CH11-Determination of taxable income

Special deductions:

* Donations to charitable orgs (Max 75% of NI)
* Net capital losses (against cap gain)
* Non-cap losses carry fwd
* Dividends from CND corps
* Foreign divs

Loss carry forward:

* Net capital: -3+forever
* Non-capital: -3+20

Change in beneficial ownership:

* Deemed year end – at the date of change in control.
* Side effect is to age carry forward losses by one year
* Capital property deemed to be sold at FMV if < Tax cost
* Capital losses expire
* Non-capital losses:
  + Must Carry On Business industry In Which Losses Occurred
  + Reasonable Expectation Of Profit
  + Losses can only be deducted against business income earned by same or similar business.

Dividends:

* Tax free if received from active business owned by receiving company
* Deducted from taxable income if:
  + Received from a taxable CND corp
  + Received from a foreign affiliate, local owns >10%
* Private corps may be subject to Part IV Tax (Ch 13)

|  |  |
| --- | --- |
| **NI for Taxes** | |
|  | ABI |
|  | Property (interest, rent, royalty less exp) |
|  | Dividend |
|  | Taxable Capital Gains |
| **NI for Taxes** | |
|  |  |
| **Taxable Income** | |
| NI for Taxes | |
| Less | |
|  | Cap losses carry forward |
|  | Non Capital losses |
|  | Dividends |
| **Taxable Income** | |

PART I

|  |  |  |
| --- | --- | --- |
| Federal Tax | |  |
|  | Primary | 38% |
|  | Refundable tax on passive investment income (interest + capital gains) | 6.67% |
| LESS | |  |
|  | SBD (<500k$, not pub corps) | 17% |
|  | Less Abatement for provincial tax | 10% |
|  | ~~General Rate Deduction (Not inv. income)~~ | ~~13%~~ |
|  | ~~Manufacturing and Processing Deduction (M&P)~~ | ~~13%~~ |
|  | Federal Tax Credits |  |

Part IV: 1/3 of **NON** wholly owned div (only portfolio divs)

Dividend Refund – Lesser of:

* 1/3 of taxable dividend paid
* Ending RDTOH Balance (always this case on exam)

Total Fed Tax Payable: Part 1 + Part 4 - Dividend refund

Federal tax:

* General rate reduction (13%):
  + Public corp: M&P activities
  + CCCPs: >500k
* Refundable tax on investment income:
  + 6 2/3% on investment (interest + Cap gain)
  + Fully refundable when dividends are paid
* Small Business Deduction:
  + 17% on 500k of ABI
  + Recap when UCC>ACB is considered ABI
  + Makes non-eligible dividends
  + If associated corps (>50%); share 500k
  + Applied on min[ABI, Taxable Income, Max Limit]

CCCP: Private corp that is NOT controlled by:

* Public corp
* Secondary relationships

Income type:

* Passive: Residential and passive dividend

Plan to sell: Stop paying dividend

* Collect capital gain (1/2)
* Lifetime Exemption

Prevent ABIL expiring:

* Don’t claim CCA – UCC will be greater in future years
* Salaries to shareholders – don’t pay. If $ required, reimburse SH loans
* SH loans – don’t charge interest
* AFDA – don’t claim (or any other allowances)

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | FMV | Cost | UCC | Bz Income | Cap gain |
| AR | 5 | 8 |  | N/A |  |
| Inventory | 200 | 120 |  | 80 |  |
| Land | 60 | 20 |  |  | 20 |
| Building | 180 | 160 | 100 | 60 | 10 |
| Class 8eq | 50 | 100 | 70 |  |  |
| Goodwill | 40 |  |  |  | 20 |

CH 12

Return of capital:

* Share redemption = dividend
* Sell share = cap gain
* Cap gain
* CCA recap = income

Section 85 rollover:

* Pick TP, sell > to trigger a capital gain & to offset carry fwd
* Elected amnt has to be > non-share consideration received (cash or debt)
* For Tax-Free transfer: Consideration must include some shares and cash/debt < elected value
* Can be:
  + INd -> corp: Seller must become SHdler of purchasing corporation.
  + Parent -> Subsidy
  + Sub->sub is share parent

CH13

Types of income:

* ABI (Active business income): Any business except investment (rents, interest, taxable capital gains and other passive income) or personal service (incorporated employee). Exceptions: rental from leasing of movable property or other property income if 5+ employees. Get 17% on first 500k
* SIB (Specified investment business): a business whose principal purpose is to earn income from property, unless more than 5 full-time employees are employed in the business throughout the year . No SBD or 13%, add refundable 6 2/3%. Tax refund when paying dividend is 26 2/3% (so effective 18%)
* PSB (Personal services business): provides services, when the person providing the services owns 10%+, and the relationship between the person providing the services and the entity receiving the services is of an employment nature. Exceptions: 5+ FTE employed in the biz throughout the year or services are provided to an associated corporation. Not eligible for SBD & Reductions of deductions, if no employment relationship (like many contracts), is ABI

Benefits of incorporating:

* Tax deferral: Access ABD; 2 level of tax; accuml cash between
* Employment benefits: Fully deductible
* Income splitting
* Use 800k cap gain deduction
* Estate planning
* Stabilization of annual income: choose when to get taxed; use progressive rate

Disadvantages:

* Costs (lawyer, accountant)
* Losses locked in corp oration

Benefits of incorporating investment:

* No substantial tax saving (corp rate ~ personal r ate)
* Good for asset protection

Income Instruments

* Capital gains
* Dividends: Subject to Part IV Taxes
  + Non connected (<10% voting): received – taxed at 33 1/3% but fully refundable when repaid
  + Connected: Not subject to Part IV tax unless paying corp receives refund on its part IV taxes; receiving pays = refund

Payouts:

* Dividend:
  + Salary to reduce NI <500k, div rest, Affects RRSP
  + Received from non-connected corporations subject to Part IV tax (33 1/3%)
  + Received from connected corporations, no Part IV tax unless the paying corporations receive an RDTOH refund.
* Loans:
  + Permitted if SH is employee, loan avail to all employees AND
  + Purpose: residence, buy treasury shares in corp or buy car used to perform work duties
  + No tax consequence if reasonable
  + Not required to bare interest
  + Any other loan: must be repaid < 1 tax year otherwise full amount taxable as business income & loan considered income; deducted from income when repaid

Refundable Dividend Tax on Hand (RDTOH):

* \***Dividend refund**: Lesser of 1/3 dividend paid or RDTOH Balance
* Accumulate eligible tax refund for when div are paid
* Consists of Part IV taxes and 26 2/3% of all investments

|  |  |  |  |
| --- | --- | --- | --- |
| RDTOH | | |  |
| BOY Balance | | | |
| Plus | | | |
|  | Part IV Tx Payable (1/3 div income) | | |
|  | CCPC Refundable P1 Tax-**Least of** | | |
|  |  | 26 2/3% investment income (int+cap gain) | |
|  |  | 26 2/3% of (taxable income - subject to SBD) | |
|  |  | Part I tax | |
| Less | | | |
|  | Last year div refund\* (not current year) | | |
| EOY Balance | | | |

**CH14 Reorg**

**ITA85 - Asset Transfer:**

* No corp restructure
* Involves sale of property
* Price can either be FMV or elect price typically = cost
* If elected > Tax cost (UCC), recap till ACB the cap gain on rest (fucked up rollover)
* ACB of consideration = Elected Value – cash & eq receives (essentially Book value of shares)

**ITA87 Amalgamation:**

* Complete merger of assets, liabilities and shareholding of previous
* 2 old disappear and new one is formed
* If no change in shareholders, no restrictions on use of loss carry forward
* All CF balances (RDTOH, CDA, Losses, GRIP, etc.) become the opening balances in new. Any restrictions continue
* Losses can be used up immediately after amalgamation
* new corp can select a year-end for tax purposes anytime < 53 weeks after amalgamation
* Tax free, need to:
  + All corporations need to be Canadian Corps
  + All Assets/Liabilities of old are part of new
  + All SH of old are SH of new; ACB new = ACB Old

**ITA88 - windup of subsidiary and parent**

* First transfer assets to parent then terminate sub existence
* Tax free **only if the parent company owns at least 90%** of each class of the subsidiary company’s shares.
* No tax if TP = tax values of assets transferred.
* Losses only avail in tax year that commences after windup year
* All tax accounts of the subsidiary become available to the parent.

