the home's common expenses:
  - Maintenance cost (heating, home insurance, electricity, cleaning material),
  - Mortgage interest,
  - Property taxes,
  - Capital Cost Allowance
- Total expenses cannot exceed business income for the year.
- Excess is considered an expense of the following year.

Home Office – Deductible Expenses

Home Office Expenses	Salaried Employee	Commission Employee	Business
Utilities	Yes	Yes	Yes
Property tax		Yes	Yes
Insurance		Yes	Yes
Maintenance	Yes	Yes	Yes
Mortgage interest			Yes

1. Expenses Denied

Meals and entertainment [67.1(1),(2)]

- Amount permitted is limited to **50%** of actual costs incurred.
- Two of the exceptions (100% deductible):
  - cost of food, beverage, and entertainment events generally available to all employees (limited to six "occasional events" per year).
  - Cost of food, beverages at Charity functions

1. Expenses Denied II

Automobile Costs

- Cost for purposes of claiming a deduction for CCA cannot exceed **$34,000**. [13(7)(g), Reg. 7307(1)]
- The deduction for a leased automobile cannot exceed **$900/month**. [67.3, Reg. 7307(3)]
- Federal and provincial sales taxes **are not added** to the amounts above if the business is able to recover these taxes on its sales tax returns (see Chapter 22 for detailed GST/HST rules)
- The interest cost on money borrowed to acquire a vehicle cannot exceed **$300/month**. [67.2, Reg. 7307(2)]

1. Expenses Denied III

Stock Based Compensation

– Recorded as an expense for accounting purposes

– Not deductible for tax purposes [7(3)(b)]

Fines and Penalties

- Not deductible if imposed under a law [67.6]
- includes municipal parking tickets

Unpaid Remuneration

– Not deductible unless paid within **180 days** after the business year end [78(4)]

1. Expenses Denied IV

Unpaid amounts owing to related persons

– An expense accrued in **year 1** and owed to a person not at arm's length with the business must be paid by the end of **year 3**

– Otherwise, the amount accrued is added to business income in **year 4**. [78(1)]

2. Expenses Permitted

- Section 20 of the *Act* lists approximately 40 specific items that are permitted as deductions even though, according to the six general limitations, they do not normally qualify.

2. Expenses Permitted[2]

Capital cost allowance [20(1)(a)]

- The general rules prohibit the deduction of all depreciation and amortization of capital assets.
- Exception rules permits the gradual deduction:
  - In a controlled and uniform manner under the CCA system,
  - Reviewed in Chapter 6.

2. Expenses Permitted[3]

Incorporation costs [20(1)(b)]

- Up to **$3,000** per corporation is permitted is deductible
- Costs in excess of $3,000 are added to Class 14.1 and deductible through the CCA system.

Interest [20(1)(c)]

- Interest incurred on loans to acquire long-term assets is considered on account of capital and is therefore denied by the general rules.
- Section 20 permits the interest deduction provided that the long-term asset is used to assist in the income process.

2. Expenses Permitted[4]

Expenses of borrowing money or issuing shares

- Permitted as a deduction in equal proportions over five years.
  [20(1)(e)]

- Life insurance premiums may be a deductible expense of borrowing money if the insurance is required as loan collateral.
  [20(1)(e.2)]

2. Expenses Permitted[5]

Reserves for doubtful debts [20(1)(l)]

- Deductible if:
  - reserve is reasonable,
  - based on doubtful debts, and
  - the debt, when established, created income for the taxpayer.

Bad debt expense [20(1)(p)]

- Deductible if the debt was included in income previously.

2. Expenses Permitted[6]

Reserves for delayed payment revenues [20(1)(n)]

- Reserve may be deducted when:
  - inventory has been sold and
  - all or part of payment not due until after two years from date of sale.
    - Exception for land inventory
- Long-term payment schedule can be recognized over a period of time.
- Utilized for no more than three years
  - even if payment terms are longer.

2. Expenses Permitted[7]

Registered Pension Plans (RPPs) [20(1)(q). 147.1(1)]

- Money Purchase Plans – contribution is limited to:
  - 18% of employee's compensation and
  - the maximum contribution limit, **$30,780** for **2022**
- Defined Benefit Plan – as defined by an actuary
- Must be paid within **120 days** after business year end

Pooled Registered Pension Plans (PRPPs) [20(1)(q)]

- Employer portion is deductible up to the employee's RRSP limit

Deferred Profit Sharing Plans (DPSPs) [20(1)(y)]

- Contributions are limited to ½ of the RPP limit

2. Expenses Permitted[8]

Private health services plan [20.01]

- Payments to PHSP is deductible as an expense to the employer
- Individuals who are self-employed can deduct amounts paid to their PHSP provided they are actively engaged in a business either alone or as a partner AND either:
  - Self-employment is their primary source of income, OR
  - Income from other sources does not exceed $10,000

- Deductible for all employees but limited for family members to:
  - **$1,500** for owners and spouses,
  - **$750** per child.

2. Expenses Permitted – Cash Basis

Expenses deductible on a cash basis:

- Landscaping [20(1)(aa)]
  - around a structure used primarily for producing income
- Investment counsel fees [20(1)(bb)]
- Representation fees [20(1)(cc)]
  - can elect to deduct equally over 10 years [20(9)]
- Site investigation fees [20(1)(dd)]
  - allowed even when site is not acquired
- Utility service connections [20(1)(dd)]
- Convention expenses [20(10)]
  - limited to two in a year
  - within territorial scope of organization holding convention

B. Treatment of Inventories

The *Act* permits closing inventory to be valued using one of two methods:

1. Value *each* item of inventory at lower of:
   - Cost or Market [10(1)]
2. Value *all* items of inventory at their market value

The following cost flow assumptions are acceptable:

1. Specific identification
2. Average cost
3. FIFO

Each method produces different ending inventory and cost.

B. Treatment of Inventories[2]

- The ability to change from one method to the other is restricted.
- Must use the same valuation method from year to year unless a change is approved by the CRA. [10(2),(2.1)]

C. Taxation Year and the Individual Taxpayer

- The taxation year for an individual is the calendar year. [249(1)]
- This may be administratively difficult for certain businesses
  - Individuals can elect to use an alternative fiscal period other than December 31. [34.1]
  - A complex formula adjusts fiscal-year income to estimate the calendar-year income.
  - Produces similar income if profits are constant.

D. Scientific Research and Experimental Development

- Expenditures for SR&ED are usually incurred to provide a long-term benefit to the entity.
- General rules would deny a deduction, on the basis that they are capital expenditures.
- Special tax provisions apply to SR&ED expenses with the goal of encouraging such activity.
- For SR&ED carried on in Canada [37(1)] -
  - Ongoing expenditures can be deducted in full in the year incurred.
  - The business **can choose not to deduct and carry forward indefinitely**.

E. Professionals

- Professional services are often performed over a long period of time before billing.
  - Work in Progress (“WIP”).
- WIP is included in income.
- An exception is made for accountants, lawyers, medical doctors, dentists, chiropractors, and veterinarians.
  - Permitted to deduct expenses as incurred and report revenue only when amounts are billed to clients. [ITA 34].
  - For taxation years commencing **after March 21, 2017**, only 20% of the work in progress is included in income for the first year that begins after March 21, 2017. The inclusion is increased to 40% in the second year, 60% in the third, 80% in the fourth, and 100% in the fifth. I.e. the deduction for WIP is being phased out over 5 years.

F. Treatment of Reserves

- As a general limitation, no reserves are permitted as a deduction, with a few exceptions.
- Whenever a reserve **is** allowed, the deduction must be added back to income the following year. [12(1)(d),(e)]
- A new reserve can be deducted if it can still be justified.
- A permitted reserve is discretionary – it does not have to be deducted.

G. Unpaid Remuneration

- Business income is determined on an accrual basis; salaries are deductible when incurred.
  - Even if not paid.
- Unpaid remuneration can be deducted if paid within **180 days** of its taxation year.
- Payment beyond 180 days can only be deducted in subsequent years once paid [78(4)].

H. Farming

- General rule, farming income is calculated on an accrual basis.
- Taxpayers can elect to determine farming income using a **cash basis** of accounting.
- If farming is not the taxpayer's chief source of income, the amount of loss that can be deducted against other sources of income is limited:
  - Full Time Farmer - Losses Fully Deductible
  - Hobby Farmer - No Losses Deductible
  - Part Time Farmer – Restricted Farm Loss [31(1)]
    - First $2,500
    - ½ Next $30,000
    - Max = **$17,500**

I. Partnerships

- Income earned or losses incurred by a partnership are allocated to the partners,
  - Based on agreed sharing ratio, and
  - Are included in each partner's personal income for tax purposes.
- Income is allocated regardless of distributions.
  - Means partners pay the tax whether or not the funds have been received.
- Income earned retains its characteristic.

J. Ceasing to Carry On Business

- When a business is sold:
  - Sale usually results in capital transactions
    - Exception is Inventory and Accounts Receivable
- Inventory: considered to be sold in normal course of business
  - Any gain above cost is considered business income [23(1)]
- Accounts Receivable
  - Treated as a capital item – therefore any loss is only 50% deductible and restricted to being used against capital gains.
  - Any gains or losses experienced by the purchaser are also treated as capital gains or losses

Accounts Receivable - Election

- An election may be filed under **Section 22** of the Income Tax Act to avoid the results just described [22(1)]
- When the election is filed, the vendor's loss on sale of receivables is deemed to be a **business loss**
- Purchaser is deemed to acquire the receivables at their cost less a reserve for uncollectible accounts
  - Must add the reserve to income and claim a new reserve or deduct actual bad debts as a business loss
- Summary: election changes the nature of gains/losses from capital to business

IV. Business Income and the GST/HST

- Most business are entitled to a full GST refund on business related purchases.

- A GST refund on some of the expenses is disallowed or restricted:
  - Automobile lease costs > $900/month
  - Personal and living expenses
  - Club memberships
  - 50% of all food, beverage, and entertainment costs
  - Expenses that are considered to be unreasonable

- See Chapter 22 for an in-depth review of the GST/HST

V. Summary, Conclusion, and Management Perspective

A. Business Income

1. General rule: business income for tax = accounting income
2. Accounting income is modified by case law and the six general limitations in the ITA
3. Notwithstanding the general rule and general limitations, business income may be further modified by reference to two lists of exceptions: one which denies the deduction of items generally permitted; the other permits deductions otherwise denied.

V. Summary, Conclusion, and Management Perspective[2]

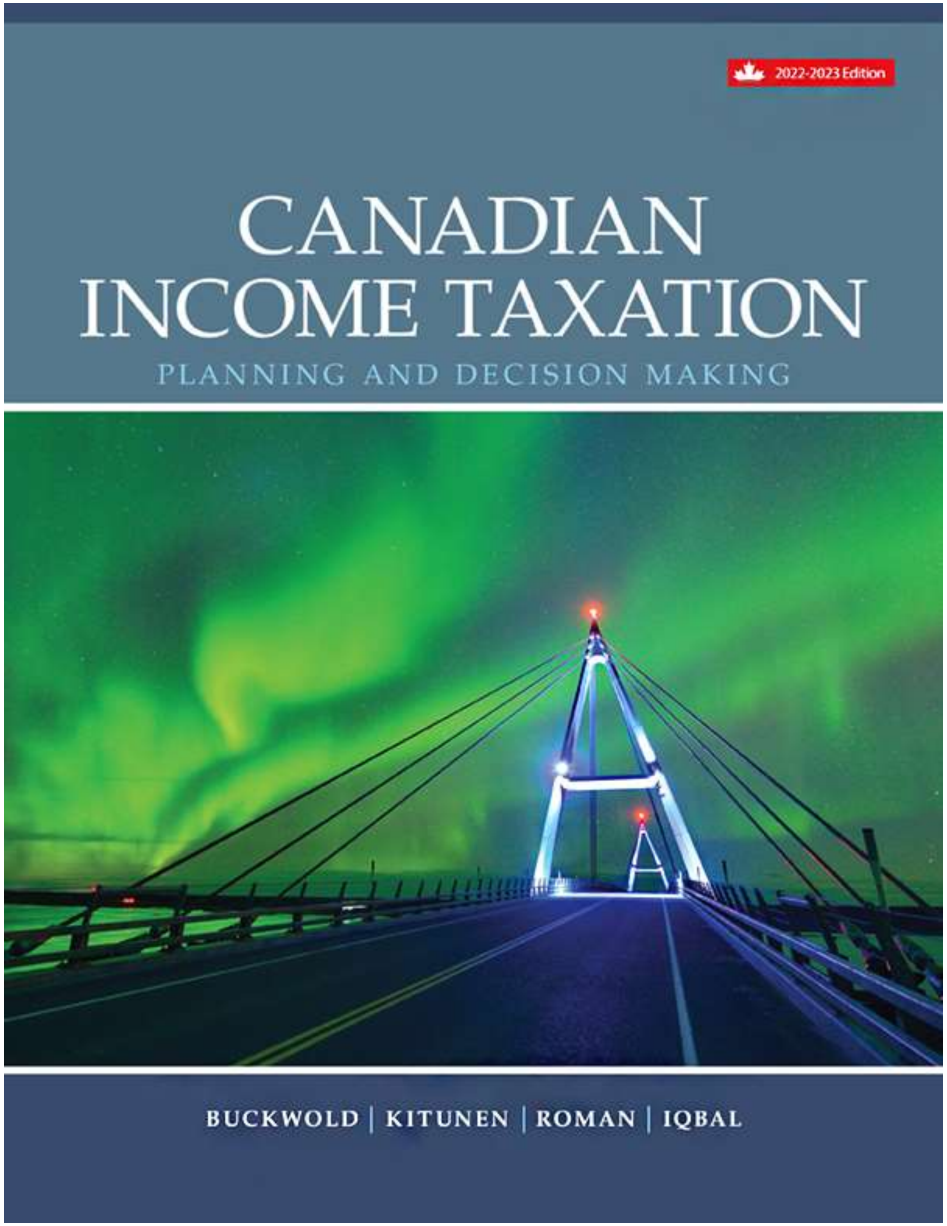
B. Business Income vs. Employment Income

	Employment	Business
Method of accounting	Cash basis	Accrual basis
Deductions permitted	Only those specifically permitted	All expenses incurred unless denied/limited
Income excluded	May have benefits not included in taxable income	No provisions for tax-free income

V. Summary, Conclusion, and Management Perspective[3]

C. Business Income and the Management Process

- Management must be familiar with the process of determining business income for tax purposes
  - Ensures no more tax is paid than required and at the latest possible time
- Familiarization with the general rules and specific exceptions may stimulate managers to expand information systems beyond normal accounting
- Familiarization with business income rules permits managers to compare such income with other types and to structure activities to create cost efficiencies.



CHAPTER 6: The Acquisition, Use, and Disposal of Depreciable Property

Prepared by
Matthew Roman, CPA, MTax
KPMG, LLP

Electronic Presentations in Microsoft® PowerPoint®

The Acquisition, Use, and Disposal of Depreciable Property

I. A Standardized System for Depreciable Property.
II. Depreciable Property and Capital Cost Allowance (“CCA”).
III. Goodwill & Other Intangibles.
IV. Accounting Rules vs. Tax Rules.
V. Impact on Management Decisions.

I. A Standardized System For Depreciable Property

- **Depreciation/Amortization is:**
  - Process of allocating the cost of an asset
  - Over its useful life
  - To match its cost against the income it generates.

- **Process requires estimates of:**
  - Useful life
  - Salvage value
  - Contribution to the business in each year

I. A Standardized System For Depreciable Property[2]

- **Process requires judgment,**
  - Similar businesses acquiring similar assets may reach different estimates
  - Leads to different income in each of the years that the asset is used.

- **Total cost deducted will be the same,**
  - Maximum deducted cannot exceed the original cost of the asset.

- **Because of these differences, accounting depreciation is disallowed as a deduction for tax.**

I. A Standardized System For Depreciable Property[3]

Each company purchases the same asset but the useful life is determined to be different

Company A		Company B	
Asset Cost	$10,000	Asset Cost	$10,000
Est. useful life	4 yrs	Est. useful life	6 yrs
Expense per year	$2,500	Expense per year	$1,667

Company A would receive the total tax benefit 2 years earlier than Company B as a result of the difference in Estimated useful life.

I. A Standardized System For Depreciable Property[4]

- Because of these differences, accounting depreciation is disallowed as a deduction for tax. [18(1)(b)]

- A uniform and arbitrary system is used to expense asset's cost. [20(1)(a)]

II. Depreciable Property and Capital Cost Allowance (CCA)

Calculation of the CCA: [13(21) *undepreciated capital cost* definition]

1. Start with opening balance (UCC).
2. Add any additional purchases.
3. Deduct any disposals.
4. Apply the appropriate CCA rate to the resulting balance.

A. Who Qualifies for CCA? What Assets?

- **Individuals and corporations qualify for CCA**
- **Can claim on:**
  - tangible assets other than land, and
  - intangible assets.

- **To be eligible for CCA:**

  a)The taxpayer must have legal title; and

  b)The asset must be available for use for the purpose of **earning income from business or investments.** [20(26)]

Who Qualifies for CCA? What Assets? 2

- The total dollar amount available for allocation as CCA is referred to as the “capital cost” of the asset.

- The capital cost amount consists of:
  - the original purchase price plus
  - all costs incurred to bring the asset to working order.

B. Rates of Capital Cost Allowance

The *Act* assigns various types of assets to specific classes.
[Regulations - Schedule II]

- Each class has a specific rate attached to it.
  - signifies the **maximum** deductible in any year.
- No requirement to claim this maximum:
  - can choose to claim any amount up to the maximum.
- Unclaimed portion remains in the undepreciated cost balance for deduction in future years.

C. Accelerated CCA in the First Year

- The amount of CCA that can be claimed in the year assets are acquired (and available for use) is temporarily enhanced for depreciable assets acquired after November 20, 2018 and before 2024.

- For most declining balance classes, the CCA is increased by 50% for net additions (additions in excess of disposals) to the class for the year. [Reg.1100(2)]

- For manufacturing and processing equipment (class 53; 50%), clean energy equipment (class 43.2; 50%), zero-emission vehicles (class 54; 30%), and class 12, the CCA on net additions to the class for the year is 100%. [Reg.1100(2)]

C. Accelerated CCA in the First Year[2]

- For leasehold interests (class 13) and patents, franchises, concessions or licenses for a limited period (class 14), the CCA is increased by 50% in the year the cost is incurred.

