2019–
2020
EDITION

2019–2020 EDITION

Byrd & Chen's
Canadian Tax Principles

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Includes: Volume I, Volume II, and Study Guide

PREFACE

Objectives Of The Canadian Tax Principles Package

Subject Coverage

The objective of this text is to provide coverage of all the tax subjects that are taught in Canadian college and university tax courses. In so doing, it also provides comprehensive coverage of almost all the tax issues that are required in the educational programs of CPA Canada. The one area of these programs that is not covered is "Reporting Systems And Data Requirements For Tax Compliance".

This material is designed to be used in a two semester university or college course and is far too extensive to be completely covered in a single one semester course. The traditional split in the material would be to cover Chapters 1 through 11 in a first course dealing with the determination of Net Income For Tax Purposes for all taxpayers, as well as the calculation of Taxable Income and Tax Payable for individuals. This could be followed by a second course where the focus is primarily on the taxation of corporations. The relevant material on corporations is found in Chapters 12 through 17. The remaining Chapters 18 through 21 deal with partnerships, trusts, international taxation, and GST/HST.

Level Of Coverage

In terms of style, we have attempted to strike a balance between the kind of complete documentation that can render the material incomprehensible to anyone other than a tax professional, and the total elimination of references that would make it impossible for readers to expand their understanding of particular points. In those situations where we feel the issue is sufficiently complex that further investigation could be helpful, we have provided a list of references to the relevant Sections of the *Income Tax Act* or other related materials. In contrast, no direction has been provided when the material is either very straightforward, or where the relevant parts of the *Act* would be obvious.

This book can be used with or without additional source material. Some instructors require students to acquire a copy of the *Income Tax Act* and permit its use as a reference during examinations. For instructors wishing to take this approach, frequent references to the *Act* have been included. For instructors not wishing to require the use of the *Income Tax Act*, we have designed the problem material so that students should be able to solve all of the included problems relying solely on the text as a reference.

The Need For Two Volumes

In the over 30 years that we have been writing this text, we have seen the content grow from about 400 pages to more than 1,500 pages. We initially dealt with this increase in size by providing a separate Study Guide. However, the text alone has grown to over 1,000 pages and, while accommodating this in a single volume is feasible, the result would be far less useful to students than dividing the material into two reasonably sized volumes.

If there was any consensus among our users as to which subjects should be dealt with in each volume, they could be made available separately. However, virtually all of our users omit material from Volume I and include material from Volume II. Further, there is no consistent

pattern as to which material is omitted and which material is included. Given this, it would not be possible to produce separate volumes that meet the needs of all of our users.

The Study Guide

The major objective of the Study Guide is to provide students with convenient access to the solutions for the Exercises and Self Study Problems. Having these solutions in a separate volume makes it much easier for students to simultaneously view the problem while solving it and then consult its complete and detailed solution.

The Study Guide also provides a number of additional features to enhance the learning experience. These can be described as follows:

- Detailed instructions on "How To Work Through" each Chapter in the text. This includes guidance on when to attempt Exercises and Self Study Problems as the student reads through the text.
- A detailed list of "Learning Objectives" for each Chapter. This allows the student to ensure that he/she has understood all of the relevant subjects covered in the Chapter.
- Sample tax returns for both individuals and corporations. These are useful practice for students using the ProFile tax software that is available with this text.
- At the end of each Chapter in the text, there is a list of key terms that were used in that Chapter. All of these terms are alphabetically listed in a Glossary that is at the back of the Study Guide. This provides an easy way to find the meaning of a term that was introduced in one Chapter, but is being referred to again in a subsequent Chapter.

Problem Material Available

For Students - Problems and Practice Exams With Solutions

The *Canadian Tax Principles* package contains a large number of problems with detailed solutions. See the **Online Student Supplements** section of this preface for more information about online access. The various types of problems and their location are as follows:

Exercises These are short problems that are focused on a single issue. Each Exercise is presented in the *Canadian Tax Principles* text, directly following the material that is relevant to its solution. This provides you with immediate feedback as to whether you have understood the material that you have just read. Solutions to the Exercises can be found in the Study Guide.

Self Study Problems These problems are more complex than the Exercises and include a number of comprehensive problems. Solutions to the Self Study Problems are included in the Study Guide while the problems are available online.

Tax Software Self Study Problems These problems are designed to be solved using the ProFile software that is available with *Canadian Tax Principles*. These problems are found in the Study Guide. The completed tax returns are available online.

Supplementary Self Study Problems Additional Self Study Problems, along with their detailed solutions, are available online for each chapter.

Practice Examinations A 90 minute practice examination and solution is available online for each chapter.

For Instructors - Assignment Problems And Test Items

Canadian Tax Principles contains several types of problems designed for instructors:

Assignment Problems These problems vary in difficulty and include the most difficult non-comprehensive problems in the text. They are found at the end of each chapter of *Canadian Tax Principles*. They are sometimes adapted from professional examinations and may involve a number of different issues. Solutions to these

problems are available only to instructors. These solutions are not available to students.

Assignment Problems (Comprehensive) These comprehensive problems are the most challenging type of problem material in the text. They are cumulative in that they incorporate issues from previous chapters. There are two comprehensive assignment problems per chapter in Chapters 6 through 11 and they are found at the end of the Assignment Problems for the chapter. Solutions to these problems are available only to instructors.

Assignment Tax Software Problems Assignment Tax Software Problems dealing with personal tax returns are found at the end of Chapters 4 and 11. An additional Assignment Tax Software Problem, involving a corporate tax return, is located at the end of Chapter 14. Solutions to Assignment Tax Software Problems are available only to instructors.

Examination Problems For instructors adopting *Canadian Tax Principles*, a large and comprehensive selection of problems and solutions for use on examinations is available. These include multiple choice questions (over 700), true/false questions (over 200), essay questions (over 400), exercises (over 400), as well as more than 350 comprehensive types of problem ranging in difficulty from easy to very difficult.

