Chapter Eleven Test Item File Solutions

TIF Solution Eleven - 1

1. Such lump-sum payments often reflect compensation for services rendered over several years. The fact that it is received in a single year can result in significant portions of it being taxed at rates higher than would have been applicable had it been received over the several years during which it was earned. The deduction of such amounts provides the basis for an alternative Tax Payable calculation which attempts to adjust the amount paid to the amount that would have been paid if the amount had been received over several years. The objective of such provisions is fairness or equity.

2. The carry forward periods for the various types of losses identified in the *Income Tax Act* and covered in the text up to Chapter 11 are as follows:

   - Non-Capital Losses and Farm Losses: 20 years.
   - Net Capital Loss: Unlimited.
   - Listed Personal Property Losses: 7 years.
   - Allowable Business Investment Losses: 10 years, then converted to net capital loss with unlimited carry forward.

   Covered in Chapter 18 are limited partnership losses. They have no carry back and an unlimited carry forward, but only against the partnership income to which they relate.

3. There are two reasons for having to track each type of loss carry forward separately. First, different types of losses have different carry forward periods (e.g., 20 years for farm losses vs. unlimited for capital losses). Second, some types of losses can only be applied against the equivalent type of income (e.g., capital losses can only be carried over and applied against capital gains).

4. Losses on listed personal property can be deducted during the current year, but only against gains on listed personal property. If the loss cannot be used during the current year, it can be carried back three years or forward seven years. However, in the carry back or carry forward years, it can only be deducted to the extent of capital gains on listed personal property during those years.

5. The difference between the two loss carry forwards is that the non-capital loss balance is time limited and will expire at the end of 20 years. In contrast, the net capital loss will never expire but can only be applied against taxable capital gains. If Mr. Broley is concerned about having sufficient income to use the non-capital balance in the time remaining until it expires, he should deduct that balance. Alternatively, if he feels that he is likely to have sufficient income in that period, but that he is unlikely to have further capital gains, he should deduct the net capital loss. There is no clear answer to this question as it involves estimates about the future.

6. ITA 111(2) contains a special provision with respect to both net capital losses from years prior to death and to net capital losses arising in the year of death. Essentially, this provision allows these accumulated losses to be applied against any type of income in the year of death, or the immediately preceding year, as long as the lifetime capital gains deduction has not been claimed. A further difference is that, in the case of carry overs, the deduction in the year of death is applied using the capital gains inclusion rate (1/2, 2/3, or 3/4) that prevailed in the year the loss was realized, rather than at the rate that applies in the year of deduction.

7. An Allowable Business Investment Loss is the deductible portion of a capital loss resulting from the disposition of shares or debt of a small business corporation. The special provisions associated with this type of loss are:

   - It can be deducted against any type of income in the year in which it occurs.

- It can be carried back and applied against any type of income in the preceding three taxation years.
- If it cannot be used during the current or three preceding years, it becomes part of the non-capital loss balance and can be deducted against any type of income in the 10 subsequent years.
- If it is not used in the subsequent 10 years, it becomes part of the net capital loss balance and can be carried forward indefinitely, subject to the constraint that during these additional years, it can only be deducted against taxable capital gains.

8. A small business corporation is defined in ITA 248(1) as a Canadian controlled private corporation (CCPC) of which "all or substantially all", of the fair market value of its assets are used in an active business carried on "primarily" in Canada. In tax work, the term "substantially all" generally means 90 percent or more, while "primarily" is generally interpreted to mean more than 50 percent.

9. The three categories, along with the treatment of their losses, are as follows:

   Hobby Farmer This is an individual who runs a farming operation on a part time basis as a hobby or as a way of enhancing his lifestyle. The operation has no reasonable expectation of a profit and its losses cannot be deducted against any other source of income.

   Part Time Farmer This is an individual for whom farming is not his principal source of income. However, there is a reasonable expectation of a profit and he is allowed to deduct a portion of his farm losses. In each year, the portion of the farm loss that can be deducted against any source of income is limited to the first $2,500, plus one-half of the next $12,500, to a maximum amount of $8,750. Losses in excess of this deductible amount are referred to as restricted farm losses and, when they are carried over to earlier or later years, they can only be deducted to the extent of farm income in that year.

   Full Time Farmer This is an individual for whom farming is his principal source of income and activity. For this category of farmer, farm losses are fully deductible against any other source of income.

10. In order to be a qualified small business corporation for the purposes of the lifetime capital gains deduction, the corporation must be a "small business corporation" at the time of the disposition of the shares. This means that substantially all (90 percent or more) of the fair market value of its assets must be used to produce active business income, primarily (more than 50 percent) in Canada. If the small business corporation test is met, two other conditions must be met for the enterprise to be a "qualified" small business. These are as follows:

    - the shares must not be owned by anyone other than the taxpayer or a related person for at least 24 months preceding the disposition; and
    - throughout this 24 month period, more than 50 percent of the fair market value of the corporation's assets must be used in an active business carried on primarily in Canada.

11. The tax policy issue is the fact that some individuals, through the use of tax privileges (e.g., tax shelters, the non-taxable component of capital gains, or employee stock option deductions) can wind up paying little or no tax, despite having a very large income. The alternative minimum tax deals with this by requiring an alternative calculation of income in which these tax privileges are added back. After the deduction of a basic $40,000 exemption, the minimum tax rate is applied to the balance. If the result is a Tax Payable figure that is larger than that resulting from the regular calculation, this amount must be paid. Any excess of alternative minimum tax over regular Tax Payable can be carried forward for up to seven years to be applied against any future excess of regular Tax Payable over the alternative minimum tax.

TIF Solution Eleven - 2

1. False. There are other deductions that can create a difference between Net Income For Tax Purposes and Taxable Income.

2. False. It can be carried back three years and forward 20 years.

3. False. The Allowable Business Investment Loss is $10,000 [(1/2)($20,000)].

4. False. Its net allowable capital loss for the year is $5,500 [(1/2)($11,000)].

5. True. Net capital losses can only be carried forward or back to be deducted against net taxable capital gains.

6. i. False. In the current year, she can deduct a maximum of $8,750 [$2,500 + (1/2)($12,500)] of the farm loss against other income.

   ii. False. Any loss that is not deductible in the current year can be carried forward for a maximum of 20 years.

   iii. True. A restricted farm loss can only be used to the extent of farm income in the carry over period.

7. True. The $375,000 deduction can be used against gains arising on the disposition of either type of property.

8. True. The foreign tax credit deductible from federal Tax Payable cannot exceed 15 percent of the foreign investment income that, in this case, is $1,500. The remaining $500 would be deductible under ITA 20(11).

9. True. ITA 82(3) only allows such transfers when the spousal credit is either created or increased for the taxpayer.

10. True. Any gain would be deemed to be nil.

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TIF Solution Eleven - 3

1. D. A credit for a charitable donation.

2. A. A non-capital loss carried forward from a previous year.

3. C. i and iv.

4. C. If a gain occurs, one-half of this amount can be used to offset allowable capital losses on any disposition of capital property.

5. A. Nil.

6. A. When such balances are deducted, the amount deducted will be based on the capital gains inclusion rate which applied in the year in which the loss was realized.

7. D. If they are not used during the current year, they are added to the non-capital loss balance.

8. B. If not used during the current year, an Allowable Business Investment Loss can only be applied against taxable capital gains in a carry forward or carry back period.

9. B. An individual sells 15 percent of the shares of a CCPC that uses 95 percent of its assets in the operation of an active business.

10. D. The deduction is available on any disposition of shares of a small business corporation.

11. B The tax is applied at a 29 percent rate to all of the income of a specified individual.

12. C \$139,500 [(75%)(\$147,500) + (25%)(1/2)(\$300,000 - \$225,000) + (25%)(\$225,000 - \$147,000)]

13. A. Business income only.

14. B. Dividend tax credits.

15. A. Stock options not yet exercised.

TIF Solution Eleven - 4

Exam Exercise Solution Eleven - 1

Ms. Michaels will have a listed personal property loss carry forward from 2009 of $12,000 [(1/2)($78,000 - $102,000)]. This can only be applied against the 2010 taxable capital gain on listed personal property of $2,950 [(1/2)($7,000 - $1,100)]. As this is a listed personal property loss carry forward, it will be deducted in the calculation of Net Income For Tax Purposes, leaving this balance at the amount of her employment income, $69,000. This will also be her 2010 Taxable Income. In addition, she will have a listed personal property loss carry forward of $9,050 ($12,000 - $2,950) that can only be applied against taxable capital gains on listed personal property.

If the sale had been of shares, Ms. Michaels would have had a regular net capital loss carry forward of $12,000 from 2009. Her 2010 Net Income For Tax Purposes would have been $71,950 ($69,000 + $2,950) and her Taxable Income would have been $69,000 ($71,950 - $2,950), the same as under the original assumption. The $9,050 net capital loss carry forward would be available to be applied against any taxable capital gains.

Exam Exercise Solution Eleven - 2

Mr. Klaus will have Net Income For Tax Purposes and Taxable Income of nil for 2010. Prior to making any use of the amounts, he will have a non-capital loss balance of $56,000 and a net capital loss of $3,300 [(1/2)($9,800 - $3,200)]. Of this net capital loss amount, $3,000 can be carried back to the preceding year, leaving a net capital loss carry forward of $300. With respect to the $56,000 non-capital loss, $19,000 ($22,000 - $3,000) can be carried back to the previous year.

The 2009 Net Income For Tax Purposes is unchanged at $22,000 and the 2009 Taxable Income is amended to nil after the carry back. This leaves a non-capital loss carry forward of $37,000 ($56,000 - $19,000).

Exam Exercise Solution Eleven - 3

Ms. Claus will have Net Income For Tax Purposes and Taxable Income of nil for 2010. Prior to making any use of the amounts, she will have a net capital loss carry forward of $5,250 [(1/2)($10,500)] from 2009 and a 2010 non-capital loss balance of $79,850 [$83,000 - (1/2)($12,600 - $6,300)]. To the extent that there were taxable capital gains in 2010 ($3,150), the net capital loss carry forward from the previous year can be deducted, and added to the non-capital loss balance. This will leave a net capital loss carry forward of $2,100 ($5,250 - $3,150) and a non-capital loss carry over of $83,000 ($79,850 + $3,150). This can be carried back to the previous year.

The 2009 Net Income For Tax Purposes is unchanged at $45,000 and the 2009 Taxable Income is amended to nil after the carry back. This leaves a non-capital loss carry forward of $38,000 ($83,000 - $45,000).

Exam Exercise Solution Eleven - 4

The net amount that would be included in Ms. Forester's income as a result of these items would be calculated as follows:

Employment Income	$47,000
Taxable Capital Gain	15,500
Net Capital Loss Applied Against Current Taxable Capital Gain [(1/2)($31,000)]	(15,500)
Net Capital Loss Applied Against Other Income [(3/4)($42,000 - $31,000)]	(8,250)
Net Inclusion	$38,750

As it is Ms. Forester's year of death, the net capital loss can be deducted against any type of income. Note that the carry forward amount must be adjusted for application against current taxable capital gains, but does not require adjustment for application against other types of income.

Exam Exercise Solution Eleven - 5

The Allowable Business Investment Loss for the year would be calculated as follows:

Actual Loss On Disposition	$47,000
Reduction For Capital Gains Deduction [(2/1)($15,000)]	(30,000)
Business Investment Loss	$17,000
Inclusion Rate	1/2
Allowable Business Investment Loss	$ 8,500

All of the $8,500 can be deducted against Mrs. Brown's employment income. With respect to the disallowed $30,000, it becomes an ordinary capital loss, of which $21,000 can be deducted against the current year's capital gains on the publicly traded securities. This leaves a net capital loss carry over of $4,500 [(1/2)($30,000 - $21,000)].

Exam Exercise Solution Eleven - 6

Ms. Close's maximum lifetime capital gains deduction is the least of the following three items:

Available Deduction Her remaining deduction would be $339,000 [$375,000 - (1/2)($18,000 + $54,000)].

Annual Gains Limit In the absence of capital gains on non-qualified property in any of the years under consideration, the simplified version of this calculation can be used. The annual gains limit for 2010 would be the qualified taxable capital gain of $374,000 [(1/2)($748,000)], reduced by the net capital loss deducted of $30,000. This leaves a net amount of $344,000 ($374,000 - $30,000).

Cumulative Gains Limit This amount would be calculated as follows:

Sum Of Annual Gains Limits ($9,000 + $27,000 + $344,000)	$380,000
Previous Years' Capital Gains Deduction ($9,000 + $27,000)	(36,000)
CNIL	(23,000)
Cumulative Gains Limit	$321,000

The least of these three amounts is $321,000, the Cumulative Gains Limit.

Exam Exercise Solution Eleven - 7

Joanne's Net Income For Tax Purposes would be calculated as follows:

Income Under ITA 3(a):		
Employment Income	$61,000	
Business Income	14,200	
Farming Income	2,950	$78,150
Income Under ITA 3(b):		
Taxable Capital Gains		10,500
Net Income For Tax Purposes		$88,650

Joanne's Taxable Income is as follows:

Net Income For Tax Purposes	$88,650
Loss Carry Forwards:	
Restricted Farm Losses (Limited to farming income)	(2,950)
Net Capital Losses (Limited to taxable capital gains)	(10,500)
Non-Capital Losses (All)	(41,000)
Taxable Income	$34,200

The restricted farm loss carry forward would be $4,250 ($7,200 - $2,950). The remaining net capital loss carry forward equals $14,500 ($25,000 - $10,500). There would be no non-capital loss carry forward.

Exam Exercise Solution Eleven - 8

Harriet's regular Tax Payable would be calculated as follows:

Tax On Split Income [(29%)(125%)($13,000)]	$4,713
Tax On Balance [(15%)($13,100)]	1,965
Dividend Tax Credit [(2/3)(25%)($13,000)]	(2,167)
Basic Personal Credit [(15%)($10,382)]	(1,557)
Regular Tax Payable	$2,954

The alternative calculation under ITA 120.4(3) is as follows:

Tax On Split Income [(29%)(125%)($13,000)]	$4,713
Tax On Balance (Only Split Income Is Included In This Calculation)	Nil
Dividend Tax Credit [(2/3)(25%)($13,000)]	(2,167)
Basic Personal Credit (Not Available)	Nil
ITA 120.4(3) Tax	$2,546

Harriet's tax payable would be the greater of these two amounts, $2,954.

Exam Exercise Solution Eleven - 9

In the absence of the transfer, Mrs. Senton would have no spousal tax credit. In contrast, with the transfer, she would be eligible for the full $1,557 [(15%)($10,382)]. Given this, the analysis of her position at the federal level would be as follows:

Additional Tax On Dividends [(144%)($9,000)(29%)]	$3,758
Spousal Tax Credit	(1,557)
Dividend Tax Credit [(10/17)(44%)($9,000)]	(2,329)
Tax Increase (Decrease)	($ 128)

As there is a decrease in federal Tax Payable, the election would be desirable.

Exam Exercise Solution Eleven - 10

Ms. Wave's gift will result in a taxable capital gain of $55,250 [(1/2)($132,500 - $22,000)]. Her Net Income For Tax Purposes equals $67,750 ($12,500 + $55,250).

The limit on the credit base for the charitable donations credit is as follows:

75% Of Net Income For Tax Purposes [(75%)($67,750)]	$50,813
25% Of Taxable Capital Gain [(25%)($55,250)]	13,813
Charitable Donations Credit Base Limit	$64,626

This base results in a potential credit of $18,714 [(15%)($200) + (29%)($64,626 - $200)].

While this amount could be used, she does not have sufficient Tax Payable to utilize the whole potential credit. Her federal Tax Payable for the year would be calculated as follows:

Tax On First $40,970	$ 6,146
22 Percent Of $26,780 ($67,750 - $40,970)	5,892
Tax Payable Before Credits	$12,038
Basic Personal Credit	(1,557)
Federal Tax Payable Before Donations Credit	$10,481

Given this amount of federal Tax Payable, the use of $36,237 of her donation will produce a credit of $10,481 [(15%)($200) + (29%)($36,237 - $200)], an amount sufficient to eliminate her federal Tax Payable. This will leave a carry forward of $96,263 ($132,500 - $36,237).

Exam Exercise Solution Eleven - 11

Mr. Deveau's gift will result in a capital gain of $174,000 ($346,000 - $172,000), with a taxable amount of $87,000 [(1/2)($174,000)]. In addition, there will be recapture of $95,000 ($172,000 - $34,000 - $43,000). This will bring his total Net Income For Tax Purposes for 2010 to $190,300 ($8,300 + $87,000 + $95,000).

The limit on the credit base for the charitable donations credit is as follows:

75% Of Net Income For Tax Purposes [(75%)($190,300)]	$142,725
25% Of Taxable Capital Gain [(25%)($87,000)]	21,750
25% Of Recapture [(25%)($95,000)]	23,750
Charitable Donations Credit Base Limit	$188,225

This base results in a potential credit of $54,557 [(15%)($200) + (29%)($188,225 - $200)]. While this amount could be used, he does not have sufficient Tax Payable to utilize the whole potential credit. His federal Tax Payable for the year would be calculated as follows:

Tax On First $127,021	$26,880
29 Percent Of $63,279 ($190,300 - $127,021)	18,351
Tax Payable Before Credits	$45,231
Basic Personal Credit	(1,557)
Federal Tax Payable Before Donations Credit	$43,674

Given this amount of federal Tax Payable, the use of $150,697 of his donation will produce a credit of $43,674 [(15%)($200) + (29%)($150,697 - $200)], an amount sufficient to eliminate his Tax Payable. This will leave a carry forward of $195,303 ($346,000 - $150,697).

Exam Exercise Solution Eleven - 12

Mr. Fung's credit for foreign tax paid would be the lesser of $507 [(13%)($3,900)] and an amount determined by the following formula:

[(Foreign Non-Business Income ÷ Adjusted Division B Income)(Tax Otherwise Payable)]

In this formula, the Adjusted Division B Income would be $53,300 ($56,500 - $3,200). Tax Otherwise Payable would be $6,202 [$6,146 + (22%)($48,300 - $40,970) - $1,557)]. Using these figures, the calculation would be as follows:

[($3,900 ÷ $53,300)($6,202)] = $454

As the amount determined by the formula would be the lesser of the two figures, his tax credit for 2010 would be $454.

Exam Exercise Solution Eleven - 13

Mr. Leigh's regular Tax Payable would be calculated as follows:

$25,344 At 15 Percent	$3,802
Basic Personal Credit	(1,557)
Dividend Tax Credit [(10/17)(44%)($17,600)]	(4,555)
Federal Tax Payable - Regular	Nil

His Adjusted Taxable Income for minimum tax purposes would be calculated as follows:

Regular Taxable Income	$25,344
30 Percent Of Capital Gains [(30%)(2)($120,000)]	72,000
Dividend Gross Up [(44%)($17,600)]	(7,744)
Adjusted Taxable Income	$89,600

The calculation of the alternative minimum tax would be as follows:

Adjusted Taxable Income	$89,600
Basic Exemption	(40,000)
Amount Subject To Tax	$49,600
Rate	15%
Minimum Tax Before Credit	$ 7,440
Basic Personal Credit	(1,557)
Alternative Minimum Tax Payable	$ 5,883

As the alternative minimum tax payable is higher than the regular tax payable, the alternative amount would have to be paid. The $5,883 excess can be carried forward to be applied against any excess of regular tax payable over minimum tax payable in the next seven years.

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TIF Solution Eleven - 5

For each term there is both a 100 percent correct answer and an answer that is close. We have indicated the "close answer" in brackets. This would allow you to mix terms from various chapters if you wish to do so.

The correct definitions for each of the listed key terms are as follows:

A. 3 (not 6)

B. 9 (not 1)

C. 2 (not 10)

D. 8 (not 4)

E. 5 (not 7)

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TIF Solution Eleven - 6

The calculation of Mr. Fine's minimum Net Income For Tax Purposes and Taxable Income for the year would be as follows:

Gross Billings		$162,000
Additions:		
Opening Allowance For Bad Debts	$ 2,500	
Bad Debts Recovered	300	2,800
		$164,800
Deductions:		
Salaries For Staff	($42,900)	
Office Rent	(12,000)	
Bad Debts Written Off	(1,300)	
Closing Allowance For Bad Debts	(1,800)	
Cost Of Legal Convention	(800)	
Office Expenses	(33,700)	(92,500)
Net Business Income		$ 72,300
Less: Farm Loss [$2,500 + (1/2)($2,000)] (Note 2)		(3,500)
Net Income For Tax Purposes And Taxable Income		$ 68,800

Notes:

1. While the charitable donations will generate a credit against Tax Payable, they are not deductible in the computation of Taxable Income.

2. Mr. Fine has a restricted farm loss carry over of $1,000 ($4,500 - $3,500) that can be carried back 3 years and forward 20 years, but can only be applied against farming income in those years.

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TIF Solution Eleven - 7

Part A

Mr. Leonard's net employment income would be calculated as follows:

Salary	$58,000
Housing Benefit (12 Months At $1,000)	12,000
Less: Rents Paid	(1,200)
Award	2,100
Director's Fees	1,300
Stock Option Benefits [(100)($16 - $7)]	900
Net Employment Income	$73,100

Part B

Since Mr. Leonard's son is over 17 years of age, the interest on the bonds is not attributed to Mr. Leonard. Mr. Leonard's income from property would be calculated as follows:

Royalties On Patent	$24,070
Interest On Bonds	430
Income From Property	$24,500

Part C

Mr. Leonard's net taxable capital gains would be calculated as follows:

Listed Personal Property:			
Proceeds From Ring	$1,200		
Deemed Cost	(1,000)	$ 200	
Proceeds From Painting	$1,100		
Cost	(1,800)	(700)	Nil
Personal Use Property:			
Proceeds From Pistols		$2,000	
Cost		(1,400)	
Capital Gain		$ 600	
Inclusion Rate		1/2	$300
Net Taxable Capital Gains			$300

The preceding calculations indicate that Mr. Leonard would be left with a listed personal property loss of $250 [(1/2)($$200 - $700)]. Unlike other capital losses, this amount can be carried back three years and forward for only seven years, to be deducted against capital gains on listed personal property.

Part D

Mr. Leonard's Net Income For Tax Purposes would be calculated as follows:

Employment Income	$73,100
Income From Property	24,500
Taxable Capital Gain	300
RRSP Contribution (Actual - See Note)	(3,600)
Net Income For Tax Purposes	$94,300

Note Mr. Leonard's RRSP Deduction Limit for 2010 is the lesser of $22,000 and 18 percent of his 2009 Earned Income. His Earned Income for 2009 is assumed to be equal to his 2010 Earned Income. This amount is calculated as $13,158 by taking 18 percent of his employment income of $73,100. There is no PA to take into consideration. However, his actual deduction is limited by the fact that his contribution during 2010 is only $3,600. The royalty income would not form part of earned income for RRSP purposes since Mr. Leonard is not the author or inventor.

Part E

Mr. Leonard's Taxable Income would be calculated as follows:

Net Income For Tax Purposes	$94,300
Stock Option Deduction [(1/2)($900)]	(450)
Taxable Income	$93,850

Part F

Mr. Leonard's federal Tax Payable would be calculated as follows:

Federal Tax On First $81,941		$15,159
Federal Tax On Next $11,909 ($93,850 - $81,941) At 26 Percent		3,096
Gross Federal Tax		$18,255
Tax Credits:		
Basic Personal Amount	($10,382)	
Spousal ($10,382 - $2,990)	(7,392)	
CPP	(2,163)	
EI	(747)	
Canada Employment	(1,051)	
Transfer Of Son's Tuition, Education And Textbook		
- Lesser Of (See Note):		
• $5,000		
• [$3,000 + (4)($400) + (4)($65)] = $4,860	(4,860)	
Credit Base	($26,595)	
Rate	15%	(3,989)
Federal Tax Payable		$14,266

Note As his son's income is $3,700 [(12)$250) + $700], he will have no Tax Payable and Mr. Leonard will be able to take the full credit. There is no credit for his aunt because she is not a resident of Canada.

TIF Solution Eleven - 8

Part A - Taxable Income

Daniel Tong's employment income would be calculated as follows:

Inclusions:		
Salary	$78,000	
2009 Bonus (Cash Basis)	6,000	
Home Office Allowance	2,400	
Standby Charge - No Reduction [($5,200)(2/3)]	3,467	
Automobile Operating Benefit [(14,000 km)($0.24)]	3,360	
Group Term Life Insurance Premium	650	
Stock Option Benefit [(2,500)($15 - $12)]	7,500	$101,377
Deductions:		
Company Pension Contributions	($ 3,900)	
Home Office [(30/300)($2,100 + $750)]	(285)	
Office Supplies	(230)	(4,415)
Net Employment Income		$ 96,962

Notes

- In general, the only home office costs that can be deducted are utilities and maintenance. In the case of employees with commission income, a pro rata share of insurance and property taxes would also be deductible. However, it does not appear that Mr. Tong has any commission income.
- As the only capital costs that are deductible by an employee are those related to an automobile, aircraft, or musical instrument, the cost of the computer and fax machine are not deductible.
- The use of employment related frequent flyer points is no longer considered a taxable benefit by the CRA.
- In the determination of his Taxable Income, Mr. Tong will be able to deduct one-half of the stock option benefit.

Mr. Tong's Net Income For Tax Purposes and Taxable Income would be calculated as follows:

Net Employment Income (See Preceding)		$ 96,962
Business Income - Sale Of Automobile [$14,500 - ($2,500 + $8,100)]		3,900
Property Income:		
Portus Dividend [(144%)($4,500)]	$6,480	
Less Interest Expense	(1,200)	5,280
Spousal RRSP Withdrawal (Attributed To Mr. Tong)		1,000
Net Taxable Capital Gain:		
Taxable Capital Gain On Portus Shares (Note 1)	$3,581	
Allowable Capital Loss On Global Shares (Note 2)	Nil	3,581
RRSP Contribution (Note 3)		(10,200)
Net Income For Tax Purposes		$100,523
Stock Option Benefit		(3,750)
Net Capital Loss Carry Forward (Note 4)		(3,581)
Taxable Income		$ 93,192

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Note 1 For shares acquired through the exercise of stock options, the adjusted cost base is the fair market value of the shares at the time of exercise. Applying the identical property rules, the adjusted cost base of Mr. Tong's entire shareholding of Portus Ltd. shares is $42,000 [(2,500)($15) + (250)($18)]. This provides for an average cost per share of $15.27 ($42,000 ÷ 2,750). The taxable capital gain would be calculated as follows:

Proceeds [(1,250)($21)]	$26,250
Adjusted Cost Base [(1,250)($15.27)]	(19,088)
Capital Gain	$ 7,162
Inclusion Rate	1/2
Taxable Capital Gain	$ 3,581

Note 2 The $2,400 loss ($8,600 - $11,000) is deemed to be superficial, as Mr. Tong repurchased 800 Global shares within 30 days of the original disposition. This means that the loss will be disallowed. However, it will be added to the adjusted cost base of the replacement shares, giving a total adjusted cost base of $8,200 ($5,800 + $2,400).

Note 3 Mr. Tong's 2010 RRSP Deduction Limit is the lesser of the 2010 RRSP Dollar Limit of $22,000 and $11,070, 18 percent of his $61,500 Earned Income for 2009. However, his actual deduction is limited to $10,200, the sum of his undeducted $2,200 contribution from 2009 and his $8,000 contribution to his spouse's RRSP.

Note 4 Mr. Tong has a net capital loss balance of $11,500 ($2,500 + $6,000 + $3,000). However, the amount that can be deducted is limited to the 2010 taxable capital gain, or $3,581. This will leave a net capital loss balance of $7,919 ($11,500 - $3,581).

Part B - Tax Payable

Mr. Tong's minimum federal Tax Payable is calculated as follows:

Tax On First $81,941		$15,159
Tax On Next $11,251 ($93,192 - $81,941) At 26 Percent		2,925
Gross Federal Tax		$18,084
Basic Personal Amount	($10,382)	
Spousal	(10,382)	
Child	(2,101)	
CPP	(2,163)	
EI	(747)	
Canada Employment	(1,051)	
Transfer Of Education Related Amounts (Note 5)	(5,000)	
Credit Base	($31,826)	
Rate	15%	(4,774)
Dividend Tax Credit [(10/17)(44%)($4,500)]		(1,164)
Federal Tax Payable		$12,146

Note 5 Marion's federal Tax Payable is nil as the scholarship is not taxable income.

Interest Income	$ 3,000
Scholarship ($10,000 - $10,000)	Nil
Taxable Income	$ 3,000
Basic Personal Amount	(10,382)
Federal Tax Payable	Nil

As Marion is unable to use her education related credits, a portion can be transferred to her father. The transfer is the lesser of:

- $5,000
- [$7,150 + (8)($400) + (8)($65)] = $10,870

Given this, the maximum transfer is $5,000. However, the $5,870 ($10,870 - $5,000) excess can be carried forward indefinitely to be used against Marion's future Tax Payable.

Part B - Carry Forwards

- From Note 4, there is a net capital loss of $7,919 available for carry forward to subsequent years.
- From Note 5, Marion has a $5,870 education related credit amount available for carry forward to subsequent years.

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Chapter Twelve Test Item File Solutions

TIF Solution Twelve - 1

1. A corporation does not get a tax deduction for dividends paid. As a consequence, dividends are paid out of the corporation's after tax income. When such dividends are received by an individual, they are subject to taxation (the gross up and tax credit procedures result in dividends being taxed at favourable rates).

   However, if a corporation had to pay taxes on dividends received out of the after tax income of another corporation, it would involve double taxation of the same income stream. In fact, if the income passed through more than one corporation, the result could be triple or even higher multiples of taxation. This would clearly not be an equitable situation and, as a consequence, a corporation is not required to pay taxes on dividends received from another taxable Canadian corporation. (The Part IV tax payable by CCPCs on dividends received is a refundable tax.)

2. The stop loss rules reflect the fact that the value of shares usually falls when dividends are paid. Further, the payment of such dividends is, in general, fairly predictable. Given this, a corporation could acquire shares in anticipation of receiving a dividend payment. As dividend payments to corporations are, in general, not subject to tax, this dividend payment could be received tax free. Provided the value of the shares falls after the dividend payment, the corporation could then sell the shares at a loss. The net result would be the receipt of tax free income, combined with a deductible loss for a similar amount.

   As this is not an appropriate result, the stop loss rules will disallow the loss if:

   - the shares are held for less than one year; or
   - if the corporation holding the shares, along with other non-arm's length persons, owns more than 5 percent of the class of shares on which the dividend was received.

3. For corporations, charitable donations are a deduction in the calculation of Taxable Income. In contrast, charitable donations made by an individual form the basis for a credit against Tax Payable. Note, however, that the other rules associated with contributions are the same for corporations and individuals (e.g., they can only be used to the extent of 75 percent of Net Income For Tax Purposes and unused amounts can be carried forward for 5 years).

4. ITA 111(3) requires that losses within any single category must be deducted in chronological order. That is, if a corporation chooses to deduct a portion of its non-capital loss balance during the current year, the oldest losses of this type must be deducted first. However, there are no rules with respect to the order in which the individual types of loss carry forwards must be deducted.

   In deciding which loss should be deducted first, management must evaluate which type of loss is more likely to be lost. Non-capital loss carry forwards have restrictions on the time for which they are available. If there are losses that are nearing the end of their carry forward period and there is uncertainty of whether there will be sufficient income in that period to be able to use the losses, these losses should be deducted first.

   While there is no restriction on the period of availability for net capital loss carry forwards, these amounts can only be used to the extent that there are net taxable capital gains during the period. For a corporation that experiences only limited capital gains, these restrictions may be a more important consideration than the period of time during which the loss will be available. This is particularly the case now that the carry forward period for

non-capital losses has been extended to 20 years.

A decision will have to be made on the basis of considerations such as these.

5. Provincial taxes are paid in provinces where the corporation has permanent establishments. The amount allocated to each province is based on the simple average of two percentages — the percentage of sales in the province and the percentage of wages and salaries paid in the province.

6. A specified investment business is a business carried on by a corporation, the principal purpose of which is to earn property income, but does not include a corporation that employs more than five full time employees in the business throughout the year.

   The problem that was resolved by this definition was that, while the government did not want to make the small business deduction available to individuals attempting to simply shelter income earned by their investments, it did recognize that it was possible to have a business that was "actively" engaged in earning property income. The specified investment business definition provided a clear, though somewhat arbitrary, criteria for identifying such businesses.

7. This limitation is included in order to ensure that these deductions are not given on amounts of income that have not been taxed. Amounts of active business income and/or M&P profits that have been included in Net Income For Tax Purposes may be eliminated by either charitable donations or non-capital loss carry forwards, resulting in their not being included in Taxable Income and not being subject to tax.

8. This reduction is made in order to eliminate the amount of foreign business income on which the foreign tax credit has eliminated all of the Canadian taxation. The 3 times figure is based on the assumption that the corporation's tax rate is 33-1/3 percent on this type of income.

9. The M&P deduction is no longer important in the determination of federal Tax Payable as its rate is identical to that used in the general rate reduction (10% for 2010). While income that is eligible for the M&P deduction can be used for the general rate reduction, the taxpayer cannot use both. As the rate is the same for each of these tax preferences, there is little point in bothering to determine M&P profits at the federal level.

   However, the legislation has not been eliminated because some provinces still provide special treatment for M&P profits. More specifically, Newfoundland, Ontario and Saskatchewan have reduced rates for this type of income.

10. The "tax otherwise payable" calculation is to ensure that any foreign tax credit does not exceed a proportionate share of Canadian taxes paid on the foreign income. Foreign business income is not earned in a province and, as a consequence, there will be no applicable provincial taxes. As the ITA 124(1) abatement was put in place to leave room for provincial taxes, it would not be appropriate to deduct this amount in determining "tax otherwise payable", which serves as a limiting factor for the foreign business income tax credit.

Rybak

TIF Solution Twelve - 2

1. True. The carry forward rules are the same for corporations and individuals.

2. False. Such dividends are not included in Taxable Income. However, they are included in Net Income For Tax Purposes.

3. False. Only dividends from taxable Canadian corporations can be deducted.

4. True. A net capital loss carry forward can only be deducted to the extent that there are taxable capital gains in the carry forward year.

5. True. While there is no requirement that non-capital losses be deducted prior to other types of losses, ITA 111(3) requires that a given type be deducted in the order in which the losses were incurred.

6. False. 10 percent of Taxable Income must be multiplied by the percentage of that income that is allocated to the provinces.

7. True. The general rate reduction is implemented through a deduction from Tax Payable equal to 10 percent of full rate Taxable Income.

8. False. Incidental amounts of interest on temporarily invested funds are considered to be active business income.

9. False. The base used for calculating the M&P deduction is reduced by the amount that is eligible for the small business deduction, not by the amount of the small business deduction.