- Assets do not qualify for the accelerated first-year CCA when acquired from a non-arm’s length person or on a tax-deferred basis, such as under the elective provisions of section 85 (Chapter 12) or an amalgamation (Chapter 14)

C. Accelerated CCA in the First Year[3]

- Assets generally do not qualify for the accelerated first-year CCA when acquired from a non-arm's length person or on a tax-deferred basis

- For Canadian-controlled private corporations (CCPCs),Canadian resident individuals, and Canadian partnerships the 2022 Federal Budget expands on previous measures to accelerate tax deductions for most classes. A first-year CCA rate of 100% is available on up to $1.5 million of assets acquired in the year. This applies to most assets acquired by CCPCs on or after April 19, 2021.
  - For simplicity, the text assumes additions occur prior to April 19, 2021 unless otherwise stated

C. Accelerated CCA in the First Year[4]

- ***Immediate expensing*** on up to $1.5 million of assets acquired in the year is available to Canadian-controlled private corporations (CCPCs),Canadian resident individuals, and Canadian partnerships
  - The immediate expensing is taken as 100% CCA on net additions for eligible immediate expensing property (excludes classes 1 to 6, 14.1, 17, 47, 49 and 51)
  - Where the cost of immediate expensing property acquired in the year exceeds $1.5 million, the taxpayer can choose which additions to designate and the excess capital cost is subject to the normal CCA rules.
- Assets generally do not qualify for the accelerated first-year CCA or immediate expensing when acquired from a non-arm’s length person or on a tax-deferred basis

D. The Declining Balance Method

- CCA system uses the declining balance method.
  - with some exceptions, i.e. Class 13 & 14.
- Applies a constant percentage to the remaining un-depreciated portion of the original capital cost.
- Each class of assets has a specific percentage rate attached. [Reg.1100(1)]

D. The Declining Balance Method[2]

- CCA claim may be limited when a taxation year is less than 365 days.
  - CCA is prorated by the number of days in the taxation year divided by 365. [Reg.1100(3)]

Common Declining Balance Classes

- **Class 1 (4%)**
  – Buildings acquired after 1987
  – Additional 2% allowance for non-residential buildings [Reg.1100(1)(a.2)]
  – Additional 6% allowance for manufacturing or processing buildings [Reg.1100(1)(a.1)]
  – For additional 2% or 6% allowance, building cannot have been used before Mar 19, 2007, and must elect to place each building in a separate Class 1. [Reg.1101(5b.1)]

- **Class 3 (5%)**
  – Buildings acquired before 1988

Common Declining Balance Classes[2]

- **Class 8 (20%)**
  - Miscellaneous tangible (equipment, office furniture etc.)

- **Class 10 (30%)**
  - Vehicles
  - Movable equipment

- **Class 10.1 (30%)**
  - Vehicles with cost greater than $30,000
  - Additions limited to $30,000 plus any applicable GST/HST (for GST/HST registered businesses, the GST/HST is not included since the business will get an input tax credit instead)

Common Declining Balance Classes[3]

- **Class 12 (100%)**
  - Small tools costing less than $500
  - Computer application software
  - Dishes, cutlery, linen
  - Library books

With accelerated first year CCA, the deduction cannot exceed 100% of the net additions.

Common Declining Balance Classes[4]

- **Class 14.1 (5%)**
  - Unlimited life intangibles:
    - Goodwill (purchased)
    - Franchise with indefinite life
    - Incorporation costs in excess of $3,000
    - Amendments to articles of incorporation
- **Class 17 (8%)**
  - Parking lot

Common Declining Balance Classes[5]

- **Class 38 (30%)**
  - Power-operated and movable equipment
  - Acquired after 1987
  - Used for excavating
- **Class 43**
  - Manufacturing equipment
  - See Class 53 also
- **Class 43.2**
  - Clean energy generation & storage equipment
    - solar panels, windmills, electrical vehicle charging stations

Common Declining Balance Classes[6]

- **Class 44 (25%)**
  - Patents After April 26, 1993
    - Can choose to use Class 14
- **Class 46 (30%)**
  - Data network infrastructure equipment
- **Class 50 (55%)**
  - Computer hardware
- **Class 53 (50%) - increased to 100% on net additions**
  - Manufacturing equipment (acquired after 2015 and before 2026)

E. Pooling of Assets of the Same Class

- Assets of the same class are placed in a common pool,
  - provided all used in the same business. [13(21) *undepreciated capital cost* definition]
- A purchased asset will be added to a pool of assets.
- A sale of an asset will remove it from the pool.

E. Pooling of Assets of the Same Class[2]

- CCA on the undepreciated capital cost at the beginning of the year is treated differently from CCA on net additions (disposals)
- The accelerated first year CCA or immediate expensing applies only on net additions. [Reg. 1100 (2)]
  - If disposals exceed purchases, no accelerated CCA or immediate expensing.
- When assets are sold, the CCA pool is reduced by lower of
  - Original cost, or
  - Proceeds of disposition. [13(21) *undepreciated capital cost* definition]

Example – Class 8

Undepreciated Cost of Capital

UCC beginning of year:		$70,000
Additions	$60,000	
Disposals	(50,000)	10,000
		$80,000
CCA		
20% x $70,000	14,000	
20% x $10,000 x **150%**	3,000	
		(17,000)
UCC		$63,000

F. Short Taxation Year

- The amount of CCA that can be claimed is limited when the taxpayer has a *taxation year that is less than 365 days* (e.g., the first taxation year of a new corporation or a proprietorship)

- Example: an individual starts a new business on September 1, 2022, and purchases a Class 1 (6%) building costing $500,000. The first fiscal period ends on December 31, 2022, and includes 122 days (September 1 to December 31)

  – The CCA for the period is $15,041, calculated as follows:

$$6\% \times \$\ 500{,}000 \times 1.5 \times 122 / 365 = \$\ 15{,}041$$

G. Gains and Losses on Disposal of Depreciable Property

Generally:

- Gains and losses remain in the pool, and
- Are averaged over the life of the pool *except* when
  Sale Price > Original Cost
- A loss remains in the pool to be deducted in future year.

G. Gains and Losses on Disposal of Depreciable Property[2]

- **Gains and losses can occur at three points:**
  1. **Terminal Loss:**
     - All assets in pool are disposed of and
     - Positive balance in the pool is written off against business or property income [20(16)]
  2. **Recapture:**
     - Negative balance in a pool at year end
     - regardless of whether there are assets left
     - Gain is fully taxable [13(1)]
  3. **Capital Gain**
     - the selling price exceeds the original cost. [39(1)(a)]

H. Special Treatment of Passenger Vehicles

- Passenger vehicles costing more than $30,000 are placed in Class 10.1.
- Maximum addition to Class is $34,000 on most vehicles [Reg. 7307] and $59,000 on zero-emission vehicles [Reg 7307]
- Assets are not pooled [Reg. 1101(1af)]
- No recapture or terminal loss when vehicle is sold [13(2), 20(16.1)(a)]
- One-half rule
  - One-half of the CCA is claimable in disposal year. [Reg. 1100(2.5)]
- Vehicles < $34,000 are placed in Class 10

I. Special Treatment of Faxes, Photocopiers and Telephone Equipment

- Equipment subject to rapid obsolescence.
- Can elect to set up a separate class for *each* property costing more than $1,000 [Reg.1101(5p)]
- Enable a taxpayer to recognize terminal losses on disposal.
- If these assets were pooled, the loss would be averaged with the remaining assets.

J. Exceptions to the Declining Balance Method

- Two exceptions are as follows:
  1. Leasehold Improvements
  2. Franchises, Concessions, and Licenses with a stated legal life

1. Leasehold Improvements Class 13

- Tenant is responsible for the cost of making the rented space suitable to their needs.
- Expenditures are:
  - tangible improvements to the rental property and,
  - at the end of the lease, cannot be removed.
- Costs qualify as depreciable property (Class 13).
- Allocated using the straight-line method over the life of the lease plus one renewable option period. [Reg.- Schedule III]

1. Leasehold Improvements Class 13[2]

- **Minimum 5 years**; maximum is 40 years.
- Additional improvements are allocated over the remaining term of the lease and one renewal period.
- Accelerated first year CCA specific to Class 13 applies.
  - The straight line CCA amount is multiplied by 150% in the year the improvement is made. [Reg.1100(1)(b)]
- Inducement payments:
  - May be recognized as either business income [12(1)(x)] or
  - reduction of the cost of leasehold improvements. [13(7.4)]

2. Franchises, Concessions, and Licences Class 14

- Class 14 if have a **limited** legal life.
  - If unlimited life = Class 14.1
- CCA is determined separately for each item.
- The annual CCA:
  - straight-line basis based on number of days owned in the year divided by the total number of days in the life of the asset. [Reg.1100(1)(c)]
- 50% accelerated CCA is applicable in the first year

K. Involuntary and Voluntary Dispositions

- Tax on recapture is often a burden when replacement assets are not purchased in same year.
  - Requires tax be paid in current year,
  - Even though replacing asset.
- **Involuntary disposition** (i.e., fire, expropriation) often triggers recapture.
  - Permitted to defer recapture if
    - Acquire similar-use property within **24 months** after the end of the year the asset disposed. [13(4), (4.1)]
      - **Rental properties qualify**.

K. Involuntary and Voluntary Dispositions[2]

- **Voluntary dispositions** – can defer recapture if:
  - Property disposed is a ***Former Business Property***
    - Building used in carrying on business [248(1) *former business property* definition]
  - Replacement property purchased within **12 months** after the end of the year former building disposed. [13(4)]
- Year of disposition – show recapture and pay relating tax.
- Year of replacement – file amended return to remove recapture and receive a refund of tax paid.

L. Change in Use

From Personal Use to Business Use:

– Deemed disposition when occurs: [13(7)(b)]
  - If FMV < Original Cost then
    – FMV is the proceeds of disposition and new cost base for CCA.
  - If FMV> Original Cost then
    – Cost + taxable capital Gain is new cost base for CCA.

From Business Use to Personal Use:

- A change in use from business use to personal use causes a deemed disposition at FMV [13(7)(a)]

M. Depreciable Property Acquired from Non-Arm's Length Person

- Non-arm's length generally refers to related persons (including corporations)
- If purchase price > seller's cost
  - Seller has a capital gain; ½ taxable
  - Buyer's capital cost reduced by tax-free portion of gain (1/2)
  - Future CCA for the purchaser is based on the reduced amount [13(7)(e)]

N. Terminal Loss Restriction on Sales to Affiliated Persons

- Terminal loss on transfer to **affiliated person** is **denied** (deemed to be nil) [13(21.2)]
- Denied terminal loss remains with the seller ("notional property")
- May claim CCA on the amount
- Recognize the terminal loss on the notional property when sold by affiliated person.
- **Affiliated Persons**: individual and spouse and any corporation controlled by either [251.1(1)]

O. Cost of a Business Website

- Cost normally includes the cost of design and writing computer code
  - Can be considered application software
  - Class 12 - 100% CCA rate
- Computers acquired to host website.
  - Computer and systems software costs – Class 50
  - CCA rate 55%
- Ongoing reprogramming for maintenance, improvements, etc. are current expenses and deducted in the year incurred
  - Substantial alterations would be capital expenditures and added to Class 12

III. Goodwill & Other Intangibles Class 14.1

- Capital expenditure of an intangible nature with no specific legal life.
  - ➢Goodwill (purchased),
  - ➢Franchises, licences, and concessions with no *legal limited life,*
  - ➢Trademarks,
  - ➢Customer lists,
  - ➢Farm Quotas,
  - ➢Incorporation costs in excess of $3,000
- Goodwill = the value attributed to a business in excess of the sum of the value of all other, specific assets.

Tax Treatment of Class 14.1 Depreciable Property

- Full cost is added to the UCC pool
- CCA rate is 5%
- Accelerated CCA applies on net additions (if positive)
- Not eligible for immediate expensing available to CCPCs, Canadian individuals, and Canadian partnerships
- Dispositions may result in recapture and a capital gain

Tax Treatment of Class 14.1 Depreciable Property[2]

- Certain items may not be identifiable properties
  - Cannot be sold separately
  - Example - Incorporation costs
- Non-identifiable properties are added to the class as part of goodwill

IV. Accounting Rules vs. Tax Rules

- **Cost allocation**
  - **GAAP:**
    - Useful life to allocate capital costs
    - Requirements management estimates.
  - **Tax:**
    - CCA predetermined rates
    - Rates are determined on the basis of the average normal use of particular types of assets.

IV. Accounting Rules vs. Tax Rules[2]

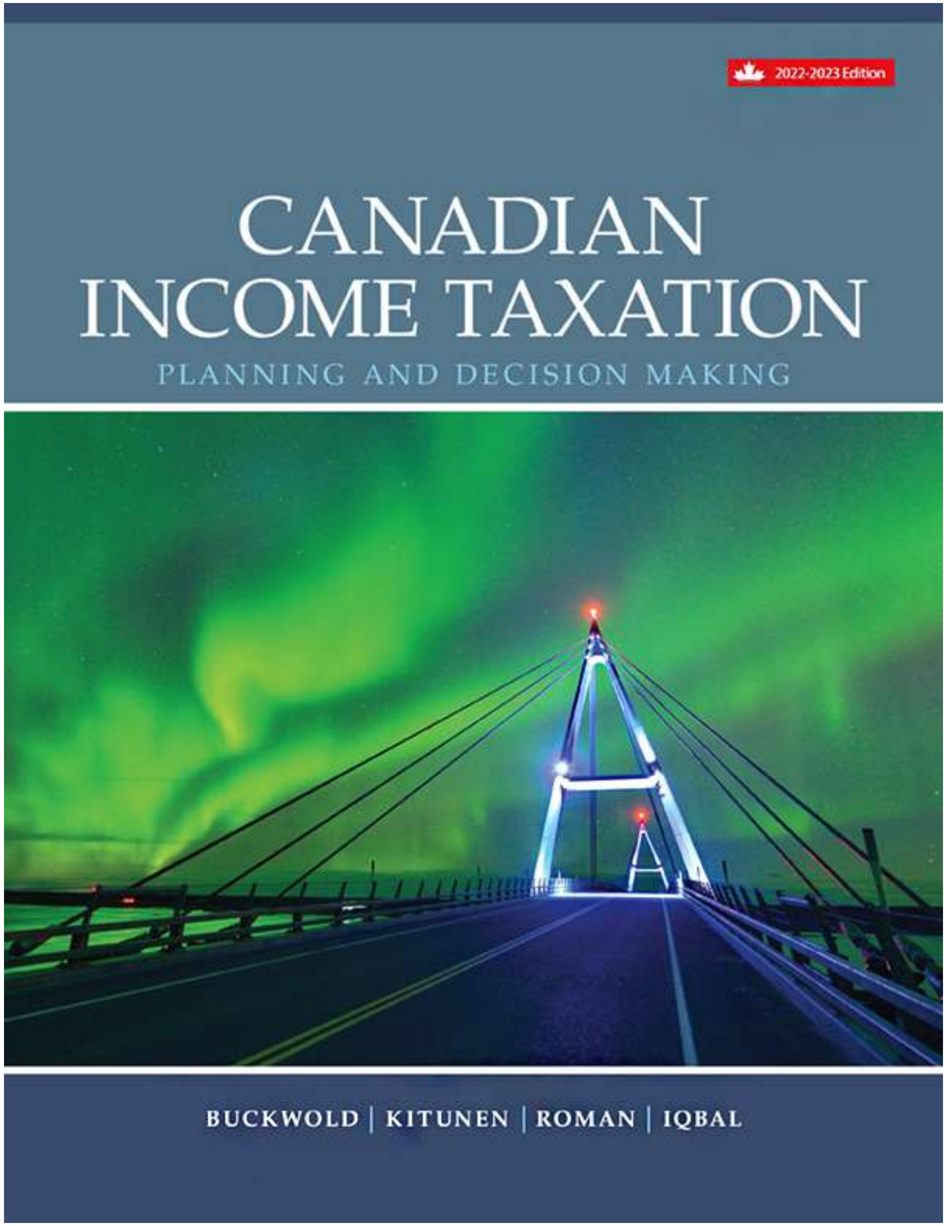
- **Gains and losses – Depreciable Property**
  - **Accounting:**
    - Gain and loss are recognized.
  - **Tax purposes:**
    - Only capital gains are recognized.
    - One-half of the capital gain is taxable.
    - Capital losses are not recognized on depreciable property [39(1)(b)(i)]

V. Impact on Management Decisions

The tax treatment of depreciable property has a significant impact on management decisions.

A. The tax method of dealing with depreciable property influences the rates and method of amortization/depreciation chosen by Canadian businesses.

B. The way that capital costs are allocated and gains and losses are treated influences the amount and timing of income tax, which in turn affects cash flow and all decisions relating to capital expansion.



CHAPTER 7:
Income from Property

Prepared by
Matthew Roman, CPA, MTax
KPMG, LLP

Electronic Presentations in Microsoft® PowerPoint®

I. Income from Property

I. Income from Property Defined
II. General Rules for Determining Property Income
III. The Unique Features of Property Income
IV. Impact on Investment Decisions

I. Income from Property Defined

- **Return on invested capital where:**
  – little or no time, labour or attention has been expended.

- **Includes the following:**
  1. **Dividends** - on capital shares of corporations
  2. **Interest** – loans, deposits, etc.
  3. **Rental income** – real estate or other tangible property
  4. **Royalties** – patents, mineral rights, etc.

I. Income from Property Defined[2]

- Property income is the annual or regular return received for allowing another party to use one’s property.

- Does not include capital gain or loss.

The Statutory Formula

Employment

Business

Property

Other

3(a) Income from all sources

3(b) + Taxable capital gains

3(c) - Other deductions

3(d) - **Loss** from Employ, Bus, **Prop**, ABIL

Division B net income

Division C deductions

Taxable Income

II. General Rules for Determining Property Income

- Property income = profit therefrom.