Online Student Supplements

MyLab Accounting

MyLab Accounting for *Canadian Tax Principles* contains a great deal of additional material that will provide significant assistance to users of this text. Instructions on how to access MyLab can be found on the access card provided with this package. The URL for MyLab is:

http://www.pearsonmylabandmastering.com

The various items that are included on MyLab can be described as follows:

- **Pearson eText** In response to concerns over the growing size (and weight) of the print version of this text, access to the eText is included with the print version. This eText gives you access to the text whenever and wherever you have access to the Internet, through various devices. It contains the content of both volumes of the text and the Study Guide. The eText pages look exactly like the printed text and offer powerful functionality. You can create notes, highlight text in different colours, create bookmarks, zoom, and search.
- **Self Study Problems** While the actual Self Study Problems are only available on MyLab, we have marked the point within the text that you should work each Self Study Problem. Their solutions are included in the Study Guide.
- **Supplementary Self Study Problems** Additional Self Study Problems for each chapter, along with their detailed solutions, are available for further practice in problem solving.
- **CPA Canada's Federal Income Tax Collection (FITAC)** This comprehensive electronic tax research library contains the *Income Tax Act*, *Income Tax Folios,* and other official materials. In addition, it includes an electronic version of the *Canadian Tax Principles* text. Designed for reference purposes, this version provides electronic links from the text material to the various references contained in FITAC (e.g., the *Income Tax Act*). Note however, it only includes the text and does not have the Exercises and other problem material that are provided with the printed text.
- **ProFile Tax Return Preparation Software** Intuit's professional tax preparation software, ProFile, is available free of charge to users of *Canadian Tax Principles*. You can use this software to prepare returns for individuals, corporations and trusts and a large number of tax forms. This software is for educational use only and cannot be used to file tax returns.
- **Corrections** Any corrections to the text, Study Guide, or other student material are provided here throughout the year. Please check periodically to help avoid frustration.

- **Practice Examinations** A 90-minute practice examination, along with a solution and suggested marking guide, is available for each chapter. These examinations contain a variety of problems, including multiple choice, essay questions and longer problems.
- **Power Point Presentations** There is a PowerPoint presentation for each chapter. These provide the basis for a quick review of the material covered in the chapter.
- **Glossary Flashcards** These flashcards help you test your understanding of the key terms used in each chapter.
- **2019 Tax Rates, Credits and Common CCA Classes** This is available as a PDF file, for reference. This tax information is also available at the front of Volumes 1 and 2, and CCA classes are available in the Chapter 5 Appendix.
- **Tax Returns** The Study Guide contains tax return examples and Self Study tax software problems, along with notes to their solutions. The completed tax returns are available on MyLab, to download and use with your ProFile software, or to view in PDF files.

Instructor Supplements

In addition to all of the materials that are available to students, instructors will be provided with the following additional resources through the Pearson online catalogue:

- **Solutions Manual** A complete solutions manual is available to instructors. This manual includes detailed solutions to all of the Assignment Problems found in the textbook, including those that use the ProFile software. It also includes a problem concordance which correlates all problems from the last edition to this one. This is provided to assist instructors who have used the last edition with revising their courses.
- **Test Item File** For instructors adopting *Canadian Tax Principles*, a large and comprehensive selection of problems with detailed solutions for use on examinations is available (see previous description).

Recent Changes

Fall Economic Statement

Perhaps the most important change for 2019 was announced on November 21, 2018, when the Department Of Finance released the Accelerated Investment Incentive (AccII) provisions as part of its fall economic statement. These provisions remove the half-year reduction for most depreciable assets. In its place, there is a 50 percent addition to the base for calculating CCA on assets acquired during the year. This, in effect, triples the amount of CCA that can be deducted in the first year of a depreciable asset's life.

These provisions are discussed in detail in Chapter 5. However, the application of the AccII provisions required changes to material in almost every subsequent Chapter.

The Federal Budget

Complications

While the fall economic statement included what is, perhaps the most important change for 2019, most changes in legislation are introduced in the annual federal budget. This can greatly complicate the production of a comprehensive text that must be in bookstores the first week in September.

The first complication is that the date for each year's budget is not entirely predictable. Between 2002 and 2019, the arrival date has ranged from December 10th of the preceding year (the 2002 budget) to May 2nd of the budget year (the 2006 budget). For 2019, the budget was presented on March 19, 2019.

The second potential complication is there is usually a considerable period of time between the budget statement and the release of the required legislation. This is further complicated in

2019 by fact that there will be a fall election. If the Liberals do not maintain their majority in parliament, some or all of the provisions in the 2019 budget may never see the light of day. In preparing material based on the budget announcements, we have to recognize that some of the included material may not be appropriate if the proposed changes do not make it through parliament.

Previously Announced Measures

There are several measures that were announced in previous budgets that are still working their way through the system in 2019. They can be described as follows:

Small Business Deduction In October, 2017, the government announced a phased in increase in the small business deduction. The applicable amounts are as follows:

2017	17.5%
2018	18.0%
2019	19.0%

The increases in this deduction are reflected in lower rates on income eligible for the small business deduction. The federal rate on such income goes from 10.5 percent in 2017, to 10 percent in 2018, and to 9 percent in 2019.

Non-Eligible Dividends Non-eligible dividends are dividends that are paid out of income that is eligible for the small business deduction. The gross up and tax credit amounts that are applicable to these dividends are being altered to reflect the changes in the small business deduction. The phased in changes are as follows:

	Gross Up (% Of Dividends)	Federal Credit (Fraction Of Gross Up)
2017	17%	21/29
2018	16%	8/11
2019	15%	9/13

Income Sprinkling Prior to 2018, the Tax On Split Income (TOSI) only applied to related minors. However, on December 13, 2017, the government released measures that extended this punitive tax measure to individuals of any age. The measures are effective for 2018 and subsequent taxation years. The goal of these measures was to make splitting income with related individuals significantly more difficult. These complex and complicated measures are likely to achieve this goal.

Billed Basis Accounting The 2017 budget indicated that the government will eliminate the use of the billed basis of revenue recognition that is currently permitted for some groups of professionals. The elimination of this provision is being phased in over a five year period at the rate of 20 percent in each year, starting in 2018.