10. False. This rule applies to individuals but not to corporations.

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TIF Solution Twelve - 3

1. D. Included in Net Income For Tax Purposes, but not in Taxable Income.

2. C. They are a deduction in the determination of corporate Taxable Income but not in the determination of corporate Net Income.

3. C. The lifetime capital gains deduction.

4. B. $220,000 [($250,000 + $15,000 + $35,000) - ($35,000 + $45,000)].

5. B. The general rate reduction percentage is applied to full rate taxable income.

6. D. Full rate taxable income includes any income that is not eligible for the small business deduction.

7. E. None of the above.

8. E. Both A and C.

9. A. The maximum amount of the claim for the small business deduction is the active business income earned in Canada of $125,000.

10. B. The small business deduction is calculated as the least of three figures:

Net Income For Tax Purposes	$185,000
Taxable Capital Gain	(2,000)
Village's Active Business Income	$ 183,000

Net Income For Tax Purposes	$185,000
Charitable Donations	(2,500)
Village's Taxable Income	$182,500

Annual Business Limit	$500,000
Allocation To Bob's	(116,500)
Business Limit	$383,500

Therefore, the small business deduction is $31,025 [($182,500)(17%)].

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11. C. $3,500

In this case the amount eligible for the small business deduction would be limited to the annual business limit of $500,000. This means that the M&P deduction would be 10 percent of the lesser of:

M&P Profits	$575,000
Amount Eligible For The Small Business Deduction	(500,000)
	$ 75,000

Taxable Income ($625,000 - $75,000)	$550,000
Amount Eligible For The Small Business Deduction	(500,000)
Three Times The Foreign Tax Credit Of $5,000	(15,000)
	$ 35,000

The lesser figure is $35,000 and the M&P deduction would be $3,500.

12. A. The manufacturing and processing deduction is available to any corporation that has manufacturing and processing profits. M&P has to be 10 percent or more of Canadian active business income.

13. C. The general rate reduction is not available to Canadian Controlled Private Corporations (CCPCs).

14. D. The full amount of foreign non-business income earned must be included in the corporation's Taxable Income.

15. B. In the formula that limits this credit, the Tax Otherwise Payable is reduced by the federal tax abatement.

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TIF Solution Twelve - 4

Exam Exercise Solution Twelve - 1

Item 1 You would deduct the accounting gain of $66,600 ($93,000 - $26,400). You would also add the taxable capital gain of $1,850 [(1/2)($93,000 - $89,300)], for a net deduction of $64,750.

Item 2 You would add the estimated warranty costs of $22,000.

Item 3 As goodwill is not amortized for accounting purposes and there was no impairment during the year, no adjustment of the accounting figures is required. However, when the goodwill is added to the CEC balance, it would be subject to amortization at a rate of 7 percent per year. This means that you would deduct CEC amortization of $3,570 [($68,000)(3/4)(7%)].

Item 4 You would add the discount amortization of $2,300.

Exam Exercise Solution Twelve - 2

Net Income For Tax Purposes	$275,000
Dividends Received	(15,600)
Charitable Donations	(9,100)
Non-Capital Loss Carry Forward (All)	(74,000)
Net Capital Loss Carry Forward*	(13,720)
Taxable Income	$162,580

*While there is a $20,000 net capital loss available, the actual deduction is limited to the current year's taxable capital gains of $13,720. The remaining net capital loss carry forward is $6,280 ($20,000 - $13,720).

Exam Exercise Solution Twelve - 3

As Markham has not held the shares for 365 days, this transaction would be subject to the stop loss rules. The deductible loss would be calculated as follows:

Proceeds Of Disposition [($22.11)(1,000)]	$22,110
Adjusted Cost Base [($27.60)(1,000)]	(27,600)
Total Loss	($ 5,490)
Disallowed Portion [($1.97)(1,000)]	1,970
Capital Loss	($ 3,520)
Inclusion Rate	1/2
Allowable Capital Loss	($ 1,760)

Exam Exercise Solution Twelve - 4

The non-capital loss balance at the end of the year would be calculated as follows:

Amount E	
ABIL	$ 10,450
Dividends Deducted	87,000
Business Loss	427,500
Net Capital Loss Carry Forward Deducted*	16,500
Total	$541,450
Amount F - ITA 3(c) Income	
[$87,000 + $53,100 + (1/2)($204,000 - $171,000)]	(156,600)
Non-Capital Loss At End Of Year	$384,850

*While there is a net capital loss of $37,400 available, the 2010 deduction is limited to the net taxable capital gains of $16,500 [($204,000 - $171,000)(1/2)]. This leaves a net capital loss carry forward of $20,900 ($37,400 - $16,500).

Exam Exercise Solution Twelve - 5

The required calculations for 2009 would be as follows:

Accounting Net Income	$225,000
Donations	7,100
Accounting Gain On Sale Of Shares	(33,000)
Taxable Capital Gain [(1/2)($33,000)]	16,500
Net Income For Tax Purposes	$215,600
Donations	(7,100)
Dividends Received	(23,000)
Non-Capital Loss Carry Forward (All)	(12,000)
Net Capital Loss Carry Forward (All)	(10,000)
2009 Taxable Income	$163,500

There are no carry forwards of any type at the end of 2009.

The 2010 Net Income For Tax Purposes and Taxable Income would be nil, calculated as follows:

Accounting Net Loss	($372,000)
Donations	9,600
Accounting Loss On Sale Of Shares	17,000
2010 Net Income For Tax Purposes And Taxable Income	Nil

The net business loss for 2010 would be calculated as follows:

Accounting Net Loss	($372,000)
Charitable Donations	9,600
Accounting Loss On Sale Of Shares	17,000
Dividends Included In Accounting Income	(37,000)
Business Loss	($382,400)

Using this information, the non-capital loss for the year is calculated as follows:

Amount E		
Business Loss	$382,400	
Dividends Deducted	37,000	$419,400
Amount F (Income Under ITA 3(c) - Dividends		(37,000)
2010 Non-Capital Loss		$382,400

Of the $382,400 loss, $163,500 can be carried back to 2009, leaving a non-capital loss carry forward of $218,900 ($382,400 - $163,500).

As the policy of the Company is to minimize non-capital losses, none of the 2010 capital loss can be carried back. This will leave a net capital loss carry forward of $8,500 [(1/2)($17,000)].

There is also a carry forward of charitable donations of $9,600.

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Exam Exercise Solution Twelve - 6

The percentage of Taxable Income earned in each province would be calculated as follows:

	Gross Revenues		Wages And Salaries	
	Amount	Percent	Amount	Percent
Saskatchewan	$1,520,000	50.4%	$ 63,000	32.8%
Alberta	912,000	30.3%	85,000	44.3%
Not Related To A Province	581,000	19.3%	44,000	22.9%
Total	$3,013,000	100.0%	$192,000	100.0%

The average of the two percentages applicable for income not related to a province is 21.1%, leaving an average for income related to a province of 78.9%. Given this, federal Tax Payable can be calculated as follows:

Base Amount Of Part I Tax [(38%)($242,000)]	$91,960
Federal Tax Abatement [(10%)(78.9%)($242,000)]	(19,094)
General Rate Reduction [(10%)($242,000)]	(24,200)
Federal Tax Payable	$48,666

Exam Exercise Solution Twelve - 7

As a CCPC throughout the year and with no associated companies, Meridian is eligible for the full amount of the $500,000 annual business limit. The amount eligible for the small business deduction is $283,333, the least of:

Active Business Income	**$400,000**
Adjusted Taxable Income (See following calculation)	**$283,333**
Annual Business Limit	**$500,000**

Net Income For Tax Purposes	$522,000
Dividends	(72,000)
Non-Capital Loss Carry Forward	(145,000)
Taxable Income	$305,000
10/3 Times Foreign Non-Business Tax Credit [(10/3)(13%)($50,000)]	(21,667)
Adjusted Taxable Income	$283,333

Exam Exercise Solution Twelve - 8

The B component of the ITA 125(5.1) reduction formula is $6,638 [(.00225)($12,950,000 - $10,000,000)]. Given this, the required reduction would be calculated as follows:

[($500,000)($6,638 ÷ $11,250)] = $295,022

This reduction leaves the annual business limit at $204,978 ($500,000 - $295,022).

The small business deduction for Teeny Ltd. is equal to 17 percent of the least of:

• Active Business Income ($652,000 - $21,000)		$631,000
• Taxable Income ($652,000 - $415,000)	$237,000	
[(10/3)(10%)($21,000)]	(7,000)	$230,000
• Reduced Annual Business Limit		$204,978

The small business deduction is equal to $34,846 [(17%)($204,978)].

Exam Exercise Solution Twelve - 9

The small business deduction for Bartlett Operations Inc. would be equal to 17 percent of the least of:

• Canadian Active Business Income		$424,000
• Taxable Income ($476,000 - $201,000)	$275,000	
Less 3 Times Business Income FTC Of $3,700	(11,100)	$263,900
• Annual Business Limit		$500,000

Based on this, the small business deduction would be $44,863 [(17%)($263,900)].

The M&P deduction would be equal to 10 percent of the lesser of:

• M&P Profits	$424,000	
Less Amount Eligible For Small Business Deduction	(263,900)	$160,100
• Taxable Income	$275,000	
Less:		
Amount Eligible For Small Business Deduction	(263,900)	
3 Times Business Income FTC Of $3,700	(11,100)	
Aggregate Investment Income	(27,000)	$ Nil

The M&P profits deduction would be equal to nil.

It would have been possible to increase the amount eligible for the small business deduction to the $424,000 of active business income by increasing taxable income to $435,100. This could be accomplished by deducting only $40,900 ($476,000 - $424,000 - $11,100) of the charitable donations. The remaining unclaimed donations of $160,100 ($201,000 - $40,900) could be carried forward for up to five years.

Although this increases Taxable Income and the total Tax Payable for the year, there could still be an ultimate tax savings with this approach, as the small business deduction cannot be carried forward, while charitable donations can be. As the Exercise states that Bartlett expects large increases in income in the future, this approach could be advantageous.

Exam Exercise Solution Twelve - 10

The federal Tax Payable for Tuleta Ltd. would be calculated as follows:

Base Amount Of Part I Tax [(38%)($296,000)]	$ 112,480
Federal Tax Abatement [(10%)($296,000)]	(29,600)
M&P Deduction [(10%)($165,000)]	(16,500)
General Rate Reduction [(10%)($296,000 - $165,000)]	(13,100)
Federal Tax Payable	$ 53,280

Exam Exercise Solution Twelve - 11

The federal Tax Payable for Danforth Inc. would be calculated as follows:

Base Amount Of Part I Tax [(38%)($262,000)]	$99,560
Federal Tax Abatement [(10%)($262,000)]	(26,200)
Small Business Deduction (Note One)	(19,890)
M&P Deduction (Note Two)	(8,400)
General Rate Reduction (Note Three)	(6,100)
Federal Tax Payable	$38,970

Note One The small business deduction would be equal to 17 percent of the least of active business income ($262,000), Taxable Income ($262,000), and the Company's business limit ($117,000). The deduction is $19,890 [(17%)($117,000)].

Note Two The M&P deduction would be equal to 10 percent of the lesser of $84,000 (M&P profits of $201,000, reduced by the $117,000 that is eligible for the small business deduction), and $145,000 (Taxable Income, reduced by the $117,000 that is eligible for the small business deduction). The M&P deduction would be $8,400 [(10%)($84,000)].

Note Three The general rate reduction would be calculated as follows:

Taxable Income	$262,000
Amount Eligible For The SBD	(117,000)
Amount Eligible For The M&P Deduction	(84,000)
Full Rate Taxable Income	$ 61,000
Rate	10%
General Rate Reduction	$ 6,100

Exam Exercise Solution Twelve - 12

The Taxable Income figure would be $42,000 ($135,000 - $23,000 - $51,000 - $19,000). Based on this figure, the required calculation of Part I Tax Payable would be as follows:

Base Amount Of Part I Tax [(38%)($42,000)]	$15,960
Federal Tax Abatement [(91%)(10%)($42,000)]	(3,822)
General Rate Reduction [(10%)($42,000)]	(4,200)
Foreign Business Income Tax Credit (See Note)	(3,414)
Part I Tax Payable	$ 4,524

Note The foreign business income tax credit would be the least of:

• The amount withheld	$ 4,050
• [$27,000 ÷ ($135,000 - $23,000 - $19,000)][$15,960 - $4,200]	$ 3,414
• $15,960 - $4,200	$11,760

The unused foreign tax amount of $636 ($4,050 - $3,414) can be carried back 3 years and forward for 10 years. In calculating the allowable tax credit for such carry overs, these unused amounts will be added to the foreign tax paid factor in the calculation of the foreign business income tax credit.

TIF Solution Twelve - 5

For each term there is both a 100 percent correct answer and an answer that is close. We have indicated the "close answer" in brackets. This would allow you to mix terms from various chapters if you wish to do so.

The correct definitions for each of the listed key terms are as follows:

A. 7 (not 2)

B. 1 (not 5)

C. 10 (not 6)

D. 4 (not 8)

E. 9 (not 3)

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TIF Solution Twelve - 6

Part 1 The adjustment for this Part is an addition of the $15,000 in charitable donations.

Part 2 Two adjustments are required for this Part.

- The addition of the accounting loss on the sale of $42,000 ($120,000 - $162,000).
- The deduction of the terminal loss of $11,500 ($131,500 - $120,000).

Part 3 Two adjustments are required for this Part.

- The addition of the accounting write-down (goodwill impairment loss) of $19,400.
- The deduction of $5,093 for the write-off of cumulative eligible capital [($97,000)(3/4)(7%)].

Part 4 Two adjustments are required for this Part.

- The addition of $176,000 for accounting amortization.
- The deduction of $220,000 for maximum CCA.

Part 5 Two adjustments are required for this Part.

- The deduction of the accounting gain of $75,000 ($250,000 - $175,000).
- The addition of the taxable capital gain, net of the maximum capital gains reserve. As the $62,500 [(25%)($250,000)] in proceeds received is greater than 20 percent of the total proceeds, the maximum capital gains reserve is equal to $56,250 {[$250,000 - $175,000][($250,000 - $62,500) ÷ $250,000]}. The net addition is equal to $9,375 [(1/2)($250,000 - $175,000 - $56,250 reserve].

Part 6 There would a deduction of $3,000 for premium amortization and an addition of $4,200 for discount amortization, a net addition of $1,200.

Part 7 The adjustment for this Part is an addition of $25,000 for the five non-deductible memberships. There is no adjustment related to the entertainment costs as they were not paid by the Company.

Summary Of Adjustments

Part 1		$15,000
Part 2	$ 42,000	
	(11,500)	30,500
Part 3	$ 19,400	
	(5,093)	14,307
Part 4	$176,000	
	(220,000)	(44,000)
Part 5	($ 75,000)	
	9,375	(65,625)
Part 6	($ 3,000)	
	4,200	1,200
Part 7		25,000
Total Of Adjustments		($23,618)

TIF Solution Twelve - 7

Part A - Minimum Net Income For Tax Purposes

MSL's minimum Net Income For Tax Purposes would be calculated as follows:

Accounting Income Before Taxes		$213,000
Add:		
Amortization	$126,000	
Taxable Capital Gain [(1/2)($132,000 - $109,000)]	11,500	137,500
Deduct:		
CCA	($138,000)	
Accounting Gain On Depreciable Asset	(27,000)	(165,000)
Net Income For Tax Purposes		$185,500

Part B - Minimum Taxable Income

MSL's minimum Taxable Income would be calculated as follows:

Net Income For Tax Purposes	$185,500
Dividends Received From Taxable Canadian Corporations	(12,000)
Net Capital Loss Carry Forward*	(11,500)
Non-Capital Loss Carry Forward	(126,000)
Taxable Income	$ 36,000

*Limited to the amount of taxable capital gains included in Net Income For Tax Purposes. This deduction leaves a net capital loss carry forward of $11,000 ($22,500 - $11,500).

Part C - Minimum Tax Payable

MSL's minimum federal Tax Payable would be calculated as follows:

Base Amount Of Part I Tax [(38%)($36,000)]	$13,680
Federal Tax Abatement [(86.8%)(10%)($36,000)] (Note One)	(3,125)
Small Business Deduction (Note Two)	(6,120)
General Rate Reduction (Note Three)	Nil
Federal Part I Tax Payable	$4,435

Note One The abatement percentage would be based on the following calculations:

Percent Distribution Of Revenues

	Revenues	Percent Of Total
Ontario	$427,000	48.1%
Manitoba	310,000	35.0%
United States	150,000	16.9%
Total	$887,000	100.0%

Percent Distribution Of Salaries

	Salaries	Percent Of Total
Ontario	$162,000	58.9%
Manitoba	87,000	31.6%
United States	26,000	9.5%
Total	$275,000	100.0%

Average Percentages

Ontario [(48.1 + 58.9) ÷ 2]	53.5%
Manitoba [(35.0 + 31.6) ÷ 2]	33.3%
United States [(16.9 + 9.5) ÷ 2]	13.2%
Total	100.0%

Based on the preceding calculations, the percentage of income earned in Canada would be 86.8 percent (53.5% + 33.3%). This means that the abatement would be $3,125 [(86.8%)(10%)($36,000)].

Note Two The small business deduction would be equal to 17 percent of the least of:

• Canadian Active Business Income	$156,000
• Taxable Income (no foreign tax credit adjustment needed)	36,000
• Annual Business Limit	500,000

The least of these three amounts would be $36,000, giving a small business deduction of $6,120 [(17%)($36,000)].

Note Three The general rate reduction would be nil [(10%)($36,000 - $36,000)]. Note that aggregate investment income is nil ($11,500 - $11,500).

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TIF Solution Twelve - 8

Part A - Tax Payable

The calculation of federal Part I Tax Payable would be as follows:

Canadian Active Business Income	$187,000
Foreign Income (U.S. Branches)	32,000
Net Income For Tax Purposes And Taxable Income	$219,000
Base Amount of Part I Tax [(38%)($219,000)]	$ 83,220
Federal Tax Abatement [(10%)($187,000)] - Note One	(18,700)
Foreign Business Income Tax Credit - Given	(9,600)
Small Business Deduction [(17%)($187,000)] - Note Two	(31,790)
General Rate Reduction [(10%)($219,000 - $187,000)] - Note Three	(3,200)
Part I Tax Payable	$ 19,930

Note One The U.S. business income is not earned in a province and, as a consequence, is not eligible for the federal tax abatement. In addition, such foreign business income is not eligible for the small business deduction.

Note Two The small business deduction would be equal to 17 percent of the least of:

1.	Canadian Active Business Income		$187,000
2.	Taxable Income	$219,000	
	Less [(3)($9,600)]	(28,800)	$190,200
3.	Annual Business Limit		$500,000

The least of the three figures is $187,000, and 17 percent of this amount is $31,790.

Note Three The general rate reduction would be calculated as follows:

Taxable Income	$219,000
Amount Eligible For Small Business Deduction	(187,000)
Full Rate Taxable Income	$ 32,000
Rate	10%
General Rate Reduction	$ 3,200

Part B - Foreign Tax Credit

The foreign business income tax credit is $9,600, the least of the following three amounts:

- Actual Foreign Taxes Withheld ($6,200 + $3,400) $9,600
- An amount calculated as follows:

  [Foreign Business Income ÷ Adjusted Net Income][Tax Otherwise Payable]
  = [($32,000 ÷ $219,000)($83,220 - $3,200)] $11,692
- Tax Otherwise Payable, Less Non-Business Foreign Tax Credits Deducted [($83,220 - $3,200) - Nil] $80,020

Note that the tests of the foreign tax credit amounts include the effect of the general rate reduction.

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Chapter Thirteen Test Item File Solutions

TIF Solution Thirteen - 1

1. The basic objective of integration is to neutralize the effect of incorporating a source of income. That is, integration procedures attempt to ensure that, for a given income source, the after tax amount that will be received by an individual will be the same, whether the income is received directly or, alternatively, flowed through a corporation. This would mean that the individual taxes paid on income received directly would be equal to the combined corporate and individual taxes paid on income flowed through a corporation.

   In a somewhat broader sense, full integration would imply that the timing of the tax payments would be the same under the two alternatives. That is, integration should serve to prevent a corporation from being used to defer payment of part of the total tax obligation.

2. The 25 percent gross up of dividends received is based on the assumption of a notional 20 percent tax rate being applicable at the corporate level. When this rate is applicable, the 25 percent gross up restores the Taxable Income to the same amount that was initially earned at the corporate level.

   After the shareholder's taxes are calculated, a dividend tax credit is deducted. At the federal level, this credit equals two-thirds of the gross up. In those cases where the provincial tax credit is equal to one-third of the gross up, this results in a total credit that is equal to the gross up. As the 25 percent gross up reflects corporate taxes paid at a 20 percent rate, this combined credit will eliminate the effect of corporate taxation, thereby achieving the basic goal of integration, assuring that the same amount of taxes will be paid whether the income is received directly or channeled through a corporation.

3. Prior to the introduction of eligible dividends, the dividend gross up and tax credit procedures for all dividends were based on the assumption that the combined federal/provincial rate on corporations was equal to 20 percent. While this was an appropriate rate for a CCPC earning income eligible for the small business deduction, it was too low for income that did not benefit from the small business deduction. This meant that, in many situations, the taxes paid on income flowed through a corporation were far higher than the taxes that would have been assessed if the individual had received the income directly.

   The eligible dividend procedures corrected this situation as they are based on the assumption of a higher corporate tax rate. Instead of the 20 percent rate assumed in the non-eligible dividend procedures, the 44 percent gross up on eligible dividends for 2010 assumes a corporate rate of about 30.6 percent. When this is combined with a revised dividend tax credit, the result is lower tax rates on eligible dividends and a restoration of integration for income that does not benefit from the small business deduction.

4. As defined in ITA 129(4), aggregate investment income is made up of:

   - Net taxable capital gains for the year, reduced by any net capital loss carry overs deducted during the year.
   - Property income other than dividends that are deductible in determining the corporation's Taxable Income.

5. When a corporation's income is distributed to its shareholders, the Part I refund lowers the effective corporate tax rate to about 20 percent. However, until the income is distributed, the rate is between 45 and 50 percent, depending on what province the

corporation's income is taxed in. As this rate is similar to that which is applicable on the direct receipt of investment income, it makes no economic sense to place investments in a corporation unless there is an intent to distribute most of the resulting income to shareholders. If, alternatively, the corporate tax rate had been lowered to 20 percent, the corporation could be used to shelter investment income. It would appear that the policy goal of using a refundable tax, as opposed to a lower corporate tax rate, is to prevent the corporation from being used to shelter investment income from current taxation.

6. The objective is to discourage the use of a corporation to shelter income from property. This additional tax is assessed on the aggregate investment income of a Canadian controlled private corporation in order to raise the combined federal/provincial tax rate on the investment income of such companies to a level that is as high or higher than the combined federal/provincial rate that would be paid by an individual in the highest tax bracket on direct receipt of the income. When this is accomplished, the individual has no tax incentive to channel this type of income into a CCPC. In the absence of this tax, the corporate tax rate could be lower than the individual tax rate, resulting in a deferral of tax until such time as the income is distributed as dividends.

7. The problem here is that a corporation will receive dividends on a tax free basis. If these are portfolio dividends or dividends on which the payor corporation has received a dividend refund, the result will be a significant amount of deferral, relative to direct receipt of such dividends, through the use of a corporation. Imposing a Part IV refundable tax on portfolio dividends and dividends received from a connected corporation, on which the payor received a refund (dividends paid by a private corporation or a subject corporation out of investment income) corrects this imperfection in the integration system. By making the tax refundable, the goal of having the total corporate and personal taxes approximate the taxes that would be imposed on an individual receiving the income directly is still achieved.

8. A connected corporation is either:

   - a controlled corporation, where control represents ownership of more than 50 percent of the voting shares by any combination of the other corporation and persons with whom it does not deal at arm's length, or
   - a corporation in which the other corporation owns more than 10 percent of the voting shares, and more than 10 percent of the fair market value of all of the issued shares of the corporation.

   Dividends from such corporations are subject to Part IV tax to the extent they are the basis for a dividend refund received by the paying corporation.

9. The RDTOH balance is made up of:

   - the refundable portion of Part I tax for the year; plus
   - the Part IV taxes paid for the year; plus
   - the corporation's RDTOH balance at the end of the preceding year; less
   - the corporation's dividend refund for the preceding year.

10. The two most common additions to the GRIP balance of a CCPC would be:

    - 69 percent of active business income that is not eligible for the small business deduction in 2010. This could arise either because the CCPC has active business income in excess of its share of the annual business limit, or because the active business income exceeds the CCPC's adjusted Taxable Income.
    - The full amount of eligible dividends received from other corporations.

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TIF Solution Thirteen - 2

1. True.

2. False. The combined federal/provincial dividend tax credit must be equal to 100 percent of the gross up.

3. True.

4. True.

5. False. It does not include dividends that are deductible in the calculation of Taxable Income.

6. False. It is only assessed on dividends received from connected companies in those situations where the paying company received a dividend refund as a result of paying the dividend.

7. True. Company A owns more than 10 percent of the voting shares, and more than 10 percent of the fair market value of all of the issued shares of Company B.

8. True.

9. False. It is the RDTOH balance at the end of the year that is relevant.

10. False. GRIP is increased by 100 percent of eligible dividends received during the year.

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TIF Solution Thirteen - 3

1. C. They can only be designated as eligible dividends by public companies.

2. D. To the extent that the company has an LRIP balance, dividends paid by public companies will be non-eligible.

3. D. For integration to be effective in situations where non-eligible dividends are paid, the combined federal/provincial tax rate on corporations must be equal to 20 percent.

4. B. Net taxable capital gains for the year, less net capital loss carry overs deducted.

5. C. $4,400 [(6-2/3%)($45,000 + $21,000)]

6. B. [($250,000 - $200,000)(26-2/3%)] = $13,333. The addition is limited by Taxable Income, less the amount eligible for the small business deduction [ITA 129(3)(a)(ii)].

7. D. It is designed to prevent the deferral of taxes on investment income that is retained by a CCPC.

8. C. The correct answer is as follows:

Dividends Received	$20,000	
Part IV Tax Rate	1/3	$6,667
Less: Non-Capital Losses Applied:		
Non-Capital Losses	($ 3,000)	
Farm Losses	(7,000)	
Subtotal	($10,000)	
Rate	1/3	(3,333)
Minimum Part IV Tax		$3,334

In general, reducing Part IV tax by one-third of non-capital losses would only be advantageous if the losses were about to expire.

9. D. The Part IV tax is assessed on portfolio dividends.

10. B. $30,000.

RDTOH, end of preceding year	$25,000
Less: Dividend refund for preceding year [($15,000)(1/3)]	(5,000)
Add: Refundable portion of Part I tax	10,000
Part IV Tax Payable	Nil
RDTOH, end of year	$30,000

11. B. The balance is reduced by one-third of any dividends paid during the taxation year.

12. A. The required amount would be calculated as follows:

Balance At End Of 2009		$53,400
Taxable Income	$143,000	
Income Eligible For SBD		
($14,450 ÷ .17)	(85,000)	
Aggregate Investment Income	(19,000)	
Adjusted Taxable Income	$ 39,000	
Rate	69%	26,910
Eligible Dividends Received		12,300
Eligible Dividends Designated in 2009		(13,700)
GRIP At End Of 2010		$78,910

The eligible dividends paid during 2010 will be deducted from the GRIP in 2011.

13. D. A CCPC's GRIP balance will be reduced by 100 percent of the amount eligible for the small business deduction. The reduction will be 69 percent of the eligible amount.

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TIF Solution Thirteen - 4

Exam Exercise Solution Thirteen - 1

If he incorporates, the corporation will pay taxes of $22,100 [(17%)($130,000)], leaving $107,900 to be distributed as dividends. His individual Tax Payable on these dividends would be calculated as follows:

Dividends Received	$107,900
Gross Up [(25%)($107,900)]	26,975
Grossed Up Dividends	$134,875
Tax Rate	42%
Tax Before Credit	$ 56,648
Dividend Tax Credit [(2/3 + 20%)($26,975)]	(23,378)
Tax Payable On Dividends	$ 33,270

The net after tax retention would be $74,630 ($107,900 - $33,270). This compares to $75,400 [($130,000)(1 - .42)] retained if a corporation is not used. The use of a corporation is undesirable because the province's low dividend tax credit rate more than offsets the province's favourable corporate tax rate.

Exam Exercise Solution Thirteen - 2

If Mr. Fisher receives the income directly, he will retain $49,820 [($94,000)(1 - .47)]. Alternatively, if the investments are transferred to a corporation, the results would be as follows:

Corporate Investment Income	$94,000
Corporate Tax At 47 Percent	(44,180)
Income Before Dividends	$49,820
Dividend Refund ($1 For Each $3 Of Dividends Paid)	24,910
Dividends Paid To Mr. Fisher	$74,730

Non-Eligible Dividends Received	$74,730
Gross Up Of 25 Percent	18,683
Personal Taxable Income	$93,413
Personal Tax Rate	47%
Tax Payable Before Dividend Tax Credit	$43,904
Dividend Tax Credit [(2/3 + 39%)($18,683)]	(19,742)
Personal Tax Payable With Corporation	$24,162

Non-Eligible Dividends Received	$74,730
Personal Tax Payable	(24,162)
After Tax Cash Retained With Corporation	$50,568

The increase in the RDTOH of $25,067 [(26-2/3%)($94,000)] would permit the payment of a dividend refund of $24,910.

There would be a small tax advantage associated with using the corporation. The after tax cash retained with a corporation of $50,568 is $748 higher than the $49,820 retained on direct receipt of the income. With both the personal and corporate tax rate at 47 percent, there would be no tax deferral on income left in the corporation.

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Exam Exercise Solution Thirteen - 3

The refundable amount of Starfare Ltd.'s Part I tax for the current year would be the least of the following three figures:

Net Rental Income		$17,600
Taxable Capital Gains [(1/2)($91,500)]		45,750
Interest Income		17,450
Foreign Non-Business Income (100 Percent)		20,000
Net Capital Losses Deducted		(24,000)
Aggregate Investment Income Under ITA 129(4)		$76,800
Rate		26-2/3%
Amount Before Foreign Income Adjustment		$20,480
Less The Excess Of:		
Foreign Non-Business Tax Credit	$1,600	
Over 9-1/3 Percent Of $20,000	(1,867)	Nil
ITA 129(3)(a)(i) Amount		$20,480

Taxable Income ($232,350 - $41,300 - $24,000)	$167,050
Less:	
Amount Eligible For The Small Business Deduction ($12,750 ÷ 17%)	(75,000)
[(25/9)($1,600)] Foreign Non-Business Tax Credit	(4,444)
Adjusted Taxable Income	$ 87,606
Rate	26-2/3%
ITA 129(3)(a)(ii) Amount	$ 23,362

ITA 129(3)(a)(iii) Amount - Part I Tax Payable	$36,019

The least of these three amounts is $20,480, and this would be the refundable portion of Part I tax for the year.

Exam Exercise Solution Thirteen - 4

The balance in the RDTOH account of Ho Trading Company would be as follows:

Opening Balance ($43,500 - $6,000)	$37,500
Refundable Part I Tax [(26-2/3%)($43,000)]	11,467
Part IV Tax On Portfolio Dividends [(1/3)($12,350)]	4,117
Balance - RDTOH	$53,084

The dividend refund would be $11,667 [(1/3)($35,000)], the lesser of one-third of the dividends paid and the $53,084 balance in the RDTOH account.

Exam Exercise Solution Thirteen - 5

The 2010 ending balance in GRIP will be calculated as follows:

GRIP Balance At End Of 2009		$167,000
Taxable Income	$476,000	
Income Eligible For SBD ($68,000 ÷ 17%)	(400,000)	
Aggregate Investment Income		
($13,000 + $8,000 - $14,000)	(7,000)	
Adjusted Taxable Income	$ 69,000	
Rate	69%	47,610
Eligible Dividends Received		7,000
Eligible Dividends Designated in 2009		(153,000)
GRIP At End Of 2010		$ 68,610

The eligible dividends paid during 2010 will be deducted from the GRIP in 2011.

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TIF Solution Thirteen - 5

For each term there is both a 100 percent correct answer and an answer that is close. We have indicated the "close answer" in brackets. This would allow you to mix terms from various chapters if you wish to do so.

The correct definitions for each of the listed key terms are as follows:

A. 7 (not 2)

B. 4 (not 10)

C. 8 (not 3)

D. 9 (not 5)

E. 6 (not 1)

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TIF Solution Thirteen - 6

Part A - Part IV Refundable Tax

The Part IV Tax Payable for Conrod Holdings Ltd. would be calculated as follows:

Dividend Refund Received By Morsal Inc.	$7,000
Conrod's Percentage Of Ownership	70%
Part IV Payable On Morsal Inc. Dividends	$4,900
Part IV Tax On Imperial Oil Dividends [(1/3)($500)]	167
Part IV Tax Payable	$5,067

Part B - Part I Refundable Tax

As the interest received appears to be related to temporary balances resulting from the Company's normal business activities, it would be viewed as active business income and would not influence the following calculations.

The refundable portion of the Part I tax would be the least of the following amounts:

Aggregate Investment Income [(1/2)($9,200)]	$ 4,600
Rate	26-2/3%
ITA 129(3)(a)(i)	$ 1,227
Taxable Income	$44,000
Amount Eligible For Small Business Deduction	(10,000)
Total	$34,000
Rate	26-2/3%
ITA 129(3)(a)(ii)	$ 9,067
ITA 129(3)(a)(iii) Part I Tax Payable - Given	$ 9,250

The refundable portion of Part I tax is equal to $1,227, which is the least of the preceding three amounts.

Part C - RDTOH

The end of year balance in the Refundable Dividend Tax On Hand account can be calculated as follows:

RDTOH Balance - End Of The Preceding Year	$ 8,950
Dividend Refund For The Preceding Year	(4,000)
Opening Balance	$ 4,950
Part IV Tax Payable (Part A)	5,067
Refundable Part I Tax (Part B)	1,227
RDTOH Balance - End Of The Year	$11,244

Part D - Dividend Refund

The taxable dividends paid of $10,000 will generate a $3,333 [(1/3)($10,000)] dividend refund, as this is less than the ending balance in the Refundable Dividend Tax On Hand account.