- Reflects the net concept:

Property revenues

less

Related expenses

II. General Rules for Determining Property Income[2]

Expenses incurred to earn property income are deductible if:

a) Incurred to earn taxable property income [18(1)(a)]
b) Not capital in nature [18(1)(b)]
c) Not a reserve [18(1)(e)]
d) Not a personal or living expense [18(1)(h)]
e) Are reasonable under the circumstances [67]

A. Property Income and the Taxation Year

Property income is determined annually

- **Individuals:**
  - Coincide with Calendar year
- **Corporations:**
  - Coincide with fiscal period

B. The Deduction of Interest Expense

- Deductible if loan was incurred to purchase investments to earn property income. [20(1)(c)]

- **Loan documentation:**
  - Must establish purpose of loan:
    - Maintain separate accounts is recommended

Principles for Maximizing After-tax Cash Flows

1. Use excess cash to purchase personal assets.

2. Use borrowed funds to purchase investment assets – maintain clear records.

3. Use excess cash to pay down personal debt first.
    - Interest paid on personal loans is not deductible.

Principles for Maximizing After-tax Cash Flows[2]

Consider an individual who borrows $10,000 at 10% to purchase either a Cottage or an investment. Individual has a tax rate of 45%.

Cottage – personal use	
Loan	$10,000
Interest paid	1,000
Tax saving	<u>0</u>
Cost of loan	
after-tax	**$1,000**

Investments	
Loan	$10,000
Interest paid	1,000
Tax saving	<u>(450)</u>
Cost of loan	
after-tax	**$550**

III. The Unique Features of Property Income
A. Interest Income

- Interest income definition – the compensation received for the use of borrowed funds.

- Corporations – recognize on an accrual basis
  - Include as income on a daily basis,
    - even though not received or receivable until some future time. [12(3)]

A. Interest Income[2]

- Individuals have three options:

    1. The receivable method
    2. The cash method
    3. The anniversary day accrual method

A. Interest Income[3]

- Individuals may use the receivable method or the cash method subject to the rules of the anniversary day accrual method

- Method chosen must be consistently used for that investment.

- **Receivable** method:
  - – included in income when the amount is legally due and payable

A. Interest Income - Individuals

- **Cash** method:
  - – Included in income in the year received [12(1)(c)]
- **Anniversary Day Accrual** Method:
  - – Requires that interest income be recognized for **every 12-month period** from the date the investment was made [12(4), 12(11) *anniversary day* definition]
  - – Means interest can only be deferred for limited period.

Anniversary Accrual Method

Individual loans $100,000 on February 1, Year 1. Loan must be repaid in two years. Interest is charged at 12%, compounded annually and is payable at the end of two years.

Required method so cannot defer for long periods

Cash Method

Year	Income
Year 1	$ 0
Year 2	0
Year 3	25,440
Total	$25,440

Anniversary Accrual Method

Year	Income
Year 1	$ 0
Year 2	12,000
Year 3	13,440
Total	$25,440

Foreign Interest

- Interest earned recognized in Canadian dollars.
- Gross amount is included:
  - Amount received plus foreign taxes withheld
- If foreign tax is withheld – may receive a foreign tax credit (Chapter 10)
  - Reduces Canadian taxes, if applicable. [126(1)]

Deductions from Interest Income

- Interest expense on loans to acquire interest – bearing investments [20(1)(c)]
- Investment counselling fees [20(1)(bb)]
- Costs incurred to obtain a loan - 1/5 per year [20(1)(e)]
- Investment management fees [20(1)(bb)]
- Fees paid to a financial institution to hold securities
- Accounting fees
- Reserves for uncollectibles where interest income has been accrued [20(1)(l)]

Deductions from Interest Income[2]

- A loss from property can offset other sources of income.

Expenses > Property Income

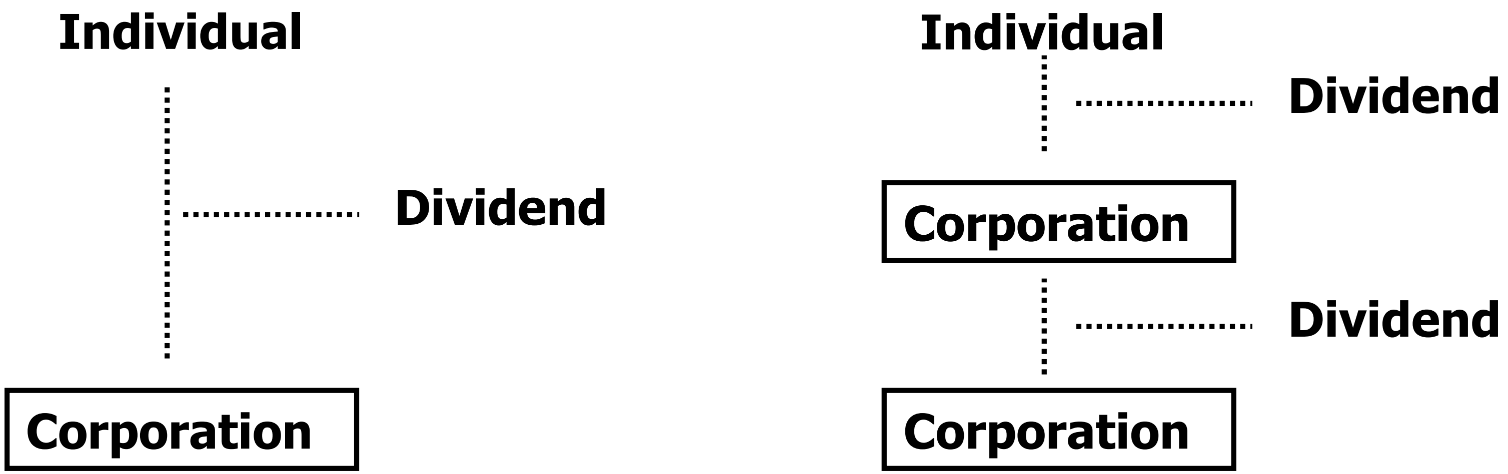
B. Dividend Income

- Dividends – the returns provided on the investment in shares of a corporation

- Dividend income can be received by both individuals and corporations.

Dividend Income

Corporate Ownership:



Dividends Received by Corporations

- Included in net income for tax purposes when received. [12(1)(j)]
- Dividends received from a **taxable Canadian corporation** are deducted when arriving at taxable income. [112(1)]
- In and out calculation.
- Result:

  Inter-corporate dividends are **not taxed**.
- Removes possibility of multiple taxation.

Dividends Received by Corporations[2]

- **Foreign Corporation Dividends:**
  - – only excluded from taxable income if the foreign corporation qualifies as a foreign affiliate. [113(1)]
- **A foreign corporation qualifies:**
  - – if Canadian corporation owns not less than 10% of foreign corporation. [95(1) *foreign affiliate* definition]

Dividends Received by Individuals

- Dividends from taxable Canadian corporate shares are included when received. [12(1)(j), 82(1)(a)&(a.1)]
- Grossed Up:
  - Received from Private Corporations: [82(1)(b)]
    - **115%** - if income eligible for low corporate tax rates (Chapter 13) - *Non-Eligible dividends;*
    - 138% - if income not eligible for low tax rates (Chapter 13) - *Eligible dividends*
  - Received from Public Corporations:
    - **138%** - *Eligible Dividends*
- A dividend tax credit ("DTC") is available – Chapter 10.
- Gross up and DTC are meant to reflect corporate tax already paid on the income since dividends are paid from after-tax retained earnings

Eligible Dividends Received by Individuals

Corporation	
Income	$1,000
Tax @ 27.5%	(275)
Net earnings	$ 725

Individual Shareholder:		
Dividend from Corporation	$ 725	
Taxable dividend ($725 x 1.38)		$1,000
Tax @ 50%		500
less DTC		(275)
Net personal tax		$225
Total tax paid on Corporate profits		
Paid by corporation	$ 275	
Paid by individual	225	$500

Dividends Received by Individuals

Corporation	
Income	$1,000
Tax @ 13%	(130)
Net earnings	$ 870

Individual Shareholder:		
Dividend from Corporation	$870	
Taxable dividend ($870 x 1.15)		$1,000
Tax @ 50%		500
less DTC		(130)
Net personal tax		$370
Total tax paid on Corporate profits		
Paid by corporation	$ 130	
Paid by individual	370	$500

Dividends Received by Individuals[2]

- Dividends from foreign corporations:
  - Not subject to the gross-up
  - Not subject to Dividend tax credit treatment
  - Actual amount of dividends (including withholding taxes) is included in income in the year received. [12(1)(k)]

Stock Dividends

- Stock dividends – corporation issues additional shares in lieu of a cash dividend
- Deemed to be a taxable dividend;
  - Individuals – dividend is subject to gross-up and Dividend Tax Credit.
- The amount of the dividend is determined based on the increase of the legal stated capital of the corporation (Chapter 12)

C. Rental Income

- Compensation received for allowing another party to use one's property.
- Included on accrual basis:
  - When earn
  - Regardless of when received
- Early payments of rent – can delay recognition until earned

Rental Income = Rent – Expenses

Deductions from Rental Income

- Costs incurred to obtain loan financing
- Insurance
- Property taxes
- Repairs
- Maintenance costs
- Utility costs
- Advertising
- Landscaping costs around a building
- CCA
- Salaries and wages
- Property management fees
- Accounting costs
- Costs incurred to collect rents

Special Rules for Capital Cost Allowance

Two special rules - apply only to rental property:

1. **CCA claimed on rental properties cannot:**
   - Create a rental loss, or
   - Increase a rental loss. [Reg.1100(11)]
2. **Separate classes for each rental building costing $50,000 or more.**
   - No pooling of rental property costing $50,000 or more [Reg.1101(1ac)]
   - Means when sold will always trigger recapture or terminal loss
     - Even when new building is acquired in same year.

D. Royalty income

- Normally treated as property income
  - Usually require little if any effort to achieve revenue
- Can be considered business income if considerable effort is made to earn the income
  - i.e. musicians, authors etc.

IV. Impact on Investment Decisions

A. Cash Flow and Return on Investment

- Interest-bearing securities:
  - Timing of tax payment may not coincide with cash received.
- Investment in corporate shares:
  - Dividends, and/or
  - Growth in value (taxation discussed in Chapter 8)
- Real Estate Investments:
  - CCA deductions, and
  - Recapture
- The ultimate *after-tax yields* vary considerably.
- Must examine relative risk and expected returns of each alternative investment.

IV. Impact on Investment Decisions[2]

B. Business Organization Structure:

- Separating appreciating assets
  - Provides protection from business failure,
  - Separate fortuitous gains from profits,
  - May accelerate recapture – due to separate class requirements for rental property.

IV. Impact on Investment Decisions[3]

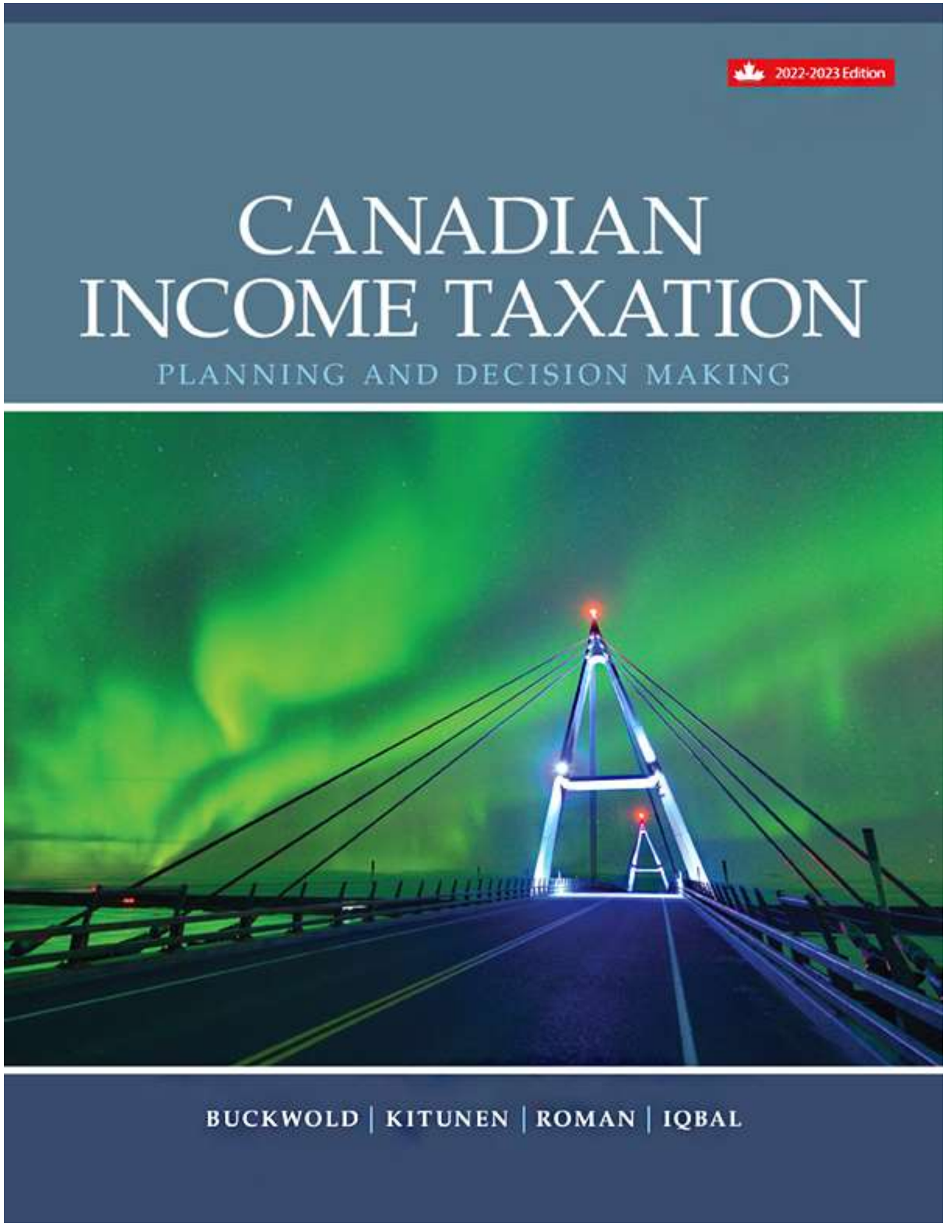
C. Corporate Financing

- Debt versus Equity financing:
  - Understanding varying tax treatments of property income on investor’s rate of return.
- Corporate financing – Chapter 21

IV. Impact on Investment Decisions[4]

D. Splitting Property Income among Family members – Attribution Rules & Tax on Split Income limit opportunities

- Tax rates vary among family members
- Attempts to lower overall family taxes paid by investing family savings with lower income individual
- Anti-Avoidance Rules – property income included in income of the taxpayer who created the wealth OR taxed at the top personal tax rate
  - See Chapter 9 for a discussion of these rules.



CHAPTER 8: Gains and Losses on the Disposition of Capital Property-Capital Gains

Prepared by

Matthew Roman, CPA, MTax

KPMG, LLP

Electronic Presentations in Microsoft® PowerPoint®

Gains and Losses on the Disposition of Capital Property – Capital Gains

I. Capital Gain and Capital Loss Defined

II. Determining Capital Gains and Losses – General Rules

III. Unique Aspects of Capital Losses

IV. Unique Aspects of Specific Capital Properties

V. The Aggregating Formula Revisited

VI. Impact on Investment and Management Decisions

I. Capital Gain and Capital Loss Defined

- Realized on disposition of capital property.
- Classified as capital property
  - Must be acquired & used to provide long-term or enduring benefit.
- Key - establishing the intended purpose!
  - Definition does not require that it be held for the long-term or that it must provide a benefit.
  - Nature of the asset is not relevant.

A. Capital vs. Business Income

Intended Purpose:

Intent → Resale for Profit → Business Treatment

Intent → Long-term Benefit → Capital Treatment

A. Capital vs. Business Income[2]

TRUCK

Deliveries → Sale is Capital **50%**

Resell to Truckers → Sale is Business **100%**

B. Intention

- Four factors in establishing the taxpayer’s original intention:
    1. Period of ownership.
    2. Nature of the transaction.
    3. Number and frequency of the transactions.
    4. Relation of transaction to taxpayer’s business.

Period of Ownership

Long-period Time

↓

Speaks of Long-term intent

Short-period Time

↓

Speaks of Short-term intent

Period of ownership by itself does not provide compelling evidence of intention.

Nature of the Transaction

Courts will examine the entity's course of conduct, dwelling on

- the point of acquisition,
- the use of the property during its ownership, and
- reasons for and nature of its disposition.

Number and Frequency of Transactions

- A historical pattern of frequent buying and selling supports intent to resell at a profit

Relation of Transaction to Taxpayer's Business

- Property sold is similar to those in the owner's trade or occupation.
  - Business income treatment.
- Difficult to establish that the ownership of such property was of a capital nature.

1. Change in Purpose

Acquired and used to provide a long-term benefit

↓

now converted into inventory and held for the purpose of resale

↓

Sale is Capital in nature until converted.

Acquired as inventory for resale

↓

not sold, converted to capital property & used to produce income

↓

Sale is Business in nature until converted.

Based on Property Value at time of change in purpose

2. Canadian Securities

Dual Purpose

Generate annual returns

Profits on resale

The *Act* permits a taxpayer to elect to have all sales of **Canadian** securities treated as capital transactions

2. Canadian Securities[2]

- Choosing this election ensures capital treatment,
  - also locks the investor into using this method indefinitely.

- May not always be desirable - losses will be capital losses and only deductible against capital gains.

2. Canadian Securities[3]

Canadian securities are:

- Share of a resident Canadian corporation,
- Obligations issued by a resident of Canada such as,
  - a unit of a mutual fund,
  - bond,
  - debenture,
  - mortgage, or
  - other similar obligations

C. Categories of Capital Property

Three categories of capital property:

1. Personal-use property
2. Listed personal property
3. Financial property

Personal-Use Property (PUP)

- Property used primarily for personal use and enjoyment and that does not generate financial returns. [54 personal-use property definition]
- $1,000 floor rule for Proceeds & ACB [46(1)]

Listed Personal Property (LPP)

- PUP that has some element of investment value
- That is: [54 *listed personal property* definition]
  - A print, etching, drawing, painting, or sculpture, or other similar works of art
  - Jewellery
  - A rare folio, rare manuscript, or rare book
  - A stamp
  - A coin
- Remember
  - Minimum POD = $1,000
  - Minimum ACB = $1,000

Financial Property

- Property acquired primarily to generate a benefit through a financial reward.
- Includes:
  - shares, bonds, loans,
  - land, buildings, equipment,
  - patents, licences, franchises, and
  - vehicles.

