CORPORATE TAXATION IN CANADA

Prof. Michel L. Bilodeau

Corporate Income Taxes

Corporate taxes paid to both the federal and provincial governments

	Income from all Sources
Less	Allowable Expenses and Deductions
Equals	Taxable Income
Times	Tax Rate
Equals	Taxes otherwise Payable
Less	Tax Credits
Equals	Taxes Payable

Corporate Income Tax Rates

Table 2.7 (p. 39)

Federal	Small businesses – 13.12 %
	Manufacturing and processing – 22.12 %
	Basic corporations – 24.12 %
Provincial	Ontario – 5.5 % / 11.0 % / 12.5 %

Thus, overall tax rate in Ontario for basic corporations: 36.62 %

Allowable Expenses

Costs incurred to earn income (except capital expenses)

Deduction of Expenses

↓

Reduction in Taxable Income

↓

Reduction in Tax Payments → Tax Savings

	Before	After
Revenue	100	100
Expenses	30	40
Taxable Income	70	60
Tax @ 40%	28	24
Earnings After Taxes	42	36

→ Tax saving: 4

10 (0.4) = 4

Cost after taxes: 6 (i.e. net of tax saving)

10 (1 - 0.4) = 6

Implicit assumptions

- There is enough taxable income to absorb the entire expense
- The tax rate is constant
- In the case of an incremental expense, there is no accompanying proportional incremental revenue

Conclusion:

Any taxable income or deductible expense can be converted from a before-tax basis to an after-tax basis by multiplying it by the factor (1 - tax rate)

Deductions – Capital Cost Allowance (CCA)

Depreciation allowance in the Canadian tax system

All depreciable assets (land and securities excluded) are categorized into 37 classes. Those depreciated by the declining-balance method are grouped into 'POOLS' and depreciated together. Assets depreciated by the straight-line method are NOT grouped into pools. They must be depreciated individually.

Depreciation rates depend on asset useful or legal life, or on a specific policy objective

See Table 2.8 for examples of classes and depreciation methods (almost entirely declining balance) and rates

e.g., class 1 (buildings) – DBD at 4 %; class 10 (trucks) – DBD at 30 %

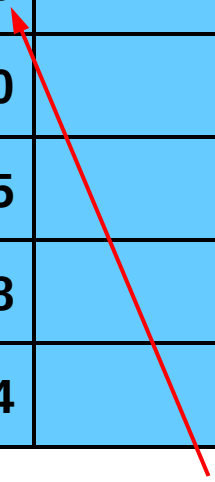
The CCA represents the maximum depreciation expense that a firm can claim in any given operating period.

Half-year Rule

The CCA rate applicable in the first year in which the asset is depreciated is half the normal rate, i.e. the firm can claim only half of the total CCA that it would normally be entitled to otherwise.

Example – CCA for a Class 10 asset (30 %) costing $30 000

Year	Opening Balance	CCA	Closing Balance
1	30 000	4500	25 500
2	25 500	7650	17 850
3	17 850	5355	12 495
4	12 495	3748	8 747
5	8 747	2624	6 123



Tax Shields Created by CCAs

The deduction of CCAs over an asset's life (and beyond for assets depreciated by the declining-balance method) results in annual tax savings. These annual tax savings, referred to as tax shields, are equal to the CCA deduction times the tax rate (as seen in slide #4).

The present value of the tax shields at the time of purchase of the asset can be determined for both the straight-line and declining-balance depreciation methods.

In the case of declining-balance depreciation, the present value of tax shields associated with a capital expense of $1 is:

$$\frac{\text{(depreciation rate x tax rate)}}{\text{(depreciation rate + discount rate)}}$$

Correction factor for half-year rule:

$(1 + i/2) / (1 + i)$ in which i=discount rate

Implicit assumptions

- There is enough taxable income to absorb the annual CCA

- The tax rate is constant

Conclusion:

A capital expenditure depreciated by the declining-balance method can be converted from a before-tax basis to an after-tax equivalent at the time of purchase by subtracting from it the present value of tax shields.