Passive Income Of CCPCs The government has concluded that these companies have an unfair advantage in the accumulation of passive investments held within the corporation. This is because they retain more funds after the payment of the small amount of taxes applicable to income that is eligible for the small business deduction,

To make this situation less attractive, the 2018 Budget included legislation that would grind down the annual limit on the amount of income that is eligible for the small business deduction. Specifically, the $500,000 limit will be reduced on a straight-line basis for CCPCs having between $50,000 and $150,000 in investment income. This was accompanied by a number of other changes to the taxation of this income.

While this legislation was included in the 2018 Budget, it is only applicable to 2019 and subsequent years. Our coverage of these changes is found in Chapter 13.

2019 Content

They March 19, 2019 budget contained a fairly large number of proposals that were of varying importance. The following lists describes most of these changes.

Personal Tax Measures

- A proposal to limit access to the 50 percent deduction on stock options (see Chapter 3). The limit would be based on the first $200,000 of the fair market value of the securities included in new grants. It is unlikely that these proposals will be implemented this year.
- Provisions designed to limit the ability of mutual funds to defer certain types of capital gains and to convert ordinary income into capital gains.
- A new Canada training credit that will become available in 2020 (see Chapter 4).
- An increase in the Home Buyers' Plan limit from $25,000 to $35,000 (see Chapter 10).
- A modification of the change in use rules for multi-unit residential properties (see Chapter 8).
- An expansion of the types of annuities that can be used by registered plans to fund retirement income (see Chapter 10).
- Changes to the rules for Registered Disability Savings Plans.
- Changes to the rules for kinship care providers.
- Removal of the requirement that donations of cultural property be of national importance in order to qualify for enhanced charitable donations treatment.
- Amended the legislation for the medical expense tax credit to reflect the new rules for cannabis regulation.
- Modification of the rules for determining pensionable service under an individual pension plan.
- New rules applicable to individuals carrying on a business in a tax free savings account.

Business Tax Measures

- New rules that provide for a 100 percent write off of zero emission vehicles in the year of acquisition (see Chapter 5).
- Removal of the income constraint for determining the amount of scientific research expenditures that are eligible for the enhanced 35 percent investment tax credit (see Chapter 14).
- Changes in the rules for determining the amount of farming and fishing income that is eligible for the small business deduction.
- Several provisions to enhance government support for Canadian journalism. These include:
  - a non-refundable tax credit for digital news subscriptions (see Chapter 4);
  - a refundable credit for salaries paid to newsroom employees (see Chapter 12); and
  - a provision that extends qualified donee status to registered journalism organizations.

We have provided coverage of some, but not all, of these changes as indicated by the Chapter references included in the list items.

Acknowledgments

We would like to thank the many students who have used this book, the instructors who have adopted it at colleges and universities throughout Canada, as well as the assistants and tutors who have been involved in these courses.

In terms of the content of the book, we would like to give special thanks to:

Gary Donell After many years with the CRA, Gary is now affiliated with the Ottawa office of Welch LLP. Gary has been a significant contributor to this text for nearly 20

years, bringing to it an outstanding knowledge of income tax issues. He has made many valuable suggestions that have contributed greatly to the accuracy and clarity of the material. In addition, he was responsible for writing much of the Chapter 18 material on partnerships and the Chapter 20 material on international taxation. Mr. Donell has undertaken this work independently of his work with Welch LLP. The views that are contained in this publication do not, in any way, reflect the policies of Welch LLP.

Ruth Ann Strickland (a.k.a. Eagle Eye) - Western University (London) Over the last few years, Ruth Ann has shown an uncanny ability to spot both major and minor errors. She has been responsible for helping us eliminate many such items, greatly enhancing the quality of our material. We are very grateful for her assistance.

Also of great help in improving the text over the years were the comments and corrections provided by the following instructors:

- **Joseph Armanious** - McGill University (Montreal)
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- **Larry Goldsman** - McGill University (Montreal)
- **Susan Hurley** - NAIT (Edmonton)
- **Patrick Massicotte** - St. Lawrence College
- **Jay Perry** - Niagara College (Niagara-On-The-Lake)
- **Victor Waese** - BCIT (Burnaby)
- **Ronald Wong** - Capilano University (Vancouver)

It's Our Fault

As always, we have made every effort to accurately reflect appropriate tax rules. Every word in the text, problems, and solutions has been read by at least two and, in most cases three, individuals. However, it is virtually certain that errors remain. These errors are solely the responsibility of the authors and we apologize for any confusion that they may cause you.

Clarence Byrd, Clarence Byrd Inc.
Ida Chen, Clarence Byrd Inc.
June, 2019

2019 Rates, Credits And Other Data

For your convenience, this information, as well as the Chapter 5 Appendix of common CCA rates, is available **online** as a .PDF file.

Information Applicable To Individuals

Federal Tax Rates For Individuals

Taxable Income In Excess Of	Federal Tax	Marginal Rate On Excess
$ -0-	$ -0-	15.0%
47,630	7,145	20.5%
95,259	16,908	26.0%
147,667	30,535	29.0%
210,371	48,719	33.0%

Federal Tax Credits For Individuals - Personal Credits (ITA 118)

Reference

118(1)(a) **Married Persons** 15% of $12,069 ($1,810).

118(1)(a) **Spousal** 15% of $12,069 ($1,810), less 15% of the spouse's Net Income For Tax Purposes. Base amount increased by $2,230 (to $14,299) if the spouse is mentally or physically infirm. Not available when the spouse's income is more than $12,069 (or $14,299).

118(1)(b) **Eligible Dependant** 15% of $12,069 ($1,810), less 15% of the eligible dependant's Net Income For Tax Purposes. Base amount increased by $2,230 (to $14,299) if the eligible dependant is mentally or physically infirm. Not available when the eligible dependant's income is more than $12,069 (or $14,299).

118(1)(b.1) **Canada Caregiver For Child Under 18** 15% of $2,230 ($335).

118(1)(c) **Single Persons** 15% of $12,069 ($1,810).

118(1)(d) **Canada Caregiver** 15% of $7,140 ($1,071), reduced by 15% of the dependant's income in excess of $16,766.

118(1)(e) **Canada Caregiver - Additional Amount** If either the income adjusted infirm spousal credit base or the income adjusted infirm eligible dependant credit base is less than the spouse or eligible dependant's income adjusted credit base ($7,140, less the spouse or dependant's income in excess of $16,766), an additional Canada caregiver credit is available based on 15% of the deficiency.