The Statutory Formula

Employment

Business

Property

Other

3(a) Income from all sources

3(b) + **Taxable capital gains**

TCG other than LPP gains

\+ LPP taxable net gain

\- ACL other than LPP losses

3(c) - Other deductions

3(d) - Loss from Employ, Bus, Prop, ABIL

Division B net income

II. Determining Capital Gains & Losses – General Rules

In aggregating formula (Chapter 3) includes amount by which total taxable capital gains exceed total allowable capital losses for the year

Capital losses can only be offset against capital gains

- Cannot be used to offset other sources of income

A. General Calculation

Proceed of disposition		XXX
Less		
Adjusted Cost Base	XX	
Expense of dispositions	<u>X</u>	<u>XX</u>
Capital Gain (Loss)		<u>XX</u>

B. Disposition and Proceeds of Disposition

- Capital Gains (losses) only recognized when a disposition occurs.
- A disposition of property occurs when:
  a) Property is sold;
  b) Involuntary disposition - theft, destruction, or expropriation;
  c) A share, bond, etc. is cancelled, redeemed, or settled; or,
  d) Share converted by amalgamation or merger.

B. Disposition and Proceeds of Disposition[2]

- Sold → POD = Selling price.
- Property exchange → POD = FMV of property received
- Involuntary → POD = Compensation received

Deemed Disposition

- No actual proceeds but deemed to have sold for:
  - Gift: POD = Value at time of gifting. [(69(1)(b)(ii)]
  - Change in use: POD = Value at time of change. [45(1)(a)]
  - Giving up residency: POD = Value when cease Canadian Residency. [128.1(1)(b)]
  - Death: POD = Value immediately prior to death. [70(5)(a)]

C. Adjusted Cost Base (ACB)

- **Normally:**

  ACB = original purchase price plus other costs incurred, like:

  - brokerage fees,
  - installation costs, and
  - legal fees

- **ITA 53** - lists a number of specific additions to and deductions from cost.

C. Adjusted Cost Base (ACB) 2

Negative ACB, when

accumulated cost base reductions > cost of the asset

- Negative balance is considered a capital gain and is recognized in the year in which it occurs.

D. Expenses of Disposition

- All costs incurred are deductible:
  - legal fees to complete the sale agreement
  - brokerage fees or commissions to agents
  - advertising
  - mortgage discharge fees

E. Deferred Proceeds

- Seller may choose to finance the sale by receiving payments over time.
- Capital gain rules allow the vendor to recognize the capital gain over time based on receipt of proceeds.
  - subject to a time limitation
    - Deferred recognition is restricted to a maximum of five years, **and**
    - Minimum of 20% of the capital gain must be recognized, on a cumulative basis, for each of the five years. [40(1)(a)(iii)]

E. Deferred Proceeds[2]

- The reserve is deducted from the gain in the year to arrive at the capital gain for tax purposes.

- The reserve is a *discretionary* deduction.

- **Maximum reserve** in any year is equal to the lesser of:

  [Proceeds due after year end / Total proceeds] x Gain

  and

  4/5 of the gain in year 1; 3/5 in year 2; 2/5 in year 3; 1/5 in year 4; and 0 in year 5.

Capital Gains Reserves – An example

Sell a piece of land with ACB of $150,000 for $200,000. Taxpayer receives $80,000 in cash at time of sale, $30,000 in Year 1 and $90,000 in Year 3. What must be included in his income in Year 1?

Gain			$50,000
Reserve claimed in Year 1 (lesser of):			
• $50,000 x [120,000/200,000]	=	$ 30,000, or	
• 4/5 x 50,000	=	$ 40,000	(30,000)
Capital Gain recognized in Year 1			$20,000
Taxable Capital Gain (1/2)			$10,000

III. Unique Aspects of Capital Losses

- Only recognized when a disposition occurs
- Can only be deducted against capital gains realized in the same year. [3(b)]
- If cannot be used in the current year,
  - Carry-forward indefinitely and used against future capital gains, or
  - Carried back to the previous three years. [111(1)(b)]

A. Allowable Business Investment Loss (ABIL)

- Incurred on the disposition of:
  - a loan to a small business corporation, or
  - sale of that corporation's shares. [39(1)(c)]
- A small business corporation ("SBC") is:
  - a *Canadian-controlled private corporation*
  - that uses all or substantially all of its assets (at least 90%) to conduct an active business. [248(1) *small business corporation* definition]

A. Allowable Business Investment Loss (ABIL) 2

- An ABIL can offset against all other sources of income, as an exception to the normal capital loss rules.

The Statutory Formula

Employment

Business

Property

Other

3(a) Income from all sources

3(b) + Taxable capital gains

3(c) - Other deductions

3(d) - **Loss** from Employ, Bus, Prop, **ABIL**

Division B net income

Division C deductions

Taxable Income

B. Deemed Disposition on Loans and Shares

- Subject to ***an election*** that permit the loss to be recognized before an actual disposition occurs –
  - Loans [50(1)(a)]
    - ➢the loan can be deemed to be disposed of for a value of nil at the time it is established to be a bad debt and, thus, trigger a capital loss before the debt is actually disposed.
  - Shares [50(1)(b)]
    - ➢deemed disposition for a value of nil but cannot be triggered until the corporation has become legally bankrupt or equivalent.

C. Depreciable Property

- **No Capital loss** on Depreciable Property [39(1)(b)]
- Original cost is written off through CCA
- Any loss arising reflected in the annual CCA calculation or the terminal loss or recapture, if any.

D. Superficial Losses

- No intention of disposing of the asset
  - disposed of and then reacquired within **30 days**. [54 *superficial loss* definition]

- Classified as a superficial loss, and deemed nil [40(20(g)(i)]

- The actual loss is not permanently denied,
  - **added to the ACB** of the reacquired asset [53(1)(f)]

- Rule applies when the asset is sold to an *affiliated person* (the taxpayer, spouse, or a corporation controlled by the taxpayer or spouse) [251.1(1) affiliated person definition]

D. Superficial Loss Example

Taxpayer sold 500 shares in Corp X for $8,000 on Dec. 31, Year 1. They had an ACB of $10,000. On Jan 5, Year 2 he reacquires 500 shares of Corp X for $7,500.

Shares sold on December 31, Year 1

POD	$ 8,000
ACB	(10,000)
Actual loss	$ (2,000)
Superficial loss deemed to be nil	nil

ACB of shares purchased on Jan 5, Year 2

Cost	$7,500
Denied loss – ITA 53(1)(f)	2,000
New ACB	$9,500

D. Superficial Losses[2]

- Where seller is a corporation:
  - Denied loss is **retained by seller** corporation
  - Not transferred to the cost base of the property
  - Recognition of capital loss is deferred until affiliated person sells the property or asset sold under deemed disposition rules [40(3.4)]
  - Intended to prevent transferring of cost base from one corporation to another

E. Personal-Use Property

- Losses are deemed to be **nil** [40(2)(g)(iii)]
  - even though gains are taxable.
- This restriction is applied to each item of personal property.
- Remember [46(1)]
  - Minimum POD = $1,000
  - Minimum ACB = $1,000

F. Listed Personal Property

- Losses on LPP are recognized, but only deductible against gains on LPP. [3(b)(i)(B), 41(1),(2)]

- Unused losses [41(2)(b)]
  - Carried back three years or
  - forward seven years and
  - deducted in computing LPP net gains [3(b)]

- Remember [46(1)]
  - Minimum POD = $1,000
  - Minimum ACB = $1,000

G. Assets Transferred to an RRSP or TFSA

- If market value < investment's ACB **no capital loss** (deemed to be zero) [40(2)(g)(iv)]
- Tax planning point – sell such investments to trigger the capital loss then transfer the cash to the RRSP or TFSA
- If desire is to hold the same investments in RRSP/TFSA must wait 30 days to reacquire to avoid superficial loss rules
  - RRSPs/TFSAs are considered affiliated persons [251.1(1)(g)]

IV. Unique Aspects of Specific Capital Properties

A. Identical Properties
B. Convertible Securities
C. Options and Warrants
D. Commodities and Futures Transactions
E. Principal Residence
F. Voluntary and Involuntary Dispositions
G. Mutual Funds
H. Eligible Small Business Investments
I. Charitable Gifts and Capital Gains

A. Identical Properties

- Properties of an identical nature acquired over a period of time and at different costs.
- The ACB of each identical property acquired is the weighted average cost of all the identical properties acquired up to the point of sale. [47(1)]
- Election available to treat shares acquired under an employee stock option agreement as not identical to shares acquired on open market if sell within 30 days of acquiring them [7(1.31)]

A. Identical Properties - ACB

Acquire shares as follows:

Year	# of Shares	Cost per share	Total
1	100	$6	$ 600
2	200	8	1,600
3	80	10	800
	380		$3,000

ACB per share ($3,000/380) = $7.89

Sale Proceeds (150 x $9)	$1,350
ACB (150 x 7.89)	(1,183)
Capital Gain	$ 167

B. Convertible Securities and C. Options and Warrants

Convertible securities

– Disposition considered not to have occurred

– New ACB = Old ACB [51(1),(2)]

Options and Warrants

Payer:

– Costs of option is added to ACB if option is exercised and shares acquired [49(3)]

– Option expires – Capital loss in year expired.

Grantor

– amount received is a capital gain in year received [49(1)]

D. Commodities and Futures Transactions

- By definition, cannot be capital property
  - – No long-term or enduring benefit
  - – Solely for purpose of obtaining a gain on resale
- CRA policy allows taxpayers to choose capital or business income treatment [IT-346R]
  - – Used consistently in future years
  - – Not permitted for taxpayers associated in the commodity business or who take commodity positions as part of business

E. Principal Residence

- A principal residence: [54 *principal residence* definition, part (a)]
  - Owned and ordinarily inhabited for personal use
  - May be subject to capital gain on sale
  - Capital gain can be reduced if designated as principal residence
  - T2091
- Designation in tax return for year of sale
- One principal residence designation per year per family unit [54 *principal residence* definition, part (c)]

E. Principal Residence[2]

- **Reduction Formula:** [40(2)(b)]

$$\frac{\textbf{1 + \# of Years Designated Principal Residence}}{\textbf{Number of Years Owned}} \quad \textbf{X} \quad \textbf{Gain}$$

- The “+1” is included to cover the year in which two houses are owned as a result of the normal process of selling one house and acquiring a new one.
- Must designate at least one year to get the benefit of the “+1”

F. Voluntary and Involuntary Disposition

- Special treatment for deferring capital gains on disposition of real estate used to carry on a business providing: [44(1)]
  - For **voluntary dispositions**:
    - replacement property acquired **used for similar purpose**
    - must be replaced:
      - in the same taxation year of disposition, or
      - before the end of the first taxation year that begins after the property was sold [44(1)(d)]
    - Deferred gain reduces the ACB of replacement property [44(1)(f)]
    - The deferral does not apply to real estate used to earn property income from rentals.

Real Estate Used to Carry on a Business

Involuntary dispositions i.e. such as expropriation:

- Replaced by the end of the second taxation year following the year of disposition [44(1)(c)]
- the deferred gain will reduce the ACB of the replacement property [44(1)(f)]

- Not restricted to business real estate.
  - Applies to rental properties and machinery/equipment

G. Mutual Funds

- Units of a mutual fund are capital property;

  ACB = the purchase price + reinvested income
- Distributions retain characteristics of the income earned by the mutual fund:
  - capital gains,
  - dividends,
  - interest, and
  - ordinary income
- Included in recipient's income for tax purposes when distributed.

G. Mutual Funds[2]

- Reinvested distributions are still taxable when made
  - distribution is added to the ACB of the investment.

- A disposition when units are redeemed for cash or transferred to another mutual fund.

- The disposition will result in a capital gain or loss if redemption price differs from the ACB.

Mutual Funds[3]

Distribution Reinvested		Taxable Amount
• Interest	$100	$100
• Dividend	100	138
• Capital Gain	100	50
Total	$300	$288

Increase in ACB = $300; actual amount reinvested

H. Eligible Small Business Investments

- Individuals disposing of eligible small business corporation shares can defer recognition of the gain if:
  - Proceeds are used to reinvest in another eligible small business within **120 days** after the end of the year of the sale [44.1]
  - New investment must be treasury shares:
  - Strengthens the capital resources to encourage growth.

H. Deferral On Small Business Investments – An Example

In Year 1, taxpayer disposes of shares in a small business for $1,000,000. The ACB is $400,000. Within the qualifying period reinvests $900,000 in treasury shares of another eligible small business corporation.

Capital Gain $1,000,000 - $400,000	=	$600,000
Deferral:		
($900,000/$1,000,000)($600,000)	=	(540,000)
Capital Gain recognized in Year 1		$ 60,000
ACB of new investment:		
$600,000 - $540,000	=	$360,000

I. Charitable Gifts and Capital Gains

- Public company shares transferred directly to public charity as a gift.
  - Capital gain:
    - is deemed **nil** [38(a.1)]
    - no tax payable
- Taxpayer still receives a donation receipt for full value.
- Substantial tax savings as a result.

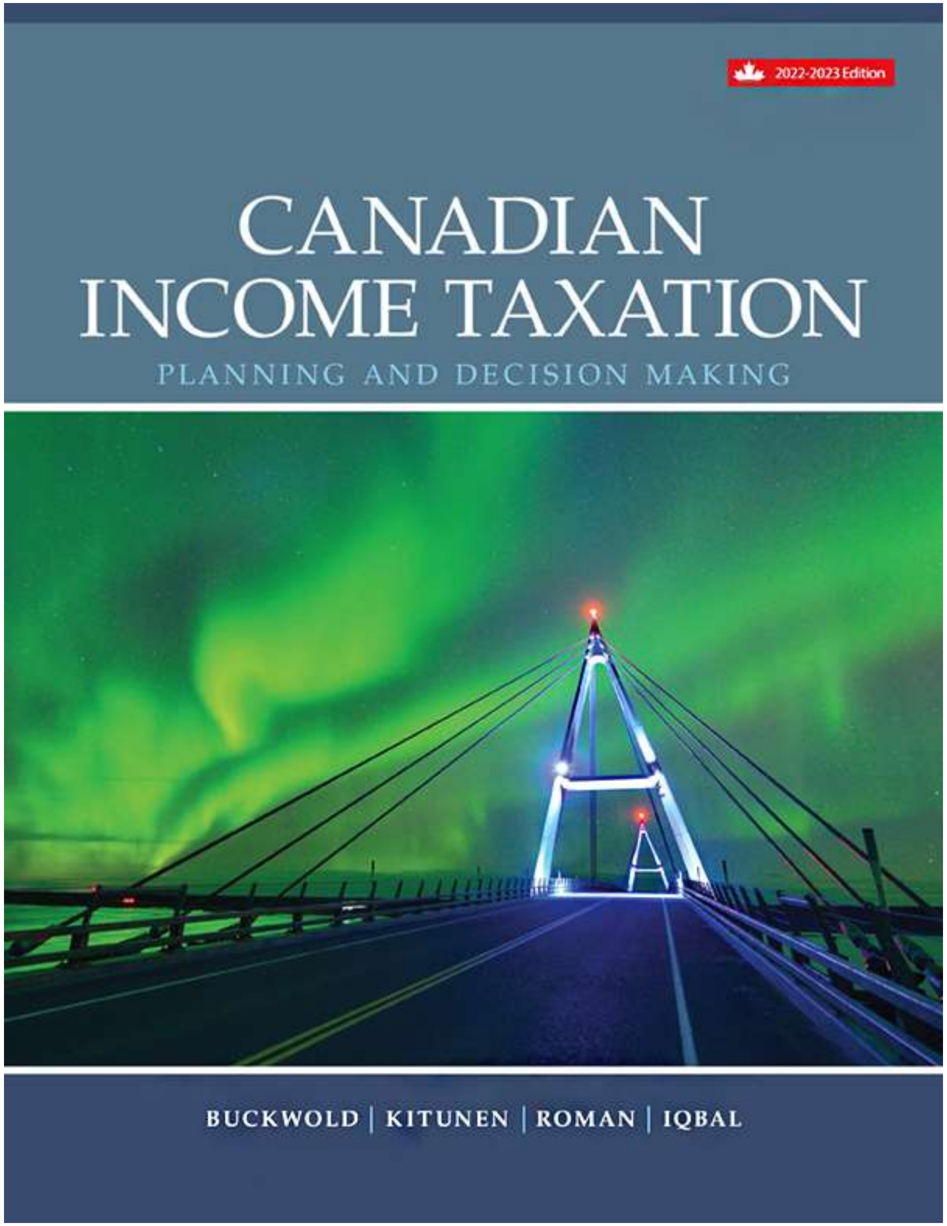
VI. Impact on Investment and Management Decisions

A. Return on Investments

- Preferential treatment of capital gains increases the after-tax yield.
- Increasing a return on capital growth is riskier than with interest-bearing securities.

B. Downside Risk

- Restriction on potential loss
- Ability to use capital losses in uncertain.



CHAPTER 9:
Other Income, Other Deductions, and Special Rules for Completing Net Income for Tax Purposes

Prepared by
Matthew Roman, CPA, MTax
KPMG, LLP

Electronic Presentations in Microsoft® PowerPoint®

Other Income, Other Deductions, and Special Rules for Completing Net Income for Tax Purposes

I. Other Sources of Income
II. Other Deductions
III. Registered Retirement Savings Plans
IV. Pooled Registered Pension Plans
V. Registered Education Savings Plans
VI. Registered Disability Savings Plans
VII. Tax-Free Savings Accounts
VIII. Tax-Free first Home Savings Account
IX. Special Rules for Net Income Determination

I. Other Sources of Income

- **Catch-all category – other income that does not qualify as:**
  - Employment income
  - Business income
  - Property income
  - Capital Gains/Losses
- Sections 56 through 59.1 of the *Act*.

