

Solution to Assignment Problem Seventeen - 3

Part A

Gift To James Derek owns 80 percent (12,000 ÷ 15,000) of the Nome Industries shares. His gift to James would be calculated as follows:

Fair Market Value Of Old Common Shares		
[(80%)(1,500,000)]		\$1,200,000
Fair Market Value Of Consideration:		
Non-Share Consideration	(\$200,000)	
Preferred Shares (Fair Market Value)	(800,000)	(1,000,000)
<u>Gift</u>		<u>\$ 200,000</u>

It is fair to assume that this amount is a gift to James, as he is the only other holder of common shares in Nome Ltd.

PUC Of New Preferred Shares The PUC reduction required under ITA 86(2.1) would be calculated as follows:

Legal Stated Capital Of New Shares		\$800,000
Less The Excess, If Any, Of:		
PUC Of Old Shares [(12,000)(\$60)]	(\$720,000)	
Over The Non-Share Consideration	200,000	(520,000)
<u>PUC Reduction</u>		<u>\$280,000</u>
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PUC Of Preferred Shares (\$800,000 - \$280,000)		\$520,000

Adjusted Cost Base Of New Preferred Shares This amount would be calculated as follows:

Adjusted Cost Base Of Old Shares [(12,000)(\$85)]		\$1,020,000
Deduct:		
Non-Share Consideration	(\$200,000)	
Gift	(200,000)	(400,000)
<u>Adjusted Cost Base Of New Shares</u>		<u>\$ 620,000</u>

ITA 84(3) Dividend For the purposes of determining any ITA 84(3) deemed dividend on the redemption of the old shares, the proceeds of redemption would be as follows:

PUC Of New Preferred Shares	\$520,000
Non-Share Consideration	200,000
<u>Proceeds Of Redemption</u>	<u>\$720,000</u>

As shown in the following calculation, there would be no ITA 84(3) dividend:

Proceeds Of Redemption	\$720,000
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PUC Of Old Shares	(720,000)
ITA 84(3) Dividend	Nil

Capital Loss For the purposes of determining any capital gain or loss on the redemption of the old common shares, the proceeds of disposition would be the lesser of the \$1,200,000 fair market value of the old common shares and the following amount:

Non-Share Consideration	\$200,000
Gift	200,000
Proceeds Of Disposition	\$400,000

As shown in the following calculation, there would be a capital loss:

Proceeds Of Disposition	\$ 400,000
ITA 84(3) Deemed Dividend	Nil
Adjusted Proceeds Of Disposition	\$ 400,000
Adjusted Cost Base Of Old Shares	(1,020,000)
Capital Gain (Loss)	(\$ 620,000)

This capital loss would be disallowed by ITA 86(2)(d), resulting in no immediate tax consequences for Derek Blume.

Part B

This transaction will not alter the total fair market value of the Company. However, the value of the common shares will increase by the \$200,000 amount of the gift. There will be no corresponding increase in the amount of the tax cost of these shares and, as a consequence, this value will be taxed when James sells the common shares or they are redeemed. As this value will also be taxed in the hands of Derek Blume, there will be double taxation on this \$200,000 amount.

Part C

If Derek's preferred shares were redeemed at their fair market value of \$800,000, the tax consequences would be as follows:

Redemption Proceeds	\$800,000
PUC	(520,000)
ITA 84(3) Deemed Dividend (Non-Eligible)	\$280,000
Redemption Proceeds	\$800,000
Deemed ITA 84(3) Dividend	(280,000)
Adjusted Proceeds Of Disposition	\$520,000
Adjusted Cost Base	(620,000)
Capital Loss	(\$100,000)

If Derek had simply sold his shares, there would have been a capital gain of \$180,000 (\$1,200,000 - \$1,020,000). The net result of this redemption is the same \$180,000 (\$280,000 in

dividends - \$100,000 capital loss). However, as noted in Part B, his son James will be paying taxes on an additional \$200,000 capital gain because of the increased fair market value of his shares which results from the gift.

A further problem is the form of the income. On the straight sale of shares, the \$180,000 would have been a capital gain, only one-half of which would be taxable. The inappropriate use of ITA 86 has resulted in a \$280,000 dividend which will be taxed at higher rates, offset by a capital loss which is only one-half deductible. Although capital losses can generally be deducted only to the extent of available capital gains, if Derek's cancer treatment is unsuccessful, the capital loss will be deductible against other income in the year of death or the immediately preceding year.

Although the special rule for capital losses at death is tax advantageous, it is unlikely that Derek would want to be in the position to take advantage of it.

Solution to Assignment Problem Seventeen - 8

Sale Of Assets

This calculation requires two steps. First, we must determine the after tax proceeds that will be available at the corporate level subsequent to the sale of the assets. Then, a second stage analysis is required to determine the amount that will be retained by Mr. Lange after he pays all of the taxes that are due on the proceeds that are distributed to him.