Depreciation Pool Mechanics

When a pooled asset is purchased, its cost is added to the pool balance which it belongs to. Conversely, when an used asset is disposed of, the net proceeds are subtracted from the pool balance. Thus, there is no explicit recapture of excess depreciation for pooled assets in the Canadian tax system.

Procedure:

	Starting pool balance (ending balance from preceding year)
Add:	Acquisitions net of "tax credits"
Less:	Disposals (lower of proceeds and original cost)
Less:	Half of net acquisitions if + (acquisitions less disposals)
	Balance available for CCA
Less:	CCA claimed
Add:	Half of net acquisitions if +
	Ending pool balance carried forward
	(UCC, i.e. undepreciated capital cost)

Note: If assets are both acquired and disposed of in a particular year, the half-year rule applies to the excess of acquisitions over disposals. If disposals exceed acquisitions, the half-year rule does not apply.

Example – 20 % DB Depreciation Pool

Starting Balance	100 000
Add acquisitions	200 000
Less disposals	20 000
Less 50% of net acquisitions*	90 000
Balance available for CCA	190 000
Depreciation @ 20 %	**38 000**
	152 000
Add 50% of net acquisitions*	90 000
Balance carried forward	**242 000**

* If disposals > purchases, the 50% subtraction/addition does not apply.

Explicit Recapture

When a pool balance becomes negative (or a non-pooled asset is sold for an amount more than its UCC but for less than its purchase price), this reflects over-depreciation.

The absolute amount is added back to ordinary taxable income and taxed accordingly. This is referred to a the 'recapture' of excess depreciation.

Terminal Loss

When a pool has a positive balance and no assets remain in the pool (or a non-pooled asset is sold for an amount less than its UCC), this reflects under-depreciation.

The balance is claimed as an ordinary expense. This is referred to a the write-off of a 'terminal loss'.

Loss Carry Forward/Backward Provision

The objective of any business is to reduce taxable income to a level that is tax exempt (usually, but not always, 0)

If Revenues - Operating Expenses < 0, then there is an operating loss. In the majority of corporate tax systems, operating losses can be carried to other years.

- Such losses can be carried forward for up to 7 years. If not used within that period, they are lost.
- These losses can also be carried backwards for up to 3 years (i.e. used to reduce taxable income in previous years).

Capital Gain

Occurs when an asset is sold for more that its original cost

The capital gain is the excess of the sales price over the original cost

Currently, 50% of net capital gains (capital gains less capital losses) are taxable at the normal rate

Capital Loss

Occurs when an non-depreciable asset is sold for less than its original cost

Capital losses can only offset capital gains, can be carry backwards for up to three years and forward indefinitely

Tax Credits

Allowances that reduce tax liability, therefore more valuable than expenses that reduce taxable income

- The Canadian investment tax credit (ITC) applies to qualified capital expenditures and certain other expenses in NFLD, PEI, NS, NB and the Gaspé region of QC
- The ITC is a specific proportion of the qualified capital expenditure or other expense
- The amount of investment tax credit must be subtracted from the cost of the capital expenditure for the purpose of calculating depreciation allowances, or from the expense for the purpose of calculating taxable income
- The amount of tax credit used in any given year cannot exceed 75% of the taxes otherwise payable. Unused tax credits can be carried forward for up to seven years and backwards for up to three years.

Example – Tax Credit

Investment: $2 million in 1996 and $3 million in 1997
ITC: 7 %
Depreciation: 25 % / 50 % / 25 % (class 24 asset @ 50 % SL)
Tax rate: 45 %

(in '000 $)	1996	1997	1998	1999
Gross investment	2000	3000	-	-
Investment tax credit	140	210	-	-
Net investment	1860	2790		
Depreciation	465	1627.50	1860	697.50
Tax savings from depreciation	209.25	732.38	837	313.88
Total tax shield	349.25	942.38	837	313.88

1860 (0.25)

1860 (0.50) + 2790 (0.25)

1860 (0.25) + 2790 (0.50)

2790 (0.25)

Personal Income Taxes

Read sections on Personal Income Taxes (pages 36-38) by yourself.