The Statutory Formula

Employment

Business

Property

Other

3(a) Income from all sources

3(b) + Taxable capital gains

3(c) - **Other deductions**

<u>3(d) - Loss from Employ, Bus, Prop, ABIL</u>

Division B net income

<u>Division C deductions</u>

Taxable Income

I. Other Sources of Income[2]

Major sources of other income:

- Pension benefits from employer's pension plan [56(1)(a)]
- OAS, CPP, EI [56(1)(a)]
- Foreign pension benefits [56(1)(a)]
- Retiring allowance [56(1)(a)]
- Split pension income reallocation [56(1)(a.2]
- Spousal support payments received [56(1)(b)]
- RRSP, RRIF Income [56(1)(h)]
- DPSP benefits [56(1)(i)]
- Scholarship, fellowships, bursaries [56(1)(n)]
- Research grants [56(1)(o)]
- RESP payments [56(1)(q)]

I. Other Sources of Income[3]

Scholarships, fellowships, or bursaries:

- not taxable if student is enrolled in a qualifying education program,
- otherwise exempt only to the extent of $500 annually. [56(3)]

Research grants:

- Total grant less expenses is taxable.

Support payments from a former spouse:

- taxable providing received as periodic payments, pursuant to a court order or written agreement.

What items are not subject to tax under the Canadian tax system?

- Lottery winnings
- Receipt of a gift
- Receipt of an inheritance
- Life insurance proceeds on the death of an individual
- Profits from betting or gambling,
  - when conducted for pleasure or enjoyment
- Proceeds from accident, disability, sickness, or income maintenance insurance policies,
  - if the employee has paid all of the premiums.

II. Other Deductions

- A catch-all category.
- Specific list of items found in section 60 through 66.8 of the *Act*.

II. Other Deductions[2]

Major items included are:

- Support payments to a former spouse, if
  - Periodic and
  - By virtue of a court order, or written agreement [60(b)]
- Pension income reallocation [60(c)]
- CPP contributions on self-employment earnings [60(e)]
- Enhanced CPP contributions
- RRSP contributions [60(i)]
- Retiring allowances for pre-1996 employment transferred to RRSP [60(j.1)]
- Fees/expenses for objection or appeal of a tax assessment [60(o)]
- Moving expenses [62(1)]
- Child care expenses – lower income spouse [63(1)]

Moving Expenses

- **Deductible if:**
  - – incurred for relocation to commence a business or employment,
    - in another part of Canada,
  - – to attend a university or other post-secondary school,
  - – to the extent of income earned in the new location. [62(1); 248(1) *eligible relocation* definition]

Moving Expenses[2]

Deductible expenses include:

- Travel costs,
- Transportation and storage of belongings,
- Temporary board and lodging (up to 15 days),
- Costs of cancelling a lease for the old residence,
- Selling costs of the old residence,
- Legal fees and land transfer taxes,
- Cost of maintaining a vacant former residence within limits,
- Cost of revising legal documents, etc. [62(2)]

Moving Expenses[3]

- Eligible if new residence location is at least 40 kilometres closer to the new work location than the previous residence.

IF

Moving Expense	>	Income in new location

Then

- Carry forward unclaimed portion and deduct in following year.

Child Care Expenses

Includes:

- the cost of babysitting, day care, or lodging at a boarding school,
- children 16 years of age or less,
- If incurred so taxpayer could pursue employment, business, or research activities. [63(3)]

Limit to lessor of three amounts:

- Amount paid in the year,
- $5,000 per child 7 to 16, + $8,000 per child under 7, + $11,000 for child with mental or physical disability, or
- 2/3 of the taxpayer’s earned income for the year. [63(1),(3)]

Lower income spouse claims deduction [63(1)]

CPP Basic Contributions

- Pensionable earnings between $3,501 and $64,900 (**2022**) are subject to CPP contributions.

Employees:

- 4.95% paid by employee (no deduction, but eligible for a tax credit – see Chapter 10).
- 4.95% paid by employer (non-taxable benefit to employee and generally deductible to the employer).

Self-Employed:

- Both portions (9.9%) paid by self-employed individuals.
  - No deduction on first half, but eligible for a tax credit – see Chapter 10.
  - Second half is fully deductible as an “other deduction”. [60(e)]

CPP Enhanced Contributions

- CPP contributions have been increased in recent years to help increase retirement income for working Canadians.
- The contribution rate on the first half of the CPP contributions (i.e. amount paid by employees and the non-deductible half paid by self-employed individuals) is raised to **5.7%** (from 4.95%).
- Difference between enhanced rate and basic rate is deductible as an "other deduction":

  [(5.7% – 4.95%) × (pensionable earnings up to $64,900 [for 2022] – basic exemption $3,500)]

- Maximum enhanced contribution is $460.50 for **2022**
- The CPP tax credit (Chapter 10) is still limited to the 4.95% contribution.

Retiring Allowance

- Can be transferred to an RRSP or RPP within limits
  - $2,000 for each year employed prior to 1996.
  - Increased an additional $1,500 for years employed prior to 1989 if RPP contributions for those years are unvested. [60(j.1)]

III. Registered Retirement Savings Plans "RRSP"

- Private, tax-sheltered retirement program
- Initiated and controlled by the individual taxpayer

- **Investments in an RRSP:**
  - Income & gains not taxed until withdrawn, therefore
  - Generate higher return because they permit investment of pre-tax earnings.

A. Benefits of Investing in an RRSP

In an RRSP

Invest	$6,000
Earn 10% / year	600
Tax Payable in interest	0
After year 1	$6,600
Year 2 interest	660

Outside an RRSP

Invest	$6,000
Earn 10% / year	600
Tax Payable @ 45%	(270)
Value Yr 1	$6,330
Year 2 interest	633

$27 less

Note this ignores the tax savings from contributing to the RRSP

B. Contribution Limits

Individuals not belonging to an RPP or DPSP:

- Annual limit is equal to: [60(i), 146(1)]
  - 18% of the individual's prior year's *earned income*,
  - up to a maximum of **$29,210** (for **2022** based on **2021** earned income)
    - Increases every year.
- Unused portion (contribution room) can be carried forward indefinitely.

Individuals belonging to an RPP or DPSP, the RRSP contribution limit is integrated with those plans.

Contribution Room – an example

Annual limit for **2022** lesser of:

- Salary – **2021** $160,000 x 18% $28,800
- **2022** limit $29,210

If no carry forward amount… Total contribution limit in this example is $28,800 in **2022** due to the prior year's earned income

Earned Income

“Earned income” includes: [146(1)]

– employment income (without RPP deduction)
– business income
– rental income, royalty income
– Spousal support received
– research grants net of related expenses.

Reduced by:

– business losses
– rental losses
– deductible spousal support payments

RRSP – Over-contribution

- Contributions exceeding the annual limit are subject to a penalty tax of 1% per month on excess. [204.1(2.1)]
- Permitted to accumulate over-contributions up to **$2,000**. [204.2(1.1)]
- Over-contribution can be carried forward and deducted in a future year when sufficient contribution room is created.

C. RRSP Investment Opportunities

- Restricted to certain types of investments.
- Qualified investments includes:
  - cash deposits in banks or other financial institutions,
  - term deposits,
  - government-insured or guaranteed bonds,
  - bonds and debentures of public corporations,
  - shares of public corporations,
  - mutual finds and
  - mortgages on real estate.

D. Retirement Options

- Funds accumulated in an RRSP can be paid out in a lump sum or gradually over a period of time in the form of a pension.
- To receive regular payments from an RRSP, the plan must be converted into a pension vehicle.
    - Life annuity – risk vehicle
    - Guaranteed fixed term annuity – full funds are paid out.
    - Registered retirement income fund (RRIF) – minimum amount of withdrawal required.
        - Provides greatest flexibility.
        - After 65 - Can transfer up to ½ of RRIF income to spouse's tax return for income splitting

D. Retirement Options[2]

- Mandatory to convert RRSP funds to a retirement income vehicle by December 31 of year reach **age 71**.
- Retirement income can begin the following calendar year.
- Failure to convert by end of year turn 71 will result in the full amount of the plan being taxable in the following year.

E. Spousal RRSP

- An individual can contribute all or any part of his/her contribution limit to the RRSP of a spouse.
- Contributor - entitled to tax deduction.
- Allows for income splitting:
  - Allows for income to be taxed in the spouse's hand rather than that of the contributor.
- Limitations – withdrawals from the spousal plan within two taxation years of the contribution year are included in the contributor's income. [146(8.3)]

Home Buyers' Plan

- Can withdraw up to **$35,000** RRSP funds tax-free to purchase a home.
- Must be repaid over a 15-year period.
- Must be a ***first-time*** home buyer --
  - neither taxpayer nor spouse owned a home in the prior 5 years. [146.01]

Lifelong Learning Plan

- Can withdraw **$10,000/yr** ($20,000 cumulative max over 4 years) RRSP funds tax-free for full-time post-secondary education (at least 3 months).

- Repayable over 10 years after graduation. [146.02]

IV. Pooled Registered Pension Plans

- Similar to an RPP:
  - – but with greater flexibility for individuals and employers
  - – employers can deduct contributions
  - – employees not taxed until withdrawn
- Attractive to small business employers and self-employed individuals.

V. Registered Education Savings Plans

- Primary purpose is to provide funding for post secondary education.
- Can contribute to an RESP prior to child turning 31 years old.
- **$50,000 lifetime contribution limit**
- Earn income on tax deferred basis.
  - Income is taxed when funds are withdrawn from the plan
- Contributions are not tax deductible
  - Differs from RRSP contribution

RESP and the CESG

- Canada Education Savings Grant CESG
  - Children **under 18** can receive the grant
    - Annually – **20% of contribution up to $2,500** – max grant $500
      - May be increased to $1,000 if maximum grant was not received in prior years.
    - Lifetime – maximum grant $7,200
  - Child must pursue post-secondary education
    - If not, CESG must be returned

B. Withdrawals from RESP

- Educational Assistance Payments (EAPs)
  - To support studies
- **$5,000** EAP withdrawal limit in the first 13 weeks of school
  - For part-time students the limit is $2,500
- After that no limit.

RESPs and Taxation

- Receipts from Contributions made by Contributor
  - Tax Free
- Receipts from Earnings and Grant
  - Taxable when received

RESPs

- **Withdrawals to Contributor**
  - – Original contributions – not taxable
  - – Earnings – two levels of tax
    - Income taxed at usual levels
    - Additional tax of 20%
      - – To remove the deferral benefit
- **Rollover To RRSP avoids both levels of tax**
  - – Must have contribution room

C. Benefits of an RESP

1. **Investment returns accumulate in plan on tax deferred basis**
   - Similar to RRSP
2. **Amount saved is enhanced by the federal grant**
   - **$7,200** plus investment returns
3. **Income Splitting Benefits**
   - Investment returns are taxed in child's hands
     - Usually a lower income levels resulting in lower overall tax

VI. Registered Disability Savings Plans (RDSP)

- Tax-deferred way for families to save for the long-term financial security of a person with a disability eligible for the disability tax credit

Contributions

- Lifetime limit of **$200,000**
- Not tax deductible;
- May be eligible for Canada Disability Savings Grant and the Canada Disability Savings Bond (based on family income)
  - can receive a maximum of $3,500 in matching grants in one year, and up to $70,000 over the beneficiary's lifetime.
  - Low income individuals with disability eligible for up to $1,000 per year up to $20,000 over the beneficiary's lifetime
  - Bonds only eligible up to beneficiaries until year they turn 49
- Withdrawals only taxable to the extent they include withdrawals of grants, bonds or investment income earned in the plan

VII. Tax-Free Savings Accounts (TFSA)

- Preferential treatment on investment returns

Contributions

- limited to **$6,000** (**2022**) per year
- Can contribute individual and/or spouse's plan
  - Combined annual contribution is $12,000
- Not tax deductible
- Can be carried forward indefinitely [146.2]
- The total cumulative contribution room for a TFSA is **$81,500** (including **2022**) for those who have been 18 years or older and a resident of Canada since 2009

VII. Tax-Free Savings Accounts (TFSA) 2

- **Overcontribution**
  - 1% per month penalty tax on the excess
- **Investments**
  - Qualified investments similar to those permitted for RRSP
- **Income and Withdrawals**
  - Tax free
- **Withdraws added to accumulated contribution limit in the following year**
  - Means can withdraw funds and replaced later
    - Unlike RRSP

VIII. Tax-Free First Home Savings Account (FHSA)

- Beginning in 2023, the FHSA is available to help Canadians save for a down payment on their first home.
- Contributions are tax deductible
- Withdrawals not taxable as long as they are used to acquire a first home (taxable otherwise)
- Annual contribution limit of $8,000 (lifetime contribution limit of $40,000)
- Cannot carry forward unused amounts (e.g. if $1,000 of $8,000 annual limit is contributed in Year 1, the Year 2 annual limit is still $8,000)
- If the FHSA is not used to purchase a home within 15 years of first opening the account, the FHSA must be closed and unused savings transferred into an RRSP or withdrawn and brought into income

IX. Special Rules for Net Income Determination

- Unusual transactions may occur, where the tax treatment is unclear.
- Taxpayers may attempt to structure transactions to avoid the application of the general rules
  - Special rules provide greater certainty for unusual transactions, and also deter certain tax avoidance schemes. (ITA s. 67 – 81)
    - Take precedence over other principles.
    - Apply to all of the five sources of income.

A. The Reasonableness Test

- Expenses are only deductible if considered **reasonable** in the particular circumstances. [67]
- What is reasonable? It’s a question of fact.

A. The Reasonableness Test[2]

- Business owner may be denied deduction for salary paid to a spouse or child if excessive in relation to services provided
- Salary remains taxable to the spouse or child
- Creates a double taxation within the related unit

A. The Reasonableness Test[3]

- **ITA provides limitations for specific categories:**
  - Deduction for meals, beverages, and entertainment expenses limited to 50% of the actual costs. [67.1(1)]
  - Limits placed on the deduction of interest, lease costs, and the capital cost for a passenger vehicle. [13(7)(g), 67.2, 67.3]

B. Allocation of Purchase Price for Multiple Assets

- Properties may be acquired or sold as a group.
- Difficult to allocate that price among the various assets included in the transaction.
- Conflict may arise between the purchaser and the vendor:
    - ➢Buyer's interest – allocate to assets that have a faster write-off rate for tax purposes.
    - ➢Vendor's interest to – wants to reduce tax on the sale.

B. Allocation of Purchase Price for Multiple Assets[2]

- Special rules permit CRA to allocate or reallocate the total price in accordance with the fair market values of individual properties.
- Irrespective of the legal agreement of sale.

C. Transactions with Inadequate Consideration

Non-arm’s length

– special rules prevent the elimination or reduction of tax by selling at a price other than fair market value.

- Taxpayers are considered not to be dealing at arm’s length if they are related to each other. [251(1), (2)]

Non-Arm's Length

1. Sell Price < FMV:
   - Vendor – deemed to have sold at FMV [69(1)(b)(i)]
   - Purchaser – ACB equal to sell price
   - Results in double tax on future sale
2. Sell Price > FMV:
   - Vendor – proceeds equal to sell price
   - Purchaser – ACB is deemed equal to FMV [69(1)(a)]
   - Results in double tax on future sale
3. Gifting:
   - Vendor – sales price = FMV [69(1)(b)(ii)]
   - Purchaser – ACB = FMV [69(1)(c)]
   - No double tax

Non-Arm's Length[2]

- Punitive provisions apply even when intended to deal at FMV.
- Include a price adjustment clause in written agreement
  - indicates the established price is a reasonable estimate of FMV and that, if found to be in error, the price charged and paid will be altered accordingly.
- Existence of such an agreement will cause CRA to adjust both sides of the transaction,
  - thereby eliminating the punitive result, which is double taxation.

D. Non-Arm's Length Defined

- The *Act* deems parties not to be dealing with each other at arm's length if they are related. [251(1)]

- Non-arm's length transactions can occur between:
  - ➢An individual and another individual
  - ➢An individual and a corporation
  - ➢A corporation and another corporation

D. Non-Arm's Length Defined[2]

Individuals are related to each other if they are direct-line descendants: [251(2)(a)]

- grandparents
- parents
- children
- grandchildren, etc.