TIF Solution Thirteen - 7

The required calculation of Part I Tax Payable would be as follows:

Taxable Income (Given)	$95,000
Base Amount Of Part I Tax [(38%)($95,000)]	$36,100
Federal Tax Abatement [(10%)($95,000)]	(9,500)
Small Business Deduction (Note One)	(15,470)
Additional Refundable Tax On Investment Income (Note Two)	267
Foreign Non-Business Income Tax Credit (Equal To Withholding)	(1,200)
Manufacturing And Processing Profits Deduction (Note Three)	Nil
General Rate Reduction (Note Four)	Nil
Part I Tax Payable	$10,197

Note One There is a circular calculation involved in the calculation of foreign tax credits, the small business deduction, and the ART. This adds considerable complexity to the calculation of Tax Payable and, in most situations, the additional calculations do not influence the outcome (that would, in fact, be the case in this problem). To avoid these additional calculations, we have stated that the foreign tax credit is equal to the amount withheld.

Given the preceding assumption with respect to the foreign tax credit, the small business deduction would be equal to 17 percent of the least of:

1. Active Business Income		$133,000
2. Taxable Income	$95,000	
Deduct:		
[(10/3)($1,200)] Foreign Non-Business Tax Credit	(4,000)	$ 91,000
3. Annual Business Limit		$500,000

The least of the three figures is $91,000, resulting in a small business deduction of $15,470 [(17%)($91,000)].

Note Two The aggregate investment income is equal to the gross foreign investment income of $8,000. The ITA 123.3 refundable tax (ART) is 6-2/3 percent of the lesser of:

1. Aggregate Investment Income		$8,000
2. Taxable Income	$95,000	
Deduct: Amount Eligible For The SBD	(91,000)	$4,000

The ITA 123.3 tax on aggregate investment income is $267 [(6-2/3%)($4,000)].

Note Three The manufacturing and processing deduction would be 10 percent of the lesser of:

1. Canadian M & P Profits (Given)	$99,000	
Deduct: Amount Eligible For SBD	(91,000)	$8,000
2. Taxable Income	$95,000	
Deduct:		
Amount Eligible For The SBD	(91,000)	
Aggregate Investment Income (Note Two)	(8,000)	Nil

Given these calculations, the M& P deduction would be nil.

Note Four The general rate reduction is nil, calculated as follows:

Taxable Income	$95,000
Amount Eligible For The SBD	(91,000)
Amount Eligible For The M&P Deduction	Nil
Aggregate Investment Income (Note Two)	(8,000)
Full Rate Taxable Income	Nil
Rate	10%
General Rate Reduction	Nil

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TIF Solution Thirteen - 8

Landor Ltd.'s Taxable Income would be calculated as follows:

Net Income For Tax Purposes	$223,500
Net Capital Loss Carry Forward Deducted (All)	(5,250)
Taxable Income	$218,250

Landor Ltd.'s net federal Tax Payable would be calculated as follows:

Base Amount Of Part I Tax [(38%)($218,250)]	$82,935
Federal Tax Abatement (Note One)	(19,643)
Small Business Deduction (Note Two)	(18,700)
Additional Refundable Tax On Investment Income (Note Three)	400
Foreign Tax Credit On Business Income [(10%)($28,800)]	(2,880)
Manufacturing And Processing Profits Deduction (Note Four)	(3,670)
General Rate Reduction (Note Five)	(6,555)
Part I Tax Payable	$31,887
Dividend Refund (Note Six)	(1,600)
Net Federal Tax Payable	$30,287

Note One The abatement is based on 90 percent [(88% + 92%) ÷ 2] of Landor's income being taxed in a province. This gives a figure of $19,643 [(90%)(10%)($218,250)].

Note Two The small business deduction is 17 percent of the least of the following three amounts:

1. Canadian Active Business Income (Given)		$183,450
2. Taxable Income	$218,250	
Deduct: [(3)($2,880)] Business FTC	(8,640)	$209,610
3. Allocated Annual Business Limit (Given)		$110,000

The least of these figures is the Company's $110,000 share of the annual business limit, resulting in a small business deduction of $18,700 [(17%)($110,000)].

Note Three The aggregate investment income of $6,000 is calculated as follows:

Taxable Capital Gains	$11,250
Net Capital Loss Carry Forward Deducted	(5,250)
Aggregate Investment Income	$ 6,000

The ITA 123.3 refundable tax (ART) is 6-2/3 percent of the lesser of:

1. Aggregate Investment Income		$ 6,000
2. Taxable Income	$218,250	
Deduct: Amount Eligible For The SBD	(110,000)	$108,250

The ITA 123.3 tax on aggregate investment income is $400 [(6-2/3%)($6,000)].

Note Four The manufacturing and processing profits deduction would be 10 percent of the lesser of:

1.	M & P Profits (Given)	$146,700	
	Deduct: Amount Eligible For The SBD	(110,000)	$36,700
2.	Taxable Income	$218,250	
	Deduct:		
	Amount Eligible For The SBD	(110,000)	
	[(3)($2,880)] Foreign Business Tax Credit	(8,640)	
	Aggregate Investment Income (Note Three)	(6,000)	$93,610

The lesser of these figures is $36,700, resulting in a manufacturing and processing profits deduction in the amount of $3,670 [(10%)($36,700)].

Note Five The general rate reduction is calculated as follows:

Taxable Income	$218,250
Amount Eligible For The SBD	(110,000)
Amount Eligible For The M&P Deduction	(36,700)
Aggregate Investment Income (Note Three)	(6,000)
Full Rate Taxable Income	$ 65,550
Rate	10%
General Rate Reduction	$ 6,555

Note Six The only addition to the RDTOH account for the year would be the refundable portion of Part I tax. This amount would be the least of three figures as follows:

Aggregate Investment Income (Note Three)	$6,000
Rate	26-2/3%
Amount Under ITA 129(3)(a)(i)	$1,600
Taxable Income	$218,250
Deduct:	
Amount Eligible For Small Business Deduction	(110,000)
[(3)($2,880)] Foreign Business Tax Credit	(8,640)
Balance	$ 99,610
Rate	26-2/3%
Amount Under ITA 129(3)(a)(ii)	$ 26,563
Amount Under ITA 129(3)(a)(iii) Part I Tax Payable	$31,887

The least of these three amounts would be $1,600 and this will be the balance in the RDTOH account, given that the RDTOH balance at the end of the preceding year was nil.

The dividend refund for the year would be $1,600, the lesser of:

- One-third of taxable dividends paid ($46,000/3) = $15,333
- RDTOH balance - December 31, 2010 = $1,600

TIF Solution Thirteen - 9

Part A - Net And Taxable Income

Minimum Net Income For Tax Purposes and Taxable Income would be calculated as follows:

Income From Operations		$660,000
Canadian Source Interest Income		55,000
Eligible Portfolio Dividends		48,000
Income As Per Financial Statements		$763,000
Additions:		
Amortization Expense	$1,250,000	
Deductions:		
Maximum CCA	(1,350,000)	(100,000)
Net Income For Tax Purposes		**$663,000**
Dividend Income		(48,000)
Taxable Income		**$615,000**

Part B - Federal Tax Payable

Minimum federal Tax Payable would be calculated as follows:

Base Amount Of Part I Tax [(38%)($615,000)]	$233,700
Federal Tax Abatement [(10%)($615,000)]	(61,500)
Small Business Deduction (Note One)	(85,000)
Additional Refundable Tax On Investment Income (Note Two)	3,667
General Rate Reduction (Note Three)	(6,000)
Part I Tax Payable	$ 84,867
Part IV Tax Payable [(1/3)($48,000)]	16,000
Total Tax Payable	$100,867

Note One The Small Business Deduction is equal to 17 percent of the least of the following three amounts:

1.	Active Business Income ($660,000 + $1,250,000 - $1,350,000)	$560,000
2.	Taxable Income (Part A)	$615,000
3.	Annual Business Limit	$500,000

As the least of these amounts is the annual business limit, the Small Business Deduction is equal to $85,000 [(17%)($500,000)].

Note Two The ITA 123.3 refundable tax (ART) is 6-2/3 percent of the lesser of:

1.	Aggregate Investment Income (Canadian source interest income)		$ 55,000
2.	Taxable Income	$615,000	
	Deduct: Amount Eligible For The SBD	(500,000)	$115,000

The ITA 123.3 tax on aggregate investment income is $3,667 [(6-2/3%)($55,000)].

Note Three The general rate reduction is based on the amount of Taxable Income that is not subject to other types of favourable tax treatment. The reduction would be calculated as follows:

Taxable Income	$615,000
Amount Eligible For Small Business Deduction	(500,000)
Aggregate Investment Income	(55,000)
Full Rate Taxable Income	$ 60,000
Rate	10%
General Rate Reduction	$ 6,000

Part C - Dividend Refund

The amount of refundable Part I tax will be the least of the following three amounts. In this problem, the calculation of these amounts is greatly simplified by the absence of foreign income. The calculations are as follows:

ITA 129(3)(a)(i) This amount would be $14,667, 26-2/3 percent of aggregate investment income of $55,000.

ITA 129(3)(a)(ii) This amount would be $30,667, 26-2/3 percent of Taxable Income, reduced by the amount of income that is eligible for the small business deduction [(26-2/3%)($615,000 - $500,000)].

ITA 129(3)(a)(iii) This amount would be Part I Tax Payable of $84,867.

The least of these amounts is $14,667.

Given this calculation, the balance in the RDTOH account would be calculated as follows:

Opening Balance	Nil
Dividend Refund For 2009	Nil
Part I Refundable Tax [(26-2/3%)($55,000)]	$14,667
Part IV Refundable Tax [(1/3)($48,000)]	16,000
Refundable Dividend Tax On Hand	$30,667

The dividend refund for 2010 would be $30,667, the lesser of:

- One-third of taxable dividends paid during the year [(1/3)($97,000)] = $32,333
- RDTOH Balance - December 31, 2010 = $30,667

Part D - GRIP Balance

The December 31, 2010 GRIP balance would be calculated as follows:

GRIP Balance At End Of 2009		$ 42,500
Taxable Income	$615,000	
Income Eligible For SBD	(500,000)	
Aggregate Investment Income	(55,000)	
Adjusted Taxable Income	$ 60,000	
Rate	69%	41,400
Eligible Dividends Received		48,000
Eligible Dividends Designated in 2009		(31,300)
GRIP At End Of 2010		$100,600

The eligible dividends paid during 2010 will be deducted from the GRIP in 2011.

TIF Solution Thirteen - 10

Part A - Minimum Taxable Income

Glandly Inc.'s minimum Taxable Income would be calculated as follows:

Net Income For Tax Purposes (Given)	$563,000
Dividends From Taxable Canadian Corporations ($22,670 + $21,600)	(44,270)
Donations To Registered Charities	(49,500)
Net Capital Loss Carry Forward (Note One)	(38,250)
Non-Capital Loss Carry Forward (All)	(10,200)
Taxable Income	$420,780

Note One The deduction of the net capital loss is limited to $38,250, the amount of the Company's net taxable capital gains for the current year.

Part B - Part I Tax Payable

The Part I Tax Payable is calculated as follows:

Base Amount Of Part I Tax [(38%)($420,780)]	$159,896
Federal Tax Abatement [(10%)($420,780)(87%)]	(36,608)
Small Business Deduction (Note Two)	(20,400)
Additional Refundable Tax On Investment Income (Note Three)	6,410
Foreign Business Income Tax Credit (Amount Withheld)	(4,150)
Foreign Non-Business Income Tax Credit (Amount Withheld)	(4,500)
Manufacturing And Processing Profits Deduction (Note Four)	(6,423)
General Rate Reduction (Note Five)	(14,040)
Part I Tax Payable	$80,185

Note Two The small business deduction is 17 percent of the least of the following three amounts:

1. Canadian Active Business Income ($184,230 + $117,100)		$301,330
2. Taxable Income	$420,780	
Deduct:		
[(10/3)($4,500)] Foreign Non-Business Tax Credit	(15,000)	
[(3)($4,150)] Foreign Business Tax Credit	(12,450)	$393,330
3. Allocated Annual Business Limit (Given)		$120,000

The least of these figures is the Company's $120,000 share of the annual business limit, resulting in a small business deduction of $20,400 [(17%)($120,000)].

Note Three The aggregate investment income of $96,150 is calculated as follows:

Canadian Interest Income	$78,150
Taxable Capital Gains	38,250
Foreign Non-Business Income	18,000
Net Capital Loss Carry Forward Deducted	(38,250)
Aggregate Investment Income	$96,150

The ITA 123.3 refundable tax (ART) is 6-2/3 percent of the lesser of:

1.	Aggregate Investment Income		$ 96,150
2.	Taxable Income	$420,780	
	Deduct: Amount Eligible For The SBD	(120,000)	$300,780

The ITA 123.3 tax on aggregate investment income is $6,410 [(6-2/3%)($96,150)].

Note Four The manufacturing and processing profits deduction is 10 percent of the lesser of:

1.	M & P Profits As Per ITR 5200 (Given)	$184,230	
	Deduct: Amount Eligible For The SBD	(120,000)	$ 64,230
2.	Taxable Income	$420,780	
	Deduct:		
	Amount Eligible For The SBD	(120,000)	
	[(3)($4,150)] Foreign Business Tax Credit	(12,450)	
	Aggregate Investment Income (Note Three)	(96,150)	$192,180

The lesser of these figures is $64,230, resulting in a manufacturing and processing profits deduction in the amount of $6,423 [(10%)($64,230)].

Note Five The general rate reduction is calculated as follows:

Taxable Income	$420,780
Amount Eligible For The SBD	(120,000)
Amount Eligible For The M&P Deduction	(64,230)
Aggregate Investment Income (Note Three)	(96,150)
Full Rate Taxable Income	$140,400
Rate	10%
General Rate Reduction	$ 14,040

Part C - Part IV Tax Payable

The Part IV tax will be assessed at a rate of 33-1/3 percent on the portfolio dividends. With respect to the dividends from the connected company, the Part IV tax will be equal to 100 percent of the dividend refund that was received by the wholly owned subsidiary.

The Part IV Tax Payable would be calculated as follows:

One-Third Of Portfolio Dividends Received [(1/3)($22,670)]	$ 7,557
Share Of Dividend Refund Included In Dividends From Subsidiary [(100%)($6,000)]	6,000
Part IV Tax Payable	$13,557

Part D - RDTOH Balance

The refundable portion of the Part I tax would be the least of the following three amounts:

Aggregate Investment Income (Note Three)		$96,150
Rate		26-2/3%
		$25,640
Deduct Excess Of:		
Foreign Non-Business Tax Credit	$4,500	
Over 9-1/3% Of Foreign Non-Business Income [(9-1/3%)($18,000)]	(1,680)	(2,820)
Amount Under ITA 129(3)(a)(i)		$22,820

Taxable Income	$420,780
Deduct:	
Amount Eligible For The Small Business Deduction	(120,000)
[(25/9)($4,500)] Foreign Non-Business Tax Credit	(12,500)
[(3)($4,150)] Foreign Business Tax Credit	(12,450)
Total	$275,830
Rate	26-2/3%
Amount Under ITA 129(3)(a)(ii)	$ 73,555

Amount Under ITA 129(3)(a)(iii) Part I Tax Payable	$80,185

The least of these three figures is $22,820, the amount determined under ITA 129(3)(a)(i).

The balance in the Refundable Dividend Tax On Hand account is calculated as follows:

RDTOH, End Of The Preceding Year	$193,500	
Dividend Refund For The Preceding Year	(47,300)	$146,200
Refundable Portion Of Part I Tax	$ 22,820	
Part IV Tax (Part C)	13,557	36,377
RDTOH Balance - December 31, 2010		$182,577

Part E - Dividend Refund

The dividend refund for the year would be $54,000, the lesser of:

- One-third of taxable dividends paid ($162,000/3) = $54,000
- RDTOH balance - December 31, 2010 (Part D) = $182,577

Part F - GRIP Balance

The December 31, 2010 GRIP balance would be calculated as follows:

GRIP Balance At End Of 2009		$32,400
Taxable Income	$420,780	
Income Eligible For SBD	(120,000)	
Aggregate Investment Income	(96,150)	
Adjusted Taxable Income	$204,630	
Rate	69%	141,195
Eligible Dividends Received		22,670
Eligible Dividends Designated in 2009		(26,800)
GRIP At End Of 2010		$169,465

The eligible dividends paid during 2010 will be deducted from the GRIP in 2011.

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Chapter Fourteen Test Item File Solutions

TIF Solution Fourteen - 1

1. The basic tax consequences of an acquisition of control are as follows:
   - There is a deemed year end at the time the acquisition of control occurs.
   - Unused charitable deductions cannot be carried forward to years subsequent to the acquisition of control. In addition, no deduction is available on a gift made subsequent to the acquisition of control if the gifted property was acquired prior to the acquisition date in anticipation of the acquisition of control.
   - With respect to non-capital losses, they can only be used in years subsequent to the acquisition of control to offset profits that have occurred from operating in the same or a similar line of business. There are similar restrictions on the use of pre-acquisition of control investment tax credits.
   - With respect to net capital losses, including allowable business investment losses, they cannot be carried forward to years subsequent to the acquisition of control. In addition, if there are capital gains in the three years before the deemed year end, capital losses from years subsequent to the deemed year end cannot be carried back to those years.
   - There are special rules requiring the write down of assets to fair market value at the deemed year end.

2. The ITA 111(4)(e) election is clearly desirable when there are net capital loss carry forwards or Allowable Business Investment Losses that will expire at the deemed year end created by the acquisition of control, or when there are net capital losses from the current year that have not been fully utilized. If there are unused non-capital losses, the election may be desirable if there is uncertainty as to the company's ability to use these amounts in the loss carry forward period.

3. It is the intent of the government to limit the availability of the small business deduction to an amount of active business income not exceeding $500,000. In the absence of special rules, the owner of a corporation with $1,000,000 in active business income could easily split that corporation into two corporations with $500,000 each in active business income. In the absence of special rules, this would mean that the taxpayer would get the small business deduction on $1,000,000 in active business income. The associated company rules prevent this from happening by requiring that these two companies would have to share a single $500,000 limit.

4. For purposes of applying the associated company rules, control is defined as follows:

   Control A corporation is deemed to be controlled by another corporation, a person, or a group of persons, if the corporation, person, or group of persons owns either:

   - shares (common and/or preferred) of capital stock with a fair market value of more than 50 percent of all issued and outstanding shares of capital stock; or
   - common shares with a fair market value of more than 50 percent of all issued and outstanding common shares.

5. This deeming provision requires that rights to acquire shares be treated as though they were exercised for purposes of determining associated companies.

Wiley

6. Investment tax credits can limit their benefits to very specific types of activity or regions of Canada. For example, the child care spaces tax credit provides benefits only to those taxpayers that incur costs to provide additional child care spaces. In contrast, general rate reductions are generally available to all taxpayers, without regard to the type of activity they are involved in or the region of Canada in which they operate. Choosing between these two types of tax benefits would be based on whether the government wished to achieve a specific objective (e.g., assistance to manufacturers in the Yukon) or, alternatively, provide general tax relief to corporations.

7. Per share PUC is based on the total amount of consideration received by the issuing corporation for the shares, divided by the total number of shares issued and outstanding. It is an average value that, at a given point in time, is the same for all issued and outstanding shares of a particular class.

   Per share ACB, in contrast, is shareholder specific. It is based on the average amount paid by that investor for the shares he owns. If the shares were purchased in the secondary market, rather than on issuance by the corporation, the total value would be different than the total PUC value for those shares. While it would be possible that per share PUC would equal per share ACB, this would not be the usual situation for large publicly traded companies. However, it would not be uncommon for private companies to have per share PUC equal per share ACB (e.g., a CCPC issues all of its shares to a single individual and this individual has retained these shares from the commencement date of the corporation).

8. The tax equivalent to accounting's Contributed Capital is Paid Up Capital (PUC). For tax purposes, the equivalent of Retained Earnings is divided into several components. They are as follows:

   - Pre-1972 Undistributed Surplus
   - Post-1971 Undistributed Surplus
   - Pre-1972 Capital Surplus On Hand
   - Capital Dividend Account (private companies only)

9. It is the intent of the government to allow certain types of income to be received on a tax free basis by all taxpayers. While there are other types of income that fall into this category, the most important example of this type of income is the non-taxable portion of capital gains, currently one-half. When such amounts are earned by a private corporation, a special mechanism is required to allow the corporation to distribute the funds to its shareholders without the amounts losing their tax free status. The capital dividend account is that mechanism. Eligible income amounts, such as the non-taxable one-half of capital gains earned by the corporation, are added to this account. To the extent there is a balance in this account, the corporation can elect to distribute such amounts to shareholders as a tax free capital dividend.

10. This is accomplished through the ITA 54 definition of the proceeds of disposition to be used in determining the capital gain. Under this definition, any amount that has been treated as an ITA 84(3) deemed dividend is removed from the proceeds of disposition for purposes of determining any capital gain on the transaction.

Unlicensed

TIF Solution Fourteen - 2

1. True. Unused net capital losses cannot be used in periods subsequent to an acquisition of control.

2. False. The write down is required when the fair market value is less than the UCC.

3. False. The elected value must be between the adjusted cost base of the asset and its fair market value at the time the acquisition of control takes place.

4. True. ITA 256(1.3) deems such shares to be owned by the taxpayer.

5. False. For association to exist, there would have to be cross ownership of shares that are not of a specified class.

6. True.

7. True.

8. False. The addition will be $25,000 [(1/2)($250,000 - $200,000)]

9. False. Under ITA 84(3), the difference will be treated as a deemed dividend.

10. True.

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TIF Solution Fourteen - 3

1. B. The inability to deduct non-capital losses subsequent to the acquisition of control.

2. B. 15% + 36% = 51%.

3. C. Subsequent to the deemed year end, non-capital losses can be deducted against any type of income.

4. C. Jimbo Corp., Hughes Corp., and ARC Ltd. are associated.

   Hughes and ARC are associated under ITA 256(1)(a).

   Jimbo and ARC - Mr. Hanes is deemed to own 32% [(40%)(80%)] of ARC and his daughter-in-law is deemed to own 4% [(5%)(80%)] of ARC by the look through rules in ITA 256(1.2)(d). When added to the 15% that the daughter-in-law owns outright, a related group owns 51% (32% + 4% + 15%) of ARC. The corporations are associated by ITA 256(1)(d) since Mr. Hanes controls Jimbo, a related group controls ARC, and Mr. Hanes is deemed to own greater than 25% of ARC.

5. C. A Ltd. and B Ltd. are associated under ITA 256(1)(b) as they are controlled by the same group (Amos and his brother). The fact that they are related is not relevant.

6. C. Wonder and Speedy are associated in that they are both associated with Scarlet. They would normally share the $500,000 small business deduction limit. However, since they are associated solely by virtue of their mutual association with the third corporation, the third corporation can elect not to be associated with them. With this election, the two corporations are eligible for the full $500,000 small business deduction, for a total of $1,000,000. As a consequence of making this election, Scarlet is deemed to have an annual business limit of nil.

7. D. If she were to sell the Torin shares for $4,000, she would have a deemed dividend of $500.

8. B. Dividends received from other taxable Canadian corporations.

9. D. All of the above.

10. C. $13,750 [$22,000)(50%)(125%)]

11. B. Sico has Taxable Income of $8,000 and Mark has Taxable Income $90,000.

12. B. Redeeming shares for $350,000. The PUC of the shares was $350,000 and the adjusted cost base was $250,000. There is no deemed dividend as the proceeds are equal to the PUC.

13. D. $750,000 This amount would be calculated as follows:

Proceeds Of Redemption	$3,500,000
PUC [(10%)($30,000,000)]	(3,000,000)
ITA 84(3) Deemed Dividend	$ 500,000
Gross Up [(25%)($500,000)]	125,000
Taxable Dividend	$ 625,000

Proceeds Of Disposition	$3,500,000
ITA 84(3) Deemed Dividend	(500,000)
Adjusted Proceeds Of Disposition	$2,500,000
Adjusted Cost Base	(2,250,000)
Capital Gain	$ 250,000
Inclusion Rate	1/2
Taxable Capital Gain	$ 125,000

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TIF Solution Fourteen - 4

Exam Exercise Solution Fourteen - 1

No Acquisition Of Control Taxable Income for 2009 would be nil, with a non-capital loss carry forward of $79,400 ($104,000 - $24,600). Net Income For Tax Purposes for 2010 would be $154,650 ($21,250 + $133,400) and, if there was no acquisition of control, the entire $79,400 non-capital loss carry forward could be deducted, resulting in a Taxable Income for 2010 of $75,250 ($133,400 + $21,250 - $79,400).

Acquisition Of Control The results for 2009 would be the same — a Taxable Income of nil, with a non-capital loss carry forward of $79,400. However, there would be a deemed year end and, in the following taxation year, the 2009 non-capital loss carry forward could only be deducted to the extent of the profits in the engineering services business. This would result in a 2010 Taxable Income of $133,400 ($133,400 + $21,250 - $21,250), and leave a non-capital loss carry forward of $58,150 ($79,400 - $21,250).

Exam Exercise Solution Fourteen - 2

It would clearly be desirable to elect to have a deemed disposition of the non-depreciable assets. This could be achieved by electing to have a deemed disposition of the non-depreciable assets for $740,000. This would result in a $65,000 taxable capital gain [(1/2)($740,000 - $610,000)] on the deemed disposition. This will leave $60,000 ($125,000 - $65,000) of the net capital loss carry forward.

This $60,000 could be eliminated by electing to have a deemed disposition of the depreciable property at an elected value of $495,000. This election would produce the required taxable capital gain of $60,000 [(1/2)($495,000 - $375,000)]

The election would also produce recapture of $95,000 ($375,000 - $280,000). As this is $4,000 ($95,000 - $91,000) greater than the operating loss, this would result in Taxable Income and Tax Payable. However, the ability to use the remaining $60,000 net capital loss carry forward is probably worth the cost of the Tax Payable on the extra $4,000 of income.

Exam Exercise Solution Fourteen - 3

Anderson Inc. and BDO Ltd. These Companies are associated under ITA 256(1)(d) as follows:

- John Anderson controls Anderson Inc.
- John Anderson is related to each member of the group that controls BDO Ltd.
- John Anderson owns not less than 25 percent of the shares of BDO Ltd.

Copper Inc. and BDO Ltd. These companies are associated under ITA 256(1)(e) as follows:

- Each corporation is controlled by a related group (Copper Inc. by Mr. and Mrs. Copper, BDO Ltd. by Mr. and Mrs. Anderson and Mrs. Copper).
- Each of the members of one of the related groups was related to all of the members of the other related group.
- One person (Mrs. Copper) who is a member of both related groups owns at least 25 percent of the shares of each corporation.

They are also associated under ITA 256(1)(b) as both Companies are controlled by the same group (Mr. and Mrs. Copper).

Anderson Inc. and Copper Inc. These Companies are associated under ITA 256(2) as they are both associated with a third corporation, BDO.

Exam Exercise Solution Fourteen - 4

With respect to the $460,000 in current expenditures, there will be an $46,000 [(10%)($460,000)] credit against 2010 Tax Payable. This $46,000 credit will be added to income in 2011.

With respect to the $675,000 in capital expenditures, there will be a 2010 credit against Tax Payable of $135,000 [(20%)($675,000)].

The $135,000 credit will not influence the calculation of 2010 CCA. This amount will be $101,250 [(30%)(1/2)($675,000)].

In 2011, the $135,000 credit will be deducted from the January 1, 2011 UCC, leaving a balance of $438,750 ($675,000 - $101,250 - $135,000). Given this, 2011 CCA will be $131,625 [(30%)($438,750)].

Exam Exercise Solution Fourteen - 5

The total amount of investment tax credits available, given the $3,000,000 annual expenditure limit for the 35 percent rate, can be calculated as follows:

Qualified Property [(10%)($132,000)]		$ 13,200
SR&ED Current Expenditures [(35%)($1,060,000)]		371,000
SR&ED Capital Expenditures:		
1st $1,940,000 [(35%)($3,000,000 - $1,060,000)]	$679,000	
Remaining $370,000		
[(20%)($2,310,000 - $1,940,000)]	74,000	753,000
Total Available Amount		$1,137,200

The refund available would be as follows:

Qualified Property [(40%)($13,200)]	$ 5,280
SR&ED Current Expenditures [(100%)($371,000)]	371,000
SR&ED Capital Expenditures [(40%)($753,000)]	301,200
Total Refund Available	$677,480

The non-refunded investment tax credit of $459,720 ($1,137,200 - $677,480) can be carried forward 20 years to be applied against Tax Payable.

The cost of the qualified property will be reduced in the following year by the refundable investment tax credit of $5,280. The refundable investment tax credit on current expenditures of $371,000 will be added to income in the following year.

The treatment of the refundable investment tax credit on SR&ED capital expenditures of $301,200 will depend on whether they are deductible or capital costs (see Supplementary Reading No. 6, if interested). If they are deductible, the deductible R&D expenditures for the following year will be reduced by $301,200. If they are capitalized, the cost of the property will be reduced in the following year by $301,200.

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Exam Exercise Solution Fourteen - 6

The adjusted cost base of the shares would be determined as follows:

	Number of Shares	Cost/Share	Total Cost
First Purchase	1,350	$ 5.60	$ 7,560
Second Purchase	4,230	$10.15	42,935
Totals	5,580		$50,495

The adjusted cost base per share would be $9.05 ($50,495 ÷ 5,580).

The PUC for the investor's shares would be calculated as follows:

	Number of Shares	PUC/Share	Total PUC
First Sale	123,000	$5.60	$ 688,800
Second Sale	32,000	$8.62	275,840
Third Sale	81,000	$10.15	822,150
Total PUC Of Outstanding Shares	236,000		$1,786,790

Number Of Shares (From First Table)	5,580
PUC Per Share [$1,786,790 ÷ 236,000 Shares]	$ 7.57
PUC For Investor's Shares	$42,241

Exam Exercise Solution Fourteen - 7

The balance in the capital dividend account as at December 31, 2010 would be as follows:

1987 Capital Gain [(1/2)($129,000 - $105,000)]	$12,000
1996 Capital Loss [(1/4)($83,000 - $91,000)]	(2,000)
Capital Dividend Received - 2009	10,600
2010 Sale Of Goodwill [(3/4)($50,000 - $39,500)(2/3)]	5,250
Capital Dividend Paid - 2010	(13,750)
Balance - End Of 2010	$12,100

Exam Exercise Solution Fourteen - 8

This transaction will result in an ITA 84(1) deemed dividend for all shareholders, calculated as follows:

PUC Of New Shares [(43,000)($12.05)]	$518,150
Increase In Net Assets	(505,000)
ITA 84(1) Deemed Dividend	$ 13,150

This would be allocated to all 174,000 (131,000 + 43,000) shares outstanding, on the basis of $0.08 per share. This would be a taxable dividend, subject to either the eligible or non-eligible dividend gross up and tax credit procedures. The $0.08 per share dividend would be added to the adjusted cost base of all 174,000 shares.

With the addition of $0.08, the new adjusted cost base of Mr. Scott's shares would be $11.33 ($11.25 + $0.08) per share. The taxable capital gain on their disposition would be calculated as follows:

Proceeds Of Disposition [(7,000)($14.36)]	$100,520
Adjusted Cost Base [(7,000)($11.33)]	(79,310)
Capital Gain	$ 21,210
Inclusion Rate	1/2
Taxable Capital Gain	$ 10,605

Exam Exercise Solution Fourteen - 9

The redemption transaction would have no tax consequences for Mr. Izaak Alleham. For his sister, the tax consequences would be as follows:

Proceeds Of Redemption [(30,000)($24.35)]	$730,500
PUC [(30,000)($22.50)]	(675,000)
ITA 84(3) Deemed Dividend	$ 55,500
Gross Up Of 25 Percent	13,875
Taxable Dividend	$ 69,375

Proceeds Of Redemption [(30,000)($24.35)]	$730,500
ITA 84(3) Deemed Dividend	(55,500)
ITA 54 Proceeds of Disposition	$675,000
Adjusted Cost Base [(30,000)($18.75)]	(562,500)
Capital Gain (PUC - ACB)	$112,500
Inclusion Rate	1/2
Taxable Capital Gain	$ 56,250

Both the taxable dividend and the taxable capital gain would be included in Mr. Alleham's sister's Net Income For Tax Purposes. The non-eligible dividend qualifies for a federal dividend tax credit of $9,250 [(2/3)($13,875)].

Exam Exercise Solution Fourteen - 10

To the extent of the $217,000 PUC reduction, the dividend will be treated as a tax free distribution. The tax consequences will be a reduction in the PUC of these shares to $173,000 ($390,000 - $217,000), as well as an adjusted cost base reduction to $328,000 ($545,000 - $217,000).

The $82,000 ($299,000 - $217,000) excess of the distribution over the PUC reduction will be an ITA 84(4) deemed dividend, subject to either the eligible or non-eligible dividend gross up and tax credit procedures. As it will be taxed as a dividend, this part of the distribution will not be subtracted from the adjusted cost base of the shares.

TIF Solution Fourteen - 5

For each term there is both a 100 percent correct answer and an answer that is close. We have indicated the "close answer" in brackets. This would allow you to mix terms from various chapters if you wish to do so.

The correct definitions for each of the listed key terms are as follows:

A. 7 (not 2)

B. 4 (not 10)

C. 8 (not 3)

D. 9 (not 5)

E. 6 (not 1)

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TIF Solution Fourteen - 6

Part A - Non-Capital And Net Capital Losses

The following elections would be made to minimize loss carry forwards:

Land Electing to have a deemed disposition of the Land at its fair market value of $127,000 would result in a capital gain of $92,000 ($127,000 - $35,000).

Building Electing to have a deemed disposition of the Building at its fair market value of $151,000 would result in recapture of $19,000 ($151,000 - $132,000).

In addition to these elections, the Inventories and the Fixtures And Equipment would have to be written down to their respective fair market values, resulting in a business loss of $11,000 ($126,000 - $115,000) and deemed CCA of $14,000 ($85,000 - $71,000).

Given the preceding, Seeman's net business income for the period ending March 31, 2010 would be calculated as follows:

Revenues (Given)	$41,000
Expenses (Given)	(27,000)
Recapture On Building ($132,000 - $151,000)	19,000
Inventory Write-Down (Required)	(11,000)
Deemed CCA On Fixtures And Equipment ($85,000 - $71,000)	(14,000)
Net Business Income	$ 8,000

Seeman's Net Income For Tax Purposes and Taxable Income for the period ending March 31, 2010 would be as follows:

ITA 3(a) Net Business Income	$ 8,000
ITA 3(b) Net Taxable Capital Gain On Land [(1/2)($127,000 - $35,000)]	46,000
ITA 3(c)	$ 54,000
ITA 3(d) Non-Capital Losses	Nil
Net Income For Tax Purposes	$ 54,000
Net Capital Loss Carry Forward [Limited To The Amount Included Under ITA 3(b)]	(46,000)
Non-Capital Loss Carry Forward (Given)	(173,000)
Taxable Income	Nil

The net capital loss carry forward that would be lost is $33,000 ($79,000 - $46,000). The remaining non-capital loss carry forward would be calculated as follows:

December 31, 2009 Non-Capital Loss Carry Forward Balance	$173,000
Net Capital Loss Carry Forward Deducted	46,000
Total For Amount E Under ITA 111(8)	$219,000
Income Under ITA 3(c)	(54,000)
Non-Capital Loss Carry Forward	$165,000

Part B - Net And Taxable Income For 2010

SHL's Net Income For Tax Purposes for the period ending December 31, 2010 would be $52,000 ($78,000 - $26,000). This would allow the deduction of $52,000 of the non-capital loss carry forward, resulting in a Taxable Income of nil, and a remaining non-capital loss carry forward of $113,000 ($165,000 - $52,000).