**ITA86 – Reorg Share Capital**

* Share redemption triggers dividend tax treatment w/o 86
* Can swap classes of shares as long as all parties keep interest in corp
* Use cases:
  + Estate planning: flip to preferred at 800k and give to kids, keep common control at 1$
  + New investor: flip to preferred and add new common at 1$

Use cases

* Transfer assets with accrued gains with no tax consequences. (ITA 85).
* Qualify for the $800k Super Cap. Gain deduction. (ITA 85, 86).
* Use carry FWD losses: sell operating to new holding @ cap gain
* Eliminate unnecessary companies (ITA 87, 88(1) )
* Estate plan for succession (ITA 85, 86): Roll over to estate company, set preferred shares @800k. At death, liable for assets at FVM, but preferred @fixed price so no tax because FMV = 800k even if company is worth millions. To preserve control, make preferred shares voting.
* New shareholder. (ITA 85, 86). If company is worth 800k. Rollover assets into preferred shares worth 800k. Issue 2 new common shares at 1$ each, old shareholder buys 1 new common and new shareholder buys second common at 1$. After, 2 shareholders at 50%/50%.

CH15 Partnerships

Taxation:

* P/L allocated to the partners based on partnership agreement, regardless if cash actually distributed
* Income retains its source characteristic and taxed accordingly (business, property and cap gains)

Partnership interest:

* rights and obligations created by being party to a partnership agreement
* Tradable asset
* Treated as capital property; disposal =cap gain
* Disposal by selling to new or existing partner, or withdraw capital from treasury

Interest ACB:

* Additions to the ACB (most common)
  + Partner's contribution of capital
  + Partner’s share of income from the partnership (every year add NI to ACB). Increase ACB by NI to ensure not to pay capital gain on it and be double taxed
  + Partner’s share of Capital Dividends received by the partnership.
  + Partner’s share of the net proceeds of life insurance
* Deductions from ACB ( most common)
  + Partner’s share of loss
  + Partner’s share of charitable gifts or political contributions (decrease ACB since benefited from tax savings from original donation)
  + Partner’s drawings (will slap you in the face with capital gain in the future)

Transactions:

* Partnership considered separate entity holding assets
* Transitions partner->partnership taken at FMV
* Tax free rollover is ITA 97 (same as ITA85)
* Asset transfer partnership -> partner always at FMV

Why:

* If capital intensive and generate losses, better to have partnership since loss not locked up in corp (open, generate loss on you then when profitable incorporate and rollover assets)
* The choice of a partnership form of organization is not binding on the participants.
* A partnership can be converted into a corporation in which the former partners are shareholders, no tax consequences with Section 85
* But, partnership not eligible for 800k cap gain deduction

Small Business Deduction:

* ABI earned by partnership can be entitled to use the SBD by a CCPC partner.
* Limited to $500,000 across partnership

CH17 – Trusts: legal arrangement whereby a person transfers property to another person to hold for the benefit of one or more persons; Does not have status of a person

Types:

* Both have access to DTC, FTC, political, investment & donation credits
* In vivos:
  + used to protect assets against creditors
  + Assets in Trust are no longer yours
  + Pay taxes today on asset @FMV Except if beneficiary is wife
  + Highest personal tax rate (29%) to avoid using for income split
* Testamentary:
  + Tax consequence transferred to your beneficiary
  + Same gradual rates available to individuals
  + To save tax elect to designate amnt payable to beneficiary rather than pay it out if trust tax bracket < personal of benificiary

More types

* Personal:
  + Used for estate and tax planning
  + Taxable if resident in CDA, established by residency status of trustee (if multiple, who exercises control)
  + Taxed at highest tax rate
  + Uses:
    - Provide a vehicle to manage property for those who cannot
    - Provide direction on how to use the property
    - Preserve the asset
    - Hold property for future grandchildren
* Commercial:
  + Traded on the stock exchange
  + Examples include mutual funds (mutual fund is a trust), REITs and royalty trusts
  + Not taxed at 29%
  + Uses:
    - Participate in variety of investments
    - Spread risk
    - Gain access to professional investment management
* Spousal:
  + Spouse entitled to receive income
  + No other person can receive or use capital of trust until spouse death
  + Use: take care of spouse until death but preserve assets for children
  + Property transferred into trust at cost.
  + 21 year rule is waived for the 1st 21 year anniversary.
  + Upon death of spouse assets are deemed to be disposed of at FMV
* Tax Deferred Income Trust Plans:
  + RPP, RRSP, DPSP, RRIF, RESP
  + Income earned is Not taxable and hold income for future distribution to beneficiaries
  + Only taxable when amounts are withdrawn or distributed to beneficiary
* Investment Trusts
  + Mutual funds, REIT, Income trust, Royalty trust
  + All annual income must be allocated to unit holders/beneficiaries are is TAXABLE