118(2) **Age** 15% of $7,494 ($1,124). The base for this credit is reduced by the lesser of $7,494 and 15% of the individual's net income in excess of $37,790. Not available when income is more than $87,750. If the individual cannot use this credit, it can be transferred to a spouse or common-law partner.

118(3) **Pension** 15% of up to $2,000 of eligible pension income for a maximum credit of $300 [(15%)($2,000)]. If the individual cannot use this credit, it can be transferred to a spouse or common-law partner.

118(10) **Canada Employment Credit** 15% of up to $1,222. This produces a maximum credit of $183.

Other Common Federal Personal Credits (Various ITA)

118.01 **Adoption Expenses Credit** 15% of eligible expenses (reduced by any reimbursements) up to a maximum of $16,255 per adoption. This results in a maximum credit of $2,438.

118.041 **Home Accessibility Credit** 15% of lesser of $10,000 and the amount of qualifying expenditures for the year.

118.05 **First Time Home Buyer's Credit** 15% of $5,000 ($750) of the cost of an eligible home.

118.06 **Volunteer Firefighters Credit** 15% of $3,000 ($450) for qualifying volunteers.

118.07 **Volunteer Search And Rescue Workers Credit** 15% of $3,000 ($450) for qualifying volunteers.

118.1 **Charitable Donations - Regular** The general limit on amounts for this credit is 75% of Net Income. There is an addition to this general limit equal to 25% of any taxable capital gains and 25% of any recapture of CCA resulting from a gift of capital property. In addition, the income inclusion on capital gains arising from a gift of some publicly traded shares is reduced from one-half to nil. For individuals, the credit is equal to:

[(15%)(A)] + [(33%)(B)] + [(29%)(C)] where:

A = The first $200 of eligible gifts.
B = The lesser of:
- Total gifts, less $200; and
- Taxable Income, less $210,371.

C = The excess, if any, by which the individual's total gifts exceed the sum of $200 plus the amount determined in B.

118.2 **Medical Expenses** The medical expense tax credit is determined by the following formula:

[15%] [(B - C) + D], where:

B is the total of an individual's medical expenses for himself, his spouse or common-law partner, and any of his children who have not reached 18 years of age at the end of the year.
C is the lesser of 3% of the individual's Net Income For Tax Purposes and $2,352 (2019 figure).
D is the total of all amounts each of which is, in respect of a dependant of the individual (other than a child of the individual who has not attained the age of 18 years before the end of the taxation year), an amount determined by the formula:

E - F, where:

E is the total of the dependant's medical expenses
F is the lesser of 3% of the dependant's Net Income For Tax Purposes and $2,352 (2019 figure).

118.3 **Disability - All Ages** 15% of $8,416 ($1,262). If not used by the disabled individual, it can be transferred to a person claiming that individual as a dependant.

118.3 **Disability Supplement - Under 18 And Qualifies For The Disability Tax Credit** 15% of $4,909 ($736), reduced by the total of amounts paid for attendant care or supervision in excess of $2,875 that are deducted as child care costs, deducted as a disability support amount, or claimed as a medical expense in calculating the medical expense tax credit.

Education Related Credits

118.5 • **Tuition Fees Which Includes Examination And Ancillary Fees**
- 15% of qualifying tuition fees
- 15% of examination fees for both post-secondary examinations and examinations required in a professional program
- 15% of ancillary fees that are imposed by a post-secondary educational institution on all of their full or part-time students. Up to $250 in such ancillary fees can be claimed even if not required of all students.

118.62 • **Interest On Student Loans**
15% of interest paid on qualifying student loans.

118.9 • **Transfer Of Tuition Credit**
If the individual cannot use the credit, is not claimed as a dependant by his spouse, and does not transfer the unused credit to a spouse or common-law partner, then a parent or grandparent of the individual can claim up to $750 [(15%)($5,000)] of any unused tuition credit. The amount that can be transferred is reduced by the amount of the credit claimed by the student for the year.

118.7 **Employment Insurance** 15% of amounts paid by employees up to the maximum Employment Insurance premium of $860 (1.62% of $53,100). This produces a maximum tax credit of $129 [(15%)($860)].

118.7 **Canada Pension Plan** 15% of amounts paid by employees up to the maximum Canada Pension Plan contribution of $2,749 [5.1% of ($57,400 less $3,500)]. This produces a maximum tax credit of $412 [(15%)($2,749)]. For self-employed individuals, the payment is $5,498 ($2,749 times 2).

122.51 **Refundable Medical Expense Supplement** The individual claiming this amount must be over 17 and have earned income of at least $3,645. The amount is equal to the lesser of $1,248 and 25/15 of the medical expense tax credit. The refundable amount is then reduced by 5% of family Net Income in excess of $27,639. Not available when family income is more than $52,599.

122.9 **Refundable Teacher And Early Childhood Educator School Supply Tax Credit** A maximum of 15% of up to $1,000 ($150) of eligible expenditures that are made by eligible educators.

127(3) **Political Donations** Three-quarters of the first $400, one-half of the next $350, one-third of the next $525, to a maximum credit of $650 on donations of $1,275.

127.4 **Labour Sponsored Venture Capital Corporations (LSVCC) Credit** The federal credit is equal to 15 percent of acquisitions of provincially registered LSVCCs.

ITA 82 and ITA 121 **Dividend Tax Credit**
- **Eligible Dividends** These dividends are grossed up by 38%. The federal dividend tax credit is equal to 6/11 of the gross up. The credit can also be calculated as 15.02% of the grossed up dividends, or 20.7272% of the actual dividends received.
- **Non-Eligible Dividends** These dividends are grossed up by 15%. The federal dividend tax credit is equal to 9/13 of the gross up. The credit can also be calculated as 9.0301% of the grossed up dividends, or 10.3846% of the actual dividends received.

Other Data For Individuals

ITA 82 **Dividend Gross Up**

Eligible Dividends For these dividends, the gross up is 38% of dividends received.

Non-Eligible Dividends For these dividends, the gross up is 15% of dividends received.

Chapter 4 **OAS Clawback Limits** The tax (clawback) on Old Age Security (OAS) benefits is based on the lesser of 100% of OAS benefits received, and 15% of the amount by which "threshold income" (Net Income For Tax Purposes, calculated without the OAS clawback) exceeds $77,580.