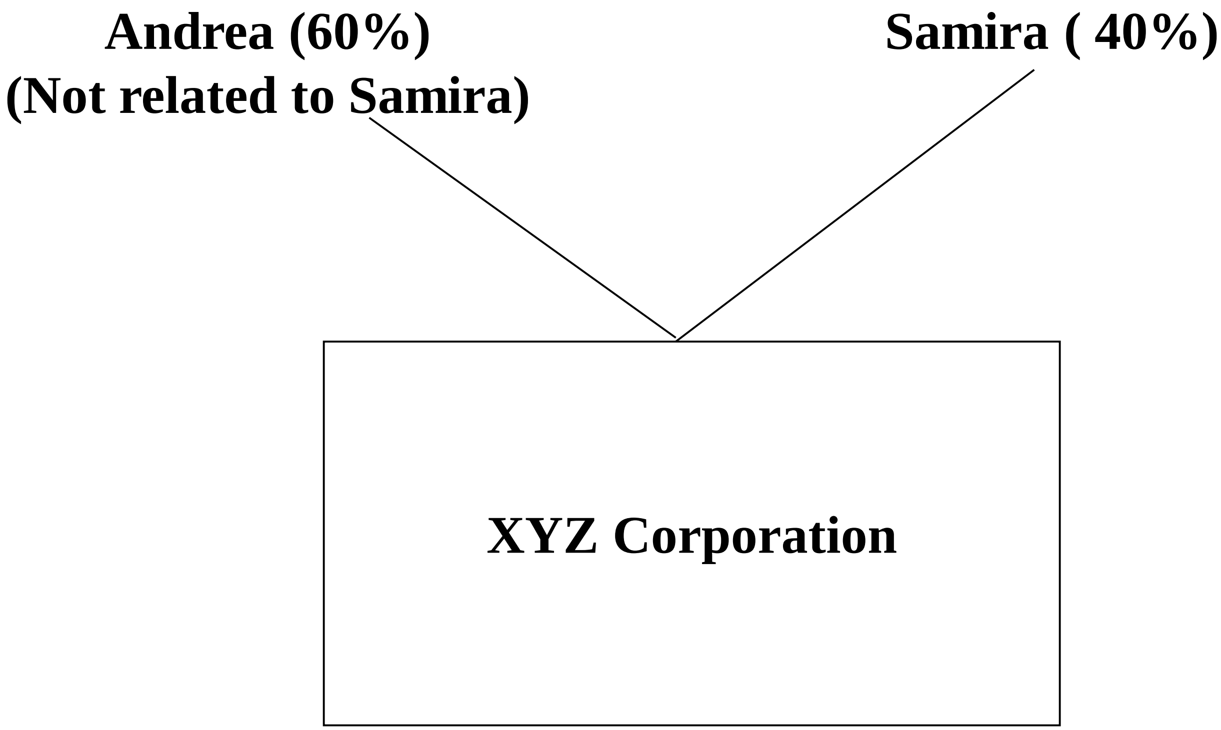
or if they are:

- siblings
- spouses
- in-laws

D. Non-Arm's Length Defined[3]

- **Individual is related to a corporation if:** [251(2)(b)]
  – He or she controls the corporation,
  – Is a member of a related group that controls the corporation
  – Is related to an individual who controls the corporation

D. Non-Arm's Length Defined[4]

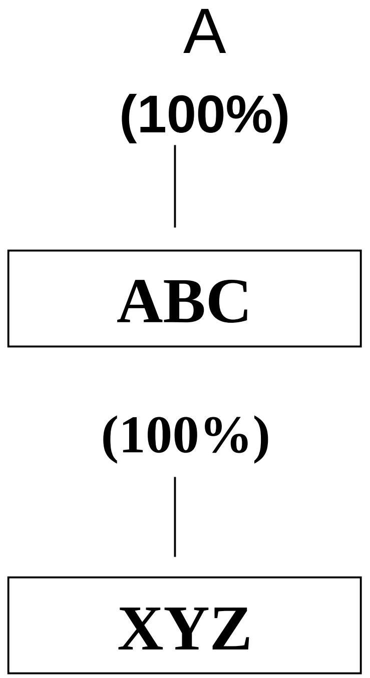


Who is related to the corporation?

D. Non-Arm's Length Defined[5]

Corporations are related if:

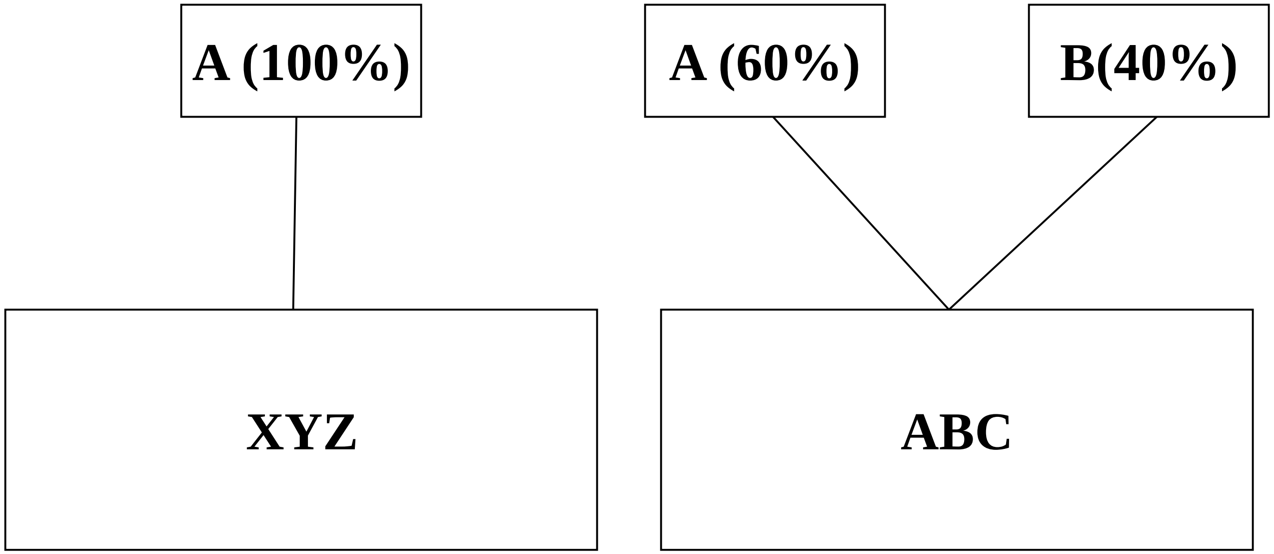
- One corporation controls the other corporation [251(2)(c)]



D. Non-Arm's Length Defined[6]

Corporations are related if:

- Both corporations are control by the same person [251(2)(c)(i)]

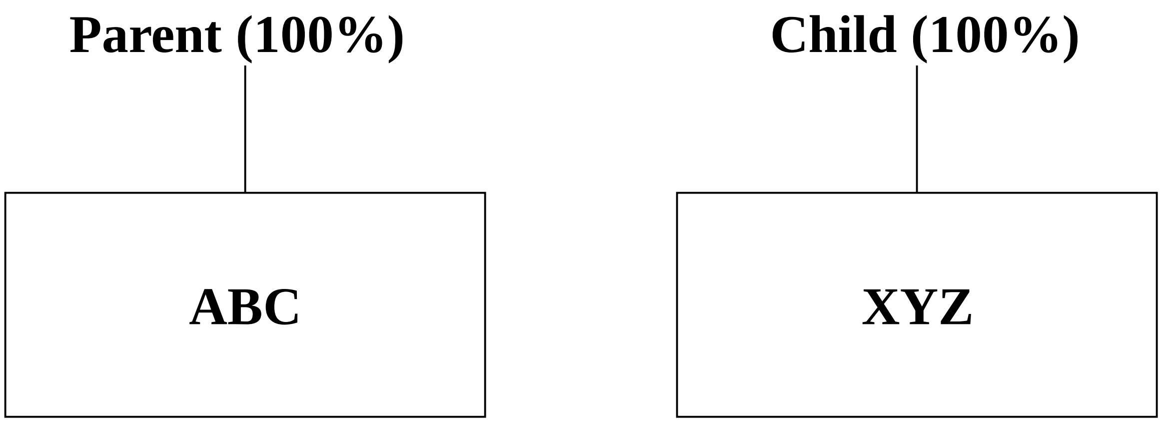


Both corporations are controlled by A, which means the two corporations are related

D. Non-Arm's Length Defined[7]

Corporations are related if: [251(2)(c)(ii)]

- If one corporation is controlled by one person who is related to the person who controls the other corporation



The two corporations are related even though they are controlled by different individuals, since the parent and child are related under 251(2)

D. Non-Arm's Length Defined[8]

- Even when parties are *not related*, it is a question of fact whether they are dealing at arm's length for a particular transaction. [251(1)(c)]

- Where there is sufficient cause, CRA can deem two unrelated parties not to be dealing at arm's length.

E. Property Transferred to a Spouse or Child

Property transferred to a child:

- Deemed sold at fair market value [69(1)]
- Exception: farm property may be sold at less than FMV

Property transferred to a spouse:

- Sold or gifted, deemed to have been sold and acquired at its cost amount ("spousal rollover") [73(1), (1.01)]
  - Capital property deemed sold at ACB
  - Depreciable property deemed sold at UCC
- No taxable income is created
- May choose to recognize the gain [73(1)]

F. The Attribution Rules – Income Splitting

Attribution Rules:

- Additional special rules govern the taxation of income earned on property after transfer.

F. The Attribution Rules – Income Splitting[2]

1. Income from Property Transferred to a Spouse:

- Subsequent income received by spouse on transferred property is included in income of original owner
  - for as long as the couple remains married. [74.1(1)]

– Subsequent capital gains received by spouse on transferred property is included in income or original owner. [74.2(1)]

– **Does not apply** if property is transferred to a spouse in a manner equivalent to an arm's length transfer

- Must receive fair market value consideration. [74.5(1)]
- Must elect out of spousal rollover. [73(1)]

F. The Attribution Rules – Income Splitting[3]

2. Property Transferred to a Minor Child

- Income on property transferred to a child attributes to the parent
  - until the year the **child turns 18**. [74.1(2)]
- Capital gains or losses are NOT subject to attribution.
- Rules apply not just to children; may also apply when property transferred to other minors i.e., nieces and nephews. [74.1(2)]

3. Tax on Split Income (TOSI)

- **Dividend received by minor children**
  - From **private** Canadian or foreign corporations
  - Not subject to attribution rules, however
  - Subject to tax at top marginal rate [120.4(2)]
    - Less dividend tax credit [120.4(3)]

- Higher tax rate also applies to Capital gains on sale of private corporation, derived from the sale to non-arm's length party
  - Capital gains are treated as dividends
  - No ability to use the Lifetime Capital Gains Exemption

3. Tax on Split Income (TOSI) 2

- TOSI rules apply to **dividends, capital gains and interest** received by adult family members from private corporations.
- **Main Exclusions**:
  - Capital gains eligible for capital gains deduction
  - Income received by a business owner’s spouse where the business owner is 65 years of age or older;
  - Amounts received by adults age 18 or older who work more than 20 hours a week in the business;
  - Amounts received by adults age 25 or older who own at least 10% of the corporation carrying on the business,
    - provided less than 90% of its income is from providing services and the corporation is not a professional corporation (e.g., legal, accounting, medical and dental practices).

3. Tax on Split Income (TOSI) 3

- Adults who do not meet any of the above exclusions will be subject to a reasonableness test.
  - If an amount received is unreasonable, then the income will be taxed under the TOSI rules at the top personal tax rate.
  - Newness of rules results in limited guidance available on what would be considered “reasonable”

- The TOSI rules prevent small-business owners from lowering their tax burden by *income sprinkling*—distributing earnings among family members who do not make significant contributions to the company.

Note that **reasonable salaries** paid to family members are not subject to TOSI.

4. Transfers and Loans to Corporations

- Taxpayer may loan funds to a corporation of which spouse or child(ren) is a shareholder
  - Usually does not receive interest
- Corporation invests the funds → dividend income to shareholders
- This arrangement is acceptable if a small business corporation [74.4(2)]
- If not an SBC, CRA may include a prescribed rate of interest in the transferor's income
  - If the purpose was to reduce income to benefit a spouse or related person under age 18. [74.4(2)]
  - Punitive as corporation, transferor and spouse or child are all taxed

5. Loans to Adult Family Members

- Loans to non-arm's length persons 18 years of age or older [56(4.1)]
- No interest or low-interest
- **If main reason is to reduce or avoid tax** on property income
- Income from property earned on loaned funds is subject to attribution
- Only applies to loans not gifts

6. Income Splitting permitted by the ITA

- CPP can be shared with a spouse – maximum 50%.
- Spousal RRSP.
- Eligible pension income – annually up to 50% of income can be reallocated to a spouse.
- Canada Child Benefit – can be invested on behalf of the child.
- Capital gains earned by children on transferred property – not subject to attribution
- Income from property earned by children over 17 on transferred property
- Contributions to a spouse’s TFSA

I. Death of a Taxpayer

Tax implications triggered by death are as follows:

1. Income from all sources is accrued up to the date of death [70(1)]

2. All capital property that was owned by the deceased is deemed to have been sold at fair market value [70(5)]

3. Executors are given control of the assets.
   - Once liabilities are satisfied, the assets are either sold or transferred to beneficiaries.

I. Death of a Taxpayer - Reserves

- Reserves – must be included in income in year of death
  - Exception – can elect to deduct reserve if transferred to spouse

I. Death of a Taxpayer - RRSPs

- Unmatured RRSP
  - Taxed in beneficiary's hands – not deceased taxpayer where beneficiary is the spouse/common-law partner. [60(l); 146(8.8), (8.9)]

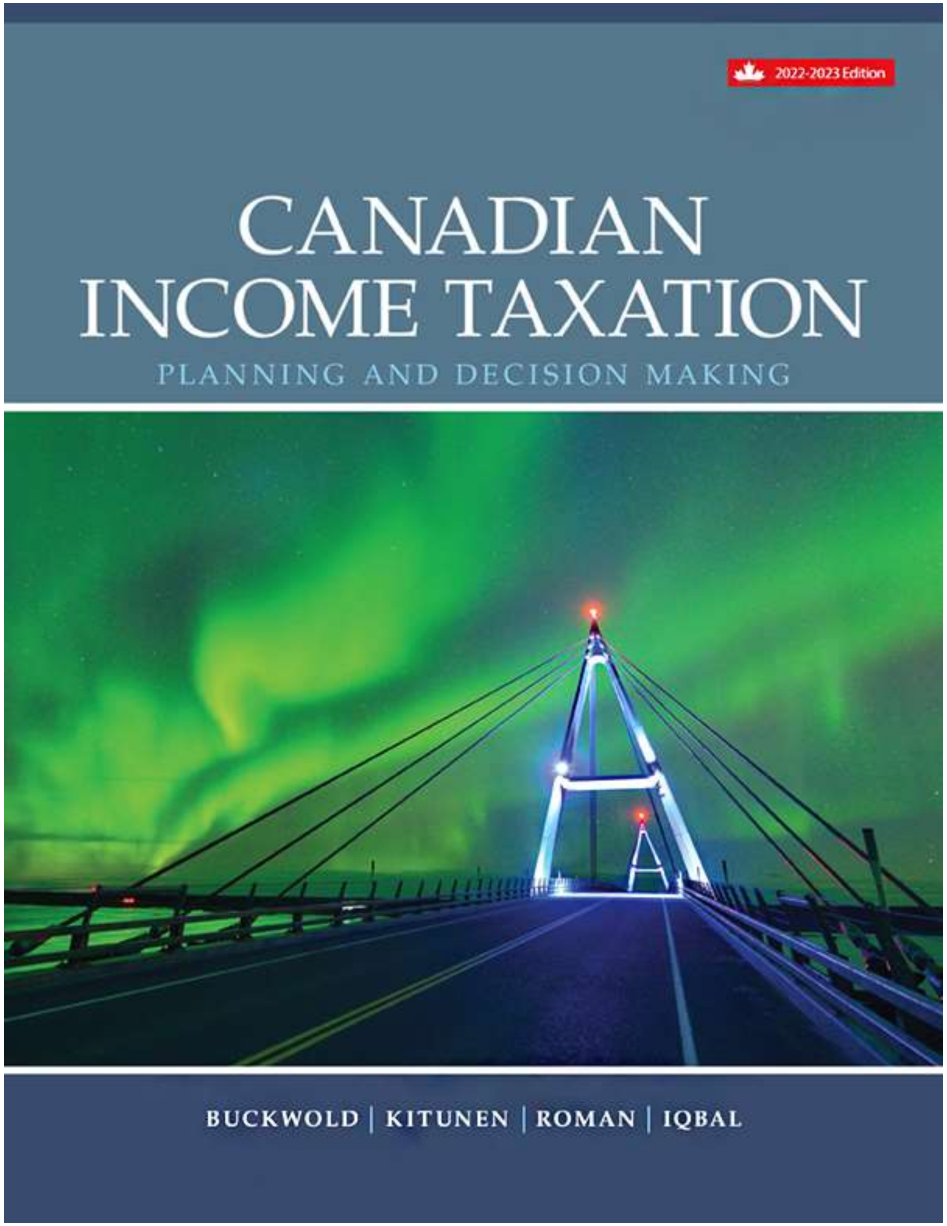
- Matured RRSP
  - Annuity payments have begun
  - Taxation depends on beneficiary
  - Spouse – payments taxed in spouse's hands in future [60(l); 146(8.8), (8.9)]
    - Other – FMV taxed in deceased taxpayer final return [56(1)(h)]

I. Death of a taxpayer – Capital Property

- Deemed disposition at FMV [70(5)]
- Unless spouse is beneficiary [70(6)]
  - – Deemed disposition at cost – deferring tax implications
  - – Can elect to dispose at FMV to trigger a capital gain [70(6.2)]
    - Use up capital gains exemption or capital loss carry-forward

J. Amounts Not Included in Income

- **ITA 81** – Items given preferential treatment – excluded from income:
  - Allowances received by members of provincial legislature
  - Special pensions received by members of RCMP for injury or disability.



CHAPTER 10: Individuals: Determination of Taxable Income and Taxes Payable

Prepared by

Matthew Roman, CPA, MTax

KPMG, LLP

Electronic Presentations in Microsoft® PowerPoint®

Individuals: Determination of Taxable Income and Taxes Payable

I. Determination of Taxable Income
II. Loss Carry-Overs
III. Loss Utilization – Impact on Decision Making
IV. The Capital Gain Deduction
V. Calculation of Tax for Individuals
VI. Special Adjustments to the Tax Calculation
VII. Final Returns of Deceased Taxpayers

I. Determination of Taxable Income

Net income – Division C deductions = Taxable income

The Statutory Formula

Employment

Business

Property

Other

3(a) Income from all sources

3(b) + Taxable capital gains

3(c) - Other deductions

<u>3(d) - Loss from Employ, Bus, Prop, ABIL</u>

Division B net income

<u>Division C deductions</u>

Taxable Income

Taxable Income Formula

Net income for tax purposes	XXX
Less	
Division C deductions:	
a) Stock options deduction	(XXX)
b) Social Assistance, worker’s compensation and amounts exempt by treaty	(XXX)
c) Capital gains deduction	(XXX)
d) Losses carried over from other years	<u>(XXX)</u>
	= Taxable Income

II. Loss Carry-Overs

- Business and Property Losses incurred in the year can be offset against other sources of income.
  - as part of the net income calculation. [3(d)]

- Capital losses deductible only to extent of capital gains realized in the year [3(b)]

- Losses that cannot be used in the year incurred are available for carry-over to other years

A. Net Capital Losses

- Allowable capital losses incurred in current year but cannot be utilized,
  - can be carried back three years and
  - forward indefinitely [111(1)(b)]
  - Deducted in a carryover year as a *net capital loss*
  - only deductible to the extent taxable capital gains exist
  - Net capital losses are stated at the inclusion rate for the year incurred.