TIF Solution Fourteen - 7

Part A

As Barton Ltd. controls Norton Inc., the two Companies are associated under ITA 256(1)(a).

Part B

As both Boulding Ltd. and Boulding Inc. are controlled by the same individual (Thomas Boulding), they are associated under ITA 256(1)(b).

Part C

As Elm Ltd. and Maple Inc. are controlled by the same group of persons (Mary Cunningham and Brenda Parton), they are associated under ITA 256(1)(b).

Part D

Fielding Inc. and Lawson Ltd. are associated under ITA 256(1)(d) because:

- Alice Fielding controls Fielding Inc.
- Alice is related to each member of a group (Alice and Betty Falcon) that controls Lawson Ltd. Note that under ITA 256(1.5), a person is related to himself.
- Alice owns not less than 25 percent of the shares of Lawson Ltd.

In similar fashion, Falcon Inc. and Lawson Ltd. are associated under ITA 256(1)(d) because:

- Betty Falcon controls Falcon Inc.
- Betty is related to each member of a group (Betty and Alice Fielding) that controls Lawson Ltd. Again, under ITA 256(1.5), a person is related to himself.
- Betty owns not less than 25 percent of the shares of Lawson Ltd.

Because both Fielding Inc. and Falcon Inc. are associated with Lawson Ltd., Fielding Inc. and Falcon Inc. are associated under ITA 256(2). If it was desirable, Lawson Ltd. could make the appropriate election under ITA 256(2) to be deemed not to be associated with Fielding Inc. and Falcon Inc. However, the annual business limit for Lawson Ltd. would be reduced to nil.

Part E

As Michael has direct control over Forbes Ltd. and indirect control of Malcom Inc., the two Companies are associated under ITA 256(1)(b). Indirect control is provided for under ITA 256(1.2)(d). The interest of Michael in Malcolm Inc. is 51 percent. This is calculated as 30 percent direct control plus 21 percent [(70%)(30%)] indirect control.

Part F

Both Rastau Ltd. and Sucrol Inc. are controlled by the group Richard Barnes and Susan Firth. Therefore, they are associated under ITA 256(1)(b).

TIF Solution Fourteen - 8

Case A

The tax consequences in this Case would be calculated as follows:

Redemption Proceeds	$78,000
PUC [(1/2)($150,000)]	(75,000)
ITA 84(3) Deemed Dividend	$ 3,000
Gross Up Of 25 Percent	750
Taxable Dividend	$ 3,750

Redemption Proceeds	$78,000
ITA 84(3) Deemed Dividend	(3,000)
Proceeds Of Disposition	$75,000
Adjusted Cost Base	(72,000)
Capital Gain	$ 3,000
Inclusion Rate	1/2
Taxable Capital Gain	$ 1,500

The total increase in Taxable Income would be $5,250 ($3,750 + $1,500). As all of this individual's shares have been redeemed, information on changes in the adjusted cost base is not relevant.

Case B

The total dividend would be $92,500 [($0.50)(185,000)]. However, as it is a capital dividend, it would have no tax consequences for the individuals holding the Common Shares. The adjusted cost base of the shares held would not be changed. While this has no immediate tax consequences for the shareholders, this transaction would reduce Deemit's Capital Dividend Account by $92,500.

Case C

The tax consequences in this Case would be calculated as follows:

Liquidating Dividend [(185,000)($2.10)]	$388,500
PUC Of Common Shares	(370,000)
ITA 84(4) Deemed Dividend	$ 18,500
Gross Up Of 25 Percent	4,625
Taxable Dividend And Increase In Taxable Income	$ 23,125

The adjusted cost base of the shares would be reduced by the PUC amount of $370,000. This amounts to $2.00 per share for each of the 185,000 outstanding shares.

Case D

The tax consequences in this Case would be calculated as follows:

PUC Of New Shares	$60,000
Increase In Net Assets (Liability Eliminated)	(50,000)
ITA 84(1) Deemed Dividend	$10,000

The deemed dividend would be allocated over all 28,000 (20,000 + 8,000) shares outstanding at a rate of $0.36 per share ($10,000 ÷ 28,000) and subject to the 25 percent gross up and tax credit procedures. This means that only $2,880 [(8,000)($0.36)] of the dividend would be allocated to the shareholder whose debt was converted to Preferred Shares. This amount would also be added to the adjusted cost base of his shares, resulting in the following capital gains calculation:

Proceeds Of Disposition		$60,000
Adjusted Cost Base:		
Cost Of Debt	$50,000	
Deemed Dividend [(8,000)($.36)]	2,880	(52,880)
Capital Gain		$ 7,120
Inclusion Rate		1/2
Taxable Capital Gain		$ 3,560

This amount would be added to his taxable dividend of $3,600 [($2,880)(125%)], resulting in an increase in Taxable Income of $7,160 ($3,600 + $3,560).

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Chapter Fifteen Test Item File Solutions

TIF Solution Fifteen - 1

1. The use of a corporation only defers taxes in those cases where income can be left in the business and not paid out to the shareholders. As Frank requires all of the income of his business in order to provide for his personal consumption needs, the use of a corporation will not provide any deferral. However, as he anticipates that the business's income will exceed his personal consumption needs in the foreseeable future, there will be deferral on amounts of income that are left in the corporation in future years.

   It appears that Frank's business would be a CCPC earning active business income. Provided this income does not exceed the amount eligible for the small business deduction, in most provinces there will be a tax savings resulting from the use of a corporation. However, this tax savings may not be large enough to justify the costs of establishing and maintaining a corporation

2. If Ms. Copeland receives the dividends directly, the effective tax rate will be 22.2 percent {[(Dividends)(144%)(29% + 12%)] - [(Dividends)(44%)(10/17 + 25%)]}. Given that her investments are in large public companies, if she incorporates, the dividends would be subject to Part IV tax at a rate of 33-1/3 percent. This means that there is no tax deferral through the use of a corporation in this situation.

   With respect to tax savings, the 33-1/3 percent Part IV tax would be refunded and the full amount of dividends received by the corporation could be paid out to Ms. Copeland. The tax that she would pay would be exactly the same as if she had received the dividends directly. This means that there would be no tax savings through the use of a corporation in this situation.

3. The goal of integration is to ensure that, when a corporation is used, the combined corporate and individual taxes paid will be same as those paid by an individual receiving the same income directly. For eligible dividends, the enhanced gross up and tax credit procedures are based on the assumption of a combined federal/provincial corporate tax rate of 30.56 percent. For non-eligible dividends, the gross up and tax credit procedures are based on the assumption of a combined federal/provincial corporate tax rate of 20 percent. If the actual combined rate exceeds these rates, it will discourage the use of a corporation. If the actual combined rate is less than these rates, use of a corporation becomes more attractive.

   The other assumption that is inherent in the integration system is that the combined federal/provincial dividend tax credit will be equal to the gross up. For eligible dividends, the federal credit is equal to 10/17 of the gross up. For the combined credit to equal the gross up, the provincial credit must be equal to 7/17 of the gross up. For non-eligible dividends, the federal credit is equal to two-thirds of the gross up. For the combined credit here to equal the gross up, the provincial credit must be equal to one-third of the gross up. If the provincial credit exceeds these values, the combined credit exceeds the notional corporate taxes and makes the use of a corporation more attractive. Alternatively, if the provincial credit is less than these values, the credit does not compensate for corporate taxes paid and this discourages the use of a corporation.

4. Because a corporation is a separate legal entity, the shareholders' liabilities to creditors are limited to the amount that they have invested. That is, creditors of the corporation can look only to the assets of the corporation for satisfaction of their claims. However, for owner-managed corporations, obtaining significant amounts of financing will almost always require the owners to provide personal guarantees on any loans, making this advantage somewhat illusory for this type of company. Note, however, limited liability may still be important for a business that is exposed to significant product or environmental claims.

5. The effect of a provincial tax holiday for a Canadian controlled private corporation is to reduce the overall tax rate to well below 20 percent. The tax rate on the first $500,000 of active business income earned by such a corporation would be 11% (38% - 10% - 17% + 0%). This is 9 percent below the 20 percent rate that is assumed in the integration provisions and, as a consequence, the tax deduction associated with salary payments would be less significant. Without considering other factors, the presence of a provincial tax holiday would favour the use of dividend payments to the owner-manager over the use of salary compensation.

6. For each dollar of non-eligible dividends received, the individual must add a gross up of $0.25 to Taxable Income. For individuals in the lowest federal tax bracket, the federal tax on this amount will be $0.1875 [($1.25)(15%)]. However, there will be a federal credit against this tax payable equal to two-thirds of the gross up, or $0.1667 [(2/3)($0.25)]. This means that, as long as an individual is in the lowest federal tax bracket, the increase in tax associated with one dollar of dividends received can be calculated as follows:

Federal Tax Payable On Grossed Up Dividend	$.1875
Federal Dividend Tax Credit	(.1667)
Increase In Federal Tax Payable	$.0208

As compared to an increase in federal tax of $.15 for each one dollar increase in interest income, there is only a $.0208 increase in federal tax for each one dollar increase in dividends received. This means that dividend income uses up an individual's available tax credits at a much slower rate than other types of income. For example, while one dollar of interest income will use up one dollar [($1.00)($.15 ÷ $.15)] of an individual's personal tax credit base of $10,382, one dollar of non-eligible dividends received will use up only $.1387 of this base [($1.00)($.0208 ÷ $.15)]. This means that, in comparison with other types of income, a much larger amount of dividends can be received before an individual's tax credits are absorbed and taxes will have to be paid.

7. With the corporation earning over $500,000 per year, the excess will not be eligible for the small business deduction. This non-eligible portion will be taxed at full corporate rates and the amount of taxes paid will be similar to amounts that would be paid on the direct receipt of income. Further, when these amounts are taken out of the corporation as dividends, they will be taxed a second time, resulting in an overall tax burden that is in excess of the amount that would be paid on the direct receipt of income.

   To deal with this problem, income in excess of the $500,000 small business limit should be paid out as salary in order to reduce the amount of corporate Taxable Income to the desired level. While this will shift the level of taxation from the corporation to the shareholder, it should not significantly increase the current amount of taxes paid. More importantly, it will reduce the overall level of taxation on these amounts of income.

8. This would not be a good idea. To begin, the value of the pool would be included in your friend's income on the same basis as the payment of an equivalent amount of salary. However, as the pool would be a benefit under ITA 15(1), its cost would not be deductible to his company. The friend would be better off either paying sufficient salary to finance the pool (while he would pay taxes on the salary, the amount paid would be deductible to the company) or, alternatively, paying sufficient dividends to finance the pool (while the dividends could not be deducted by the corporation, they would be taxed more favourably than the taxable benefit resulting from the construction of the pool).

9. In order to make a convincing case that the loan was received by the owner-manager in his capacity as an employee, the same type of loan must be extended to all employees with similar duties and responsibilities. If the loan is particularly large, or on particularly favourable terms, the owner-manager may not wish to extend this privilege. In addition, in some cases the business may not have other employees. This could make it impossible to make the case for receipt of the loan as an employee. The CRA, in cases where a private corporation has few employees with which to make a comparison, looks to what is standard or accepted practice within a given industry in deciding whether a loan is received in an employment capacity.

10. As dividends use up available tax credits at a much slower rate than is the case with salary, the payment of all compensation in the form of dividends may result in unused tax credits for the current taxation year. As most of these credits are non-refundable, if they are not used during the current year they will be lost. Given this, it may be beneficial to pay a combination of salary and dividends that is sufficient to use up all of the individual's non-refundable tax credits.

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TIF Solution Fifteen - 2

1. True. For certain types of income, the use of a corporation can defer the payment of taxes on income that can be left in the corporation.

2. False. This is only true to the extent that the income is eligible for the small business deduction. If the income exceeds the annual business limit, any excess will not be favourably taxed.

3. False. Higher corporate rates favour the direct receipt of income.

4. True. As charitable donations are a deduction for a corporation, they would have a value of $0.15 on the dollar to a corporation that is taxed at 15 percent. In contrast, donations made by individuals in excess of $200 create a federal credit against Tax Payable of $0.29 on the dollar. There would be additional credits at the provincial level.

5. False. Income splitting refers to procedures designed to divide an individual's income between a group of related individuals.

6. True.

7. True.

8. False. A low provincial dividend tax credit favours the use of salary.

9. True.

10. False. Only individuals with no other source of income can receive this amount of dividends tax free.

11. True. The shareholder is liable for tax on the $40,000 benefit. [ITA 15(1)]

12. True. The loan principal will not have to be included in income.

TIF Solution Fifteen - 3

1. B. The ability to absorb business losses against employment income.

2. D. The corporation is a CCPC earning active business income.

3. B. If the corporation is a CCPC earning active business income, its use can result in a tax savings.

4. B John could protect himself from being held personally liable if a client sustained injuries by falling overboard.

5. D. Lynn's financial risk is limited to $225,000 ($150,000 + $75,000).

6. C. All of the federal corporate taxes paid on the dividends would be refunded when all of the dividends received by the corporation are paid out to the individual.

7. C. Incorporation will result in a deferral of taxes to the extent profits can be left in the corporation.

8. A. There can be a small tax advantage associated with incorporation. C is incorrect as the individual needs all of the earnings so there is no deferral.

9. C. There will be tax deferral because of the small business deduction.

10. i. C. The amount of the loan of $30,000 must be added to the shareholder's income as the loan is going to be outstanding on two consecutive corporate year ends. No imputed interest will be added to income.

    ii. F. The imputed interest of $450 [(9/12)(2%)($30,000)] will be added to income. However, as the proceeds of the loan were used to make an income producing investment, the imputed interest will be deductible under ITA 20(1)(c) through ITA 80.5. The net effect on Taxable Income is nil.

    iii. C. The amount of the loan of $30,000 must be added to the shareholder's income as the loan is going to be outstanding on two consecutive corporate year ends. No imputed interest will be added to income. Since the shareholder is not an employee, there is no exception for a housing loan.

11. A. $5,000 in 2010. ITA 15(2) taxes the amount of the loan to the recipient of the loan. In this case, Albert Jay is taxed on $5,000 in 2010 and his son would be taxed on $2,000 for 2010, as the loans were still outstanding on January 31, 2012.

12. C. Jacquie's 2010 Taxable Income is $1,409.68.

Grossed Up Non-Eligible Dividend [($1,100)(125%)]		$1,375.00
ITA 80.4 Interest Benefit		
[($10,000)(4%)(90/365)]	$98.63	
[($10,000)(3%)(91/365)]	74.79	173.42
ITA 20(1)(c) Interest Deduction		
[($10,000 - $2,000)(4%)(90/365)]	($78.90)	
[($10,000 - $2,000)(3%)(91/365)]	(59.84)	(138.74)
Total		$1,409.68

13. C. It must be repaid within one year of the end of the fiscal year in which it was made.

14. C. Martin will have to include $14,000 in his Net Income For Tax Purposes for 2009 and $17,500 in his Net Income For Tax Purposes for 2010. As there are no other employees, the ITA 80.4(2) benefit must be calculated using the actual rates.

15. C. A desire to eliminate a large CNIL balance.

16. C. The corporation has Taxable Income in excess of $500,000.

17. B. He should take the salary because he will have more left after tax. Since the Company is not a CCPC, it is not eligible for the small business deduction. The fact that the company will pay dividends that are eligible for the enhanced gross up and tax credit procedures will not compensate Larry for corporate taxes paid at a 41 percent rate (the rate assumed for the enhanced credit is 30.56 percent).

18. D. The best solution is to take the funds out as salary so that she can maximize her contribution to her RRSP.

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TIF Solution Fifteen - 4

Exam Exercise Solution Fifteen - 1

Mr. Lee's combined tax rate on income earned by the unincorporated business is 45 percent (29% + 16%). If he does incorporate, all of the $98,000 will be eligible for the small business deduction. This means that it will be taxed at a rate of 15 percent (38% - 10% - 17% + 4%).

Mr. Lee's tax rate on non-eligible dividend income is 31.25 percent [(125%)(45%) - (2/3 + 1/3)(25%)].

Using these tax rates, a comparison of the income retained with and without the use of a corporation is as follows:

	With Corporation	Without Corporation
Business Income	$98,000	$98,000
Tax Rate	15%	45%
Tax Payable	$14,700	$44,100
Business Income	$98,000	$98,000
Tax Payable	(14,700)	(44,100)
Maximum Non-Eligible Dividend Payable	$83,300	N/A
Personal Tax On Dividends [(31.25%)($83,300)]	(26,031)	N/A
Income Retained By Mr. Lee	$57,269	$53,900

There is clearly a significant amount of tax deferral with respect to income left in the corporation. His Tax Payable on direct receipt of the $98,000 of business income would be $44,100, far higher than the $14,700 that would be paid by the corporation. There would also be a tax savings as the $57,269 in income retained using the corporation is $3,369 greater than the $53,900 in income retained without the use of the corporation.

Exam Exercise Solution Fifteen - 2

Ms. MacDonald's combined tax rate on interest income earned outside the corporation is 44 percent (29% + 15%). If she incorporates, the interest income will not be eligible for the small business deduction or the general rate reduction and it will be subject to the ART. This means that, if the investments are transferred to a corporation, the interest will be taxed at a rate of 48.7 percent (38% - 10% + 6-2/3% + 14%).

Ms. MacDonald's tax rate on non-eligible dividends received is 32.08 percent [(125%)(44%) - (2/3 + 25%)(25%)].

Using these tax rates, a comparison of the income retained with and without the use of a corporation is as follows:

	With Corporation	Without Corporation
Interest Income	$143,000	$143,000
Tax Rate	48.7%	44%
Tax Payable	$ 69,641	$ 62,920
Interest Income	$143,000	$143,000
Tax Payable	(69,641)	(62,920)
Net Corporate Income Before Dividend Refund	$ 73,359	N/A
Maximum Dividend Refund	36,680	
Maximum Dividend Payable	$110,039	
Personal Tax On Dividends [(32.08%)($110,039)]	(35,301)	
Income Retained By Ms. MacDonald	$ 74,738	$ 80,080

As the corporate tax rate is higher than the 44 percent rate applicable to the direct receipt of interest income, the corporation does not provide any deferral on amounts left within the corporation. In this case, incorporation requires prepayment of taxes.

After being taxed at 48.7 percent, the corporation would have $73,359 in after tax funds available. With the available dividend refund, this would allow the payment of a dividend of $110,039 [(3/2)($73,359)]. The RDTOH balance prior to the dividend refund would be $38,133 [($143,000)(26-2/3%)], which would be sufficient to pay the dividend refund. An additional amount of $1,453 ($38,133 - $36,680) remains refundable on future dividends.

After payment of taxes at this rate, she would be left with $74,738 in after tax funds. If she does not incorporate, the $143,000 in interest income would be taxed at 44 percent, leaving an after tax amount of $80,080. There is clearly a tax cost as a result of transferring the investments to a corporation.

Exam Exercise Solution Fifteen - 3

Direct Receipt

If the income is received directly, the total Tax Payable will be as follows:

Non-Eligible Dividends Received ($39,000 + $75,000)	$114,000
Gross Up At 25 Percent	28,500
Taxable Dividends	$142,500
Interest Income	36,500
Taxable Income	$179,000
Personal Tax Rate (29% + 12%)	41%
Tax Payable Before Dividend Tax Credit	$ 73,390
Dividend Tax Credit [(2/3 + 25%)($28,500)]	(26,125)
Personal Tax Payable	$ 47,265

The after tax retention can be calculated as follows:

Cash Received ($39,000 + $75,000 + $36,500)	$150,500
Tax Payable	(47,265)
After Tax Retention	$103,235

Transfer To Corporation

If the investments are transferred to a corporation, the corporate taxes will be as follows:

Part IV Tax On Dividends Received [(1/3)($39,000) + $20,000]	$33,000
Part I Tax On Interest Income [($36,500)(38% - 10% + 6-2/3% + 10%]	16,305
Corporate Tax Payable Before Refund	$49,305

As this Tax Payable is larger than the $47,265 that would be paid on the direct receipt of income, the use of a corporation would not provide for any deferral of taxes.

As this would be a new corporation, it would have no RDTOH balance at the beginning of the year. The RDTOH balance prior to the dividend refund would be calculated as follows:

Part IV Addition	$33,000
Part I Addition [(26-2/3%)($36,500)]	9,733
RDTOH Balance	$42,733

The cash available for paying dividends would be $101,195 ($150,500 - $49,305). This represents two-thirds of $151,793, a dividend that would generate a dividend refund of $50,598. However, as the balance in the RDTOH is only $42,733, the maximum dividend that can be paid is $143,928 ($101,195 + $42,733). This would result in personal taxes as follows:

Non-Eligible Dividends Received	$143,928
Gross Up At 25 Percent	35,982
Taxable Dividends	$179,910
Personal Tax Rate	41%
Tax Before Dividend Tax Credit	$ 73,763
Dividend Tax Credit [(2/3 + 25%)($35,982)]	(32,984)
Personal Tax Payable	$ 40,779

After tax retention with the use of a corporation would be $103,149 ($150,500 - $49,305 + $42,733 - $40,779). This is $86 less than the $103,235 that would be retained through direct receipt of this income.

You should advise your client that using a corporation would result in a small tax cost and would not provide for deferral of taxes. She should not transfer the assets to a corporation.

Exam Exercise Solution Fifteen - 4

Ms. Peterson's personal tax rate would be 44 percent (29% + 15%). Based on this, the after tax amount retained on direct receipt of income can be calculated as follows:

Capital Gain	$142,000
Personal Taxes [(44%)(1/2)($142,000)]	(31,240)
After Tax Retention	$110,760

The corporation's tax rate on investment income would be 49.7 percent (38% - 10% + 6-2/3% + 15%). Based on this, the maximum distribution that can be made to Ms. Peterson would be calculated as follows:

Available Cash	$142,000
Corporate Tax Payable [(49.7%)(1/2)($142,000)]	(35,287)
Tax Free Capital Dividend [(1/2)($142,000)]	(71,000)
Available For Taxable Dividend	$ 35,713
Dividend Refund*	17,857
Taxable Dividend (Non-Eligible)	$53,570

* The dividend refund would be the lesser of $17,857 [(1/3)($53,570)] and the $18,933 balance in the RDTOH [(26-2/3%)($71,000)].

The client's tax rate on non-eligible dividend income is 30 percent [(125%)(44%) - (2/3 + 1/3)(25%)]. Based on this, the net after tax retention when a corporation is used would be as follows:

Tax Free Capital Dividend Received	$ 71,000
Non-Eligible Dividend Received	53,570
Tax Payable On Non-Eligible Dividend Received [(30%)(53,570)]	(16,071)
After Tax Cash Retained	$108,499

As this is less than the after tax cash retained of $110,760 on the direct receipt of the income, the use of a corporation to hold these investments is not an appropriate choice. Note that, as the client needs all of the income produced by these investments, the use of a corporation to defer taxes is not an issue.

There is an additional refundable tax of $1,076 ($18,933 - $17,857) that is available, but only on the payment of additional dividends.

Exam Exercise Solution Fifteen - 5

The $25,000 loan is the same as any other employee loan and is exempt from inclusion in income under ITA 15(2). However, it is an interest free loan and will result in a current year taxable benefit for Ms. Thiessen of $375 [($25,000)(2% - Nil)(9/12)]. Because Ms. Thiessen received the loan in her capacity as an employee, the benefit can be calculated under ITA 80.4(1). This means that for the first five years of the loan, the benefit calculation will use a rate no higher than the prescribed rate that prevailed when the loan was made.

The $15,000 loan is unavailable to other employees and will be subject to the general rule under ITA 15(2) as Ms. Thiessen is a specified employee. However, there is an exception for the one-quarter of the loan that will be repaid prior to the end of the following taxation year of the corporation. This means that, while three-quarters of the loan, or $11,250, will have to be included in income in the current year, the remaining one-quarter, or $3,750, can be left out of income. However, this latter amount will attract a current year taxable benefit of $56.25 [($3,750)(2% - Nil)(9/12)].

This means the total income for the current year is $11,681.25 ($375 + $11,250 + $56.25).

Exam Exercise Solution Fifteen - 6

If the full $197,000 is paid out as salary, it will be deductible and will reduce the Company's Taxable Income to nil. This means that no corporate taxes will be paid. This salary payment will result in Ms. Cloister having Taxable Income of $197,000. Given this, her Tax Payable will be calculated as follows:

Federal Tax On First $127,021	$ 26,880
Federal Tax On Remaining $69,979 At 29%	20,294
Provincial Tax [(12%)($197,000)]	23,640
Tax Payable Before Credits	$70,814
Personal Tax Credits (Given)	(3,375)
Tax Payable	$67,439

Based on the preceding Tax Payable, Ms. Cloister's after tax retention would be $129,561 ($197,000 - $67,439), ignoring CPP contributions and the Canada employment credit.

Exam Exercise Solution Fifteen - 7

As dividends are not deductible for tax purposes, corporate taxes will have to be paid prior to the payment of any dividends. All of the $197,000 would be eligible for the small business deduction and the applicable rate would be 16% (38% - 10% - 17% + 5%]. Given this, the maximum dividend that could be paid would be calculated as follows:

Corporate Taxable Income	$197,000
Corporate Taxes At 16 Percent	(31,520)
Funds Available For Dividends	$165,480

Personal taxes on this dividend would be calculated as follows:

Non-Eligible Dividends Received	$165,480
Gross Up At 25 Percent	41,370
Taxable Dividends	$206,850

Federal Tax On First $127,021	$ 26,880
Federal Tax On Remaining $79,829 At 29%	23,150
Provincial Tax [(12%)($206,850)]	24,822
Tax Payable Before Credits	$ 74,852
Personal Tax Credits (Given)	(3,375)
Dividend Tax Credit [(2/3 + 1/3)($41,370)]	(41,370)
Tax Payable	$ 30,107

The after tax retention would be equal to $135,373 ($197,000 - $31,520 - $30,107).

Exam Exercise Solution Fifteen - 8

Salary Alternative

As the available cash is less than Taxable Income, some corporate taxes will have to be paid since there is insufficient cash to pay a salary equivalent to Taxable Income. To determine the maximum salary that can be paid (x), it is necessary to solve the following equation:

$$x = \$17,300 - [(\$23,600 - x)(15\%)]$$

$$x = \underline{\underline{\$16,188}}$$

Corporate taxes of $1,112 [(15%)($23,600 - $16,188)] would have to be paid. The total cash outflow equals the cash available of $17,300 ($16,188 + $1,112).

Given this salary, Ms. Ramsden would be subject to the following personal Tax Payable:

Tax Payable Before Credits [(15% + 11%)($16,188)]	$4,209
Available Tax Credits (Given)	(4,120)
Personal Tax Payable	$ 89

Given the preceding Tax Payable, Ms. Ramsden's after tax retention on salary would be $16,099 ($16,188 - $89).

Dividend Alternative

As dividends are not deductible, corporate taxes would have to be paid on the full $23,600. These taxes would be $3,540 [(15%)($23,600)], leaving an amount available for dividends of $13,760 ($17,300 - $3,540). As no individual taxes would be payable on this amount of dividends, the full $13,760 would be retained.

Given these calculations, it is clear that the preferred approach is to pay the maximum salary. Note, however, some combination of dividends and salary may provide an even better result.

Exam Exercise Solution Fifteen - 9

Required Salary Mr. Hughes' combined tax rate on additional salary is 46 percent (29% + 17%). In order to have $17,000 in after tax funds, he would have to receive salary of $31,481 [$17,000 ÷ (1 - .46)].

Tax Cost Of Salary The net tax cost of paying salary can be calculated as follows:

Tax Payments On Receipt Of Salary [(46%)($31,841))]	$14,647
Tax Savings To Corporation [(16%)($31,841)]	(5,095)
Net Tax Cost	$ 9,552

Required Dividend Mr. Hughes' tax rate on non-eligible dividends is 35.08 percent [(125%)(46%) - (2/3 + 23%)(25%)]. In order to have $17,000 in after tax funds, he would have to receive dividends of $26,186 [$17,000 ÷ (1 - .3508)].

Tax Cost Of Dividend As the dividend payment would not be deductible, its payment would not change corporate taxes. This means that the only tax cost would be the $9,186 [(35.08%)($26,186)] in personal taxes that Mr. Hughs would pay on the dividends received.

Conclusion As the tax cost associated with the payment of salary is larger, the dividend alternative would be preferable.

TIF Solution Fifteen - 5

For each term there is both a 100 percent correct answer and an answer that is close. We have indicated the "close answer" in brackets. This would allow you to mix terms from various chapters if you wish to do so.

The correct definitions for each of the listed key terms are as follows:

A. 6 (not 1)

B. 10 (not 3)

C. 2 (not 7)

D. 8 (not 5)

E. 9 (not 4)

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TIF Solution Fifteen - 6

Investments Owned Directly

If Ryan continues to own the investments directly, his total Taxable Income will be as follows:

Employment Income	$110,000
Interest Income	11,000
Eligible Dividends ($20,000 + $4,000)	24,000
Gross Up On Eligible Dividends [($24,000)(44%)]	10,560
Taxable Capital Gains [(1/2)($10,000 + $3,500)]	6,750
Net And Taxable Income	$162,310

The Taxes Payable on this income would be calculated as follows:

Federal Tax On First $127,021	$26,880
Federal Tax On Remaining $35,289 At 29 Percent	10,234
Provincial Tax [(12%)($162,310)]	19,477
Taxes Payable Before Credits	$56,591
Personal Tax Credits (Given)	(2,650)
Dividend Tax Credit [(10/17 + 35%)($10,560)]	(9,908)
Personal Taxes Payable	$44,033

After payment of these taxes, Ryan would retain cash of $114,467 ($110,000 + $48,500 - $44,033).

Investments Held By Corporation

If all of the investments are transferred to a corporation, the Taxable Income of the corporation would be as follows:

Interest Income	$11,000
Eligible Dividends Received ($20,000 + $4,000)	24,000
Taxable Capital Gains [(1/2)($10,000 + $3,500)]	6,750
Net Income For Tax Purposes	$41,750
Eligible Dividends Received	(24,000)
Taxable Income	$17,750

With the subtraction of the eligible dividends received, Taxable Income would be equal to aggregate investment income, resulting in no addition to the Company's GRIP from this source. However, there would be an addition to its GRIP equal to $24,000, 100 percent of the eligible dividends received.

The company's Part I and Part IV taxes payable would be calculated as follows:

Part I Tax Payable [(48%)($17,750)]	$ 8,520
Part IV Tax Payable [(33-1/3%)($20,000 + $4,000)]	8,000
Taxes Payable	$16,520

The end of the year balance in the RDTOH account would be calculated as follows:

Part I Refundable [(26-2/3%)($11,000 + $6,750)]	$ 4,733
Part IV Refundable (Amount Paid)	8,000
RDTOH - End Of Year	$12,733

Prior to any dividend refund, the amount of cash available to the corporation for paying dividends to Ryan would be calculated as follows:

Investment Income Received ($11,000 + $24,000 + $13,500)	$48,500
Corporate Taxes Paid	(16,520)
Cash Available	$31,980
Tax Free Capital Dividend	(6,750)
Cash Available For Taxable Dividend	$25,230
Dividend Refund (See Note)	12,615
Taxable Dividend	$37,845
Eligible Dividend (GRIP Balance)	(24,000)
Non-Eligible Dividend	$13,845

Note The dividend refund is equal to the lesser of the $12,733 balance in the RDTOH, and $12,615, one-third of the $37,845 dividend paid.

The after tax results with the use of a corporation would be as follows:

Employment Income	$110,000
Eligible Dividend	24,000
Gross Up On Eligible Dividend At 44 Percent	10,560
Non-Eligible Dividend	13,845
Gross Up On Non-Eligible Dividends At 25 Percent	3,461
Taxable Income	$161,866

Federal Tax On First $127,021	$26,880
Federal Tax On Next $34,845 At 29 Percent	10,105
Provincial Tax [(12%)($161,866)]	19,424
Taxes Payable Before Credits	$56,409
Personal Tax Credits (Given)	(2,650)
Eligible Dividend Tax Credit [(10/17 + 35%)($10,560)]	(9,908)
Non-Eligible Dividend Tax Credit [(2/3 + 35%)($3,461)]	(3,519)
Taxes Payable	$40,332

Ryan's after tax retention would be as follows:

Salary Received	$110,000
Capital Dividend Received	6,750
Dividends Received Subject To Tax ($24,000 + $13,845)	37,845
Total Cash Receipts	$154,595
Personal Taxes Payable	(40,332)
After Tax Cash Retention	$114,263

Conclusion

In terms of after tax amounts of cash retained, the use of a corporation results in $114,263 of cash retained, while holding the investments directly results in $114,467 of cash retained. This $204 difference would clearly make holding the investments directly the preferable alternative, particularly when the additional costs of incorporation are taken into consideration.

TIF Solution Fifteen - 7

The tax consequences associated with these loans are as follows:

Personal Expenditure Loans

- **June 30, 2010** As this loan is repaid prior to October 31, 2011 (the second corporate year end), it does not have to be included in income. However, as it is interest free, there will be a taxable benefit equal to $200 [($20,000)(2%)(6/12)] in 2010, as well as a benefit of $200 [($20,000)(2%)(6/12)] in 2011.

- **October 31, 2010** This loan will be outstanding on both October 31, 2010 and October 31, 2011. Therefore, the $40,000 principal amount must be included in Mr. Farr's 2010 Net Income For Tax Purposes. When it is repaid on November 1, 2011, the $40,000 can be deducted from Mr. Farr's Net Income For Tax Purposes. As the loan is included in his income, there will be no benefit associated with the low interest rate. As this result would not be changed if the loan was interest free, paying interest on this loan was not good tax planning.

- **December 1, 2010** This loan is repaid prior to its inclusion in a second corporate Balance Sheet. As a consequence, it does not have to be included in income. In addition, as the interest rate of 2 percent on the loan is equal to the prescribed rate, there will be no imputed interest benefit.