Chapter 4 **EI Clawback Limits** The tax (clawback) on Employment Insurance (EI) benefits under the *Employment Insurance Act* is based on the lesser of 30% of the EI benefits received, and 30% of the amount by which "threshold income" exceeds $66,375 (1.25 times the maximum insurable earnings of $53,100). For this purpose, "threshold income" is Net Income For Tax Purposes, calculated without the OAS or EI clawbacks.

Chapter 9 **Child Care Expenses** The least of three amounts:

1. The amount actually paid for child care services. If the child is at a camp or boarding school, this amount is limited to a weekly amount $275 (any age if eligible for disability tax credit), $200 (under 7 year of age), or $125 (age 7 through 16 or over 16 with a mental or physical impairment).
2. The sum of the **Annual Child Care Expense Amounts** for the taxpayer's eligible children. The per child amounts are $11,000 (any age if eligible for disability tax credit), $8,000 (under 7 year of age), or $5,000 (age 7 through 16 or over 16 with a mental or physical impairment).
3. 2/3 of the taxpayer's **Earned Income** (for child care expenses purposes).

Chapter 10 **RRSP Deduction Room** For 2019, the addition to RRSP deduction room is equal to:

- the lesser of $26,500 and 18% of 2018 Earned Income,
- reduced by the 2018 Pension Adjustment and any 2018 Past Service Pension Adjustment,
- and increased by any 2018 Pension Adjustment Reversal.

Chapter 11 **Lifetime Capital Gains Deduction** For 2019, the deduction limit for dispositions of shares of qualified small business corporations is $866,912. There is an additional amount for farm or fishing properties of $133,088, providing a total of $1,000,000 for such properties.

Provincial Tax Rates And Provincial Credits For Individuals Provincial taxes are based on Taxable Income, with most provinces adopting multiple rates. The number of brackets range from three to five. Provincial tax credits are generally based on the minimum provincial rate applied to a credit base that is similar to that used for federal credits. In addition to regular rates, two provinces use surtaxes.

Information Applicable To Individuals And Corporations

ITR 4301 **Prescribed Rate** The following figures show the base rate that would be used in calculations such as imputed interest on loans. It also shows the rates applicable on amounts owing to and from the CRA. For recent quarters, the interest rates were as follows:

Year	Quarter	Base Rate	Owing From*	Owing To
2017	All	1%	3%	5%
2018	I	1%	3%	5%
2018	II to IV	2%	4%	6%
2019	**I, II**	**2%**	**4%**	**6%**

*The rate on refunds to corporations is limited to the base rate, without the additional 2%.

Automobile Deduction Limits

- CCA is limited to the first $30,000 of the automobiles cost, plus applicable GST/HST/PST (not including amounts that will be refunded through input tax credits).
- Interest on financing of automobiles is limited to $10 per day.
- Deductible leasing costs are limited to $800 per month (other constraints apply).
- Operating cost benefit = $0.28 per kilometre.
- Deductible rates = $0.58 for first 5,000 kilometres, $0.52 for additional kilometres.

CCA Rates See Appendix to Chapter 5.

Quick Method Rates (GST Only)

	Percentage On GST Included Sales	
	First $30,000	On Excess
Retailers And Wholesalers	0.8%	1.8%
Service Providers And Manufacturers	2.6%	3.6%

Note Different rates apply in the provinces that have adopted an HST system.

Information Applicable To Corporations

Federal Corporate Tax Rates are as follows (federal tax abatement removed):

General Business (Before General Rate Reduction)	28%
General Business (After General Rate Reduction Of 13%)	15%
Income Eligible For M&P Deduction	15%
Income Eligible For Small Business Deduction	9%
Part IV Refundable Tax	38-1/3%
Part I Refundable Tax On Investment Income Of CCPC (ART)	10-2/3%

Reference 89(1)

General Rate Income Pool A CCPC's General Rate Income Pool (GRIP) is defined as follows:

- The GRIP balance at the end of the preceding year; plus
- 72% of the CCPC's Taxable Income after it has been reduced by amounts eligible for the small business deduction and aggregate investment income; plus
- 100% of eligible dividends received during the year; plus
- adjustments related to amalgamations and wind-ups; less
- eligible dividends paid during the preceding year.

125(1) **Small Business Deduction** is equal to 19% of the least of:

A. Net Canadian active business income.

B. Taxable Income, less:

1. 100/28 times the ITA 126(1) credit for taxes paid on foreign non-business income, calculated without consideration of the additional refundable tax under ITA 123.3 or the general rate reduction under ITA 123.4; and

2. 4 times the ITA 126(2) credit for taxes paid on foreign business income, calculated without consideration of the general rate reduction under ITA 123.4.

C. The annual business limit of $500,000, less any portion allocated to associated corporations, less the grinds for large corporations and passive income.

123.3 **Additional Refundable Tax On Investment Income (ART)** is equal to 10-2/3% of the lesser of:

- the corporation's "aggregate investment income" for the year [as defined in ITA 129(4)]; and
- the amount, if any, by which the corporation's Taxable Income for the year exceeds the amount that is eligible for the small business deduction.

123.4(2) **General Rate Reduction** is equal to 13% of Full Rate Taxable Income. This is Taxable Income, reduced by; income eligible for the small business deduction, income eligible for the M&P deduction and the corporation's "aggregate investment income" for the year.

125.1 **Manufacturing And Processing Deduction** is equal to 13% of the lesser of:

A. Manufacturing and processing profits, less amounts eligible for the small business deduction; and

B. Taxable Income, less the sum of:

1. the amount eligible for the small business deduction;
2. 4 times the foreign tax credit for business income calculated without consideration of the ITA 123.4 general rate reduction; and
3. "aggregate investment income" (of CCPCs) as defined in ITA 129(4).