Taxation:

* Personal NI less amount distributed to beneficiaries
* Files separate return (T3)
* Trust may allocate after tax income and accumulate funds on behalf of minor children till 21

Beneficiary:

* Capital
  + For ppl you trust to perpetuate assets
  + Right to capital
  + Property is deemed to be disposed at **Cost**
  + Same treatment if Beneficiary has both income and capital interest.
  + Beneficiaries assume the tax position.
* Income
  + For ppl you don’t trust
  + Has right to the income
  + Property is deemed to be disposed of at **FMV**

21 year rule:

* Deemed to sell assets at FMV on 21st anniversary
* Taxed cap gain on Capital property, Depreciable property, land and resource property
* Except spousal trust
* Can’t roll assets out of a trust

CH18-Acquisitions and Divestitures

Sales of assets:

* Usually result in 2 level of tax:
  + Corp: amnt & timing known
  + Shareholder: can be deferred, keep cash in corp and transform in assetless holding
* Establish amount and timing of tax for corporation and shareholder
* Sale of Capital property results in a capital gain
* Sale of Depreciable may result in business income (loss) (recapture or terminal loss)
* Amount of tax payable depends on the type of Corporation:
  + A public corporation pays high tax on all income
  + CCPC may be eligible for the small business deduction
* Purchaser can claim CCA on assets
* Vendor
  + Creates taxable income
  + Second level of tax on distribution
* Purchaser
  + Obtains a higher cost base for each asset
  + Higher cost base increases after-tax profits due to higher CCA.

Sale of shares:

* One asset sold (shares), one level of tax cap gain for SHo (not corp)
* Sale of shares is a capital transaction – only 50% of the gain is taxable.
* Individual shareholders may be eligible for the $800,000 capital gain deduction; if corporation qualifies as a QSBC. Need to PURIFY B4 sale.
* If vendor, preferable to do this – sell shares and claim 800k$
* Purchaser: value locked in as ACB, can’t depreciate
* CCA continues from same base
* Purchaser simply takes over the tax position of the vendor corporation.
* Purchaser may be liable for tax if or when assets are sold in the corporation
* Vendor
  + Sells a single asset – simpler
  + Results in capital gain – taxed at 50%
  + May be eligible for $800,000 capital gains exemption
* Purchaser
  + Assumes tax status of vendor corporation
  + No increase in cost base – no change in future tax savings from CCA

Purify:

* SMB is very active (90% assets active).
* Identify active or passive asset (know purchase and FMV)
* Attempt to divest passive assets prior to be eligible for 800k.
* Purify = add all FMV of active assets/total FMV; if 90%+, eligible. If not, to purify, sell off passive assets and pay down debt (liability doesn’t impact active assets)
* If not possible, sell off assets and keep $ in company; pay 25k$/year as salary

Conflict:

* Purchaser will want to allocate high values to depreciable property, Vendor will want the opposite in order to minimize tax on the sale
* Purchaser will attempt to pay a lower price for the shares than would pay for the assets

Worst case scenarios:

* Vendor: asses sale: pay tax on sale of assets; distribution of earnings as dividends
* Purchaser: buy shares: no immediate benefit from goodwill, can’t depreciate, risk of hidden liabilities

When winding down a company, all cash in accounts needs to be paid as a dividend.

CH19-Tax deferred sales

* Taxable sale =pmt of cash or deferred (notes)
* Tax-deferred sale = pmt of shares issued by the purchasing corp. Why accept risk:
  + Participate in future growth
  + Enhance AT ROI
  + Doesn’t have enough cash

Sales of assets

* Pro: can be done with min cash since commodity is share
* Con for purchaser: Cost base of the assets = transfer price elected

Ask for the cost base as cash, difference up to FMV ask for shares.