Dwelling As such loans are available to all employees, Mr. Farr can claim that he has received the loan in his capacity as an employee. This means that the $100,000 principal does not have to be included in his 2010 Net Income For Tax Purposes. However, as the rate on the loan is below the prescribed rate, there will be a taxable benefit included in Mr. Farr's Net Income For Tax Purposes. The amount to be accrued for 2010 is $1,000 [($100,000)(2% - 1%)(12/12)]. For 2011, the amount is $800 [($100,000 - $20,000)(2% - 1%)(12/12)], and for 2012, the amount is $600 [($100,000 - $40,000)(2% - 1%)(12/12)].

Automobile As there are no bona fide arrangements for repaying the loan, the $50,000 principal amount must be included in Mr. Farr's 2010 Net Income For Tax Purposes. There will be no taxable interest benefit. However, when the loan is repaid, the $50,000 principal amount can be deducted in the determination of Net Income For Tax Purposes.

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TIF Solution Fifteen - 8

Relevance Of Tax Brackets

As Mr. Shields has Taxable Income of $85,000 before any payments from Shields Inc., he is in the 26 percent federal tax bracket. This bracket begins at $81,941 and ends at $127,021. This means that the next $42,021 ($127,021 - $85,000) of Taxable Income will be taxed at this rate. This should be more than sufficient to provide the required after tax amount of $18,000.

Required Salary

When this 26 percent federal rate is combined with the flat provincial rate of 10 percent, the relevant combined tax rate is 36 percent. This means that, in order to have $18,000 in after tax income, he will have to receive $28,125 in salary [$18,000 ÷ (1 - .36)].

Tax Cost Of Salary Alternative

As the salary is deductible to the corporation, the net tax cost associated with this alternative can be calculated as follows:

Personal Taxes On Salary [(36%)($28,125)]	$10,125
Tax Savings To Corporation [(15%)($28,125)]	(4,219)
Net Tax Cost Of Salary Alternative	$ 5,906

Required Dividend

The dividend alternative involves a more complex analysis. The problem states any dividends will be non-eligible. The relevant tax rate on non-eligible dividends received would be as follows:

[(125%)(36%) - (2/3 + 1/3)(25%)] = 20%

With a tax rate of 20 percent on dividends, a dividend of $22,500 [$18,000 ÷ (1 - .20)] would be required to provide an after tax amount of $18,000. The personal Tax Payable on this dividend would be calculated as follows:

Non-Eligible Dividends Received	$22,500
Gross Up At 25 Percent	5,625
Taxable Income	$28,125
Tax Payable At 36 Percent (26% + 10%)	$10,125
Dividend Tax Credit [(2/3 + 1/3)($5,625)]	(5,625)
Personal Tax Payable	$ 4,500

Subtracting the $4,500 from the $22,500 dividend received leaves the required $18,000 in after tax funds.

Tax Cost Of Dividend Alternative

As dividends are not deductible for the corporation, corporate taxes would not be changed by the payment of the dividend. This means that the only tax cost would be the personal taxes of $4,500 [(20%)($22,500)] that would be paid by Mr. Shields.

Conclusion

The salary alternative has a net tax cost of $5,906, $1,406 higher than the additional tax cost of paying dividends. Given this, the dividend alternative would be the better choice.

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TIF Solution Fifteen - 9

Part A - All Salary

As salary payments can be deducted by the corporation, the entire $26,400 can be paid as salary. Given this deduction, no taxes would be paid by the Company for the current year. With a salary payment of $26,400, Ms. Tyler's after tax cash balance would be as follows:

Salary Payment		$26,400
Tax Before Credits [(23%)($26,400)]	($6,072)	
Personal Tax Credits (Given)	3,680	(2,392)
After Tax Cash Retained		$24,008

Part B - All Dividends

The tax rate for Tyler Inc. would be 16% (38% - 10% - 17% + 5%). As dividend payments are not deductible to the Company, taxes of $4,224 [(16%)($26,400)] will have to be paid, leaving a maximum of $22,176 to be used for the payment of dividends. When this amount is paid, the after tax retention by Ms. Tyler will be as follows:

Non-Eligible Dividends Received	$22,176
Gross Up [(25%)($22,176)]	5,544
Taxable Dividends	$27,720
Tax Before Credits [(23%)($27,720)]	$ 6,376
Personal Tax Credits (Given)	(3,680)
Dividend Tax Credit [(2/3 + 25%)($5,544)]	(5,082)
Tax Payable	Nil
Dividends Received	$22,176
Tax Payable	Nil
After Tax Cash Retained	$22,176

Part C - Possible Improvement

While Ms. Tyler's Tax Payable from Part B is nil, subtracting personal and dividend tax credits from the combined tax balance gives a negative amount of $2,386. This means that the all dividend approach leaves unused tax credits. While not conclusive, this suggests that there may be a better solution than either all salary or all dividends.

Part D - Salary/Dividend Combination

To examine the possibility of an optimum solution using both salary and dividends, consider the result that occurs when $1,000 in salary is paid in lieu of some amount of dividends. Because the deductible salary payment would reduce corporate taxes, dividends would only have to be decreased by $840 [($1,000)(1 - 0.16)]. The tax effects of this switch can be calculated as follows:

Increase In Salary	$1,000.00
Decrease In Dividend [($1,000)(1 - 0.16)]	(840.00)
Decrease In Dividend Gross Up [(25%)($840.00)]	(210.00)
Decrease In Ms. Tyler's Taxable Income	($ 50.00)
Decrease In Taxes [(23%)($50.00)]	($ 11.50)
Decrease In Dividend Tax Credit [(2/3 + 25%)($210.00)]	192.50
Increase In Personal Taxes Payable	$ 181.00

The rate on a $1,000 increase in salary is 18.1% ($181.00 ÷ $1,000). Applying this rate to the unused credits of $2,386 (see Part C) gives a required increase in salary of $13,182 ($2,386 ÷ .181).

Based on this payment of salary, corporate taxes and funds available for dividend payments would be calculated as follows:

Pre-Salary Corporate Taxable Income	$26,400
Salary	(13,182)
Corporate Taxable Income	$13,218
Corporate Tax [(16%)($13,218)]	(2,115)
Available For Dividends	$11,103

After tax retention at the personal level would be calculated as follows:

Non-Eligible Dividends Received	$11,103
Gross Up [(25%)($11,103)]	2,776
Taxable Dividends	$13,879
Salary	13,182
Ms. Tyler's Taxable Income	$27,061
Tax Before Credits [(23%)($27,061)]	$ 6,224
Personal Tax Credits (Given)	(3,680)
Dividend Tax Credit [(2/3 + 25%)($2,776)]	(2,544)
Taxes Payable	Nil
Amounts Received ($13,182 + $11,103)	$24,285
Personal Taxes Payable	Nil
After Tax Cash Retained	$24,285

The comparative results for the three alternatives are as follows:

All Salary	$24,008
All Dividends	$22,176
Salary/Dividend Combination	$24,285

The combination of salary and dividends will produce the maximum after tax cash retention for Ms. Tyler. It is a $277 ($24,285 - $24,008) improvement over the all salary solution and a $2,109 ($24,285 - $22,176) improvement over the all dividend solution.

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Chapter Sixteen Test Item File Solutions

TIF Solution Sixteen - 1

1. The owner of an existing unincorporated business will usually have assets that have been used in the business for some period of time. Because a corporation is a separate taxable entity, the transfer of these assets to a corporation will be considered a disposition for proceeds equal to their fair market value. If these fair market values exceed the tax values for the assets (adjusted cost base or UCC), the result could be capital gains and/or recapture. In the absence of ITA 85(1), the resulting tax cost could significantly discourage the transfer of unincorporated businesses to corporations.

2. Eligible assets are defined under ITA 85(1.1). These assets are depreciable and non-depreciable capital property, eligible capital property, resource property, and inventories other than those of real property. Items specifically excluded from this definition are:

   - inventories of real estate; and
   - real property owned by a non-resident (unless used in a business carried on in Canada).

   The basic idea behind the omission of transfers of real property inventories from the coverage of Section 85 is to prevent a real estate dealer from transferring inventories to a corporation, where they might subsequently qualify for capital gains treatment. This provision does, of course, have serious tax implications. Further, these implications are complicated by the fact that, in many situations, a transferor may be uncertain as to whether a particular real property is a capital asset and eligible for transfer at an elected value or, alternatively, an inventory item that is ineligible.

   With respect to real property owned by non-residents, ITA 2(3) indicates that non-residents will be taxed on gains resulting from the disposition of such "Taxable Canadian Property". This taxation might be avoided if the property was transferred on a tax free basis to a Canadian corporation.

3. The elected transfer price is important in that it usually establishes three important values. These are:

   - The deemed proceeds of disposition for the property given up by the transferor.
   - The adjusted cost base of the consideration received by the transferor.
   - The adjusted cost base of the property transferred to the corporation.

4. Boot is a slang term for non-share consideration received by the transferor. This is typically either cash or debt. However, it could also be other financial or non-financial assets. Its significance lies in the fact that, if the amount does not exceed the elected values for the transferred assets, it can be received by the transferor on a tax free basis.

5. The total adjusted cost base of the consideration received would be equal to the sum of the elected values for the assets that were transferred to the corporation. This total consideration would first be allocated to any non-share consideration in an amount equal to its fair market value (as non-share consideration is the floor for all elected values, the total elected value could not be less than the fair market value of the non-share consideration). If an amount of the total consideration remained after the allocation to non-share consideration, it would be allocated to any preferred shares to the extent of the fair market value of these shares. If a further amount remained after the preferred shares have been allocated an amount equal to their fair market value, this residual would be allocated to the common shares.

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6. To achieve the desired goals (i.e., no current taxation combined with a maximum withdrawal of cash), he should elect to transfer the assets at their tax values. This will permit him to take out cash equal to the elected value without incurring any current taxation. If he follows this course of action, the PUC and the adjusted cost base of the new shares will be equal to nil.

7. The basic problem here is that, while the *Income Tax Act* is prepared to accept other family members sharing in the future growth of assets, it attempts to prevent any retroactive sharing of asset growth that occurred prior to the transfer of the assets under Section 85. If such retroactive gifts occur, they will generate immediate capital gains for the transferor and, in so doing, eliminate some of the tax advantages of the rollover procedure.

   To avoid this problem, it is essential that the transferor take back from the corporation an amount of consideration that is equal to the fair market value of the assets transferred. The usual type of arrangement is as follows:

   - The transferor will take back non-share consideration equal to the tax values of the property transferred.
   - In addition, the transferor will take back share consideration for the difference between the fair market value and the tax values of the assets transferred.

   To accomplish income splitting, the share consideration taken back by the transferor will normally be preferred, or non-growth, shares. This will permit the other family members to subscribe to the common, or growth, shares, and, thereby, participate in the future growth of the assets transferred to the corporation. As the transferor will receive consideration equal to the full fair market value of the existing business, the new common shares can be issued at nominal values.

8. Mr. Lawson's plan would not be an effective method of avoiding taxation on the transfer of these assets. There are two reasons for this. First, in order to use Section 85, the assets must be transferred to a Canadian corporation, rather than a U.S. one, as suggested by Mr. Lawson. However, if he were to establish a Canadian corporation, Mr. Lawson would have to deal with his second problem. This is the fact that Section 85 does not apply to real property owned by a non-resident. In short, Mr. Lawson cannot use Section 85 in his circumstances.

9. The objective of the legislation that is contained in ITA 84.1 is to prevent an individual from removing resources from a corporation in a form that will result in a capital gain, without an arm's length disposition of his interest in the corporation. The usual goal here is for the taxpayer to make use of the lifetime capital gains deduction. In effect, when this is attempted, ITA 84.1 acts to convert certain capital gains into deemed dividends that are not eligible for the lifetime capital gains deduction.

10. The capital gains stripping rules are designed to deal with situations where a corporation is selling shares of an investee corporation. Because dividends can be received by a corporation on an essentially tax free basis, attempts will be made to structure the sale in a manner that will convert an accrued capital gain into a tax free dividend payment. ITA 55(2) serves to restrict such conversions.

TIF Solution Sixteen - 2

1. False. While it is better to transfer accounts receivable using the ITA 22 election, they are eligible for transfer under ITA 85(1).

2. True.

3. False. In the case of depreciable assets, the transfer price is usually the UCC, a value that is normally below the capital cost of the asset.

4. True.

5. False. If the transfer is to an affiliated person, which it usually is, any loss on the transfer will be disallowed.

6. True.

7. False. If preferred shares were part of the consideration, the excess of the total adjusted cost base over the amount allocated to the non-share consideration would be allocated to the preferred shares prior to any allocation to common shares.

8. True.

9. False. The PUC reduction will be allocated on a pro-rata basis based on the fair market values of the two classes of shares.

10. True.

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TIF Solution Sixteen - 3

1. C. A group of real properties that are being held for immediate resale.

2. D. The capital cost of depreciable property transferred to the transferee.

3. B. Redeemable preferred shares of the transferee.

4. A. $120,653. This is 4/3 of the CEC balance of $90,490.

5. C. $100,000.

6. A. $100 ($15,000 - $14,900).

7. B. $60,000 ($150,000 - $40,000 - $50,000).

8. B. The acquiring corporation will be able to deduct a bad debts reserve after the transfer.

9. A. $12,000. The PUC reduction will be $180,000 [$192,000 - ($20,000 - $8,000)]. This leaves a PUC of $12,000 ($192,000 - $180,000).

10. C. $200,000 ($100,000 + $100,000).

11. B. The subject corporation must be associated with the purchaser corporation. They must be connected, not associated.

12. B. An ITA 84(3) deemed dividend of $750,000. The PUC reduction will be $150,000, leaving the shares with a PUC of nil. Given this, the deemed dividend totals $750,000 ($150,000 + $850,000 - $100,000 - $150,000).

13. D.

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TIF Solution Sixteen - 4

Exam Exercise Solution Sixteen - 1

With respect to the inventories, the $47,000 is both the floor and the ceiling, making this the only possible elected value. The transfer would result in a loss of $8,000 ($55,000 - $47,000), an amount that would be fully deductible as a business loss [ITA(23)]. With respect to the land, the floor would be the boot of $122,000 and the ceiling would be the fair market value of $275,000. Electing the minimum amount would result in a taxable capital gain of $19,500 [($122,000 - $83,000)(1/2)].

Exam Exercise Solution Sixteen - 2

With respect to the Class 1 property, the range would be from a floor of $246,000 (the boot) to a ceiling of $390,000 (fair market value). Election of the $246,000 floor value would result in recapture of $57,000 ($191,000 - $134,000) and a taxable capital gain of $27,500 [($246,000 - $191,000)(1/2)].

The range for the Class 8 asset would be from a floor of $11,000 (the boot) to a ceiling of $15,000 (fair market value). Electing the minimum value of $11,000 would result in recapture of $1,000 ($11,000 - $10,000).

Exam Exercise Solution Sixteen - 3

The cumulative eligible capital balance before the 2008 deduction was $90,750 [($121,000)(3/4)]. The deduction for 2008 was $6,353 [($90,750)(7%)]. The cumulative eligible capital balance at the time of transfer would be $84,397 ($90,750 - $6,353). Four-thirds of this amount would be $112,529. However, the floor would be established by the boot of $121,000. The ceiling would be the fair market value of $168,000.

With the election at $121,000, three-quarters of this amount would be subtracted from the CEC balance, leaving a negative balance of $6,353 ($84,397 - $90,750). This would result in a 2009 income inclusion of $6,353. Since the elected amount was also the cost of the franchise, this full amount is included in income with no adjustment as it is equal to the CEC deducted in 2008.

Exam Exercise Solution Sixteen - 4

The adjusted cost base amounts would be calculated as follows:

Elected Value	$86,800
ACB Of Note (Fair Market Value)	(71,400)
ACB Of All Shares	$15,400
ACB Of Preferred Shares*	(15,400)
ACB Of Common Shares (Residual)	Nil

*Remainder available as it is less than the fair market value of $74,200.

Exam Exercise Solution Sixteen - 5

The adjusted cost base amounts would be calculated as follows:

Elected Value	$91,200
ACB Of Note (Fair Market Value)	(66,400)
Available For Shares	$24,800
ACB Of Preferred Shares*	(24,800)
ACB Of Common Shares (Residual)	Nil

*Remainder available as it is less than the fair market value of $77,600.

The total PUC reduction would be calculated as follows:

Increase In Legal Stated Capital ($77,600 + $43,200)		$120,800
Less The Excess Of:		
Total Elected Value	($91,200)	
Over The Non-Share Consideration	66,400	(24,800)
PUC Reduction		$ 96,000

This PUC reduction would be split between the preferred and common shares on the basis of their fair market values, resulting in the following PUC values:

- Preferred Shares = $77,600 - [($77,600/$120,800)($96,000)] = $15,931
- Common Shares = $43,200 - [($43,200/$120,800)($96,000)] = $8,869

Exam Exercise Solution Sixteen - 6

Part 1 The adjusted cost base of all of the consideration will be the elected value of $275,000. It will be allocated as follows:

Elected Value	$275,000
Non-Share Consideration ($83,000 + $17,000)	(100,000)
Adjusted Cost Base Of All Shares	$175,000
Adjusted Cost Base Of Preferred Shares (FMV)	(125,000)
Adjusted Cost Base Of Common Shares (Residual)	$ 50,000

Part 2 The PUC of the shares issued must be reduced as follows:

Increase In Legal Stated Capital ($125,000 + $925,000)		$1,050,000
Less The Excess Of:		
Elected Value	($275,000)	
Over The Non-Share Consideration	100,000	(175,000)
PUC Reduction		$ 875,000

This PUC reduction would be split between the preferred and common shares on the basis of their fair market values, resulting in the following PUC values:

- Preferred Shares = $125,000 - [($125,000/$1,050,000)($875,000)] = $20,833
- Common Shares = $925,000 - [($925,000/$1,050,000)($875,000)] = $154,167

Part 3 The tax consequences of the preferred stock redemption would be as follows:

Proceeds Of Redemption	$125,000
PUC Of The Preferred Shares	(20,833)
ITA 84(3) Deemed Dividend (Non-Eligible)	$104,167

Proceeds Of Redemption	$125,000
ITA 84(3) Deemed Dividend	(104,167)
ITA 54 Deemed Proceeds Of Disposition	$ 20,833
Adjusted Cost Base	(125,000)
Capital Loss	($104,167)
Inclusion Rate	1/2
Allowable Capital Loss	($ 52,084)

The grossed up non-eligible dividend of $130,209 [(125%)($104,167)] would qualify for a federal dividend tax credit of $17,361 [(2/3)(25%)($104,167)]. The allowable capital loss is only deductible against taxable capital gains.

Exam Exercise Solution Sixteen - 7

As Mr. Rosen transferred property with a fair market value of $148,500 and received consideration with a fair market value of $87,750 ($67,500 + $20,250), he has made a gift to his daughter of $60,750 ($148,500 - $87,750). The tax consequences for Mr. Rosen and his daughter are as follows:

- The $60,750 gift will be added to the $67,500 elected value, giving Mr. Rosen a total proceeds of disposition of $128,250. This will result in a taxable capital gain of $30,375 [(1/2)($128,250 - $67,500)].

- The preferred shares issued to Mr. Rosen will have an adjusted cost base and a PUC of nil. A subsequent sale for fair market value will result in a taxable capital gain of $10,125 [(1/2)($20,250 - Nil)].

- The shares acquired by the daughter will have an adjusted cost base and PUC of $500. However, because of the gift, they will have a fair market value of $61,250 ($500 + $60,750). This means that on a subsequent sale for fair market value, the daughter would have a capital gain of $60,750 ($61,250 - $500), with a taxable amount of $30,375 [(1/2)($60,750)].

Exam Exercise Solution Sixteen - 8

By electing to transfer at the fair market value of $224,000, Mrs. Keaning will have a taxable capital gain of $44,000 [(1/2)($224,000 - $136,000)].

There is an ITA 15(1) shareholder benefit calculated as follows:

Fair Market Value Of Total Consideration ($193,000 + $90,000)	$283,000
Fair Market Value Of Property	(224,000)
ITA 15(1) Shareholder Benefit	$ 59,000

The total effect on Net Income For Tax Purposes is as follows:

Taxable Capital Gain	$ 44,000
Shareholder Benefit	59,000
Total Addition To Net Income For Tax Purposes	$103,000

The ITA 15(1) benefit of $59,000 would be added to the adjusted cost base of the preferred shares, resulting in the following adjusted cost base:

Elected Value	$224,000
ACB Of Note (Fair Market Value)	(193,000)
Available For Shares	$ 31,000
ITA 15(1) Shareholder Benefit	59,000
ACB Of Preferred Shares	$ 90,000

There will be a PUC reduction of $59,000 calculated as follows:

Increase In Legal Stated Capital		$90,000
Less Excess, If Any, Of:		
Total Elected Value	($224,000)	
Over The Non-Share Consideration	193,000	(31,000)
ITA 85(2.1) PUC Reduction		$59,000

This will leave a PUC of $31,000 ($90,000 - $59,000).

Exam Exercise Solution Sixteen - 9

Mr. Stack (an individual) has sold shares of a subject corporation to a purchasing corporation, both corporations do not deal with Mr. Stack at arm's length, and the two corporations are connected subsequent to the sale. As a consequence, ITA 84.1 is applicable. Given this, the tax consequences of this transaction to Mr. Stack are as follows:

Increase In Legal Stated Capital		$309,000
Less Excess, If Any, Of:		
PUC And ACB Of Subject Shares	($132,000)	
Over The Non-Share Consideration	390,000	Nil
PUC Reduction		$309,000
PUC Of New Shares ($309,000 - $309,000)		Nil
Increase In Legal Stated Capital		$309,000
Non-Share Consideration		390,000
Total		$699,000
Less The Sum Of:		
PUC And ACB Of Subject Shares	($132,000)	
PUC Reduction	(309,000)	(441,000)
ITA 84.1 Deemed Dividend (Non-Eligible)		$258,000
Elected Proceeds Of Disposition For Subject Shares		$699,000
ITA 84.1 Deemed Dividend		(258,000)
Proceeds For Capital Gains Purposes		$441,000
ACB Of Subject Shares		(132,000)
Capital Gain		$309,000
Inclusion Rate		1/2
Taxable Capital Gain		$154,500
ACB Of New Shares ($699,000 - $390,000)		$309,000

The grossed up non-eligible dividend of $322,500 [(125%)($258,000)] would qualify for a federal dividend tax credit of $43,000 [(2/3)(25%)($258,000)]. In addition, there would be a taxable capital gain of $154,500 that would be eligible for the $750,000 ($375,000 taxable amount) lifetime capital gains deduction. Mr. Stack may need to pay alternative minimum tax because of this transaction.

Exam Exercise Solution Sixteen - 10

The redemption of the preferred shares received from Sored Company would result in an ITA 84(3) deemed dividend calculated as follows:

Proceeds Of Redemption	$940,000
PUC Of Redeemed Shares	(125,000)
ITA 84(3) Deemed Dividend	$815,000

As this is an intercorporate dividend, it would normally be deducted in calculating the Taxable Income of Foral Inc.

However, a dividend has been received in conjunction with a disposition of shares to an arm's length party. In addition, it would appear that one of the purposes of the dividend was to reduce the capital gain that would normally have resulted from the disposition of the shares. This indicates that ITA 55(2) would be applicable, resulting in the following tax consequences:

ITA 84(3) Deemed Dividend	$815,000
Amount Deemed Not To Be A Dividend Under ITA 55(2)(a) [$815,000 - (80%)($285,000)]	(587,000)
ITA 84(3) Deemed Dividend After Adjustment	$228,000

Proceeds Of Redemption Before Adjustment	$940,000
ITA 84(3) Deemed Dividend After Adjustment	(228,000)
Adjusted Redemption Proceeds	$712,000
Adjusted Cost Base	(125,000)
Capital Gain	$587,000
Inclusion Rate	1/2
Taxable Capital Gain	$293,500

There would be a tax free dividend of the safe income of $228,000 [(80%)($285,000)] and a taxable capital gain of $293,500.

TIF Solution Sixteen - 5

For each term there is both a 100 percent correct answer and an answer that is close. We have indicated the "close answer" in brackets. This would allow you to mix terms from various chapters if you wish to do so.

The correct definitions for each of the listed key terms are as follows:

A. 5 (not 1)

B. 9 (not 6)

C. 2 (not 7)

D. 10 (not 3)

E. 8 (not 4)

hzzled

TIF Solution Sixteen - 6

Part A - Elected Values For Assets

As the elected value for each asset is equal to its tax value, there will be no immediate tax consequences to Billy Bob as a result of the rollover transaction. The tax basis of the assets to LTI will be as follows:

Inventories	$164,000
Land	53,000
Building*	161,000
Goodwill	Nil
Total	$378,000

*The Building will retain its capital cost of $350,000.

Part B - Adjusted Cost Base Of Consideration Components

The adjusted cost base of all consideration received by Billy Bob will be the total elected value for the assets of $378,000. It will be allocated as follows:

Total Elected Value		$378,000
Non-Share Consideration:		
Old Debt Assumed ($76,000 + $140,000)	($216,000)	
Note	(100,000)	(316,000)
Adjusted Cost Base Of All Shares		$ 62,000
Adjusted Cost Base Of Preferred Shares (Maximum)		(62,000)
Adjusted Cost Base Of Common Shares		Nil

Part C - PUC Of Common And Preferred Shares

The calculation of PUC would be as follows:

Increase In Legal Stated Capital (Fair Market Value)		$800,000
Less Excess Of:		
Elected Amount	($378,000)	
Over The Non-Share Consideration	316,000	(62,000)
Reduction In PUC		$738,000

This reduction would be allocated pro rata on a basis of fair market values, resulting in the following values for the PUC of the preferred and common shares:

Preferred Shares: $790,000 - [($738,000)($790,000 ÷ $800,000)] = $61,225

Common Shares: $10,000 - [($738,000)($10,000 ÷ $800,000)] = $775

Part D-1 - Tax Consequences Of Note Payment

There would be no tax consequences associated with the payment of the note.

Part D-2 - Tax Consequences Of Preferred Share Redemption

The redemption of the preferred shares would result in both an ITA 84(3) deemed dividend and a capital loss. The amounts are calculated as follows:

Proceeds From Redemption	$790,000
PUC Of Preferred Shares	(61,225)
ITA 84(3) Deemed Dividend (Non-Eligible)	$728,775

Proceeds Of Redemption	$790,000
ITA 84(3) Deemed Dividend	(728,775)
Deemed Proceeds Of Disposition	$ 61,225
Adjusted Cost Base	(62,000)
Capital Gain (Loss)	($ 775)
Inclusion Rate	1/2
Allowable Capital Gain (Loss)	($ 388)

The grossed up non-eligible dividend of $910,969 [(125%)($728,775)] would qualify for a federal dividend tax credit of $121,463 [(2/3)(25%)($728,775)]. The allowable capital loss of $388 would only be deductible against taxable capital gains.

Part D-3 - Tax Consequences Of The Sale Of Common Shares

The sale of the common shares would result in a capital gain of $10,000 ($10,000 - Nil). The taxable portion of the capital gain is $5,000 [(1/2)($10,000)].

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TIF Solution Sixteen - 7

Part A - Adjusted Cost Base Of Consideration

The adjusted cost base for each item of consideration, under the three alternatives, would be calculated as follows:

	Alternative		
	One	Two	Three
Elected Transfer Price	$400,000	$400,000	$400,000
ACB - Boot	(300,000)	(200,000)	(320,000)
Available For Preferred And Common Stock	$100,000	$200,000	$ 80,000
ACB - Preferred Stock	(50,000)	(200,000)	N/A
ACB - Common Stock (Residual)	$ 50,000	N/A	$ 80,000

Part B - Legal Stated Capital And PUC

The legal stated capital for the two classes of shares would be as follows:

	Alternative		
	One	Two	Three
Preferred Stock	$ 50,000	$600,000	Nil
Common Stock	450,000	Nil	$480,000
Total Legal Stated Capital	$500,000	$600,000	$480,000

The required PUC reduction would be calculated as follows:

	Alternative		
	One	Two	Three
Increase In Legal Stated Capital - All Shares (A)	$500,000	$600,000	$480,000
Elected Amount	$400,000	$400,000	$400,000
Non-Share Consideration	(300,000)	(200,000)	(320,000)
Elected Amount, Less Boot (B)	$100,000	$200,000	$ 80,000
Required PUC Reduction (A - B)	$400,000	$400,000	$400,000

Alternative One In Alternative One, the PUC reduction would have to be split between the two classes of shares on the basis of their relative fair market values. The relevant calculation would be as follows:

Preferred Shares: [($400,000)($50,000 ÷ $500,000)] = $40,000

Common Shares: [($400,000)($450,000 ÷ $500,000)] = $360,000

This would leave a PUC of $10,000 for the preferred shares ($50,000 - $40,000), and a PUC of $90,000 for the common shares ($450,000 - $360,000).

Alternative Two In Alternative Two, the entire PUC reduction of $400,000 would be allocated to the preferred shares, leaving a PUC of $200,000 ($600,000 - $400,000).

Alternative Three In Alternative Three, the entire PUC reduction of $400,000 would be allocated to the common stock, leaving a PUC of $80,000 ($480,000 - $400,000).

TIF Solution Sixteen - 8

Part A - Tax Consequences Of Proposed Plan

Ms. Bradley's plan involves the disposition of shares of a corporation resident in Canada to a corporation with which she does not deal at arm's length (for tax purposes, Mr. Wadd would be considered Ms. Bradley's common-law spouse). Subsequent to the transaction, the two corporations are connected (Wadd Industries controls Bradley Inc.). Given these facts, the provisions of ITA 84.1 apply to this transaction.

The required calculations begin with the PUC reduction under ITA 84.1(1)(a):

Increase In Legal Stated Capital Of Wadd Industries		$1,050,000
Less The Excess Of:		
PUC And ACB Of Bradley Inc. Shares	($100,000)	
Over The Non-Share Consideration	850,000	Nil
PUC Reduction		$1,050,000
PUC After Reduction ($1,050,000 - $1,050,000)		Nil

The nil PUC reflects the fact that all of the PUC of the Bradley Inc. shares was taken out as non-share consideration.

The deemed non-eligible dividend under ITA 84.1(1)(b) and federal dividend tax credit would be calculated as follows:

Increase In Legal Stated Capital Of Wadd Industries		$1,050,000
Fair Market Value Of Boot		850,000
Total		$1,900,000
PUC And ACB Of Bradley Shares	($ 100,000)	
PUC Reduction Under ITA 84.1(1)(a)	(1,050,000)	(1,150,000)
Deemed Dividend Under ITA 84.1(1)(b)		$ 750,000
Gross Up At 25 Percent		187,500
Taxable Non-Eligible Dividend		$ 937,500
Federal Dividend Tax Credit [(2/3)($187,500)]		$ 125,000

You will note that, because of the application of ITA 84.1, no capital gain eligible for the $750,000 lifetime capital gains deduction results from this transaction. This can be seen in the following calculation:

Proceeds Before Adjustment Of Bradley Shares (Elected Amount)	$850,000
ITA 84.1(1)(b) Deemed Dividend	(750,000)
Adjusted Proceeds Of Disposition (ITA 54)	$100,000
Adjusted Cost Base Of Bradley Shares	(100,000)
Capital Gain	Nil

Part B - An Improved Solution

The approach suggested by Ms. Bradley will not be successful in producing the required $750,000 capital gain. The reason that this approach cannot be successful is that Ms. Bradley is trying to take out non-share consideration in excess of the $100,000 PUC and ACB of her Bradley Inc. shares. Fortunately, this situation can be corrected by reducing the amount of non-share consideration to $100,000. In conjunction with this reduction in the amount of non-share consideration, the PUC and fair market value of the retractable preferred shares will have to be increased to $1,800,000, so that the total fair market value of the consideration received by Ms. Bradley equals $1,900,000, the fair market value of the Bradley Inc. shares given up in the transaction. Using this approach, the required PUC reduction under ITA 84.1(1)(a) would be as follows:

Increase In Legal Stated Capital Of Wadd Industries		$1,800,000
Less The Excess Of:		
PUC And ACB Of Bradley Inc. Shares	($100,000)	
Over The Non-Share Consideration	100,000	Nil
PUC Reduction		$1,800,000
PUC After Reduction ($1,800,000 - $1,800,000)		Nil

The deemed dividend under ITA 84.1(1)(b) would be calculated as follows:

Increase In Legal Stated Capital Of Wadd Industries		$1,800,000
Fair Market Value Of Boot		100,000
Total		$1,900,000
Less The Sum Of:		
PUC And ACB Of Bradley Shares	($ 100,000)	
PUC Reduction Under ITA 84.1(1)(b)	(1,800,000)	(1,900,000)
Deemed Dividend		Nil

Given the preceding, the capital gain resulting from this transaction is calculated as follows:

Proceeds Before Adjustment Of Bradley Shares (Elected Amount)	$850,000
ITA 84.1(1)(b) Deemed Dividend	Nil
Proceeds Of Disposition	$850,000
Adjusted Cost Base Of Bradley Shares	(100,000)
Capital Gain	$750,000

Part C - Sale Of Shares

The capital gain applicable to each share of Bradley Inc. can be calculated as follows:

($1,900,000 - $100,000) ÷ 500 Shares = $3,600 Per Share

Given this per share value, the number of shares that must be sold in an attempt to produce the required $750,000 capital gain is as follows:

$750,000 ÷ $3,600 Per Share = 208.3 Shares

As it is not possible to sell a fraction of a share, 208 shares will be sold in order to produce almost the full amount of the $750,000 capital gain. Note, however, that the sale is still to a connected corporation with which Ms. Bradley does not deal at arm's length. This means that the provisions of ITA 84.1 will continue to be applicable.

As no new shares are issued by Wadd Industries, no PUC reduction is required. The sale of the shares at their fair market value of $3,800 per share ($1,900,000 ÷ 500 shares) would produce the following deemed dividend under ITA 84.1(1)(b):

Increase In Legal Stated Capital Of Wadd Industries		Nil
Non-Share Consideration Of Shares Sold [(208 Shares)($3,800)]		$790,400
Total		$790,400
Less The Sum Of:		
PUC And ACB Of Bradley Shares		
[(208 Shares)($200)]	($41,600)	
PUC Reduction Under ITA 84.1(1)(a)	Nil	(41,600)
Deemed Dividend Under ITA 84.1(1)(b)		$748,800

Given this deemed dividend, the sale of shares will not result in the desired capital gain. This can be seen in the following calculation:

Unadjusted Proceeds Of Disposition [(208 Shares)($3,800)]	$790,400
Deemed Dividend Under ITA 84.1(1)(b)	(748,800)
Adjusted Proceeds Of Disposition	$ 41,600
Adjusted Cost Base Of Shares	(41,600)
Capital Gain	Nil

The deemed non-eligible dividend will result in a taxable dividend of $936,000 [(125%)($748,800)] that qualifies for a federal dividend tax credit of $124,800 [(2/3)(25%)($748,800)].