126(1) **Foreign Tax Credits For Corporations** The Foreign Non-Business Income Tax Credit is the lesser of:

- The tax paid to the foreign government (for corporations, there is no 15% limit on the foreign non-business taxes paid); and
- An amount determined by the following formula:

$$\left[\frac{\text{Foreign Non} - \text{Business Income}}{\text{Adjusted Division B Income}}\right][\text{Tax Otherwise Payable}]$$

126(2) The Foreign Business Income Tax Credit is equal to the least of:

- The tax paid to the foreign government;
- An amount determined by the following formula:

$$\left[\frac{\text{Foreign Business Income}}{\text{Adjusted Division B Income}}\right][\text{Tax Otherwise Payable}]; \text{ and}$$

- Tax Otherwise Payable for the year, less any foreign tax credit taken on non-business income under ITA 126(1).

129(4) **Refundable Portion Of Part I Tax Payable** is defined as the least of three items:

1. the amount determined by the formula

A - B, where

A is 30-2/3% of the corporation's aggregate investment income for the year, and

B is the amount, if any, by which the foreign non-business income tax credit exceeds 8% of its foreign investment income for the year.

2. 30-2/3% of the amount, if any, by which the corporation's taxable income for the year exceeds the total of:

- the amount eligible for the small business deduction;
- 100 ÷ 38-2/3 of the tax credit for foreign non-business income; and
- 4 times the tax credit for foreign business income.

3. the corporation's tax for the year payable under Part I.

129(4) **Aggregate Investment Income** is the sum of:

- net taxable capital gains for the year, reduced by any net capital loss carry overs deducted during the year; and
- income from property including interest, rents, and royalties, but excluding dividends that are deductible in computing Taxable Income. Since foreign dividends are generally not deductible, they would be included in aggregate investment income.

129(4) **ELIGIBLE 2019 Refundable Dividend Tax On Hand** (RDTOH) is defined as follows:

Beginning Balance The transitional January 1, 2019 Eligible RDTOH balance which is the lesser of:

- The January 1, 2019 single RDTOH balance; and
- 38-1/3 percent of the January 1, 2019 GRIP balance

Additions

- Part IV taxes paid on eligible dividends from non-connected taxable Canadian corporations. These are commonly referred to as portfolio dividends.
- Part IV taxes paid on eligible dividends from connected corporations to the extent that such dividends included a refund from the paying corporation's Eligible RDTOH.

Deduction Deducted from this total would be any dividend refund claimed from the Eligible RDTOH account in the previous taxation year. For 2019, this deduction is reflected in the transitional RDTOH balance and will not be deducted again.

NON-ELIGIBLE 2019 Refundable Dividend Tax On Hand (RDTOH) is defined as follows:

Beginning Balance The transitional January 1, 2019 Non-Eligible RDTOH balance is equal to the excess, if any, of the January 1, 2019 balance in the single RDTOH account, over 38-1/3 percent of the January 1, 2019 GRIP balance.

Additions There are three items that are added to the Non-Eligible RDTOH beginning balance:

- All of the Part I refundable tax for the year.
- Part IV taxes paid on non-eligible dividends from connected corporations to the extent that such dividends included a refund from the paying corporation's Non-Eligible RDTOH.
- Part IV taxes paid on non-eligible dividends from non-connected taxable Canadian corporations.

Deduction Deducted from this total would be any dividend refund claimed from the Non-Eligible RDTOH account in the previous taxation year. For 2019, this deduction is reflected in the transitional RDTOH and will not be deducted again.

186(1) **Part IV Tax** is assessed at a rate of 38-1/3% of portfolio dividends, plus dividends received from a connected company that gave rise to a dividend refund for the connected company as a result of the payment.

Tax Related Web Sites

GOVERNMENT

Canada Revenue Agency www.canada.ca/en/revenue-agency
Department of Finance Canada www.fin.gc.ca

CPA FIRMS

BDO www.bdo.ca/en-ca/services/tax/domestic-tax-services/overview/
Deloitte. www2.deloitte.com/ca/en/pages/tax/topics/tax.html
Ernst & Young www.ey.com/CA/en/Services/Tax
KPMG www.kpmg.com/ca/en/services/tax
PricewaterhouseCoopers www.pwc.com/ca/en/tax/publications.jhtml

OTHER

CPA Canada www.CPAcanada.ca
Canadian Tax Foundation www.ctf.ca
ProFile Tax Suite www.profile.intuit.ca

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The textbook is published in two Volumes:	**Volume I** = Chapters 1 to 10 **Volume II** = Chapters 11 to 21

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Study Guide

Your two volume textbook is accompanied by a separate Study Guide that is available in print and online.

The chapters of this Study Guide correspond to the chapters of ***Byrd & Chen's Canadian Tax Principles*.**

Each of these Study Guide chapters contains the following:

- Detailed guidance on how to work through the text and problems in the chapter.
- Detailed solutions to the Exercises and Self Study Problems in the textbook for the chapter.
- A list of learning objectives for the material in the chapter.

In addition, the Study Guide contains:

- Two sample personal tax returns and two Self Study Tax Software Problems in Chapters 4 and 11.
- A sample corporate tax return in Chapter 13.
- An extensive Glossary.

CHAPTER 1

Introduction To Federal Taxation In Canada

The Canadian Tax System

Alternative Tax Bases

1-1. There are a variety of ways in which taxes can be classified. One possible basis of classification would be the economic feature or event that is to be taxed. Such features or events are referred to as the base for taxation and a large number of different bases are used in different tax systems throughout the world. Some of the more common tax bases are as follows:

Income Tax A tax on the income of certain defined entities.

Property Tax A tax on the ownership of some particular set of goods.

Consumption Tax A tax levied on the consumption or use of a good or service. Also referred to as sales tax or commodity tax.

Value Added Tax A tax levied on the increase in value of a good or service that has been created by the taxpayer's stage of the production or distribution cycle.

Tariffs or Customs Duties A tax imposed on the importation or exportation of certain goods or services.

Transfer Tax A tax on the transfer of property from one owner to another.

User Tax A tax levied on the user of some facility such as a road or airport.