Conclusion:

* Vendor defers tax on sale bc pmt of shares (but risk)
* Buyer assumes lower cost base=less CCA but reduce cash requirement for transaction

CH-India

Why:

* India’s recent growth has led to an increasing need for electrical power
* Indian government policies promote its utilities to use local rather than foreign manufacturers
* Prices and lead times for supplying the Indian market from existing plants not competitive
* Internal need to outsource certain head-office support services to low-cost jurisdictions

Why not:

* India is a high tax jurisdiction: effective rate over 40% vs. 27% QC
* India is a very bureaucratic jurisdiction: Red tape and burdensome regulations
* Many different types of taxes (customs duty, excise, duty, central sales tax, state sales tax, transfer taxes).
* Strong foreign currency controls.
* Indian businesses transacting with each other must use the Indian rupee.

Choice 1: Foreign Branch of Canadian Corporation

Pro:

* Easy to set-up – less start-up costs
* Start-up phase losses can be used to reduce taxes on profitable Canadian operations
* Repatriation of profits are easier – No foreign currency controls.

Cons:

* Worldwide sales into India from other subsidiaries may be “attracted” to the Indian branch resulting in increased taxes.
* Limited flexibility with tax planning
* Does not solve local content or outsourcing issues

Choice 2: New Indian subsidy:

Pros:

* More Indian sales opportunities due to local content
* Simpler to offshore head office support services
* Corporate veil
* Easier to obtain local financing
* Greater flexibility with tax planning

Cons:

* Subject to foreign currency controls.
* Greater compliance costs and administrative burdens.
* No loss utilization in start-up phase.

Tax considerations:

* Minimize effective corporate income tax rate (Debt push down, Transfer pricing)
* Minimize taxes on repatriation of profits (Dividend distribution tax of 16.995%)
* Minimize indirect taxes (Special economic zones (“SEZs”))
* Minimize taxes on future exit (Not a concern for Velan)

Pros/Cons of salary:

* RRSP
* Insurable earnings
* CSST, EI, QPP, other levies

Divestiture

Funds avail for distribution:

1. Disposal of asset Find Cap Gain & ABI (Recap)
   * Delta Book&FMV ST asset = ABI
   * LT asset: FMV > UCC recap till cost then cap gain
   * LT Asset FMV < UCC = ABI loss (not capital)
2. Compute taxable income = cap + ABI
3. Tax on ABI + Tax on Inv (cap gain) = Part 1 Tx
4. Adjust RDTOH – add inv tax on cap gains
5. Calculate cash proceeds
6. Dist to SH (max Div) = Proceeds – tax + RDTOH

Distribution

1. Adjust capital dividend acct (add ½ cap gains)
2. Dist to SH – PUC = Deemed dividend
3. Deemed Dividend – Cap divided acct = Div subj to tax

Shareholder capital gains

1. Deemed Proceeds = Dist to SH (Max div) - Deemed Div
2. Capital gain = deemed Proceeds – ACB of share

If all distributed in dividend, cap gain = 0

Section 85 tax

* shares have ACB of $50,000 & FMV $1,000,000
* S85 to Holdings @ elected value of $850,000
* Consideration: $700,000note + $300,000 Preferred

Tax:

* Deemed div of cash consideration-ACB = $650,000

Capital gain:

Proceeds elected under section 85 $850,000

Less amount deemed to be a dividend (650,000)

Adjusted proceeds [S.54] 200,000

ACB (50,000)

Capital gain $150,000

Taxable capital gain (1/2) $ 75,000

Preferred shares of Holdings have an ACB of $150,000

800k lifetime cap gain conditions – qualified small business corporation:

* Must be a small business corporation at the time of the sale (>90% FMV of assets used in active business)

Throughout the 24 months preceding the sale:

* must be a Canadian-controlled private corporation (CH11)
* An unrelated person cannot have owned shares that are being sold
* > 50% of the FMV of assets used to catty active business in Canada

Loss on sale of depreciated asset is not allowed.

Never a capital loss on the sale of a depreciable asset

CCA = Capital Cost Allowance = Depreciation for Tax

[UCC for tax = Un-Depreciated Capital Cost - Net Book value dep amount]

**CDA Account**: Company sells an asset, half is capital gain the other half goes in Capital Dividend Account. At any point, money in CDA can be distributed to shareholders tax free – no tax consequence to shareholders. If company sells and gets a loss, depletes CDA therefore better to pay it out as soon as there is a balance. Only applies to private companies, not public.

The sale of intangibles, such as goodwill or patents, franchises, and licences having an unlimited life, may result in eligible capital property income which is classified as ABI. Put ½ in ABI and ½ in CDA