Chapter Seventeen Test Item File Solutions

TIF Solution Seventeen - 1

1. The usual situation in which ITA 85.1 is applied involves a shareholder of a Canadian corporation (Corporation A) who wishes to sell his shares, on an arm's length basis, to another Canadian corporation (Corporation B). ITA 85.1 allows the shareholder to exchange his shares in Corporation A for shares of Corporation B, with the transaction taking place at the adjusted cost base of the Corporation A shares. That is, the proceeds of disposition for the Corporation A shares will be their adjusted cost base, and this will also be the cost of these shares to the acquiring company. The major tax advantage is the fact that any gain on the Corporation A shares is deferred until such time as the Corporation B shares are sold.

2. Under ITA 86, Mr. Barris could exchange his common shares in Barris Ltd. for some combination of non-share consideration and redeemable preferred shares, with a total fair market value equal to the $3 million fair market value of the common shares. As long as the non-share consideration does not exceed the $50,000 PUC and adjusted cost base of the common shares, there would be no tax consequences to Mr. Barris. In order to for Mr. Barris to retain control, the preferred shares should be voting and their number should exceed the number of common shares outstanding.

3. The required three provisions could be selected from the following:
   - The preferred shares must be redeemable at the option of the shareholder.
   - The preferred shares should be entitled to a dividend at a reasonable rate.
   - The corporation must guarantee that dividends will not be paid on any other class of shares, if the payment would result in the corporation having insufficient net assets to redeem the preferred shares at their specified redemption price.
   - The preferred shares must become cumulative if the fair market value of the net assets of the corporation falls below the redemption value of the preferred shares, or if the corporation is unable to redeem the shares on a call for redemption.
   - The preferred shares should have preference on liquidation of the corporation.

4. Provided no gift to a related party is involved, the adjusted cost base of new shares issued in an ITA 86 reorganization would be equal to the adjusted cost base of the old shares redeemed, less any non-share consideration. However, if a gift is involved, the adjusted cost base of the new shares will be equal to the adjusted cost base of the old shares, reduced by the sum of any non-share consideration plus the amount of the gift.

5. The paid up capital (PUC) of new shares issued in an ITA 86 reorganization would be equal to their legal stated capital, less a PUC reduction. This reduction calculation would start with the legal stated capital of the shares. From this total, the formula requires the subtraction of any excess of the PUC of the old shares over any non-share consideration received. If the non-share consideration exceeds the old PUC, the reduction will be equal to the legal stated capital, resulting in a PUC of nil. This calculation is not altered by the presence of a gift to a related party.

6. The basic condition for a gift to be present is that the fair market value of the old shares exceeds the sum of the fair market value of the new shares and the fair market value of the non-share consideration received. In addition, a related party must be in a position to benefit from this difference. This would generally require that the related party be holding common shares in the reorganized corporation.

7. Under ITA 88(1), which applies when the parent owns 90 percent or more of each class of the subsidiary's shares, there is a provision that allows some part of any excess of the cost of the subsidiary, over the underlying tax values of its assets to be recognized in the tax records of the combined company. More specifically, any excess of the fair market value of non-depreciable property over its cost at the time that the subsidiary was acquired can be included in the transfer, to the extent that the value is supported by the price paid for the shares. This same provision is also available under ITA 87, but only in those cases where the parent owns 100 percent of the subsidiary's shares. This means that the only real difference with respect to the availability of this "bump-up" is that its applicability is more limited under ITA 87, since it can only be used when ownership is 100 percent.

   A second difference between these two provisions involves the use of loss carry forwards. In the case of an ITA 87 amalgamation, loss carry forwards can be used immediately after the amalgamation transaction takes place. In the case of an ITA 88(1) wind-up, subsidiary loss carry forwards will not become available until the first taxation year of the parent that begins after the date that the wind-up period commences.

   A third difference is that, in an amalgamation, CCA can be claimed in the last year of the predecessor corporations and the first year of the amalgamated corporation. In the case of a wind-up under ITA 88(1), the subsidiary will not be able to take CCA in the year of the wind-up.

   A final difference is that, in an amalgamation, both predecessor companies have a deemed year end. In the ITA 88(1) wind-up, the parent company does not have a deemed year end.

8. The failure to allocate a value to leaseholds in the purchase agreement, and the resulting allocation of these values to goodwill, has the following effects:

   Vendor If the proceeds are allocated to the lease, any excess over the tax value of the lease (usually nil) will be treated as a capital gain, only one-half of which would be taxable. Provided a CCPC is involved, this gain will be a component of investment income. This means that while it will be subject to ART and not eligible for the GRR, a large portion of the Part I tax paid will be refundable.

   If the proceeds are allocated to goodwill, three-quarters of the amount will be deducted from the cumulative eligible capital balance. If no deductions of CEC have been made under ITA 20(1)(b) in the past, this negative balance will be multiplied by two-thirds prior to its inclusion in the taxpayer's income. This multiplication reduces the amount from a three-quarters inclusion, to a one-half inclusion [(3/4)(2/3) = 1/2].

   The treatment is different if previous deductions have been made under ITA 20(1)(b). In this case, a negative balance will be added to income, without adjustment, to the extent of previous deductions made under ITA 20(1)(b). If the negative amount exceeds amounts previously deducted under ITA 20(1)(b), the excess will be multiplied by two-thirds prior to its addition to income. In this case, the total income addition will be larger than it would have been if the proceeds had been allocated to a lease.

   Without regard to the amount of the inclusion, it will be considered to be active business income rather than investment income. This means that it may be eligible for the small business deduction.

   Purchaser The distinction between allocation to a leasehold interest and allocation to goodwill is more significant to the purchaser. If the value is allocated to goodwill, only three-quarters of the amount will be deductible. In contrast, an allocation to a leasehold interest would result in the entire amount being deductible. If the lease is relatively short, a further advantage may arise in that the leasehold interest can be written off over its life, while three-quarters of the goodwill will be amortized at a maximum rate of 7 percent per year on the declining balance in the account.

9. **Accounts Receivable** In general terms, the sale of accounts receivable is treated as a capital transaction. This means that losses are capital in nature. However, any bad debt reserve from the previous year must be brought into income. There is a joint election available under ITA 22 that will allow the vendor to fully deduct bad debt losses, provided the purchaser agrees to include bad debt recoveries in income.

   Inventory Gains and losses on the sale of inventories would be included in full in the computation of Net Income For Tax Purposes.

   Depreciable Assets The situation here is fairly complex and involves a number of possibilities. They can be outlined as follows:

   1. If the proceeds exceed the capital cost, the excess will treated as a capital gain. In addition, the difference between the UCC and the capital cost will be included in income as recapture of CCA.

   2. If the proceeds are less than the balance in the UCC of the class and there are no other assets in the class, the deficiency will be fully deductible as a terminal loss.

   3. If the proceeds are less than the capital cost but more than the UCC balance, the excess will be treated as recapture.

   Goodwill Three-quarters of the proceeds from the sale of goodwill is deducted from the balance in the corporation's cumulative eligible capital account.

   If a positive balance remains in the CEC account, the situation is similar to that involving terminal losses on depreciable capital assets. As with such terminal losses, the balance remaining could be deducted in the computation of Net Income For Tax Purposes. In similar fashion, any CEC balance that is left when a business terminates can also be deducted. However, an important difference from the terminal loss situation on depreciable assets is that the deductible amount of any loss on CEC is only three-quarters of the actual amount of the loss. As is the case with terminal losses, any amount deducted from income is also deducted from the CEC balance, in order to leave a balance of nil.

   If the CEC balance is negative, ITA 14(1) requires that the negative balance be divided into two components. These components, along with their tax treatment, are as follows:

   - To the extent that there have been CEC deductions in the past, the negative amount will be added to income under ITA 14(1). This is the equivalent of recapture for depreciable assets.

   - Any excess of the negative amount over past CEC deductions will be viewed as similar to a capital gain. To give this excess amount treatment that is analogous to that given to capital gains, it will be multiplied by two-thirds prior to its inclusion in the taxpayer's income. This multiplication reduces the amount from a three-quarters inclusion, to a one-half inclusion [(3/4)(2/3) = 1/2].

10. The three reasons can be selected from the following:

- In acquiring assets, the purchaser acquires a completely new, and usually higher, set of tax values for the assets transferred. This will result in higher CCA claims and/or lower gains on future dispositions.
- Goodwill (cumulative eligible capital) can be recognized when assets are acquired. The CEC deductions related to these amounts are not available if shares are acquired.
- If shares are acquired, all of the assets must be acquired. If redundant assets are present, they can be left out of an acquisition of assets.
- If shares are acquired, the purchaser becomes responsible for any future tax reassessments. If assets are purchased, the new owner starts with a clean slate and, in general, has no responsibility for any tax problems that may exist from previous corporate tax returns.
- If assets are acquired, the purchaser may avoid potential non-tax liabilities such as those related to polluting the environment.

TIF Solution Seventeen - 2

1. True.

2. False. Such a transfer cannot be made under ITA 86(1).

3. False. The only requirement is that he transfer all of the shares that he owns of a particular class.

4. True.

5. False. Such gifts may occur when the fair market value of the shares received is less than the fair market value of the shares given up.

6. False. ITA 88(1) can only be used when there is 90 percent or greater ownership of the subsidiary.

7. True.

8. False. There is no deemed year end for the parent company in an ITA 88(1) rollover.

9. True.

10. False. There will be an ITA 84(2) deemed dividend.

11. True.

12. True.

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TIF Solution Seventeen - 3

1. B. This rollover provision is commonly used in business combination transactions.

2. C. ITA 85.1 - Share for share exchange.

3. A. All of the outstanding shares of the particular class must be exchanged. This is not required. The only requirement is that all of the shares of that class that are held by the transferor must be exchanged.

4. D. Voting rights.

5. B. The PUC of the new shares will be equal to their legal stated capital.

6. D. $200,000. The reduction would be $1,200,000 [$1,400,000 - ($800,000 - $600,000)]. This would leave a balance of $200,000 ($1,400,000 - $1,200,000).

7. A. Nil. The adjusted cost base would be the $600,000 [(80%)($750,000)] adjusted cost base of the old shares, less the $600,000 in non-share consideration received.

8. C. The adjusted cost base will be nil, the cost of the old shares, less the sum of the non-share consideration and the gift ($960,000 - $500,000 - $460,000).

9. D. This is not correct. The GRIP balance will only be available to the amalgamated company if it is a CCPC.

10. B. Both the subsidiary and the parent will have a deemed year end.

11. A. Jasmine will receive dividends subject to tax of $1,500,000 ($2,000,000 - $100,000 - $400,000), as well as a taxable capital gain of $25,000 [($2,000,000 - $1,900,000 - $50,000)(1/2)], when she receives the $2,000,000 distribution.

12. A. Nancy will realize a capital gain of $1,866,667, resulting in a taxable capital gain of $933,334. She will pay $466,667 in taxes, leaving her with $2,000,000.

    The supporting calculation is:
    $X - [(X - \$600,000)(1/2)(50\%)] = \$2,000,000$
    $X - (0.25X - \$150,000) = \$2,000,000$
    $0.75X + \$150,000 = \$2,000,000$
    $0.75X = \$1,850,000$
    $X = \$2,466,667$

13. C. Linden will report active business income of $212,500, and there will be a $212,500 addition to the capital dividend account.

14. D. The fair market value of the individual assets when the purchaser acquires the shares of the business.

TIF Solution Seventeen - 4

Exam Exercise Solution Seventeen - 1

It would appear that, in this case, there is a share for share exchange that meets the conditions of ITA 85.1. Unless Mr. Forbes elects out of this rollover provision in his income tax return, the tax consequences of this transaction for him would be as follows:

- Mr. Forbes would be deemed to have disposed of his Forbes Ltd. shares at a value equal to their adjusted cost base of $540,000. As a consequence, there would be no capital gain on the disposition.
- Mr. Forbes would be deemed to have acquired his Megopolis Ltd. shares at a cost equal to the adjusted cost base of the Forbes Ltd. shares, or $540,000.
- The adjusted cost base of the Forbes Ltd. shares that have been acquired by Megopolis Ltd. would be deemed to be the lesser of their fair market value and their paid up capital. In this case, the $540,000 paid up capital amount is the lower figure.
- The PUC of the Megopolis Ltd. shares that have been issued to Mr. Forbes would be $540,000, the PUC of the Forbes Ltd. shares that were given up.

Exam Exercise Solution Seventeen - 2

The required PUC reduction on the redeemable preferred shares would be calculated as follows:

Increase In Legal Stated Capital		$1,575,000
Less The Excess, If Any, Of:		
PUC Of Common Shares	($1,375,000)	
Over The Non-Share Consideration	1,375,000	Nil
PUC Reduction		$1,575,000

This means that the redeemable preferred shares would have a PUC of nil ($1,575,000 - $1,575,000).

The adjusted cost base of the redeemable preferred shares would be calculated as follows:

Adjusted Cost Base Of Common Shares	$1,375,000
Non-Share Consideration	(1,375,000)
Adjusted Cost Base Of Redeemable Preferred Shares	Nil

Because Laura took back cash equal to her PUC and ACB, there would be no ITA 84(3) deemed dividend and no capital gain or loss. These calculations would be as follows:

PUC Of New Shares	Nil
Plus Non-Share Consideration	$1,375,000
Proceeds Of Redemption Under ITA 84(5)(d)	$1,375,000
PUC Of Old Shares	(1,375,000)
ITA 84(3) Deemed Dividend	Nil

Adjusted Cost Base Of New Shares	Nil
Plus Non-Share Consideration	$1,375,000
Proceeds Of Disposition Under ITA 86(1)(c)	$1,375,000
ITA 84(3) Deemed Dividend	Nil
Adjusted Proceeds	$1,375,000
Adjusted Cost Base Of Old Shares	(1,375,000)
Capital Gain (Loss)	Nil

Exam Exercise Solution Seventeen - 3

The required PUC reduction on the redeemable preferred shares would be calculated as follows:

Increase In Legal Stated Capital		$440,000
Less The Excess, If Any, Of:		
PUC Of Common Shares	($400,000)	
Over The Non-Share Consideration	480,000	Nil
PUC Reduction		$440,000

This means that the redeemable preferred shares would have a PUC of nil ($440,000 - $440,000).

The adjusted cost base of the redeemable preferred shares would be calculated as follows:

Adjusted Cost Base Of Common Shares	$500,000
Non-Share Consideration	(480,000)
Adjusted Cost Base Of Redeemable Preferred Shares	$ 20,000

Because the non-share consideration was greater than the PUC of the old shares, the resulting ITA 84(3) deemed dividend and the capital loss would be calculated as follows:

PUC Of New Shares	Nil
Plus Non-Share Consideration	$480,000
Proceeds Of Redemption Under ITA 84(5)(d)	$480,000
PUC Of Old Shares	(400,000)
ITA 84(3) Deemed Dividend (Non-Eligible)	$ 80,000

Adjusted Cost Base Of New Shares	$ 20,000
Plus Non-Share Consideration	480,000
Proceeds Of Disposition Under ITA 86(1)(c)	$500,000
ITA 84(3) Deemed Dividend	(80,000)
Adjusted Proceeds	$420,000
Adjusted Cost Base Of Old Shares	(500,000)
Capital Gain (Loss)	($ 80,000)

The taxable non-eligible dividend would be $100,000 [(125%)($80,000)] and the allowable capital loss would be $40,000 [(1/2)($80,000)]. The taxable dividend would qualify for a federal dividend tax credit of $13,333 [(25%)($80,000)(2/3)].

Exam Exercise Solution Seventeen - 4

Mr. Doyen gave up shares with a fair market value of $2,688,000 [(80%)($3,360,000)] in return for consideration of $2,310,000 ($630,000 + $1,680,000). As his son holds the remaining common shares, it would appear that there is a gift to the son of $378,000 ($2,688,000 - $2,310,000). This means that ITA 86(2) is applicable.

The PUC reduction on the new shares would be calculated as follows:

Increase In Legal Stated Capital		$1,680,000
Less The Excess Of:		
PUC Of Common Shares [(80%)($525,000)]	($420,000)	
Over The Non-Share Consideration	630,000	Nil
PUC Reduction		$1,680,000

This means that the redeemable preferred shares would have a PUC of nil ($1,680,000 - $1,680,000).

Under ITA 86(2)(e), the adjusted cost base of the redeemable preferred shares would be calculated as follows:

Adjusted Cost Base Of Common Shares [(80%)($525,000)]		$ 420,000
Deduct:		
Non-Share Consideration	($630,000)	
Gift	(378,000)	(1,008,000)
Adjusted Cost Base Of Preferred Shares		Nil

PUC Of New Shares	Nil
Plus Non-Share Consideration	$630,000
Proceeds Of Redemption Under ITA 84(5)(d)	$630,000
PUC Of Old Shares	(420,000)
ITA 84(3) Deemed Dividend (Non-Eligible)	$210,000

Non-Share Consideration	$ 630,000
Plus Gift	378,000
Proceeds Of Disposition Under ITA 86(2)(c)	$1,008,000
ITA 84(3) Deemed Dividend	(210,000)
Adjusted Proceeds	$ 798,000
Adjusted Cost Base Of Old Shares [(80%)($525,000)]	(420,000)
Capital Gain	$ 378,000

The taxable non-eligible dividend would be $262,500 [(125%)($210,000)] and the taxable capital gain would be $189,000 [(1/2)($378,000)]. The taxable dividend would qualify for a federal dividend tax credit of $35,000 [(25%)($210,000)(2/3)].

Exam Exercise Solution Seventeen - 5

As Winner Ltd. has a clear majority of the shares in Combo Inc., it would appear that they have acquired control of Loser Inc. As the acquisition of control rules would be applicable, there would be a deemed year end for both Companies that coincides with the amalgamated year end. The non-capital loss carry forward of Loser Inc. will be flowed through to the amalgamated company, Combo Inc. However, because of the acquisition of control, the net capital loss cannot be used. In addition, for the non-capital loss to be used, Combo Inc. would have to continue the business in which the loss occurred. Further, the loss carry forward could only be applied against profits in that business.

Exam Exercise Solution Seventeen - 6

Under ITA 88(1), a limited bump-up in the value of non-depreciable assets is available. The basic limit would be calculated as follows:

Adjusted Cost Base Of Intell Inc. Shares	$1,800,000
Tax Values Of Intell Inc.'s Net Assets	
At Winding-Up ($750,000 - $112,500)	(637,500)
Dividends Paid By Intell Since Acquisition	Nil
Excess	$1,162,500

However, this basic amount cannot exceed the difference between the fair market value of the non-depreciable assets at the time of the share acquisition and their tax cost at that time. This amount would be $195,000 ($405,000 - $210,000). The bump-up in the Land value is limited to that amount, resulting in the following tax values for Intell's assets at the time of the ITA 88(1) winding-up:

Cash	$180,000
Land ($210,000 + $195,000)	405,000
Depreciable Assets - At UCC	360,000
Total Assets	$945,000

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Exam Exercise Solution Seventeen - 7

Given the size of the proceeds, the balance in the RDTOH account will clearly be less than one-third of the dividends to be declared. Given this, the total distribution to shareholders will be $3,009,600 ($2,854,500 + $155,100).

The taxable dividend component of the total distribution to the shareholders is calculated as follows:

Total Distribution	$3,009,600
Paid Up Capital	(290,400)
ITA 84(2) Deemed Dividend	$2,719,200
Capital Dividend Account (Election Required)	(85,800)
Dividend Subject To Tax	$2,633,400

The remaining dividend subject to tax will qualify for the usual gross up and tax credit procedures for non-eligible dividends. The taxable dividend would be $3,291,750 [(125%)($2,633,400)] and the related federal dividend tax credit would be $438,900 [($2,633,400)(25%)(2/3). As a disposition of shares has occurred, we must also determine whether there is a capital gain or loss. The calculations are as follows:

Total Distribution To Shareholders	$3,009,600
ITA 84(2) Deemed Dividend	(2,719,200)
Deemed Proceeds Of Disposition	$ 290,400
Adjusted Cost Base Of Shares	(290,400)
Capital Gain	Nil

TIF Solution Seventeen - 5

For each term there is both a 100 percent correct answer and an answer that is close. We have indicated the "close answer" in brackets. This would allow you to mix terms from various chapters if you wish to do so.

The correct definitions for each of the listed key terms are as follows:

A. 6 (not 2)

B. 10 (not 1)

C. 8 (not 3)

D. 4 (not 9)

E. 7 (not 5)

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TIF Solution Seventeen - 6

Part A - Rollover Values

The required information would be as follows:

Amount Of Gift

Fair Market Value - Old Shares		$1,200,000
Fair Market Value - Consideration:		
Non-Share Consideration	($225,000)	
FMV - New Shares	(775,000)	(1,000,000)
Gift To Daughter		$ 200,000

PUC - New Preferred Shares

Increase In Legal Stated Capital - New Shares		$775,000
Less The Excess, If Any, Of:		
PUC - Old Shares	($600,000)	
Over The Non-Share Consideration	225,000	(375,000)
Reduction In PUC		$400,000

Increase In Legal Stated Capital - New Shares	$775,000
Reduction In PUC	(400,000)
PUC - New Preferred Shares	$375,000

Adjusted Cost Base - New Preferred Shares

Adjusted Cost Base - Old Shares		$600,000
Deduct:		
Non-Share Consideration	($225,000)	
Gift	(200,000)	(425,000)
Adjusted Cost Base - New Preferred Shares		$175,000

Deemed Dividends

PUC - New Preferred Shares	$375,000
Non-Share Consideration	225,000
Proceeds Of Redemption - Old Shares [ITA 84(5)(d)]	$600,000
PUC - Old Shares	(600,000)
Deemed Dividend Under ITA 84(3)	Nil

Capital Gain (Loss)

Non-Share Consideration	$225,000
Gift	200,000
Proceeds Of Disposition - Old Shares [(ITA 86(2)(c)] (Less Than $1,200,000 FMV Of Common Stock)	$425,000
Adjusted Cost Base - Old Shares	(600,000)
Capital Loss	($175,000)

This capital loss would be disallowed by ITA 86(2)(d).

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Part B - Redemption Of Preferred Shares

The taxable capital gain that would be assessed to Mr. Kapp on the redemption of the new preferred shares would be calculated as follows:

Proceeds Of Redemption	$775,000
PUC Of New Preferred Shares (Part A)	(375,000)
ITA 84(3) Deemed Dividend (Non-Eligible)	$400,000

Proceeds Of Redemption	$775,000
ITA 84(3) Deemed Dividend	(400,000)
Adjusted Proceeds Of Disposition	$375,000
Adjusted Cost Base Of New Preferred Shares (Part A)	(175,000)
Capital Gain	$200,000
Inclusion Rate	1/2
Taxable Capital Gain	$100,000

The overall tax consequences of the redemption would be as follows:

Taxable Dividend [($400,000)(125%)]	$500,000
Taxable Capital Gain	100,000
Income Inclusion	$600,000

The deemed non-eligible dividend would qualify for a federal dividend tax credit of $66,667 [(2/3)($400,000)(25%)].

Note that the $400,000 deemed dividend and the $200,000 capital gain total to the same $600,000 that would have been the capital gain if the common shares had been sold prior to the roll over. The problem, however, is the fact that Emily Kapp's common shares have increased in value by $200,000, the amount of the gift provided in the reorganization. As there is no corresponding increase in the adjusted cost base, this will create additional taxation for her, with no compensating benefit to Mr. Kapp.

TIF Solution Seventeen - 7

Part A - Gift Calculation

The fair market value of the common shares exchanged was $2,625,000 [(75%)($3,500,000)]. As this amount is equal to the $2,625,000 ($2,000,000 + $625,000) total of cash and preferred shares received, there is no gift to a related party.

Part B - PUC Of Preferred Shares

Since Mr. Martinez purchased the shares directly from Ms. Cruz, the paid up capital of the common shares remains at $465,000. The PUC of the preferred shares would be calculated as follows:

Increase In Legal Stated Capital		$2,000,000
Less The Excess, If Any, Of:		
PUC Of Common Shares [(75%)($465,000)]	($348,750)	
Over The Non-Share Consideration	625,000	Nil
PUC Reduction		$2,000,000
PUC Of Preferred Shares ($2,000,000 - $2,000,000)		Nil

Part C - Adjusted Cost Base Of Preferred Shares

The adjusted cost base of the preferred shares would be calculated as follows:

Adjusted Cost Base Of Common Shares [(75%)($1,340,000)]	$1,005,000
Non-Share Consideration	(625,000)
Adjusted Cost Base Of Preferred Shares	$ 380,000

Part D - Proceeds Of Redemption And Disposition For Common Shares

The Proceeds Of Redemption would be calculated as follows:

Non-Share Consideration	$625,000
PUC Of Preferred Shares	Nil
Proceeds Of Redemption [ITA 84(5)(d)]	$625,000

The Proceeds Of Disposition would be calculated as follows:

Adjusted Cost Base Of Preferred Shares	$ 380,000
Non-Share Consideration	625,000
Proceeds Of Disposition [ITA 86(1)(c)]	$1,005,000

Part E - Tax Consequences Of Sale And Exchange Of Shares

The sale of shares to his daughter would result in a taxable capital gain calculated as follows:

Proceeds Of Disposition	$875,000
Adjusted Cost Base [(25%)($1,340,000)]	(335,000)
Capital Gain	$540,000
Inclusion Rate	1/2
Taxable Capital Gain	$270,000

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The exchange of shares would have tax consequences as follows:

Proceeds Of Redemption	$625,000
PUC Of Common Shares [(75%)($465,000)]	(348,750)
ITA 84(3) Deemed Dividend (Non-Eligible)	$276,250

Proceeds Of Disposition	$1,005,000
ITA 84(3) Deemed Dividend	(276,250)
Adjusted Proceeds Of Disposition	$ 728,750
Adjusted Cost Base Of Common Shares [(75%)($1,340,000)]	(1,005,000)
Capital Loss	($ 276,250)
Inclusion Rate	1/2
Allowable Capital Loss	($ 138,125)

The overall tax consequences of the sale to his daughter and exchange of shares would be as follows:

Taxable Dividend [($276,250)(125%)]	$345,313
Net Taxable Capital Gain ($270,000 - $138,125)	131,875
Income Inclusion	$477,188

The deemed non-eligible dividend would qualify for a federal dividend tax credit of $46,042 [(2/3)($276,250)(25%)].

Part F - Tax Consequences Of Preferred Share Redemption

The tax consequences of the immediate redemption of the preferred shares would be as follows:

Proceeds Of Redemption	$2,000,000
PUC Of Preferred Shares	Nil
ITA 84(3) Deemed Dividend	$2,000,000

Proceeds Of Disposition	$2,000,000
ITA 84(3) Deemed Dividend	(2,000,000)
Adjusted Proceeds Of Disposition	Nil
Adjusted Cost Base Of Preferred Shares	(380,000)
Capital Loss	($ 380,000)
Inclusion Rate	1/2
Allowable Capital Loss	($ 190,000)

Assuming Mr. Martinez has no other taxable capital gains in the year, there is a net capital loss carry over of $58,125 ($270,000 - $138,125 - $190,000).

TIF Solution Seventeen - 8

Part A - After Tax Funds At Corporate Level

Taxable Income And Tax Payable

Tax Payable resulting from the sale of assets can be calculated as follows:

	Active Business Income	Taxable Capital Gains
Accounts Receivable ($195,000 - $215,000)	($20,000)	Nil
Land [(1/2)($193,875 - $132,000)]	Nil	$30,938
Recapture On Building ($550,000 - $492,000)	58,000	Nil
Goodwill [($56,250 - Nil)(1/2)]	28,125	Nil
Total Income	$66,125	$30,938
Tax Rates (Note)	16.0%	47.7%
Tax Payable	$10,580	$14,757

Note The tax rate on the active business income eligible for the small business deduction is 16 percent (38% - 10% - 17% + 5%). The rate for investment income [ITA 129(4) includes taxable capital gains in its definition of investment income] is 47.7 percent (38% - 10% + 6-2/3% + 13%). Pellerin Fabrication's income is either investment income or eligible for the small business deduction, neither of which qualify for the general rate reduction.

The total Taxable Income would be $97,063 ($66,125 + $30,938). Total Tax Payable would be $25,337 ($10,580 + $14,757).

Capital Dividend Account

The balance in the capital dividend account would be calculated as follows:

Opening Balance	$ 63,000
Addition From Sale Of Land	30,938
Addition From Sale Of Goodwill	28,125
Closing Balance	$122,063

RDTOH Balance

The balance in the RDTOH account would be calculated as follows:

Opening Balance	$31,000
Add: Least Of:	
• 26-2/3% Of Investment Income [(26-2/3%)($30,938)] = $8,250	
• 26-2/3% Of Taxable Income, Less Amount Eligible For Small Business Deduction [(26-2/3%)($97,063 - $66,125)] = $8,250	
• Part I Tax Payable* [(11%)($66,125)] + [(34.7%)($30,938)] = $18,009	8,250
Closing Balance	$39,250

*Federal Tax Only

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Funds Available For Distribution

Given the preceding calculation, the after tax funds available for distribution would be calculated as follows:

Purchase Price, Plus Cash ($984,000 + $50,000)	$1,034,000
Corporate Tax Payable ($10,580 + $14,757)	(25,337)
Balance Before Dividend Refund	$1,008,663
Dividend Refund (RDTOH Balance)	39,250
After Tax Distribution	$1,047,913

The dividend refund is equal to the balance in the RDTOH account. As will be shown in a subsequent calculation, the taxable dividends paid on the winding-up will be well in excess of the amount required to use the full balance in the RDTOH account.

Part B - After Tax Retention By Mr. Pellerin

Taxable Dividend

Assuming an election has been made to declare the maximum capital dividend, the taxable dividend component of the distribution can be analyzed as follows:

Total Distribution	$1,047,913
Paid Up Capital	(600,000)
ITA 84(2) Deemed Dividend	$ 447,913
Capital Dividend (Balance In Account)	(122,063)
Deemed Dividend Subject To Tax (Non-Eligible)	$ 325,850

For capital gains purposes, the redemption of shares that occurred as part of the winding-up would not have any tax effect. This is demonstrated by the following calculation:

Proceeds Of Redemption	$1,047,913
ITA 84(2) Deemed Dividend	(447,913)
Proceeds Of Disposition Under ITA 54	$ 600,000
Adjusted Cost Base	(600,000)
Capital Gain	Nil

Personal Tax Payable

The PUC amount, as well as the capital dividend, would be received by Mr. Pellerin on a tax free basis. Tax Payable on the deemed non-eligible dividend would be calculated as follows:

Deemed Dividend Subject To Tax	$325,850
Gross Up Of 25 Percent	81,463
Taxable Dividend	$407,313
Personal Tax Rate (29% + 14%)	43%
Tax Before Dividend Tax Credit	$175,145
Dividend Tax Credit [(2/3 + 1/3)($81,463)]	(81,463)
Personal Tax Payable	$ 93,682

After Tax Retention

Given the preceding calculations, the after tax cash available to Mr. Pellerin would be calculated as follows:

Total Distribution	$1,047,913
Personal Tax Payable	(93,682)
After Tax Cash Retained	$ 954,231

Chapter Eighteen Test Item File Solutions

TIF Solution Eighteen - 1

1. There is a deeming rule applicable to partnerships that requires that it calculate business and property income as if it was a person resident in Canada. Once these amounts are determined, the total is allocated to the members of the partnership as per the terms of the partnership agreement. As the partners are taxable entities (e.g., individuals and corporations) the allocated amounts will be included in their Net Income For Tax Purposes.

2. The three elements are:

   1. There must be two or more persons (taxable entities) involved.
   2. These persons must be carrying on a business.
   3. The business must be carried on with a view to making a profit.

3. The points that could be listed here include:

- the allocation of profits and losses;
- the filing of financial statements and income tax returns as a partnership;
- the mutual right of control for management of the enterprise;
- the location of partnership bank accounts;
- the rights and duties of the partners; and
- the registration of the partnership with the appropriate provincial jurisdiction.

4. The descriptions of the three basic types of partnerships are as follows:

   General Partnership In a general partnership, all partners have unlimited liability for partnership debts.

   Limited Partnership A limited partnership has at least one general partner who has unlimited liability for the debts of the partnership. Other partners, referred to as limited partners, are only responsible to the extent of their actual and promised contributions to the partnership.

   Limited Liability Partnership Members of limited liability partnerships have unlimited liability for most types of partnership debt. There is, however, an important exception. Members of limited liability partnerships are not personally liable for obligations arising from the wrongful or negligent action of:

   - their professional partners; or
   - the employees, agents or representatives of the partnership who are conducting partnership business.

5. Factors that could be listed here include:

- co-venturers contractually do not have the power to bind other co-venturers;
- co-venturers retain ownership of property contributed to the undertaking;
- co-venturers are not jointly and severally liable for debt of the undertaking;
- co-venturers share gross revenues, not profits; and
- while partnerships may be formed for the same purpose as a joint venture, they are usually of longer duration and involve more than a single undertaking.

6. Partnership income may include business income, property income (interest, dividends, rents), and/or capital gains. These amounts will be allocated to individual partners as the same types of income. This means that it will retain the tax rules associated with these types of income. For example:

   - When partnership dividends are allocated to partners, the allocated amounts will be subject to the usual gross up and tax credit procedures.
   - When partnership capital gains are allocated to partners, only one-half the allocated amount will be taxable.

7. The CRA does not permit the deduction of partner's salaries in the determination of Net Income For Tax Purposes at the partnership level. The partners' entitlements to salaries and wages will be considered as either a return of capital or a drawing against a partnership income figure that has been determined without the deduction of these salaries and wages.

8. Charitable contributions cannot be deducted by the partnership (corporate partners) or used for a credit against Tax Payable (individual partners). They are allocated to the individual partners on the basis of the partnership agreement.

9. The treatment of each of the items is as follows:

   Capital Contributions Capital contributions are added to the adjusted cost base of the partnership interest in the period in which they are made.

   Partner's Share Of Partnership Income Each partner's share of partnership income is added to the partner's adjusted cost base on the first day of the year following the year in which the income was earned by the partnership.

   Partner's Drawings Partner's drawings are deducted from the adjusted cost base of the partnership interest in the year in which they are made.

10. Stated simply, the at-risk rules are designed to ensure that a limited partner does not receive tax deductions or tax credits that exceed the amount that he has "at risk". In somewhat simplified terms, the "at risk" amount is the amount of the partner's actual investment.

TIF Solution Eighteen - 2

1. True.

2. False. A view towards making a profit is one of the basic partnership elements.

3. False. While members of a limited liability partnership are not liable for obligations related to the negligent action of their professional partners, they are liable for most other partnership obligations.