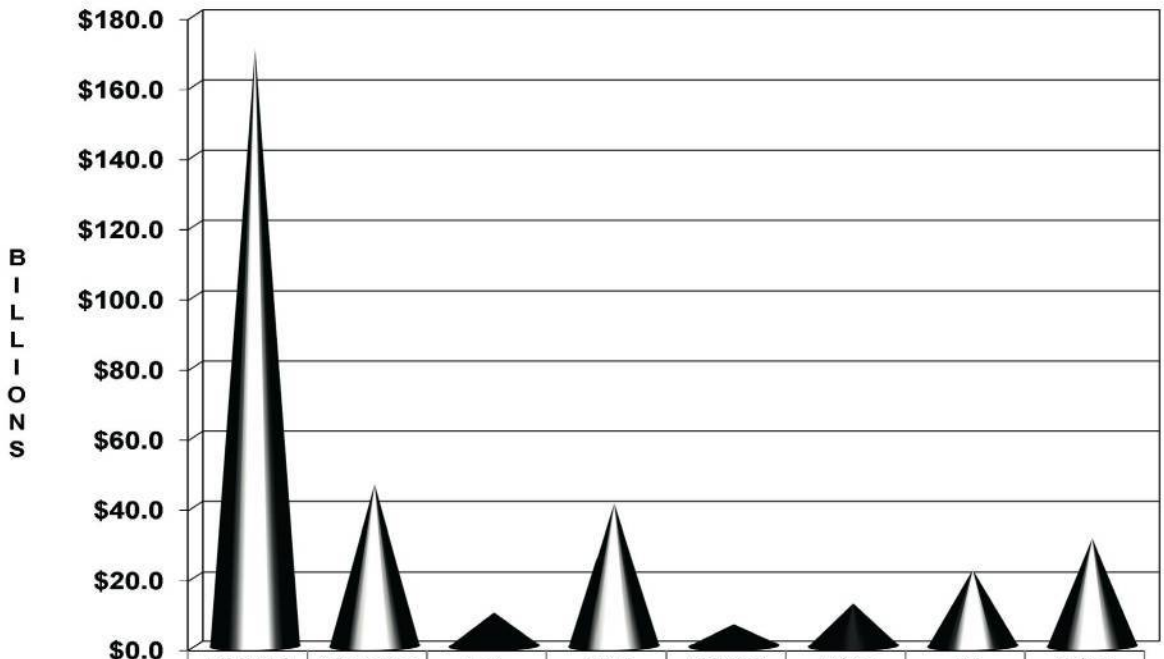
Capital Tax A tax on the invested capital of a corporation.

Head Tax A tax on the very existence of some classified group of individuals.

1-2. At one time or another, some level of Canadian government has used, or is still using, all of these bases for taxation. For example, the Canadian federal government currently has, in addition to income taxes on corporations, individuals, and trusts, such taxes as the Goods and Services Tax (GST), an alcoholic beverages tax, special transaction taxes, a gasoline tax, as well as others. The revenue figures for the major types of Canadian taxation can be found in Figure 1-1 (following page). The amounts that we have presented here are from the federal budget that was tabled on March 19, 2019.

Figure 1 - 1 Federal Government Revenues

2019 - 2020 Fiscal Year Total = $388.8 Billion



	Personal Income Tax (50.3%)	Corporate Income Tax (13.7%)	Non-Resident Income Tax (2.9%)	GST (12.0%)	Customs Import Duties (1.9%)	Other Excise Taxes (3.6%)	EI Premiums (6.5%)	Other Revenues (9.1%)
■ Billions	$170.4	$46.3	$9.7	$40.8	$6.3	$12.3	$22.0	$31.0

1-3. Figure 1-1 makes it very clear that the dominant form of Canadian taxation at the federal level is the income tax that is levied on individuals. More than 50 percent of federal revenues come from this source.

1-4. Running a distant second is income taxes on Canadian corporations at 13.7 percent of federal revenues, closely followed by GST collections at 12 percent. These two sources have been moving closer together as GST collections have become a more important source.

1-5. Employment insurance revenues at 6.5 percent of the total are also important. Taken together, non-resident revenues, customs duties, and excise taxes, provide 8.4 percent of the total.

1-6. Other revenues consist of revenues from Crown corporations, fuel charges, other programs, and net foreign exchange.

Taxable Entities In Canada

Federal Income Tax

1-7. Three types of entities are subject to federal income taxation. These are:

- Individuals (human beings)
- Corporations
- Trusts

1-8. You should note that the *Income Tax Act* uses the term "person" to refer to all three types of taxable entities. This can be a bit confusing in that the dictionary defines person as "a human being, whether man, woman, or child". Despite this conventional usage of the term person, the *Income Tax Act* applies it to both corporations and trusts. When the *Act* wishes to refer to a human taxpayer, it uses the term "individual".

1-9. For income tax purposes, unincorporated businesses such as partnerships and proprietorships are not viewed as taxable entities. Rather, income earned by an unincorporated business organization is taxed in the hands of the proprietor (who would be an individual) or the partner. Note that members of a partnership may be individuals, trusts, or corporations.

1-10. As discussed in Chapter 2, "Procedures And Administration", all three types of taxable entities are required to file income tax returns. The return for an individual is referred to as a T1, for a corporation, a T2, and for a trust, a T3. Proprietorships and partnerships do not file income tax returns as they are not taxable entities.

GST

1-11. The requirement to register to collect and remit GST generally extends to any person engaged in commercial activity in Canada. You should note that the definition of a person for GST purposes is different from that used in the *Income Tax Act*. For income tax purposes, a "person" is restricted to an individual, a corporation, or a trust. Unincorporated businesses do not file separate income tax returns.

1-12. Under GST legislation, the concept of a person is much broader, including individuals, partnerships, corporations, estates of deceased individuals, trusts, charities, societies, unions, clubs, associations, commissions, and other organizations. Chapter 21, "GST/HST" includes detailed coverage of the Goods And Services Tax and the Harmonized Sales Tax.

Exercise One - 1

Subject: Taxable Entities For Income Tax Purposes

Which of the following entities could be required to file an income tax return?

- Max Jordan (an individual)
- Jordan's Hardware Store (an unincorporated business)
- Jordan & Jordan (a partnership)
- The Jordan family trust (a trust)
- Jordan Enterprises Ltd. (a corporation)
- The Jordan Foundation (an unincorporated charity)

Exercise One - 2

Subject: Taxable Entities For GST Purposes

Which of the following entities could be required to file a GST return?