- Exception upon the death,
  - unused net capital losses may be deducted against all types of income earned in the year of death or in the preceding year [111(2)]

B. Non-Capital Losses

- Unused business, property and employment losses and ABILs
- can be carried back three years and
- forward 20 years [111(1)(a)]
- Deducted in a carryover year as a *non-capital* loss
- Deducted in arriving at taxable income
  - against all sources of income

Allowable Business Investment Losses (ABILs)

Special Treatment:

- Only carried forward ten-years.

ABIL unused after ten-years:

- reclassified as a net capital loss and
- can be carried forward indefinitely
  - to be used only against future taxable capital gains.

C. Farm Losses and Restricted Farm Losses

- ***Farm losses*** - chief source of income is farming or fishing.
- Farm losses are treated the same as business losses. [111(1)(d)]

C. Farm Losses and Restricted Farm Losses[2]

- ***Restricted farm losses*** - farming is a business but not the chief source of income. [31(1)]
- Max deduction in current year- **$17,500**
  - $2,500 plus
  - ½ x next $30,000
- Unused losses - classified as restricted farm losses and can be:
  - carried back three years and
  - forward twenty years
  - only deducted to the extent of farming income. [111(1)(c)]

III. Loss Utilization – Impact on Decision Making

- Create returns on investments by delaying recognition of income for tax purposes
- Similarly, the sooner losses are utilized, the sooner cash flow increases due to reduced taxes
  - Losses must be utilized against sources of income and
  - Within a specified time period
- Taxpayer must consider how potential losses could be used if an investment results in a loss.

A. Forms of Business Organization

- Organizational structure chosen has an influence on loss utilization.
  - Proprietorship
    - Not a taxable entity
    - Profits and losses incurred belong to the individual proprietor
      - Losses can be offset against owner’s other income sources in the same year, or
      - Carried over to other years and deducted against all sources of income

A. Forms of Business Organization[2]

- Corporate structure – the individual and corporation are two separate entities.
  - Business losses of the corporation can only be offset against the corporation’s income
  - Losses must be carried over to years in which corporation generates income
  - Diminishes the opportunity to use the losses as quickly as possible

A. Forms of Business Organization[3]

Consideration should be given to:

- Risk of business failure
  - Losses would remain in the corporation and not be available to the shareholder
- Increased risk that losses may expire
  - Restricted carry-over period
  - Shareholder would recognize the business loss when shares disposed of at a loss
    - Loss would be capital rather than business

A. Forms of Business Organization[4]

- Partnership structure
  - Like a proprietorship, is not a taxable entity
  - Losses are allocated to the partners
  - Can immediately offset against partner's other sources of income or carried over to other years by the partner

B. Preserving Tax Losses

- Risk of loss expiration can be minimized with decisions that create taxable income
  - Defer expenses for tax purposes, where possible
  - Realize accrued gains sooner rather than later

B. Preserving Tax Losses[2]

- Reducing expenses:
  - Expenses that can be claimed at the discretion of the taxpayer:
    - Capital cost allowance
    - Reserve for accounts receivable
- Creating income:
  - Trigger disposition of assets or investments that have appreciated in value
  - If do not wish to actually dispose of the asset, sell to a spouse or a corporation owned by the individual.
  - Retain use of asset through a sale-leaseback arrangement

C. Future Investment Strategies

- Existence of loss carryovers can change investment strategies
  - Especially when capital losses exist – can only be offset against future capital gains
- May change the return on investment
- Re-examine strategies relating to investment and business-asset replacement decisions when loss carryovers are available

IV. Capital Gains Deduction

Capital Gains Deduction available for disposition of [110.6]

1. Qualified small business corporation (QSBC) shares
   – Deduction is **$913,630** x ½ = $456,815 (**2022**)

2. Qualified farm property and fishing property
   – Deduction is **$1,000,000** x ½ = $500,000

IV. Capital Gains Deduction[2]

A qualified small business corporation (QSBC) must be a SBC at the time the shares are sold:

- a *Canadian-controlled private corporation*
- that uses all or substantially all of its assets (at least 90%) to conduct an active business. [248(1)]

Additionally:

- Shares must not have been owned by a non-related person in the 24 months prior to the sale, and
- During that time, more than 50% of the FMV of assets used in active business [110.6(1)]

- The deduction is discretionary

IV. Capital Gains Deduction[3]

Ability to claim is limited by two items:

1. Capital losses deducted (including ABILs)
   - Unless other capital gains exceed the capital losses.
2. Cumulative net investment losses (CNIL)
   - Balance exists when lifetime investment losses exceed investment profits (income minus expenses)
   - Capital gains deduction available is reduced by the total CNIL balance.
   - CNIL does not eliminate or reduce lifetime capital gains exemption limit;
     - it simply delays its use until a later year.

V. Calculation of Tax for Individuals

Income tax is imposed by the federal and provincial governments:

- Federal tax = % of taxable income
- Provincial tax = % of taxable income

A. Overall Tax Calculation

Federal tax:		
Federal tax (taxable income x rate)		**XX**
Personal tax credits		**(XX)**
Basic federal tax		**XX**
Other tax credits		**(XX)**
Total federal tax		**XX**
Provincial tax:		
Provincial tax (taxable income x rate)	**XX**	
Specific provincial tax credits	**(XX)**	**XX**
Combined federal and provincial tax		**XX**

B. Federal Tax

- Progressively higher tax rates to higher levels of taxable income.
- Each rate of tax is applied separately to the portion of the individual’s income that falls within applicable ranges.

B. Federal Tax[2]

Taxable Income Between (2020)	Rate
$0 - $50,197	15%
$50,197 – $100,392	20.5%
$100,392 – $155,625	26%
$155,625 – 221,708	29%
Over $221,708	33%

B. Federal Tax[3]

- Individual has taxable income of $100,000 calculates federal tax of:

$50,197 x 15%	$ 7,530
$49,803 x 20.5%	10,210
Total federal tax	$17,742

- ***Effective tax rate*** = almost 18% ($17,742/ $100,000)
- ***Marginal rate*** is 20.5% until income of $100,392 is reached (then 26% on income between $100,392 and $155,625)

C. Personal Federal Tax Credits

Tax credit:

- Specific reduction of the tax otherwise payable
- Value equal to its stated amount
- Benefits all taxpayers equally

Tax deduction:

- Reduces taxable income
- Amount of tax savings depends on the marginal tax bracket
- Provide a greater benefit to those in higher tax brackets

C. Personal Federal Tax Credits[2]

Basic personal amount [118(1)(c), 118(1.1)]

- $14,398 x 15% = $2,160 for individuals with net income not exceeding $155,625
- Reduced for net income over $155,625 but less than $221,708 using the following formula:

  $14,398– (net income – $155,625) × (1,679/66,083)

- $12,719 x 15% = $1,908 for individuals earning over $ 221,708 (**2022**)

Spouse or common-law [118(1)(a)]

- (basic personal amount – spouse's *net income*) x 15%
- increased by $2,350 x 15% if spouse is infirm

C. Personal Federal Tax Credits[3]

Eligible dependant (equivalent to spouse) [118(1)(b)]

- (basic personal amount – dependant's *net income*) x 15%
- increased by $2,350 x 15% if dependant is infirm
- Normally applies to dependent child who is under age 18 at any time in the year or child with a physical/mental disability

Canada caregiver for infirm child [118(1)(b.1)]

- $2,350 x 15% = $353
- Available for individuals supporting a child
  - under age 18 at the end of the year
  - lives with the taxpayer
  - has a disability

C. Personal Federal Tax Credits[4]

Canada caregiver for adult relatives (except spouse)
[118(1)(d)]

- ($7,525 – (dependant's *net income* - $17,670)) x 15%
- Available for individuals supporting a
  - related person
  - At least 18 years of age and
  - dependent by reason of physical or mental infirmity
  - cannot be the spouse, common-law partner, or dependant claimed for the equivalent to spouse credit
- The dependant does not have to be living with the supporting individual.
- Maximum credit = $7,525 x 15% = $1,129

C. Personal Federal Tax Credits[5]

Age [118(2]

- 65 years of age or older
- ($7,898 - 15% (*net income* - $38=9,826)) × 15%
- Maximum credit is $7,898 x 15% = $1,185
- Eliminated when net income reaches $92,479
- If unused – can be transferred to a spouse.

CPP and EI [118.7]

- 15% of CPP and EI contributions
- Does not apply to enhanced CPP contributions (Chapter 9)
- Eligible CPP and EI contributions for **2022** max at $3,992 ($953 EI + $3,039 CPP)

C. Personal Federal Tax Credits[6]

Pension [118(3)]

- $2,000 × 15% = $300
- First $2,000 of *qualified pension income* received in a year
  - Example, pension from employer, RRIF if age 65 or older
- Spouses who split pension income can double up on this credit
- CPP & OAS do NOT qualify for this credit

Employment [118(10)]

– **$1,287** × 15% = $193

Adoption Expenses [118.01]

– $17,131 maximum × 15% = $2,570

C. Personal Federal Tax Credits[7]

Digital news subscription credit [118.02]

- $500 × 15% = $75
- An individual can claim a 15% credit for up to $500 of costs for subscriptions to Canadian digital news, annually. This credit is available for years 2020 through 2024

Home accessibility [118.041]

- Maximum Credit = $10,000 × 15% = $1,500
- Renovation costs to enable a person over age 65 to access, be mobile, or functional within the house, or to reduce the risk of harm to the person

C. Personal Federal Tax Credits[8]

Multigenerational home renovation credit

- $50,000 × 15% = $7,500
- An individual can claim a 15% credit for up to $7,500 of costs incurred in constructing a secondary unit to permit a senior (age 65 or older) or an adult with a disability to live with a relative
- A secondary unit is defined as a self-contained dwelling with a private entrance, kitchen, bathroom, and sleeping area

Home buyer credit [118.05]

– $10,000 x 15% = $1,500

– Taxpayer and/or spouse cannot have owned a home in the past 4 years

– Most types of housing located in Canada qualify

C. Personal Federal Tax Credits[9]

Volunteer firefighters &/or Search & Rescue [118.07]

- Maximum Credit = $3,000 × 15% = $450
- Perform a minimum of 200 hours of volunteer hours

Disability - a severe & prolonged mental or physical impairment [118.3(1)]

- $8,870× 15% = $1,331
- Can be transferred to spouse, parent, or grandparent if individual cannot use
- Additional credit of $776 (5,174 x 15%) available if person is under age of 18

C. Personal Federal Tax Credits[10]

Tuition fees [118.5]

- tuition fees paid x 15%
- attend a university, college, or other certified post-secondary institution
- Unused credits can be carried forward or transferred to a parent, grandparent, or spouse
- Credit must be used first before the dividend tax credit (reduces benefit of income splitting with adult child in post-secondary)

C. Personal Federal Tax Credits[11]

Tuition transferred from a child [118.9]

– ($5,000 - tuition credit required to reduce child's tax to zero) × 15%.

Spouse or common-law partner transfer credits [118.8]

– Unused credits for age, pension, disability, and tuition
– tuition is subject to same limitations described above

C. Personal Federal Tax Credits[12]

Medical expenses [118.2]

- (Medical expenses *paid* - 3% net income, limited to $2,479) × 15%
  - Includes medical expenses of spouse and children under 18
  - paid in any 12-month period ending in the year
- Medical expenses paid for *other dependants* (example—children age 18 and over)
  - These medical expenses are reduced by
  - 3% of *dependant's* net income, limited to $2,479
  - Include amounts paid in any 12-month period ending in the year

C. Personal Federal Tax Credits[13]

Charitable donations [118.1]

- 15% x first $200 of annual donations, and
- 33% x lesser of donations over $200 and taxable income over $221,708 and
- 29% x donations over $200 not eligible for the 33% rate
- Annual donations cannot exceed 75% net income
- Unused Donations can be carried forward for 5 years

C. Personal Federal Tax Credits[14]

Student loan interest [118.62]

- Interest paid on student loans x 15%
- Only interest on loans under:
  - Canada Student Loan Program and
  - Provincial student loan programs.
- The credit may be claimed in the year of interest payment *or* in any of the following five years.

D. Dividend Tax Credit

- Dividend tax credit – **Eligible dividends** [121(b)]
  - **6/11 x 38%** x actual dividend, or 15% (rounded from 15.019%) of the taxable amount.

- Dividend tax credit – **Non-Eligible dividends** [121(a)]
  - **9/13 x 15%** x actual dividend, or 9% (rounded from 9.030%) of the taxable amount.

D. Dividend Tax Credit[2]

Eligible Dividends:

- Taxable dividends from Canadian public corporations
- Taxable dividends from Canadian private Corporations – not Canadian controlled
- Taxable dividends from CCPC from income taxed at the high rate

Non-eligible Dividends:

- Taxable dividends from CCPC whose income is active business income eligible for SBD
- Taxable dividends from CCPC earning investment income or non-eligible dividends from another corporation

E. Other Federal Tax Credits

Foreign Tax Credit: [126]

- Income earned in a foreign country maybe be subject to tax on that income in both the foreign country and Canada.

- Canadian taxes can be reduced by the foreign tax credit

  – Foreign business income tax credit [126(2)]
    - Unused credits from foreign business income can be carried back three years and forward 10 years.

  – Foreign investment income tax credit [126(1)]
    - Limited to 15% of foreign income earned; unused amount can be deducted from income

E. Other Federal Tax Credits[2]

Political contributions [127(3)]

- Based on a graduated scale.
- Annual credit is:
  - 75% of the first $400,
  - 50% of the next $350, and
  - 33 1/3% of contributions over $750.
- Max. of **$650** annually

- Investment tax credits [127(5)]

These credits are all non-refundable tax credits; **Can only be used to the extent of taxes otherwise payable**

E. Other Federal Tax Credits[3]

- Refundable tax credits
  - Paid to the taxpayer when the credit exceeds tax otherwise payable
  - Examples: eligible educator school supply credit (15% x up to $1,000 of eligible school supplies purchased), Canada Child Tax Benefit, GST/HST credit, Working Income Tax Benefit, and Refundable Medical Expense Supplement.

E. Other Federal Tax Credits[4]

- Canada training credit
  - provides financial support to help cover up to half of eligible tuition and fees associated with training.
  - Eligible individuals between the ages of 25 and 65 will accumulate $250 each year ($5,000 cumulative limit) in a notional account that can be accessed for this purpose.

F. Provincial Taxes

- Determine their tax by applying specified tax rates to the *federal taxable income*.
- Rates vary from province to province.
- Specify their own tax credits.
- Individuals are subject to tax based on the province they live in on **December 31** of the taxation year.

VI. Special Adjustments to the Tax Calculation

- Special rules apply that increase the amount of tax payable beyond the normal amount.
- Two basic areas where the normal tax calculation may be adjusted to a higher amount:
    1. The Alternative Minimum Tax (“AMT”) [127.5]
    2. Special Tax on Old Age Security Benefits [180.2]

A. The Alternative Minimum Tax

- Designed to impose a minimum level of tax
  - When “normal tax” has been reduced by “tax preference” items.
    - Example – Significant eligible dividends, capital gains and capital gains exemption
- Additional tax is not a permanent tax;
  - AMT paid in one year can reduce normal tax in following year.
  - can be carried forward for up to seven years

Tax Preference Items

- Taxable income is increased by the following:
  - 30% of net capital gains earned.
  - Deductions claimed from certain specified tax shelter investments, to the extent that any of these create losses.
  - 3/5 of employee stock option deduction.
  - Other items – see detailed list in Chapter 10.
- Taxable income is reduced by the following:
  - The gross-up on Canadian dividends.
  - 60% of ABILs deducted
  - A basic exemption of $40,000.

A. The Alternative Minimum Tax

- Entire income is subject to a federal tax rate of 15%.
  - Then deduct personal non-refundable tax credits.
- If revised federal tax > the normal federal tax, you have AMT.
- Provincial taxes are then calculated on the revised amount.

B. Special Tax on Old Age Security Benefits ("Clawback")

- **Clawback is a special tax imposed on individuals who:**
  - received OAS benefits and
  - Earn > $81,761 in net income for tax purposes.
- The special tax is equal to **15% of net income in excess of $81,761** up to a maximum of the OAS payments.
- Since all OAS benefits are included in income, the "Clawback" is deducted in arriving at net income. [60(w)]

VII. Final Returns of Deceased Taxpayer

Special rules apply

A. Taxable Income and Losses

- Unused capital losses can be used against any income source in year of death or previous year. [111(2)]
  - Reduced by any capital gains deductions claimed in prior years [111(2)(b)(iii)]
- Net capital losses realized in the first year of the *deceased's estate* can be used to reduce the taxable income of the deceased for the year of death [164(6)]

VII. Final Returns of Deceased Taxpayer[2]

B. Tax Returns and the Use of Tax Credits:

- Final return required
  - Include all income accrued to date of death [70(1)]
  - All non-refundable tax credits can be claimed in full [118.93]
- May file up to 3 additional returns in addition to final tax return. [70(2), 150(4), 104(23)(d)]

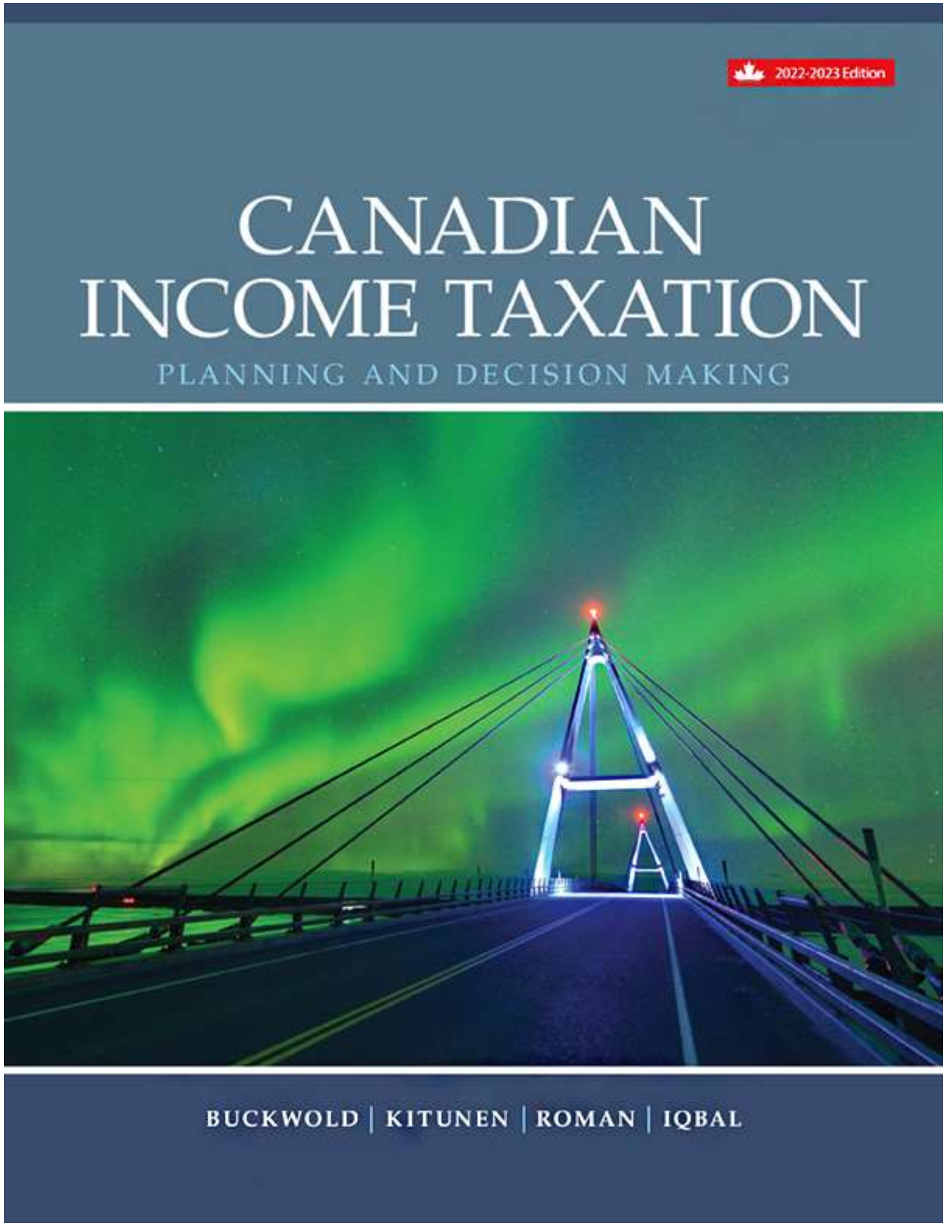
Rights or Things return: [70(2)]

- Amounts not received prior to date of death but would have been included in income if received
  - i.e. employment earnings owed but not paid, dividends declared but not paid.