4. False. While a partnership must calculate income as if it was a separate person, partnerships do not file tax returns.

5. True.

6. False. Salaries paid to partners are considered to be drawings, not deductible expenses.

7. True.

8. False. Charitable donations are allocated to the partners on the basis of the partnership agreement.

9. True.

10. False. Unlike the situation with most capital assets, where "negative" balances must be taken into income, a negative partnership interest can be carried forward beyond the end of a taxation year.

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TIF Solution Eighteen - 3

1. A. One of the partners must be an individual.

2. B. Partners are jointly and severally liable for partnership debt and wrongful acts of other partners.

3. D. A partnership must calculate income as if it were a separate person resident in Canada.

4. B. General partners are a separate legal entity from the business.

5. A. Partners may be able to reduce their personal income taxes if the business has losses in the start-up years.

6. C. 3 and 4.

7. B. $152,000.

8. C. $78,400 [(40%)($123,000 + $42,000 + $11,000 + $3,000 + $17,000)]

9. A. Martin will include on his tax return:
   - taxable capital gains of [(30%)(1/2)($42,000)] $6,300
   - a federal dividend tax credit of [(30%)(2/3)(25%)($15,000)] $750
   - a charitable donations tax credit of {[30%][(15%)($200) + (29%)($6,000 - $200)]} $513.60

10. C. $231,000 {[50%][$490,000 + (25%)($32,000) - (1/2)($96,000) + $12,000]}.

11. A. The ACB of Joe's partnership interest is $23,000, calculated as follows:

Opening ACB	$59,000
Share Of Business Loss	(25,000)
Drawings	(10,000)
Charitable Donations	(1,000)
ACB At January 1, 2011	$23,000

12. A. $60,000 [$40,000 +(1/2)($60,000 + $10,000) - $15,000].

13. B. Her share of the grossed up dividends received by the partnership.

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TIF Solution Eighteen - 4

Exam Exercise Solution Eighteen - 1

Accounting Net Income	$164,500
Interest On Partners' Capital Accounts	6,150
Salaries To Partners	42,000
Partnership Income For Tax Purposes	$212,650

Note that the salaries paid to the spouses of the partners are deductible as they are based on the fair value of the services rendered.

Exam Exercise Solution Eighteen - 2

A. Deductible - CCA on depreciable partnership property is deductible.
B. Not Deductible - Donations to registered Canadian charities are flowed through to the individual partners.
C. Not Deductible - Taxes paid on foreign source income are flowed through to the individual partners.
D. Not Deductible - Drawings made by partners will reduce the ACB of their partnership interest.

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Exam Exercise Solution Eighteen - 3

Net Accounting Loss	($164,680)
Charitable Contributions	36,800
Personal Expenditures Of Partner	18,400
Rental Expenses	(27,600)
Partnership Loss For Tax Purposes	($137,080)

Exam Exercise Solution Eighteen - 4

The allocation would be as follows:

	Paul	Martin	Total
Guaranteed income allocation (salary)	Nil	$32,000	$32,000
Share of remainder ($49,500 - $32,000)	$8,750	8,750	17,500
Net allocations	$8,750	$40,750	$49,500

Exam Exercise Solution Eighteen - 5

Natasha and Felicia will each have a disposition of one-third of their partnership interests for $124,000. The adjusted cost base of each third is $49,600 [(1/3)($148,800)], so Natasha and Felicia will each have a $74,400 ($124,000 - $49,600) capital gain, of which one-half, or $37,200, will be a taxable capital gain.

The partner capital account transactions and ending balances will be:

	Natasha	Felicia	Kyra
Opening Capital Accounts	$148,800	$148,800	Nil
Adjustment For Kyra's Admission	(49,600)	(49,600)	$ 99,200
Ending Capital Accounts (Accounting Values)	$ 99,200	$ 99,200	$ 99,200
ACB Of Partnership Interest	$ 99,200	$ 99,200	$248,000

Exam Exercise Solution Eighteen - 6

The ACB of Roberta's partnership interest on December 31, 2010 and January 1, 2011 would be determined as follows:

Original Capital Contribution	$ 52,500
Additional Contribution [ITA 53(1)(e)]	30,240
Drawing	(16,800)
ACB - December 31, 2010	$ 65,940
Adjustment For 2010 Income [(40%)($48,720 + $13,020 + $196,140)]	103,152
ACB - January 1, 2011	$169,092

Roberta's inclusion in Net Income For Tax Purposes would be as follows:

Taxable Capital Gain [(1/2)($48,720)]	$ 24,360
Non-Eligible Dividends Received	13,020
Gross Up On Non-Eligible Dividends [(25%)($13,020)]	3,255
Net Business Income	196,140
Subtotal	$236,775
Roberta's Share Of Profits	40%
Inclusion In 2010 Net Income For Tax Purposes	$ 94,710

Note that this is not the same $103,152 that was added to the ACB of Roberta's partnership interest to reflect her share of 2010 partnership income. The dividends would qualify for a federal dividend tax credit of $868 [(40%)(2/3)$3,255)].

Exam Exercise Solution Eighteen - 7

ACB Of Partnership Interest		$235,000
Share Of Partnership Income For Current Period		Nil
Subtotal		$235,000
Amounts Owed To The Partnership	($173,000)	
Other Amounts Intended To Reduce Investment Risk (The General Partner Guarantee)	(62,000)	(235,000)
At-Risk Amount - December 31, 2010		Nil

As the at-risk amount is nil, none of the loss can be deducted in 2010. The limited partnership loss at the end of 2010 is 100 percent of the $81,400 loss allocation.

Exam Exercise Solution Eighteen - 8

Part A Martha is considered to have disposed of the land for $180,000, resulting in a $60,300 [(1/2)($180,000 - $59,400)] taxable capital gain. She is also considered to have made a capital contribution of $180,000 that will be added to the ACB of her partnership interest. HP will be considered to have acquired the land for $180,000.

Part B Martha will have the same $60,300 taxable capital gain as in Part A and HP will be considered to have acquired the land for $180,000. The capital contribution and the addition to the ACB of the partnership interest is $135,000. This is the difference between the fair market value of the land transferred to HP of $180,000 and the $45,000 in other consideration received by Martha on the property transfer.

Part C Martha will have the same $60,300 taxable capital gain as in Part A and HP will be considered to have acquired the land for $180,000. No capital contribution is made. As Martha withdrew $21,600 ($201,600 - $180,000) more from HP than she transferred in, Martha will be considered to have made a net withdrawal. The ACB of her partnership interest will be reduced by $21,600.

Exam Exercise Solution Eighteen - 9

ITA 98(2) deems Trident to have disposed of the debenture bonds for their fair market value of $611,750, resulting in a $44,000 ($611,750 - $567,750) capital gain. One-tenth of the capital gain, or $4,400, will be allocated to Lamar. One-half of this amount, or $2,200, will be a taxable capital gain that he will be required to include in his income for 2010. Lamar will also be considered to have acquired his share of the debenture bonds for $61,175.

The adjusted cost base of his partnership interest on December 31, 2010 and on January 1, 2011 is calculated as follows:

Adjusted Cost Base Prior To The Distribution	$75,800
Drawings	(61,175)
Adjusted Cost Base - December 31, 2010	$14,625
Allocated Capital Gain	4,400
Adjusted Cost Base - January 1, 2011	$19,025

Exam Exercise Solution Eighteen - 10

Using the ITA 85(1) rollover provision, the property would be transferred at the $146,000 ACB of the land. Given this, the transfer would not result in any current income for Sol. The cost of the land to the partnership would be the $146,000 elected value for the transfer. This same amount would be added to the adjusted cost base of Sol's partnership interest.

TIF Solution Eighteen - 5

For each term there is both a 100 percent correct answer and an answer that is close. We have indicated the "close answer" in brackets. This would allow you to mix terms from various chapters if you wish to do so.

The correct definitions for each of the listed key terms are as follows:

A. 9 (not 3)

B. 4 (not 10)

C. 5 (not 1)

D. 7 (not 2)

E. 8 (not 6)

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TIF Solution Eighteen - 6

Part A - Net Business Income

The calculation of net business income is as follows:

Net Income As Per The Income Statement		$ 76,000
Additions:		
Salary To Sally Leung	$ 45,000	
Charitable Donations	12,000	
Drawings By Partners ($198,000 + $203,000)	401,000	
Previous Year End Work-In-Process	83,000	541,000
		$617,000
Deductions:		
Dividends	($ 8,000)	
Capital Gain	(14,000)	
Current Year End Work-In-Process	(115,000)	(137,000)
Net Business Income		$480,000

Part B - Net Income For Tax Purposes

The additions to the Net Income For Tax Purposes for each of the sisters would be calculated as follows:

	Sally	Rose
Salary Allocation	$ 45,000	N/A
Business Income [(1/2)($480,000 - $45,000)]	217,500	217,500
Dividend Income [(1/2)(125%)($8,000)]	5,000	5,000
Taxable Capital Gain [(1/2)(1/2)($14,000)]	3,500	3,500
Addition To Net Income For Tax Purposes	$271,000	$226,000

Part C - Tax Credit Allocations

Each sister would be eligible for:

- a federal dividend tax credit of $667 [(1/2)(2/3)(25%)($8,000)], and
- a charitable donations tax credit of $1,712 [(15%)($200) + (29%)($6,000 - $200)].

TIF Solution Eighteen - 7

Adjusted Cost Base

The adjusted cost base of Sam Wesson's partnership interest on the date he withdrew from the partnership is as follows:

	Partnership	Share	ACB
Initial Capital Contribution	N/A		$185,000
Drawings From The Partnership	N/A		(84,000)
Additional Capital Contributions	N/A		23,000
Partnership Business Income	$312,000	1/3	104,000
Capital Gains (Note One)	33,000	1/3	11,000
Charitable Donations (Note Two)	(21,000)	1/3	(7,000)
January 1, 2011 Adjusted Cost Base			$232,000

Note One Only one-half of the capital gain is included in the partner's income on the flow through of capital gains realized by a partnership. However, the remaining one-half is included in the assets of the partnership and, in the absence of a special provision to deal with this situation, the realization of this amount would be added to any capital gain realized on the disposition of the partnership interest. ITA 53(1)(e)(i) provides such a provision, indicating that the full amount of any capital gains must be added to the ACB of a partnership interest.

Note Two Charitable donations cannot be deducted in the calculation of partnership income for tax purposes. Instead, they are allocated to the individual partners to be used by them as the basis for credits against their personal Tax Payable. Given this, ITA 53(2)(c)(iii) requires that these amounts be deducted from the ACB of the partnership interest.

Taxable Capital Gain On Disposition

Given the preceding calculation, the gain on the disposition of the partnership interest can be calculated as follows:

Proceeds Of Disposition		$326,000
Adjusted Cost Base:		
From Preceding Calculation	($232,000)	
Legal And Accounting Fees	(2,200)	(234,200)
Capital Gain		$ 91,800
Inclusion Rate		1/2
Taxable Capital Gain		$ 45,900

This amount would be included in Sam Wesson's Net Income For Tax Purposes for 2011 as a taxable capital gain. He would not include any partnership income for the period January 1 to February 1, 2011, as he was not allocated any of this income.

Chapter Nineteen Test Item File Solutions

TIF Solution Nineteen - 1

1. The roles of these persons can be described as follows:

   - The settlor is the person who contributes assets to the trust.
   - The trustee is the person who manages the trust. This would normally include the selection of investments as well as implementing other provisions of the trust agreement (e.g., distributions to beneficiaries).
   - A beneficiary is a person who will receive the capital or income benefits that are distributed by the trust.

2. As described in the CRA's *Trust Guide*, the three characteristics that must be established with certainty are:

   1. the intent on the part of the settlor to create a trust;
   2. the identity of the property to be placed in the trust; and
   3. the identity of the beneficiary or beneficiaries of the trust.

3. While there are several other possibilities, the ones that are described in the Chapter are as follows:

   Administration Of Assets A trust can be used to provide for administration of assets by someone other than the beneficiary.

   Protection From Creditors A trust can be used to protect assets from the claims of creditors.

   Privacy Assets that are in a trust when an individual dies, or placed in a testamentary trust as the result of the individual's death, are not subject to probate, a process where the results are available to the public.

   Avoiding Changes In Beneficiaries As trusts are difficult to change, placing assets in a trust ensures that they will ultimately be given to the intended beneficiaries.

4. The term testamentary trust refers to a trust that arises upon, and as a consequence of, the death of an individual. In contrast, an inter vivos trust refers to any personal trust other than a testamentary trust. Stated alternatively, an inter vivos (Latin for "among the living") trust is a trust created during the lifetime of the settlor.

   Tax Payable for a testamentary trust is calculated using the same schedule of graduated rates that is applicable to individuals. In contrast, all of the unallocated income of an inter vivos trust is taxed at the maximum federal rate for individuals of 29 percent.

5. For a trust to be classified as a qualifying spousal trust, the following conditions must be met:

   - The transferor's spouse is entitled to receive all of the income of the trust arising before the spouse or common-law partner's death.
   - No person other than the spouse may receive or benefit from any of the income or capital of the trust, prior to the death of the spouse or common-law partner.

   The major tax advantage of a spousal trust over other types of trusts is the fact that property can be transferred to this type of trust on a rollover basis. That is, the transfer will be recorded at tax values with no tax consequences accruing to the settlor.

   The two significant non-tax reasons for using a qualifying spousal trust are:

hnziea

- The trust can provide for the appropriate management of the transferred assets, particularly when these assets include an active business.
- The trust can ensure that the assets are distributed in the manner desired by the settlor. While qualification requires that the transferred assets must "vest indefeasibly" with the spouse, the trust document can specify who the assets should be distributed to after the spouse or common-law partner dies. This could ensure, for example, that the assets are ultimately distributed only to the settlor's children if the spouse has remarried.

6. The following conditions must be met in order to establish an alter ego trust:

- The settlor must be 65 years of age or over.
- The settlor is entitled to receive all of the income of the trust that arises during the settlor's lifetime.
- No person other than the settlor can receive or make use of the capital or income of the trust during the settlor's lifetime.

The major tax advantage of these arrangements is that assets can be transferred into such trusts on a tax free basis. An additional tax feature is the possibility of establishing the trust in a low tax rate province, thereby minimizing the taxes that will arise at the time of death.

With respect to the non-tax advantage of such arrangements, the basic feature is that the assets in the trust will not be part of the settlor's estate at the time of death. This means that these assets will not have to go through the probate process, a process that can be both costly and time consuming.

7. In general, ITA 107(2) provides a tax free rollover of trust assets to a capital beneficiary. That is, the proceeds to the trust are deemed to be the trust's tax cost (i.e., adjusted cost base or UCC), with this amount also being recorded by the recipient beneficiary. The major exceptions to this rollover are as follows:

- Transfers from a qualifying spousal or common-law partner trust to anyone other than a spouse or common-law partner.
- Transfers from an alter ego trust to anyone other than the individual who settled the trust.
- Transfers from a joint spousal or common-law partner trust to anyone other than the settlor or the spouse or common-law partner.

In the case of these exceptions, the transfer will be recorded by the trust and the beneficiary at fair market value, usually resulting in a gain or loss in the trust.

8. The text describes three reasons for making such a designation:

Lower Rates In the case of a testamentary trust that pays taxes at graduated rates, the trust may have a lower marginal tax rate than the beneficiary. In addition, if the trust has no other source of Taxable Income, there will be no Tax Payable on the first $49,445 of eligible dividends if alternative minimum tax is not considered.

Instalment Avoidance Trusts are generally not required to make instalment payments.

Use Of Trust Losses A trust cannot allocate losses to beneficiaries. This means that the only way that an unused current year trust loss can be used is through a carry over to another year. With many trusts, this cannot happen under normal circumstances because they are required to distribute all of their income to beneficiaries, resulting in a nil Net Income For Tax Purposes. A solution to this problem is to designate sufficient income as having not been paid to absorb the loss carry forward. This can satisfy the legal requirement to distribute the income, while simultaneously creating sufficent Net Income For Tax Purposes to absorb the loss carry forward.

9. The earnings paid to Mrs. Barret will be taxed in her hands in the year paid and will be deductible to the trust.

   Any amounts that are paid directly to the children, or to third parties for the benefit of the children, will be deductible to the trust and should be reported as income of the children in the year the payment or benefit is received.

   The earnings that are accumulating in the trust for the benefit of the children will be taxed in the trust using the same schedule of progressive rates that is applicable to individuals.

10. In general, distributions to beneficiaries are deductions in the determination of a trust's Taxable Income. However, ITA 104(6)(b)(iv) prevents a SIFT trust from deducting its non-portfolio earnings in the determination of its Taxable Income. Tax is assessed on these non-portfolio earnings at the trust level.

    For 2010, it is assessed at a federal rate of 18 percent. This is based on the basic corporate rate of 38 percent, less the 10 percent federal abatement, less the 10 percent general rate reduction. To this rate is added a provincial SIFT factor which varies depending on the province(s) where the SIFT trust has permanent establishments.

    When the after tax balance is distributed to unitholders, ITA 104(16) deems this amount to be a dividend that is eligible for the enhanced dividend gross up and tax credit procedures.

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TIF Solution Nineteen - 2

1. False. While the identity of the beneficiaries is an essential characteristic, their respective income allocations is not.

2. True.

3. False. An alter ego trust can only be established by a living individual.

4. True. While there is a further condition for qualification as a spousal trust, the statement that this is a requirement is true.

5. False. The term "discretionary" is a non-technical term that is popularly used to describe a trust where the trustees have discretion with respect to the amounts that will be paid to each beneficiary, the timing of the payments, or both.

6. True.

7. False. The preferred beneficiary election can only be made for individuals who are either eligible for the disability tax credit or, alternatively, are eligible to be claimed by another individual as an infirm dependant 18 years or older.

8. True.

9. False. They are taxed at a flat rate of 29 percent.

10. False. Both income and capital gains will be attributed back to the spouse who is the settlor.

11. True.

12. False. For 2010, the earnings from non-portfolio properties will be taxed at the federal corporate rate of 18.0 percent, plus an additional percentage that varies with the province where the SIFT has permanent establishments.

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TIF Solution Nineteen - 3

1. B. The individual beneficiaries must be named. Naming individual beneficiaries is not necessary as long as the beneficiaries are members of an identifiable group (e.g., the settlor's children).

2. B. The trust return is due 90 days after the trust's year end.

3. C. The difference between the fair market value and the cost of assets transferred to a capital beneficiary. While there are some exceptions to this, such transfers are recorded at tax values and do not generate any income for the trust.

4. A. Losses incurred on the disposition of trust capital property.

5. C. $16,400. This would be calculated as follows:

Dividends Received	$20,000
Gross-Up On Dividends [($20,000)(44%)]	8,800
Interest Income ($10,000 - $5,000)	5,000
Interest Expense	(1,000)
Taxable Income - Trust	$32,800
Mrs. Allen's Percentage	50%
Taxable Income - Mrs. Allen	$16,400

6. C. A trust can be used to avoid the income attribution rules applicable to a spouse. In general, it is not possible to avoid the income attribution rules by transferring assets to a trust in favour of a spouse.

7. D. An alter ego trust.

8. B. The settlor must be 65 years of age or older. There is no age requirement for the settlor.

9. D. When assets are transferred out of an alter ego trust to anyone other than the settlor, the proceeds of disposition to the trust will be the fair market value of the assets transferred.

10. A. Any income and capital gains earned by the trust and allocated to the beneficiaries will be attributed back to the individual. Capital gains are not subject to attribution in this situation.

11. D. A holding of 100 shares of Royal Bank of Canada.

12. A. Income allocated to the partners will not be eligible for dividend gross up and tax credit procedures.

Sample

TIF Solution Nineteen - 4

Exam Exercise Solution Nineteen - 1

Case A While Martin has signed the agreement, it does not appear that the property has been transferred. This means that no trust has been created.

Case B "Prison inmates in Virginia" cannot be considered to be an identifiable class. As a consequence, there is no certainty as to beneficiaries and no trust would be created by her transfer.

Case C While Ms. Morgan has transferred property, it is not clear that her intention was to create a trust. No trust would be created by this transfer.

Exam Exercise Solution Nineteen - 2

With respect to Jerry's transfer of his securities to the trust, the transaction would be deemed to take place at fair market value. This would result in a taxable capital gain to Jerry of $25,000 [(1/2)($570,000 - $520,000)]. There would be no tax consequences to James or the trust as a result of this transfer.

As the trust distributed all of its income during the year, none of the interest would be taxed in the trust. All of the interest would be included in James' income and, because he is an adult, there would be no income attribution to Jerry.

Under ITA 107(2), the transfer from the trust to James on January 1, 2011 would take place at the trust's tax cost of $570,000. There would be no tax consequences for Jerry, James, or the trust as a result of this transfer. However, as James' adjusted cost base is $570,000, the sale at the fair market value of $615,000 would result in a taxable capital gain of $22,500 [(1/2)($615,000 - $570,000)].

Exam Exercise Solution Nineteen - 3

As there is a rollover available on transfers to a qualifying common-law partner trust, the accrued $303,000 gain ($723,000 - $420,000) will not be recognized until his common-law partner or the common-law partner trust eventually disposes of the portfolio. The common-law partner trust acquires the portfolio at an adjusted cost base of $420,000, which will be David's adjusted cost base if the trust transfers the portfolio to him.

Exam Exercise Solution Nineteen - 4

Scenario	Taxable Capital Gain (Settlor)	Adjusted Cost Base (Trust)
1. Inter vivos trust for adult child	$200	$2,500
2. Inter vivos trust for minor child	200	2,500
3. Testamentary trust for friend	200	2,500
4. Inter vivos spousal trust	Nil	2,100
5. Testamentary spousal trust	Nil	2,100
6. Joint common-law partner trust	Nil	2,100
7. Alter ego trust	Nil	2,100

Exam Exercise Solution Nineteen - 5

Transfer At Death Because of the available rollover to a qualifying spousal trust, the trust will be deemed to have acquired the depreciable asset at a capital cost of $224,000 and UCC of $147,200. The $76,800 difference between the capital cost and the UCC would be deemed to be CCA. The fair market value at Mark's death is not relevant to the transfer.

Sale By Trust The tax consequences of the sale by the trust would be calculated as follows:

Proceeds Of Disposition	$243,200
Capital Cost	(224,000)
Capital Gain	$ 19,200
Inclusion Rate	1/2
Taxable Capital Gain	$ 9,600

Capital Cost	$224,000
UCC At Sale ($147,200 - $19,200)	(128,000)
Recapture Of CCA	$ 96,000

All of the income from the sale can be allocated to Mark's spouse. This would be the taxable capital gain of $9,600 and the recaptured CCA of $96,000. As a result, the trust would have nil Tax Payable.

Exam Exercise Solution Nineteen - 6

The income allocation would be as follows:

	Received By Trust	Paid To Francine	Retained By Trust
Eligible Dividends	$367,000	$210,000	$157,000
Non-Eligible Dividends From CCPC	108,000	108,000	Nil
Capital Gain	47,000	47,000	Nil
Totals	$522,000	$365,000	$157,000

The Net Income For Tax Purposes of the trust would be calculated as follows:

Eligible Dividends	$157,000
Gross Up Of Eligible Dividends At 44 Percent	69,080
Net Income For Tax Purposes - Trust	$226,080

The Net Income For Tax Purposes for Francine would be as follows:

Eligible Dividends From Canadian Corporations	$210,000
Gross Up At 44 Percent	92,400
Non-Eligible Dividends From CCPC	108,000
Gross Up At 25 Percent	27,000
Taxable Capital Gains [(1/2)($47,000)]	23,500
Net Income For Tax Purposes - Francine	$460,900

The dividend tax credit that will be available to the trust is $40,635 [(10/17)($69,080)]. Francine's dividend tax credits will be $54,353 [(10/17)($92,400)] on the eligible dividends and $18,000 [(2/3)($27,000)] on the non-eligible amounts.

Exam Exercise Solution Nineteen - 7

Taxable Income and federal Tax Payable for the trust would be calculated as follows:

Non-Eligible Dividends Received	$38,000
Deduction For Distribution To Beneficiary	(24,500)
Net Dividend Income	$13,500
Dividend Gross Up (25 Percent)	3,375
Taxable Income For The Trust	$16,875
Federal Tax Rate (Inter Vivos Trust)	29%
Federal Tax Before Credits	$ 4,894
Federal Dividend Tax Credit [(2/3)($3,375)]	(2,250)
Federal Tax Payable - Trust	$ 2,644

Taxable Income and federal Tax Payable for the son would be calculated as follows:

Non-Eligible Dividend Income From The Trust	$24,500
Dividend Gross Up (25 Percent)	6,125
Taxable Income For The Son	$30,625
Federal Tax Rate	15%
Federal Tax Before Credits	$ 4,594
Basic Personal Credit [(15%)($10,382)]	(1,557)
Federal Dividend Tax Credit [(2/3)($6,125)]	(4,083)
Federal Tax Payable - Son	Nil

Although not required by the Exercise, note that, if all of the dividends had been distributed to the son, his tax liability would have still been nil. By leaving $13,500 in dividends in the trust, $2,644 in avoidable taxes were paid.

Exam Exercise Solution Nineteen - 8

Income on the bonds is subject to the attribution rules to the extent that the income is allocated to Martine's spouse, Michael, or to their minor daughter, Rachel. This means that two-thirds of the interest will be attributed back to Martine. With respect to the capital gain, the attribution rules do not apply on transfers to minors. This means that only Michael's one-third share of the gain will be attributed back to Martine.

	Michael	Rachel	Dirk
Interest Income ($108,000 ÷ 3)	$36,000	$36,000	$36,000
Taxable Capital Gain ($18,000 ÷ 3)	6,000	6,000	6,000
Interest Attribution To Martine	(36,000)	(36,000)	Nil
Capital Gain Attribution To Martine	(6,000)	Nil	Nil
Allocated Trust Income	Nil	$6,000	$42,000

The total amount attributed to Martine would be $78,000 ($36,000 + $36,000 + $6,000).

Exam Exercise Solution Nineteen - 9

The dividend income is subject to the attribution rules to the extent that the income is allocated to Devon's spouse, Connie, and to their minor son, Marvin. This means that two-thirds of the dividends, along with the related gross up, will be attributed back to Devon. As well, Connie's share of the taxable capital gain is attributed back to Devon. The income allocations are as follows:

	Connie	Marvin	Diane
Eligible Dividends ($72,900 ÷ 3)	$24,300	$24,300	$24,300
Dividend Gross Up At 44 Percent	10,692	10,692	10,692
Taxable Capital Gain ($8,100 ÷ 3)	2,700	2,700	2,700
Dividend Attribution To Devon	(24,300)	(24,300)	Nil
Gross Up Attribution To Devon	(10,692)	(10,692)	Nil
Capital Gain Attribution To Devon	(2,700)	Nil	Nil
Allocated Trust Income	Nil	$ 2,700	$37,692

The allocations of trust income are as follows:

Attributed Back To Devon {[(144%)(2)($24,300)] + $2,700}	$72,684
Connie	Nil
Marvin	2,700
Diane	37,692
Total Allocation	$113,076

This total allocation is equal to the income of the trust of $113,076 [(144%)($72,900) + $8,100].

Exam Exercise Solution Nineteen - 10

With respect to Sarah, she has acquired a capital interest for consideration of $204,500. This will be the adjusted cost base of the interest she has acquired.

With respect to Mary, she has disposed of a capital asset for proceeds of disposition of $204,500. Since she did not purchase the interest in the trust, her adjusted cost base as usually determined would be nil. However, for this disposition, the adjusted cost base of the capital interest is the greater of nil and the cost amount as determined under ITA 108(1). The cost amount would be $156,000, one-half of the $312,000 tax cost of the assets in the trust. The result would be a taxable capital gain of $24,250 [(1/2)($204,500 - $156,000)].

Exam Exercise Solution Nineteen - 11

As Fred's other income places him in the maximum federal tax bracket of 29 percent, his tax savings resulting from transferring the assets to the family trust would be $43,500 [($150,000)(29%)]. The federal tax that would be payable on the additional $50,000 received by each of the triplets is as follows:

Tax On First $40,970	$6,146
Tax On Additional $9,030 ($50,000 - $40,970) At 22 Percent	1,987
Tax Before Credit	$8,133
Personal Credit [(15%)($10,382)]	(1,557)
Federal Tax Payable	$6,576

The total tax paid by the triplets would be $19,728 [($6,576)(3)]. This is $23,772 ($43,500 - $19,728) per year less in federal taxes than the amount that would be paid by Fred without the trust. The alternative minimum tax is not relevant because the income is in the form of interest, not dividends.

TIF Solution Nineteen - 5

For each term there is both a 100 percent correct answer and an answer that is close. We have indicated the "close answer" in brackets. This would allow you to mix terms from various chapters if you wish to do so.

The correct definitions for each of the listed key terms are as follows:

A. 3 (not 7)

B. 5 (not 6)

C. 10 (not 2)

D. 1 (not 9)

E. 8 (not 4)

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TIF Solution Nineteen - 6

Calculations

Taxable Income for the trust and for Mark would be calculated as follows:

	Trust	Mark
Interest Income	Nil	$18,500
Taxable Capital Gains:		
[($43,000)(1/2)(20%)]	$ 4,300	
[($43,000)(1/2)(80%)]		17,200
Eligible Dividends Received:		
[($32,000)(20%)]	6,400	
[($32,000)(80%)]		25,600
Gross Up On Dividends:		
[($32,000)(44%)(20%)]	2,816	
[($32,000)(44%)(80%)]		11,264
Net Rental Income:		
[($19,500)(20%)]	3,900	
[($19,500)(80%)]		15,600
Taxable Income	$17,416	$88,164

The Tax Payable for the trust would be calculated as follows:

Taxable Income	$17,416
Federal Tax Rate (Inter Vivos Trust)	29%
Federal Tax Payable Before Dividend Tax Credit	$ 5,051
Dividend Tax Credit [(10/17)($2,816)]	(1,656)
Federal Tax Payable - Trust	$ 3,395

The Tax Payable for Mark would be calculated as follows:

Tax On First $81,941		$15,160
Tax On Excess $6,223 At 26 Percent		1,618
Federal Tax Before Credits		$16,778
Tax Credits:		
Personal	$10,382	
Tuition	12,500	
Education [($400)(12)]	4,800	
Textbook [($65)(12)]	780	
	$28,462	
Rate	15%	(4,269)
Dividend Tax Credit [(10/17)($11,264)]		(6,626)
Federal Tax Payable - Mark		$ 5,883

Comment

The $17,416 of income that was retained in the trust was taxed at a federal rate of 29 percent, before consideration of the dividend tax credit. If the income had been distributed to Mark, it would have been taxed at 26 percent, resulting in a $522 [($17,416)(29% - 26%)] reduction in federal Tax Payable. Based on tax considerations only, retention of the income in the trust was not advantageous.

TIF Solution Nineteen - 7

Part A - Taxable Income For The Trust And Its Beneficiaries

The allocations required by the trust agreement are as follows:

	Son (20%)	Daughter (40%)	Trust (40%)
Canadian Dividends Received	$11,600	$23,200	$23,200
Gross Up Of 44 Percent	5,104	10,208	10,208
U.S. Interest (Gross Amount Of $13,000)	2,600	5,200	5,200
Net Rental Income ($76,000)	15,200	30,400	30,400
Net And Taxable Income	$34,504	$69,008	$69,008
U.S. Tax Paid ($1,300)	$ 260	$ 520	$ 520

Part B - Federal Tax Payable For The Trust

Income that remains in a testamentary trust is taxed in the same general manner as would be applicable to an individual. However, the trust would not be able to use personal tax credits under ITA 118 to reduce the amount of Tax Payable.

Federal Tax Payable for the trust would be calculated as follows:

Federal Tax On First $40,970	$ 6,146
Tax On Excess $28,038 At 22 Percent	6,168
Federal Tax Payable Before Credits	$12,314
Federal Dividend Tax Credit [(10/17)($10,208)]	(6,005)
Foreign Tax Credit (See Note)	(520)
Federal Tax Payable	$ 5,789

Note The amount that can be deducted for the foreign tax credit is the lesser of the amount of foreign taxes withheld and an amount determined by the following formula:

[(Foreign Non-Business Income ÷ Adjusted Net Income)(Tax Payable Before Credits)]

= ($5,200 ÷ $69,008)($12,314)

= $928

As this amount is more than the actual foreign taxes withheld of $520 that were allocated to the trust, the actual foreign taxes paid would be the lesser amount, and would be the foreign tax credit.

Not Required

You might also note that, if the foreign taxes had exceeded 15 percent of the gross amount of foreign income, the excess would have been available as a deduction under ITA 20(11), rather than as an additional amount of tax credit.

Chapter Twenty Test Item File Solutions

TIF Solution Twenty - 1

1. As stated in IT-221R3, the primary factors that will be considered by the CRA are as follows:

   - Whether the individual is continuing to maintain a dwelling in Canada.
   - Whether the spouse or common-law partner of the individual remains in Canada.
   - Whether the individual has dependants who remain in Canada.

2. If an enterprise is incorporated in Canada after April 26, 1965, it will always be considered resident in Canada. However, if it is incorporated prior to April 27, 1965, it will only be considered resident in Canada in those situations where it either:

   - carried on business in Canada at any time after that date; or
   - was resident in Canada at any time after that date (as measured by the location of the mind and management of the corporation).

3. The main factors here would be:

   - Does the individual have a dwelling in Canada?
   - Does the individual's spouse or common-law partner live in Canada?
   - Do the dependants of the individual live in Canada?

   Other factors that could be mentioned include:

   - Owning personal property in Canada (such as furniture, clothing, automobiles, and recreational vehicles).
   - Social ties with Canada (such as memberships in Canadian recreational and religious organizations).
   - Economic ties with Canada (such as employment with a Canadian employer and active involvement in a Canadian business, and Canadian bank accounts, retirement savings plans, credit cards, and securities accounts).
   - Hospitalization and medical insurance coverage from a province or territory of Canada.
   - A driver's license from a province or territory of Canada.
   - A vehicle registered in a province or territory of Canada.
   - A seasonal dwelling place in Canada or a leased dwelling place.
   - Holding a Canadian passport.
   - Membership in Canadian unions or professional organizations.

4. A Canadian resident normally becomes a non-resident on the latest of the following days:

   - on leaving Canada,
   - when a spouse and/or dependants leave Canada, and
   - on becoming a resident of another country.

5. The most common reason for making this election would be a situation in which the individual has capital losses. This could be either net capital losses from previous years, or losses resulting from required deemed dispositions on departure. In this situation, the taxpayer may wish to trigger a gain on real estate that can be used to absorb these losses.