Cash Proceeds, Capital Gains, And Business Income

The direct sale of the assets would create the following amounts of cash, taxable capital gains, and business income:

Asset	Cash Proceeds	Taxable Capital Gains	Active Business Income
Accounts Receivable (\$91,000 - \$83,000)	\$ 91,000		\$ 8,000
Inventories (\$298,000 - \$237,000)	298,000	Nil	61,000
Land [(1/2)(\$656,000 - \$167,000)]	656,000	244,500	
Building: [(1/2)(\$652,000 - \$582,000)] (\$582,000 - \$176,000)	652,000	35,000	406,000
Goodwill	719,000		359,500
Totals For Purchased Assets	\$2,416,000	\$279,500	\$834,500
Term Deposits	529,000	Nil	Nil
Totals	\$2,945,000	\$279,500	\$834,500

Taxable Income And Tax Payable

Taxable Income will total \$1,114,000 (\$279,500 + \$834,500). The Tax Payable on this amount would be calculated as follows:

Federal Tax On First \$500,000 Of Business Income [(11%)(500,000)]	\$ 55,000
Federal Tax On Remaining Business Income [(15%)(334,500)]	50,175

Federal Tax On Investment Income [(28% + 6-2/3%)(\\$279,500)]	96,893
Part I Tax Payable	\$202,068
Provincial Tax On First \$500,000 Of Business Income [(3%)(\\$500,000)]	15,000
Provincial Tax On Remaining Income [(14%)(\\$334,500+ \\$279,500)]	85,960
Total Tax Payable	\$303,028

GRIP Balance

As \$334,500 of Alcove's business income was taxed at full corporate rates, a GRIP balance of \$240,840 [(72%)(\\$334,500)] would be created.

RDTOH Balance

There is no opening balance in the RDTOH account. The closing balance, which is the addition for the year, will be the least of:

- 26-2/3 Percent Of Investment Income [(26-2/3%)(\\$279,500)] \$ 74,533
- 26-2/3 Percent Of Taxable Income, Less The Amount Eligible For The Small Business Deduction [(26-2/3%)(\\$1,114,000 - \\$500,000)] \$ 163,733
- Part I Tax Payable \$202,068

The least of these figures and the balance in the RDTOH account is \$74,533.

Funds Available For Distribution

Based on the preceding figures, the amount of cash available for distribution would be calculated as follows:

Gross Proceeds For Assets	\$2,945,000
Payment Of Liabilities	(355,000)
Tax Payable	(303,028)
Dividend Refund (Balance In RDTOH)	74,533
Total Funds Available For Distribution	\$2,361,505

Note Given that the business is being liquidated, it is clear that the RDTOH balance will be less than one-third of the dividends paid.

Capital Dividend Account

The balance in the capital dividend account would be calculated as follows:

Non-Taxable One-Half Of Gain On Land	\$244,500
Non-Taxable One-Half Of Gain On Building	35,000
Non-Taxable Component Of Goodwill Disposition	359,500
Capital Dividend Account Balance	\$639,000

Taxable Dividends Resulting From Distribution

Assuming an election has been made to declare the maximum capital dividend and the maximum eligible dividend, the taxable dividend component of the total distribution to Mr. Lange can be calculated as follows:

Funds Available For Distribution	\$2,361,505
Paid Up Capital	(135,000)
ITA 84(2) Deemed Dividend	\$2,226,505
ITA 83(2) Capital Dividend (Balance In Account)	(639,000)
Deemed Dividend Subject To Tax	\$1,587,505
Eligible Dividend (Must Be Designated As Such)	(240,840)
Non-Eligible Dividend (Remainder)	\$1,346,665

There would be no capital gain on the disposition, as demonstrated in the following calculation:

Amount Distributed	\$2,361,505
ITA 84(2) Deemed Dividend	(2,226,505)
Deemed Proceeds Of Disposition	\$ 135,000
Adjusted Cost Base	(135,000)
Capital Gain	Nil

Personal Tax Payable

As there is no capital gain and the capital dividend is received tax free, the personal Tax Payable on the dividend subject to tax would be calculated as follows:

Eligible Dividend	\$ 240,840
38 Percent Gross Up	91,519
Non-Eligible Dividend	1,346,665
25 Percent Gross Up	336,666
Taxable Amount Of Dividends	\$2,015,690
Combined Rate (29% + 14%)	43%
Tax Before Dividend Tax Credit	\$ 866,747
Dividend Tax Credits:	
Eligible Dividends [(6/11 + 1/3)(\$91,519)]	(80,423)
Non-Eligible Dividends [(2/3 + 1/3)(\$336,666)]	(336,666)
Tax Payable	\$ 449,658

Sale Of Shares

The tax payable resulting from a sale of shares would be calculated as follows:

Proceeds From The Sale Of Shares	\$2,380,000
Adjusted Cost Base	(135,000)
Capital Gain	\$2,245,000
Inclusion Rate	1/2
Taxable Capital Gain	\$1,122,500
Tax Rate (29% + 14%)	43%
Tax Payable	\$ 482,675

Note This capital gain would not qualify for the lifetime capital gains deduction because Alcove is not a qualifying small business corporation. The Term Deposits are not involved in

producing active business income. As they clearly exceed 10 percent of the fair market value of the assets, Alcove is not a qualified small business corporation.

Conclusion

Given the preceding calculations, the after tax, personal cash retention under both alternatives would be as follows:

	Asset Sale	Share Sale
Proceeds From Sale	\$2,361,505	\$2,380,000
Personal Tax Payable	(449,658)	(482,675)
After Tax Retention	\$1,911,847	\$1,897,325

As the after tax retention is \$14,522 (\$1,911,847 - \$1,897,325) larger when assets are sold, this would be the preferable alternative. You should note that this alternative would not have been the better choice if the lifetime capital gains deduction had been available. The ability to use the deduction on the sale of shares would have eliminated the taxes on \$750,000 of the capital gain, clearly making the sale of shares the better alternative. We would also note that this would not have been difficult to accomplish. All that would have been required was the sale of the term deposits and distribution of the proceeds prior to selling the shares.