VII. Final Returns of Deceased Taxpayer[3]

C. Donations Made by Will or Deceased's Estate

- The donations are deemed to have been made at the time the property is transferred to the charity.
- The estate can allocate the donations among any of the following:
  - the estate's taxation year in which the donation is made;
  - any earlier year of the estate; or
  - the last two taxation years of the deceased



CHAPTER 22: Introduction to GST/HST

Prepared by
Matthew Roman, CPA, MTax
KPMG, LLP

Electronic Presentations in Microsoft® PowerPoint®

Introduction to GST/HST

I. Rules with Respect to Carrying on a Business
II. Input Tax Credits
III. Streamlined Methods for Calculating Net Tax
IV. Employees and Employment Income
V. Rules with Respect to Real Property
VI. Special Situations
VII. Administrative Matters

I. Rules with Respect to Carrying on a Business: A. GST/HST Basics

- GST is a federal value added tax imposed at a rate of **5%** on the value of most goods or services sold.
- Most business entities are entitled to recover the tax on all goods and services purchased (input tax credit "ITC").
- Result is the tax applies primarily to ultimate consumers.
- Several provinces have chosen to harmonize their PST with the GST, resulting in the Harmonized Sales Tax (HST). The *participating provinces* are:
  - New Brunswick, Newfoundland/Labrador, Nova Scotia, Ontario, and Prince Edward Island

I. Rules with Respect to Carrying on a Business: B. When GST/HST is Charged?

- The earliest of:
  - the date of the invoice or the day the invoice is first issued;
  - the day the invoice would normally have been issued but for an undue delay; and
  - the day on which the payment became due pursuant to a written agreement.
- GST/HST is payable on rental or leased property on the day the lease payments are required.
- GST/HST is payable on the sale of real property on the day the ownership or possession is transferred, whichever comes first.

I. Rules with Respect to Carrying on a Business: C. Rates

Province/Territory	*GST/HST*	*PST/QST*
Alberta	5%	0%
British Columbia	5%	7%
Manitoba	5%	7%
New Brunswick	15%	
Newfoundland and Labrador	15%	
Nova Scotia	15%	
Northwest Territories	5%	0%
Nunavut	5%	0%
Ontario	13%	
Prince Edward Island	15%	
Quebec	5%	9.975%
Saskatchewan	5%	6%
Yukon	5%	0%

I. Rules with Respect to Carrying on a Business: D. Reporting Periods

Annual taxable supplies	*Mandatory reporting period*	*Optional reporting period*
$1,500,000 or less	Annual	Monthly or Quarterly
More than $1,500,000 but not exceeding $6,000,000	Quarterly	Monthly
More than $6,000,000	Monthly	

I. Rules with Respect to Carrying on a Business: E. Characterization of Supplies

- ***Taxable supplies***. This includes any supply of goods, property, or services made in the course of a *commercial activity*.
  - Clothing
  - Sales and leases of automobiles
  - Taxi, limousine, and ridesharing services like Uber or Lyft
  - Soft drinks, candies, and potato chips
  - Sales of new residential real property
  - Short-term (less than one month) rentals of residential real property
  - Sales and rentals of commercial real property
  - Photography services
  - Most professional services (e.g., legal and accounting)
  - Hotel accommodation
  - Barber and hairstylist services

Rules with Respect to Carrying on a Business: E. Characterization of Supplies[2]

- ***Zero-rated supplies** is a special subset of Taxable supplies*.
- GST/HST is charged at a 0% rate. Still entitled to ITCs.
- Examples include the following:
  - Basic groceries (e.g., milk, raw meats, fish, bread, vegetables, most non-carbonated
  - beverages)
  - Agricultural products
  - Prescription drugs
  - Medical devices (e.g., artificial teeth or limbs, mobility devices, hearing aids, eyeglasses, contact lenses, asthmatic devices, insulin pumps, etc.)
  - Most exported goods and services

Rules with Respect to Carrying on a Business: E. Characterization of Supplies[3]

- ***Exempt supplies***
- GST/HST is completely not applicable. Not entitled to ITCs.
- These supplies can include the following:
  - Sales of used residential property
  - Most healthcare and dental services performed by a medical practitioner (i.e., a licensed
  - physician or dentist)
  - Financial services
  - Many types of insurance
  - Most educational services
  - Residential rent, provided the term is for one month or longer
  - Child care services
  - Music lessons

I. Rules with Respect to Carrying on a Business: F. Small Suppliers

- Small suppliers are not required to register for GST/HST, in which case they do not collect GST/HST on supplies and they do not claim input tax credits for the GST/HST paid on related expenses.
- A small supplier is a person whose total taxable supplies (including zero-rated supplies and exports) do not exceed **$30,000** per year.
  - Sales of capital property are excluded from the threshold so that the status is not lost on a one-time sale of business assets (e.g., selling off old equipment).

I. Rules with Respect to Carrying on a Business: G. Place of Supply Rules

- The appropriate rate to apply when charging GST/HST is based on the place **where the supply of the goods or services is considered to have occurred**.
  - **Goods –** where the goods are delivered or made available to the customer
  - **Services –** the billing address for the customer (*not* the location where services are performed)
  - **Real Property –** where the property is physically situated
  - **Intangibles –** where the intangible can be used. If no restriction on where in Canada it may be used, the billing address of the customer is generally used.

I. Rules with Respect to Carrying on a Business: H. Tax Collected or Paid in Error

- that tax must be remitted to CRA just as any other collected tax would have been.
- the person paying the excess GST/HST may apply for a rebate of the tax from the CRA
  - Within two years.

I. Rules with Respect to Carrying on a Business: I. Tax Not Charged in Error

- The supplier has the right to go back and charge the customer for the GST/HST after the fact, provided the original payment was not already inclusive of GST/HST.
- It is technically the recipient of the taxable supply who is liable to pay the GST/HST
- The supplier has the responsibility to collect and remit the tax.

II. Input Tax Credits

- In order for a person to claim an ITC, the following criteria must be met:
    1) GST/HST must have been paid or payable on the purchase or expense;
    2) the person must be a GST/HST registrant at the time GST/HST became paid or payable;
    3) the purchase or expense must be incurred or used in the course of a commercial activity carried on by the person;
    4) the ITC is claimed within prescribed time limits (discussed below); and
    5) the person maintains sufficient documentary evidence to substantiate the ITC.

II. Input Tax Credits[2]

A. Meals, Entertainment, and Club Dues

ITCs are generally limited to 50% of the expense incurred and are denied for recreational club memberships (including golf).

B. Reasonableness

ITCs are denied on the portion of the cost that is in excess of a reasonable amount.

C. Bad Debts

when an amount owing from the sale of taxable goods or services becomes uncollectible and is established to be a bad debt, the GST/HST that has been remitted on the sale may be recovered as an ITC.

II. Input Tax Credits[3]

D. Volume Discounts

When the discount is offered at the end of the year as opposed to at the time of sale, and a credit note is issued to the customer:

- The GST/HST on the discounted amount is claimed by the vendor as an ITC, and
- Reported by the customer as GST/HST collected.

II. Input Tax Credits[4]

E. Purchases and Leases of Automobiles

- The ITC on a purchase is based on a maximum purchase price of $34,000,
- The ITC on a lease cannot exceed the GST/HST that would have been paid on an $900/month lease.
- The ITC is further limited by the business use of the car

Business use	***Incorporated Businesses***	***Non-Incorporated businesses***
≤ 10%	No ITC	No ITC
>10% to 50%	No ITC	CCA based ITC
>50% to <90%	Full ITC	CCA based ITC
≥ 90%	Full ITC	Full ITC

II. Input Tax Credits[5]

F. Employee Benefits and Allowances (Except Automobiles)

- The employer who provides the benefit is considered to have charged and collected the GST/HST that is added to the benefit and, therefore, that imputed amount must be remitted as if it were collected.
- The following ratios are used to determine the GST/HST required to be remitted by the employer on non-auto benefits:
  - Ontario (HST) **12/112**
  - Nova Scotia, New Brunswick, Newfoundland and Labrador, and Prince Edward Island (HST) **14/114**
  - Alberta, British Columbia, Quebec, Saskatchewan, Manitoba, Nunavut, Northwest Territories, and Yukon (GST) **4/104**

II. Input Tax Credits[6]

G. Automobile - Related Employee Benefits

- The GST/HST to be remitted by the employer on the standby charge is calculated using the ratios shown above for non-automobile benefits (Ontario and Prince Edward Island may vary for large businesses).
- However, GST/HST on the operating cost benefit for remittance purposes uses a different and *arbitrary* calculation, as listed below:
  - Ontario* (HST) **9%**
  - Nova Scotia, New Brunswick, Newfoundland and Labrador, and Prince Edward Island*(HST) **11%**
  - Alberta, British Columbia, Quebec, Saskatchewan, Manitoba, Nunavut, Northwest Territories, and Yukon (GST) **3%**

II. Input Tax Credits[7]

H. Time limits

- The ITCs must be claimed within **four years** after the filing deadline for the reporting period in which the expense was incurred.
- Most registrants claim the ITCs in the reporting period when they occur.

II. Input Tax Credits[8]

I. Expenses Incurred Prior to Registration

- ITCs generally cannot be claimed for expenses incurred prior to being registered for GST/HST
- Limited exceptions include:
  - GST/HST paid on inventory and capital property owned at the time of registration
  - GST/HST on rent, royalties, and similar payments to the extent they relate to periods after registration

II. Input Tax Credits[9]

J. Having Both Taxable and Exempt Supplies

- For multiple use items, there needs to be some sort of reasonable allocation between the commercial and non-commercial activity.
- ITCs would then be allowed on the allocation to the commercial activity and denied on the allocation to the non-commercial activity.
- This involves professional judgement and may be challenged by CRA.

II. Input Tax Credits[10]

K. Documentation Requirements

- *Information required for ITCs of $150 or more:*
  - Supplier's business or trading name
  - Date of invoice or, if no invoice issued, the date tax is paid or payable
  - Total amount paid or payable
  - GST/HST charged for each taxable supply (other than zero-rated supplies)
  - An indication of which items are taxed at the GST rate and which are taxed at the HST rate
  - Supplier's business number
  - Registrant's name or trading name
  - Brief description of the goods or services
  - Terms of payment

III. Streamlined Methods for Calculating Net Tax

A. Quick Method

- GST/HST is charged on taxable supplies, but only a portion of GST/HST collected is remitted to CRA.
- The amount remitted is based on a percentage called the "remittance rate."
- Registrants using this method do not separate GST/HST from revenue or expenses, so the rate is applied to total taxable supplies plus the applicable GST/HST.
- An election is required to use this method.

III. Streamlined Methods for Calculating Net Tax[2]

B. Simplified ITC Calculation

- To use this method, a registrant must have taxable supplies of **$1,000,000 or less** and purchases/expenditures of **$4,000,000 or less** in the preceding fiscal year.
- Users of this method simply total up expenses that would otherwise be eligible for an ITC (inclusive of any GST/HST paid on those items) and multiply them by 5/105, 13/113, or 15/115, depending on the GST/HST rate paid on the expense.

IV. Employees and Employment Income

A. Employee Benefits

- There is no GST/HST to be remitted for Zero-rated or GST/HST exempt employee benefits, such as
  - Automobile allowance
  - Educational allowance for children
  - Gifts, awards, and social events: in cash
  - Group term life insurance premiums
  - Interest-free and low-interest loans
  - Overtime meal allowances
  - Premiums for provincial health programs
  - RRSP premiums
  - Scholarships and bursaries
  - Tuition fees

IV. Employees and Employment Income[2]

B. Employment Expenses - GST/HST Rebate

- The rebate is calculated by applying a predetermined ratio to the employment expenses.
- The rebate ratios for the provinces and territories are as follows:
  - Ontario (HST 13%) **13/113**
  - Nova Scotia, New Brunswick, Newfoundland and Labrador, and Prince Edward Island (HST 15%) **15/115**
  - Alberta, British Columbia, Quebec, Saskatchewan, Manitoba, Nunavut, Northwest Territories, and Yukon (GST 5%) **5/105**

V. Rules with Respect to Real Property

A. Residential Property

- should only be taxed once, and only when brand new.
- residential rent is exempt from GST/HST provided it is for a term of one month or more (taxable supply if shorter duration).

B. Rebate on Purchase of New Residential Property

- This rebate generally allows for a recovery of up to 36% of the GST paid on properties valued under $450,000.
- rebate must be claimed within 2 years.

C. Commercial Property

- Sale subject to GST/HST
- Rental subject to GST/HST unless landlord is a *small supplier*.

V. Rules with Respect to Real Property[2]

D. Purchaser's Requirement to Self-Assess

- This self-assessment rule is intended to apply for business-to-business transfers of real property by two registrants.
- It has significant cash-flow savings.
  - If the purchaser is a GST/HST registrant, the vendor *does not* collect tax on the sale.
  - The purchaser is instead required to self-assess tax on the purchase (i.e., the purchaser calculates the tax payable on the transaction
  - and includes it as GST/HST collected on the purchaser's own GST/HST return).
  - The purchaser can then claim an offsetting input tax credit provided the property is used in commercial activity.

VI. Special Situations

A. Sale of a Business as a Going Concern

- Where a vendor and purchaser make a joint election, the need to charge GST/HST on the sale is eliminated.

B. Intercompany and Related Party Transactions

- An election is available to treat most intercompany transactions within a related group as tax free.

C. Joint Ventures and Bare Trusts

- An election exists that allows for one participant of the venture to account for the GST/HST on behalf of all the joint venture participants.

D. Death of a Registrant

- The deceased's reporting period is deemed to end on the day of death with a new period beginning the day after death.

VI. Special Situations[2]

E. Disbursements

- Disbursements are expenses incurred by a supplier and charged back to the customer
- Disbursement could be considered part of the supply being made to the customer, or incurred as an expense on the customer’s behalf
- Where an agent/principal relationship exists, the disbursement is a pass through to the customer (like a reimbursement)
- Where an agent/principal relationship does not exist, the expense is included in the supplier’s fees.

VII. Administrative Matters

A. Deadlines for Filing Returns and Remitting Tax

- For monthly and quarterly filers, the filing & remittance due date is **1 month** after the end of the reporting period.
- For annual filers who are individuals, the filing due date is the following **June 15**th and the remittance date is the following **April 30**th.
- For annual filers who are corporations, the filing & remittance due date is **3 months** after the end of the reporting period.

B. Deadline to File Appeals

- In general, an objection must be filed within **90 days** of the date of the notice of assessment/reassessment.

VII. Administrative Matters[2]

C. Instalments

- GST/HST instalments are only applicable to annual filers, and they are due **one month** after the end of each fiscal quarter.
- Instalments are required after an annual filer has net tax owing for a fiscal year of **$3,000**.
- There are two alternatives for calculating instalments:
  - **Prior year option –** instalments are based on 25% of the net tax from the previous year.
  - **Current year option –** instalments are based on 25% of the estimated net tax owing for the current year.

VII. Administrative Matters[3]

D. Interest and Penalties

- Instalment interest is calculated beginning the day after the instalment payment was due and compounds daily.
- In addition to interest, a late filing penalty is applicable to any net tax owing if a GST/HST return is not filed on time.
- The penalty is 1% of the tax owing plus 0.25% for each month late.

E. Changing a Registration Date

- It is possible to get a registration date backdated to an earlier period, but it requires demonstrating to CRA that the business was *required* to be registered at that time.

VII. Administrative Matters[4]

F. Directors' Liability

- The directors of a corporation are jointly and severally liable, together with the corporation, to remit any net GST/HST plus applicable interest and penalties owing by the corporation.
- This means the CRA can go after the corporate directors personally, even if the corporation is dissolved without remitting the tax.
- The CRA also has the ability to apply additional penalties, and in extreme cases, jail time.