6. An individual immigrating to Canada may own capital property on which there are accrued capital gains. If there was no deemed disposition/reacquisition at the time the individual enters Canada, a subsequent sale of property could result in tax being assessed on gains that accrued prior to the individual becoming a resident of Canada. This would not appear to be an equitable situation.

7. Because Canadian corporations generally pay dividends out of income that has been subject to Canadian taxation at the corporate level, dividends received by Canadian residents from taxable Canadian corporations are given favourable tax treatment. This favourable tax treatment, based on gross up and tax credit procedures, significantly reduces the effective tax rate on this type of income.

   When dividends are received from non-resident corporations, this favourable treatment cannot be justified. The reason for this is that the non-resident corporation that paid the dividends has not paid Canadian taxes on the income that is the source of the dividends.

8. **Controlled Foreign Affiliates** Whether the resident Canadian shareholder is an individual or a corporation, Foreign Accrual Property Income (FAPI) that is earned by a Controlled Foreign Affiliate must be included in income on an accrual basis as it is earned. When these amounts are subsequently paid out as dividends they will be included in the income of the Canadian shareholder but will be eligible for an offsetting deduction to recognize the fact that the amount was previously taxed as FAPI. If the dividend is paid from non-FAPI sources of income, it will be included in income, but, in the case of Canadian corporate shareholders, may be completely or partially offset by the ITA 113(1) deduction from Taxable Income depending upon whether Canada has entered into a tax treaty or Tax Exchange Information Agreement (TEIA) with the source country. Canadian individual shareholders would obtain partial relief through the foreign tax credit system only, since they are not entitled to the ITA 113(1) deduction. This generally encourages individuals to hold shares in foreign corporations through a resident Canadian corporation.

   Non-Controlled Foreign Affiliates The income of Foreign Affiliates that are not controlled will not be accrued as it is earned. Rather, it is included in income when dividends are received from the Foreign Affiliate. If the dividend is paid from active business income earned in a country with which Canada has a tax treaty or TEIA, it will be eliminated by the ITA 113(1) deduction in the calculation of Taxable Income. In addition, dividends paid out of the non-taxable portion of some types of capital gains, or the full amount of capital gains resulting from dispositions of property used in an active business in a country with which Canada has a tax treaty or TEIA, are deductible under ITA 113(1). When the ITA 113(1) deduction is available, no credit can be taken for any foreign taxes paid.

   Alternatively, if the dividend is paid out of passive income, or earned in a non-treaty/non-TEIA country, it will be included in income and only be eligible for deductions under ITA 113 to the extent income taxes or withholding taxes have been paid on the amounts distributed.

9. An FIE is defined in the proposed ITA 94.1(1) as a subset of non-resident entities. In somewhat simplified terms, an FIE is any non-resident entity, unless at the end of its taxation year:

   - it is a partnership;
   - it is an exempt non-resident trust (largely those organized for non-profit objectives);
   - the carrying value of its investment property does not exceed one-half the carrying value of all of its property; or
   - the principal business is not an investment business.

   If a non-resident entity is considered to be an FIE and it is not an exempt interest, the taxpayer holding this interest will have to include an arbitrarily determined inclusion in Taxable Income each year. The basic method for determining this inclusion involves an application of the ITR 4301 prescribed rate. The prescribed rate, adjusted quarterly, plus 2 percent (this is the rate applicable to amounts owed by the CRA) is applied to the designated cost of the FIE.

10. If the Canadian company undertakes to deliver the goods and provide the services required in the contract, the total profit will be taxed at full Canadian rates. This reflects the fact that Canadian corporations are taxed on their worldwide income. However, tax credits for any foreign taxes paid on that income would be available to Clarkson Equipment Ltd.

    If a separate subsidiary is established in the African country, the subsidiary can purchase the required manufactured items from Clarkson and potentially resell them at a profit. Additional profits could be engendered through the training operations. Any profits will be active business income and will not be deemed Foreign Accrual Property Income (FAPI). This means that there will be no Canadian taxation until such time as the earnings are repatriated into Canada and are paid as dividends to individual shareholders. If the corporate tax rates in the African country are lower than Canadian rates, forming the subsidiary may be advantageous.

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TIF Solution Twenty - 2

1. False. Whether the individual continues to maintain social ties is not one of the three most significant factors.

2. False. The length of the period of absence from Canada is not considered a factor in determining residency retention.

3. True. A part year resident for the current year is an individual who either establishes residency in Canada during the current year or, alternatively, terminates residency in Canada during the current year.

4. False. The 183 days do not have to be consecutive.

5. False. Such children are only deemed residents if they are also dependants of the member of the Canadian armed forces.

6. False. The corporation does not have to be incorporated in Canada to be a Canadian resident.

7. True. For residents of countries with which Canada has a tax treaty, the international tax treaty overrides the Canadian *Income Tax Act*.

8. True. However, the Canada/U.S. tax treaty does provide two exceptions.

9. False. In general, such income is taxable in Canada as mining is deemed to be carrying on a business in Canada.

10. True.

11. False. Such facilities are not considered to be permanent establishments under the provisions of the Canada/U.S. tax treaty.

12. False. Only gains on dispositions of taxable Canadian property fall under ITA 2(3).

13. True.

14. False. Certain types of interest (e.g., interest on Canadian federal or provincial government bonds) are exempt from Part XIII tax.

15. True. The rate applicable to U.S. residents is reduced to either 5 percent when the U.S. resident owns 10 percent or more of the voting shares, or to 15 percent in other situations.

16. True. This rule prevents Canadian taxation of capital gains that accrued while the immigrant was not a Canadian resident.

17. False. Regardless of other actions, there is a deemed disposition/reacquisition of most capital property which will usually result in various income inclusions.

18. False. This concept includes not just corporations but, in addition, any other type of entity that could be used for investment purposes.

19. False. In addition to the 1 percent requirement, the aggregate equity percentage of the taxpayer and persons related to the taxpayer must be at least 10 percent.

20. True.

TIF Solution Twenty - 3

1. A. Sam Jackle, a Canadian citizen who has lived in Barbados for the last fifteen years.

2. D. She did not leave taxable Canadian property in Canada.

3. B. It appears Karen has severed all ties with Canada.

4. D. The Company was incorporated in the U.S. and it appears that the mind and management of the Company is currently in the U.S.

5. C. An individual who immigrates to Canada during the year is a resident of Canada for tax purposes for the full calendar year.

6. B. Bob, Charles, and Dick.

7. A. To be a resident for tax purposes, an individual must be a Canadian citizen.

8. C. Norad Inc. was incorporated in New York state on March 1, 1985 and, until the end of 1993, carried on business in Canada. At that time, all of the management and operations of the Company moved to the southern United States.

9. A. The country in which the individual earns business income.

10. D. The individual has given up his Canadian citizenship in order to become a citizen of another country.

11. C. Mr. O'Shea will be subject to Canadian Part I tax.

12. C. Interest on Government of Canada bonds.

13. B. Interest on a GIC issued by a Canadian bank.

14. D. Merivale is subject to Canadian tax on the income that is earned by the Calgary office.

15. A. The gross rents are subject to withholding under Part XIII of the *Income Tax Act*. However, the taxpayer can elect to file a Canadian tax return which will include the net rental income.

16. A. Mr. Winsome will be deemed to have disposed of his mutual funds, sailboat, TNX Co. shares, and Bell Canada shares on December 15, 2010.

17. B. Land and building that is being used as a rental property.

18. C. There will be no tax consequences at the time of departure. However, any withdrawals from the plan after his departure will be subject to Canadian Part XIII tax.

19. B. There would be an allowable capital loss of $20,000.

20. D. The gross amount received, prior to the deduction of any Italian taxes withheld, will be taxable in Canada. Maria will receive a Canadian tax credit for the Italian taxes paid.

21. D. All of the above.

22. C. A controlled foreign affiliate is not considered to be an FIE.

TIF Solution Twenty - 4

Exam Exercise Solution Twenty - 1

In retaining his residence, he has maintained one of the primary residential ties. However, the fact that he was not able to sell the property, accompanied by the long-term lease to a third party, would probably be sufficient evidence that this is not a significant residential tie. The retention of his membership in the Certified General Accountants Association of Alberta would be viewed as a secondary residential tie. However, it is unlikely that this tie would be sufficient to cause Mr. Resner to be viewed as a Canadian resident.

Exam Exercise Solution Twenty - 2

Mary did, in fact, sever most of her residential ties with Canada. This would suggest that she would not be considered a Canadian resident during the two years she worked in New York City. However, the fact that she returned frequently to visit her boyfriend might lead the CRA to assess her on the basis of being a Canadian resident during this period. However, it is not clear that such an assessment would be successful.

Exam Exercise Solution Twenty - 3

Melissa would be taxed on her worldwide income for the part of the year that she was resident in Canada. This would be the period January 1 through July 1, the date that her husband and children fly to the U.S. July 1 would be the latest of the dates that Melissa leaves Canada (March 15), the date that Melissa establishes U.S. residency (March 15), and the date that her husband and children depart Canada (July 1). It is unlikely that the fact that her house was not sold until a later date would influence her residence status.

Exam Exercise Solution Twenty - 4

Under ITA 250(1)(c)(i), Mrs. Sothor would be a deemed Canadian resident because of her position as a Canadian ambassador. As her husband is exempt from Tanzanian taxation due to his relationship to a deemed resident, he is a deemed resident of Canada under ITA 250(1)(g). Of her two children, the younger son would be a deemed resident under ITA 250(1)(f) as he is a Canadian ambassador's dependent child. However, the older son would not be a deemed resident because his income exceeds the base for the basic personal tax credit for 2010 of $10,382 and he would therefore not be considered a dependant.

Exam Exercise Solution Twenty - 5

While Ms. Washton is the child of a Canadian High Commissioner, it appears that she is no longer a dependant of this individual. It would also appear that she has income in excess of the base for the basic personal tax credit for 2010 of $10,382. As a consequence, she would not be considered a deemed resident under ITA 250(1).

Exam Exercise Solution Twenty - 6

As the Company was incorporated in Canada after April 26, 1965, it would be deemed to be a Canadian resident under ITA 250(4).

Exam Exercise Solution Twenty - 7

As Wolfhowl Ltd. was incorporated in Canada prior to April 27, 1965, it will only be considered to be a Canadian resident if it has carried on business in Canada or become a Canadian resident subsequent to April 26, 1965. As the director's meetings were held in Canada until 1971, this would suggest that the "mind and management" of the Company was in Canada during this period. This would make the Company a Canadian resident subsequent to April 26, 1965 and, despite the fact that the director's meetings are no longer held in Canada, the Company would continue to be a Canadian resident under ITA 250(4).

Exam Exercise Solution Twenty - 8

She is not correct. Under ITA 2(3) she would be subject to Canadian taxes on employment income earned in Canada. There would be an exception to this if:

- the amount was less than $10,000, or
- if she was in Canada for less than 183 days in any 12 month period beginning or ending in the current year and the employer was not a Canadian resident in a position to deduct the payments.

As neither of these exceptions apply, Michelle would be subject to Canadian taxes.

Exam Exercise Solution Twenty - 9

Case 1 The employment income is taxable in Canada. The Canada/U.S. tax treaty allows Canada to tax employment income earned in Canada unless either of two exceptions is applicable.

The first exception is the $10,000 rule. This exception however does not apply since Mary earned $13,300 Canadian in 2010 [($2,660)(5 months)].

The second exception is the 183 day rule. Although Mary was in Canada for only 153 days during 2010 and therefore met the first part of the test, she failed the remaining part of the test since the employer was a Canadian resident and could deduct the payments.

Case 2 The employment income is not taxable in Canada. The 183 day rule exempts the income from Canadian taxation because the employer was not resident in Canada, nor had a permanent establishment in Canada, and could not deduct the payments.

Case 3 The employment income is taxable in Canada. The Canada/U.S. tax treaty would exempt the income from Canadian tax if the amount was less than $10,000 Canadian, or if Bill spent less than 183 days in Canada. As he earned $53,000 Canadian and spent 217 days at his job in Canada, neither of these exceptions are applicable.

Exam Exercise Solution Twenty - 10

Case 1 Rawlings is not carrying on business in Canada and would not be subject to Canadian taxes.

Case 2 The tax treaty allows Canada to tax business income only if such income is attributable to a permanent establishment in Canada. The warehouse constitutes a fixed place of business regardless of whether it is owned or leased. However, since it appears to be used exclusively to maintain an inventory for delivery, it would be an excluded activity and would therefore not be considered to be a permanent establishment. Rawlings would not be taxable under ITA 2(3) on its Canadian profits.

Case 3 In this Case, because the employee has authority to conclude contracts on behalf of a non-resident enterprise, the employee is deemed to be a permanent establishment. This means that Rawlings is taxable in Canada under ITA 2(3) on its business profits attributable to the permanent establishment.

Exam Exercise Solution Twenty - 11

Case 1 Anne is taxable on the gain. The condo is taxable Canadian property since it is real property (e.g. land and buildings) situated in Canada. The Canada/U.S. tax treaty gives Canada the right to tax such gains. The property is not exempt from Canadian tax as a principal residence since Anne did not acquire the condo for her own habitation.

Case 2 Anne would be taxable on the gain on the shares. Shares of an unlisted Canadian corporation are taxable Canadian property. In addition, the Canada/U.S. tax treaty allows Canada to tax gains on the disposition of shares if the value of the shares is principally derived from real property situated in Canada.

Case 3 Anne would not be taxable on the gain on the shares. The shares are taxable Canadian property because they represent shares of an unlisted non-resident corporation that, at

some time in the 60 months preceding the disposition, derived more than 50 percent of their value from taxable Canadian property. However, the Canada/U.S. tax treaty does not list this as one of the items where Canada is allowed to tax U.S. residents.

Exam Exercise Solution Twenty - 12

The Canada/U.S. tax treaty states the following:

> **Article XI** Interest arising in a Contracting State and beneficially owned by a resident of the other Contracting State may be taxed only in that other State.

This means that, with respect to amounts paid to U.S. residents, Canada no longer has the right to withhold taxes under Part XIII.

Exam Exercise Solution Twenty - 13

Case 1 Carco appears to be carrying on business in Canada through a permanent establishment. As a result, no Part XIII tax is payable. However, Carco would be subject to Part I tax on its income attributable to the permanent establishment in New Brunswick.

Case 2 As the Canada/U.S. tax treaty does not reduce the rate for rentals of real property, Danielle would be subject to Part XIII tax of $11,500 [(25%)($46,000)]. Alternatively, Danielle could elect under ITA 216 to be taxed under Part I on the net rental income of $28,500 ($46,000 - $17,500). Based on her net rental income, the Part XIII tax is at a rate of 40.4 percent ($11,500 ÷ $28,500). Unless she has a significant amount of other income in Canada, the Part I alternative will result in her being taxed at the lowest federal rate, making this the preferable choice.

Case 3 Danielle would be subject to Part XIII tax on the gross rents received for the all terrain vehicles unless she would be considered to be carrying on a business. However, the Canada/U.S. tax treaty reduces the withholding tax to 10 percent of the gross rents received, or $400. Note that Danielle would not be eligible to elect under ITA 216 to be taxed under Part I on the all terrain vehicle rents, since this election is generally restricted to real property.

Exam Exercise Solution Twenty - 14

Shelley's tax liability would be calculated as follows:

Foreign Interest Received ($23,000 - $2,300)	$20,700
Foreign Tax Withheld	2,300
Taxable Income Inclusion	$23,000
Canadian Tax Payable At 42 Percent	$ 9,660
Foreign Tax Credit	(2,300)
Net Canadian Tax Payable	$ 7,360
Foreign Tax Withheld	2,300
Total Taxes Payable	$ 9,660

Based on these figures, her after tax retention and overall tax rate would be as follows:

After Tax Retention ($23,000 - $9,660)	$13,340
Overall Tax Rate ($9,660 ÷ $23,000)	42%

Exam Exercise Solution Twenty - 15

There would be a deemed disposition on his departure, leaving him liable for the taxes on a $13,000 [(1/2)($56,000 - $30,000)] taxable capital gain.

Exam Exercise Solution Twenty - 16

As real property is exempt from the deemed disposition provision contained in ITA 128.1(4)(b), there would be no tax consequences with respect to the rental property at the time of Mrs. Rand's departure. However, real property is Taxable Canadian Property and, as a consequence, she would be liable for Canadian taxes on both recapture and capital gains resulting from a subsequent sale of the property, even after she becomes a non-resident.

Exam Exercise Solution Twenty - 17

With respect to the shares of the Canadian private company, there would be a required deemed disposition, resulting in a taxable capital gain of $62,500 [(1/2)($240,000 - $115,000)]. In the absence of an election on the rental property, this would be the only tax consequence resulting from his departure.

However, if Mr. Koch elects under ITA 128.1(4)(d) to have a deemed disposition on his rental property, the result will be a terminal loss on the building of $43,000 ($121,000 - $78,000) and an allowable capital loss on the land of $14,000 [(1/2)($55,000 - $27,000)]. These amounts can be used to eliminate all but $5,500 of the $62,500 taxable capital gain on the securities.

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TIF Solution Twenty - 5

For each term there is both a 100 percent correct answer and an answer that is close. We have indicated the "close answer" in brackets. This would allow you to mix terms from various chapters if you wish to do so.

The correct definitions for each of the listed key terms are as follows:

A. 6 (not 2)

B. 3 (not 10)

C. 8 (not 1)

D. 9 (not 5)

E. 7 (not 4)

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TIF Solution Twenty - 6

Part A

As she is exempt from taxation in Indonesia because she is related to a deemed resident, Dorothy would be a deemed resident of Canada for income tax purposes during the current year under ITA 250(1)(g).

Part B

As she is present in Canada on a temporary basis for more than 183 days per year, she would be considered a sojourner. Under ITA 250(1)(a), this would make her a Canadian resident for income tax purposes for all of the current year.

Part C

Berkly Management Inc. would be considered to be a resident of Canada for income tax purposes during the current year. While it was incorporated in Canada prior to April 27, 1965, it was a resident after that date by virtue of the mind and management of the Company being in Canada.

Part D

As its mind and management are no longer in Canada, Lorris Ltd. would not be considered a resident of Canada for income tax purposes during the current year.

Part E

Because he has an employment contract that requires him to return to Canada, he will be a Canadian resident for income tax purposes during the current year. Although he has severed his ties with Canada, the requirement to return would show that he does not intend to permanently leave Canada.

Part F

Millicent would be a Canadian resident for income tax purposes during the current year. An individual is not considered to have departed from Canada until the latest of the departure date, the date of departure for their spouse and children, and the date on which residence is established in a different country. As her family is staying in Canada and Millicent will not be establishing residency in another country, she will remain a Canadian resident during her trip.

YZlad

TIF Solution Twenty - 7

Case A

As Mr. Plesser became a Canadian resident on July 1 of the current year, he would be subject to Canadian Part I tax on his worldwide income for the part of a year subsequent to that date. This would include all of his employment income, as well as one-half (£5,500) of his U.K. interest.

Case B

Members of the Canadian armed forces are deemed to be Canadian residents without regard to where they actually live. As Mrs. Jurgens is exempt from German taxation due to her relationship to a deemed resident, she is a deemed resident and will be subject to Canadian taxation on her employment income.

Case C

While Mr. Downs is not a Canadian resident, ITA 2(3) generally applies Part I tax to employment income earned in Canada. However, the Canada/U.S. tax treaty makes two exceptions to this general approach:

> **$10,000 Rule** Under this rule if, during a calendar year, a U.S. resident earns employment income in Canada that is $10,000 or less in Canadian dollars, then the income is taxable only in the U.S.
>
> **183 Day Rule** This rule exempts Canadian source employment income from Canadian taxation, provided it is earned by a U.S. resident who was physically present in Canada for no more than 183 days in any twelve month period commencing or ending in the calendar year. This exemption is conditional on employment income not being paid by an employer who would be able to deduct the amount paid from their Canadian Taxable Income.

While Mr. Downs is in Canada for less than 183 days, it would appear that his employer is in a position to deduct the payments from Taxable Income. As the amount is more than $10,000, neither exception is applicable and Mr. Downs would be taxed on his Canadian employment income.

With respect to the interest, it is an arm's length payment and does not involve participating debt. As a consequence, Part XIII tax is not applicable. In addition, it should be noted that the Canada/U.S. tax treaty has a provision which does not allow either country to assess taxes on interest paid to residents of the other country.

Case D

While Ms. Mennan has a small Canadian savings account, it is unlikely that the CRA would consider this a sufficient tie with Canada to view her as a resident. She would be considered a non-resident.

With respect to the interest she receive, Part XIII would not be applicable because it is an arm's length payment and does not involve participating debt. In addition, as was noted in Case C, the Canada/U.S. tax treaty has a provision which does not allow either country to assess taxes on interest paid to residents of the other country.

TIF Solution Twenty - 8

Mr. Morris would fall under the part year resident rules and would only be assessed for Canadian taxes on worldwide income during the portion of the year prior to his ceasing to be a resident of Canada.

By selling his house, disposing of other personal property, and resigning from various social and professional clubs, Mr. Morris appears to have done most of the things that would be required to establish that he had made a clean break from Canada as of April 1. However, IT-221R3 indicates that, in general, the CRA will view an individual as becoming a non-resident on the latest of three dates:

- The date the individual leaves Canada.
- The date the individual's spouse or common-law partner and dependants leave Canada.
- The date the individual becomes a resident of another country.

Because of the continued presence in Canada of the spouse and dependent children of Mr. Morris, he would be considered a resident of Canada until June 30, the latest of the relevant dates.

In terms of tax consequences, he would be subject to Canadian taxes on his salary until March 31. He would then be subject to U.S. taxes on income earned in that country after March 31. However, he would also be liable for Canadian taxes during the period April 1 through June 30. While he would be eligible for a tax credit for U.S. taxes paid on this income, the fact that Canadian taxes are generally higher than those in the U.S. would probably result in a liability for Canadian taxes during this period until his family departs from Canada.

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Chapter Twenty-One Test Item File Solutions

TIF Solution Twenty-One - 1

1. An accounts-based value added tax system applies a specified rate to the value added at each stage in the production/distribution process. Such systems require an accounting based measurement of the amount of value added.

   An invoice-credit value added tax applies a specified rate to the revenue generated at each stage in the production/distribution process. The remittance of this amount is offset by claiming input tax credits for the tax that has been paid on all current purchases and on the full amount of capital expenditures used in producing these revenues. Its application involves no matching of costs and revenues, and no allocation of costs to periods other than the period in which the asset was acquired.

2. While several examples could be cited here, unincorporated businesses (proprietorships and partnerships) and not-for-profit organizations are most commonly mentioned in the text.

3. This would happen if the entity had input tax credits in excess of GST/HST collections on a regular, ongoing basis. This type of situation would entitle the entity to regular payments from the government. An example of this would be a business selling goods for export.

4. The basic questions that should be asked are as follows:

   - Do you have large amounts of fully taxable costs that would generate input tax credits?
   - Do you expect to exceed $30,000 in annual taxable sales in the near future?
   - Would adding GST/HST to your sale price reduce your ability to compete?

5. The GST/HST consequences are as follows:

   Fully Taxable Goods And Services The vendor would charge GST/HST on all such sales. The vendor would be eligible for input tax credits for GST/HST paid on the costs associated with such sales.

   Zero-Rated Goods And Services The vendor would not charge GST/HST on such sales. The vendor would be eligible for input tax credits for GST/HST paid on the costs associated with such sales.

   Exempt Goods And Services The vendor would not charge GST/HST on such sales. The vendor would not be eligible for input tax credits for GST/HST paid on the costs associated with such sales.

6. For capital expenditures on real property, the full amount of GST/HST paid is eligible for an input tax credit at the time of purchase. However, if the property is not used exclusively for commercial activity, only a portion of the GST/HST is eligible for the credit. The portion is based on the extent to which the property is used for commercial activity. This is subject to a minimum rule (there is no input tax credit if the property is used 10 percent or less for commercial activity) and a maximum rule (100 percent of the GST/HST paid is eligible for the credit if the property is used 90 percent or more for commercial activity).

   For capital expenditures other than real property (capital personal property), the full amount of GST/HST paid is eligible for an input tax credit at the time of purchase. However, if the property is used 50 percent or less for commercial activity, no credit is available. Alternatively, if the property is used more than 50 percent for commercial activity, 100 percent of the GST/HST paid is eligible for an input tax credit.

7. The major advantages of using the Quick Method can be described as follows:
   - As the appropriate rate is charged to GST/HST inclusive sales, there is no need for separate tracking of GST/HST collections.
   - There is no requirement to separately track purchases, other than those for capital expenditures, in order to determine the amount of input tax credits.
   - While this is not always the case, the Quick Method may reduce the amount of GST/HST that would be paid by the registrant if he were to use the regular accounting method for determining his GST/HST liability.

8. Under the simplified method of accounting for input tax credits, detailed records are not kept of the GST/HST that is paid on all purchases other than real property. The total GST/HST and non-refundable PST inclusive amount of fully taxable costs incurred, including eligible costs incurred for capital assets other than real property, is multiplied by a factor to arrive at the figure that will be used for input tax credits in the GST/HST return of the registrant. The factor used will depend on the GST/HST rate in the province (e.g., 5/105 in Alberta, 13/113 in New Brunswick). As with the regular method of calculation, separate attention is given to the GST/HST paid on real property. This means that this amount will have to be pro rated based on the extent to which it is used in commercial activity.

9. Harmonized sales tax is a term that is used to refer to the sales tax system that results when a province chooses to integrate its provincial sales tax system with the federal GST system. Nova Scotia, New Brunswick have participated in the HST program since 1997. As of July 1, 2010, British Columbia and Ontario also participate in the system. Rates vary from 12 percent in British Columbia to 15 percent in Nova Scotia. The other participating provinces use 13 percent.

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TIF Solution Twenty-One - 2

1. False. It is a transaction tax based on transactions in both goods and services.

2. True.

3. True.

4. False. A multi-stage tax allows for a quicker accrual of revenues.

5. False. Provision of zero-rated supplies is included in the definition.

6. False. While there is no matching in the GST/HST return, the basic figures are determined on an accrual basis.

7. True.

8. True.

9. False. While they do not charge GST/HST on sales, they are still eligible to claim input tax credits.

10. True.

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TIF Solution Twenty-One - 3

1. A. All persons engaged in a business must register with the CRA for GST purposes.

2. C. The tax for nightly use of camp sites in national parks.

3. C. August 1, 2010.

4. C. Capital expenditures and goods purchased for resale during the period.

5. C. [($7,000 + $400 + $500)(5%)] = $395. An input tax credit is not permitted for the club fee as the fee is not deductible for income tax purposes.

6. A. [$80,000 - ($100,000 + $50,000 + $6,400)][5%] = ($3,820).

7. C. $3,445.

Revenues	$30,000
Office supplies	(500)
Rent	(3,000)
Total	$26,500
Rate	13%
HST Payable	$ 3,445

8. C. $16,705.

Revenues	$300,000
Purchase of bicycles	(150,000)
Purchase of tires and other parts	(18,500)
Premises rental	(3,000)
Total	$128,500
Rate	13%
HST Payable	$ 16,705

9. B. $39,325.

Revenues	$325,000
Stationery and supplies	(5,000)
Utilities	(2,500)
Rent	(15,000)
Total	$302,500
Rate	13%
HST Payable	$ 39,325

10. C. Capital expenditures are not tracked separately for purposes of determining input tax credits.

11. B. Capital expenditures are not tracked separately for purposes of determining input tax credits. Real property purchases are tracked separately.

12. E. All eligible expenses for fully taxable supplies deducted in the calculation of net employment income, including capital cost allowances.

TIF Solution Twenty-One - 4

Exam Exercise Solution Twenty-One - 1

Under an accounts-based VAT system, the 5 percent would be applied to the value added, resulting in a tax of $8,700 [(5%)($476,000 - $302,000)]. Alternatively, under a credit-invoice VAT system, $23,800 [(5%)($476,000)] would be owing on sales, but would be offset by an input tax credit of $18,550 [(5%)($371,000)] on purchases. The net tax owing in this case would be $5,250. The fact that the tax is less under the GST system reflects the fact that the purchases of goods exceeded the cost of goods sold.

Exam Exercise Solution Twenty-One - 2

As his sales exceed $30,000 in the third quarter, he will be required to begin collecting GST on the first sale in that quarter that exceeds the $30,000 threshold. This means he will have to begin collecting GST sometime between July 1 and September 30. He will be required to register within 30 days of that date.

Exam Exercise Solution Twenty-One - 3

As Ms. Holt's sales accumulate to more than $30,000 by the end of the third quarter, she will have to begin collecting GST on November 1, the first day of the second month of the fourth quarter. The fourth quarter sales are not relevant. She will be required to register December 1.

Exam Exercise Solution Twenty-One - 4

As the building is real property, an input tax credit would be available on a pro rata basis. This means that the credit would be $25,375 [($1,450,000)(5%)(35%)]. No input tax credit would be available on the equipment as it is used less than 50 percent in the provision of taxable supplies.

Exam Exercise Solution Twenty-One - 5

The GST payable would be calculated as follows:

GST On Sales [(5%)($286,650 ÷ 1.05)]	$13,650
Input Tax Credits:	
Rent [(5%)($18,000)]	(900)
Salaries	Nil
Interest	Nil
Supplies [(5%)($4,500)]	(225)
Capital Expenditure [(5%)($32,000)]	(1,600)
GST Payable For The Year	$10,925

Exam Exercise Solution Twenty-One - 6

The HST payable would be calculated as follows:

HST On Sales [(13%)($136,000)]	$17,680
Input Tax Credits:	
Rent [(13%)($29,450)]	(3,829)
Assistant's Salary	Nil
Capital Expenditures [(13%)($43,700 + $18,000)]	(8,021)
HST Payable For The Year	$ 5,830

Exam Exercise Solution Twenty-One - 7

The HST refund under the regular method would be calculated as follows:

HST On Sales [(13%)($42,300)]	$5,499
Input Tax Credits:	
Current Expenses [(13%)($37,800)]	(4,914)
Capital Expenditures [(13%)($72,000)]	(9,360)
HST Payable (Refund)	($8,775)

Alternatively, under the Quick Method, the calculation would be as follows:

Base Tax [(4.4%)(113%)($42,300)]	$2,103
Credit On First $30,000 [(1%)($30,000)]	(300)
Subtotal	$1,803
Input Tax Credit On Capital Expenditures [(13%)($72,000)]	(9,360)
HST Payable (Refund)	($7,557)

As the Regular Method produces a larger refund, it would be the preferable method. Note that input tax credits on capital expenditures are available, even when the Quick Method is used.

Exam Exercise Solution Twenty-One - 8

Since the security system is being amortized it is reasonable to assume it is a capital expenditure. If the Quick Method is not used, the GST payable (refund) would be calculated as follows:

GST On Sales [(5%)($63,400)]	$3,170
Input Tax Credits:	
Current Costs [(5%)($26,275)]	(1,314)
Capital Expenditures [(5%)($44,900)]	(2,245)
GST Payable (Refund) For Quarter	($ 389)

Alternatively, under the Quick Method, the calculation would be as follows:

Base Tax [(1.8%)(105%)($63,400)]	$1,198
Credit On First $30,000 [(1%)($30,000)]	(300)
Subtotal	$ 898
Input Tax Credit On Capital Expenditures [(5%)($44,900)]	(2,245)
GST Payable (Refund) For Quarter	($1,347)

As the Quick Method produces a larger refund, it would be the preferable method. Note that input tax credits on capital expenditures are available, even when the Quick Method is used.

Exam Exercise Solution Twenty-One - 9

Using the simplified method of accounting for input tax credits, the GST payable (refund) would be calculated as follows:

GST On Sales [(5%)($472,500 ÷ 1.05)]	$22,500
Input Tax Credits On Purchases And Personal Capital Property {[5/105][($320,000)(105%) + ($23,000)(105%)]}	(17,150)
Input Tax Credits On Real Property [(5%)($85,000)]	(4,250)
GST Payable (Refund) For The Year	$ 1,100

TIF Solution Twenty-One - 5

For each term there is both a 100 percent correct answer and an answer that is close. We have indicated the "close answer" in brackets. This would allow you to mix terms from various chapters if you wish to do so.

The correct definitions for each of the listed key terms are as follows:

A. 3 (not 9)

B. 10 (not 5)

C. 8 (not 2)

D. 7 (not 4)

E. 6 (not 1)

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TIF Solution Twenty-One - 6

The HST refund for Montagne Inc. for the year would be calculated as follows:

HST Collected [(13%)($823,000 - $120,000 - $116,000)]	$76,310
Input Tax Credits:	
Purchases [(13%)($478,000 - $74,000)]	(52,520)
Amortization Expense	Nil
Salaries And Wages	Nil
Interest Expense	Nil
Other Operating Expenses [(13%)($32,000)]	(4,160)
Building [(13%)(85%)($800,000)]	(88,400)
Other Capital Expenditures [(13%)(100%)($400,000)]	(52,000)
HST Payable (Refund)	($120,770)

Notes:

- The fact that HST is paid on all purchases is not unreasonable, despite the fact that the Company provides both zero-rated and exempt supplies to its customers. Some zero-rated supplies, for example exports, involve selling items on which HST is paid. Exempt supplies could include the provision of certain types of services for which no purchases are required.
- Amortization expense does not affect the HST calculation.
- No HST is paid on salaries and wages, or interest. As a result no input tax credits are available.
- Input tax credits on real property are available based on a pro rata portion of their usage in providing taxable supplies.
- Full input tax credits are available on capital expenditures other than real property if more than 50 percent of their usage is to provide fully taxable and zero-rated supplies.

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TIF Solution Twenty-One - 7

Part A

The GST refund for the year would be calculated as follows using the regular method:

GST On Sales [(5%)($175,000 - $25,000 - $23,000)]	$6,350
Input Tax Credits:	
Purchases [(5%)($104,000 + $6,000)]	(5,500)
Amortization Expense	Nil
Salaries And Wages	Nil
Interest Expense	Nil
Other Operating Expenses [(5%)($8,000)]	(400)
Equipment	Nil
Building [(5%)(78%)($150,000)]	(5,850)
GST Payable (Refund)	($5,400)

There is no input tax credit available on the equipment as it is used less than 50 percent to provide taxable supplies.

Part B

Using the Quick Method, the GST refund for the year would be calculated as follows:

Base Tax [(1.8%)(105%)($175,000 - $25,000 - $23,000)]	$2,400
Credit On First $30,000 [(1%)($30,000)]	(300)
Subtotal	$2,100
Input Tax Credits On Capital Expenditures:	
Equipment	Nil
Building [(5%)(78%)($150,000)]	(5,850)
GST Payable (Refund)	($3,750)

There is no input tax credit available on the equipment as it is used less than 50 percent to provide taxable supplies.

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