- Max Jordan (an individual)
- Jordan's Hardware Store (an unincorporated business)
- Jordan & Jordan (a partnership)
- The Jordan family trust (a trust)
- Jordan Enterprises Ltd. (a corporation)
- The Jordan Foundation (an unincorporated charity

SOLUTIONS available in print and online Study Guide.

Federal Taxation And The Provinces

Personal Income Taxes

1-13. Under the Constitution Act, the federal, provincial, and territorial governments have the power to impose taxes. The provinces and territories are limited to direct taxation as delegated in the Act, a constraint that leaves all residual taxation powers to the federal government. The provinces are further limited to the taxation of income earned in the particular province and the income of persons resident in that province. Within these limitations, all of the provinces and territories impose both personal and corporate income taxes.

1-14. Under the federal/provincial tax collection agreement, provincial taxes are calculated by applying a provincial tax rate to a Taxable Income figure. With the exception of Quebec, all of the provinces use the same Taxable Income figure that is used at the federal level.

1-15. Despite the use of the federal Taxable Income figure, the provinces have retained considerable flexibility in their individual tax systems. This flexibility is achieved in two ways:

- Each province can apply different rates and surtaxes to as many tax brackets as it wishes.
- More importantly, each province is able to set different provincial credits to apply against provincial Tax Payable. While most provinces have provincial credits that are similar to credits that are established at the federal level, the value of these credits varies considerably at the provincial level. For example, the 2019 base for the basic personal tax credit varies from $8,481 in Nova Scotia to $19,639 in Alberta. In addition, many provinces have additional types of credits. As an example of this, Nova Scotia and Prince Edward Island have a credit for dependent children under 6 years of age.

1-16. The provincial differences complicate the preparation of tax returns. The level of complication varies from province to province, depending on the degree to which provincial tax brackets and provincial tax credits resemble those applicable at the federal level.

1-17. Because of these complications, the problem material in this text will, in general, not require the calculation of provincial taxes for individuals. However, because the combined federal/provincial rate is important in many tax-based decisions (e.g., selecting between alternative investments), we will continue to refer to overall combined rates, despite the fact that such figures are very specific to the province in which the income is taxed, as well as the characteristics associated with the individual filing the return.

Exercise One - 3

Subject: Federal And Provincial Taxes Payable

John Forsyth has Taxable Income of $27,000. For the current year, his federal tax rate is 15 percent, while the corresponding provincial rate is 7.5 percent. Determine Mr. Forsyth's combined federal and provincial tax payable, before consideration of any available credits against Tax Payable.

SOLUTION available in print and online Study Guide.

Corporate Income Taxes

1-18. The system used to calculate provincial corporate income tax payable is similar to the system that is applicable to individuals. Provincial corporate income tax is levied on Taxable Income. All of the provinces, with the exception of Alberta and Quebec, use the federal *Income Tax Act* to compute Taxable Income. Even in Alberta and Quebec, the respective provincial Tax Acts have many of the same features as the federal *Act*.

1-19. With respect to the collection of corporate income taxes, only Alberta and Quebec collect their own corporate income taxes. In all other provinces and territories, corporate income taxes are collected by the federal government on behalf of the provinces.

GST, HST And PST

1-20. Although detailed coverage of GST and HST can be found in Chapter 21, GST/HST, we will provide a short overview here as part of our introduction to federal taxation. When the federal government proposed a joint federal/provincial goods and services tax (GST) in 1987, the lack of interest by provincial governments meant that the GST was introduced only at the federal level. Provincial sales taxes remained in place without significant alteration. As a result, two different sales taxes were collected, accounted for, and remitted.

1-21. This situation was very costly and time consuming for businesses operating in more than one province, as they had to file multiple sales tax returns under different sets of rules. This was clearly an inefficient way to generate tax revenues and, not surprisingly, considerable pressure developed for the harmonization of the separate federal and provincial sales taxes.

1-22. Despite the obvious efficiencies that would result from harmonization, it has not been accepted across Canada. Quebec administers its own Quebec sales tax (QST) which is a somewhat harmonized system. While its coverage is similar to the GST, it is not identical.

1-23. In several provinces there is a harmonized sales tax (HST) which is, in effect, a combined federal/provincial sales tax. These systems differ from the Quebec model in that the HST is a single tax administered by the federal government. The HST provinces are New Brunswick, Nova Scotia, Newfoundland, Prince Edward Island and Ontario.

1-24. Since each HST province chooses the rate for the provincial portion of the HST and the provinces have selected different rates, the HST is not a single rate throughout the HST provinces. As a result, even among the HST provinces, the application of the HST on a sale can result in a sales tax figure that varies depending on the province of sale.

1-25. The various provincial sales tax regimes have left Canada with a fragmented sales tax system. As of July 1, 2019, the different sales tax rates in the provinces are:

- GST Only
  - **5%** for Alberta
- HST Rates (Includes 5 Percent GST)
  - **13%** (5% + 8%) for Ontario
  - **15%** (5% + 10%) for New Brunswick, Newfoundland, Nova Scotia, and Prince Edward Island
- GST Plus Provincial Sales Tax
  - **11%** (5% + 6%) for Saskatchewan
  - **12%** (5% + 7%) for British Columbia
  - **12%** (5% + 7% as of July 1, 2019) for Manitoba
  - **14.975%** (5% + 9.975%) for Quebec

Tax Policy Concepts

Taxation And Economic Policy

1-26. The traditional goal of tax legislation has been to generate revenues for the relevant taxing authority. However, it is clear that today's approach to tax legislation is multi-faceted. We use tax legislation as a tool to facilitate a number of economic policy objectives:

Resource Allocation Tax revenues are used to provide public goods and services. Pure public goods such as the cost of our national defense system are thought to benefit all taxpayers. As it is not possible to allocate costs to individuals on the basis of benefits received, such costs must be supported with general tax revenues. Similar allocations occur with such widely used public goods as education, health care, and pollution control. In some cases, the tax system also has an influence on the allocation

of private goods. For example, excise taxes are used to discourage the consumption of alcohol and tobacco products.

Distribution Effects Our tax system is used to redistribute income and wealth among taxpayers. Such provisions as the federal GST tax credit and provincial sales tax exemptions on food and low priced clothing have the effect of taking taxes paid by higher income taxpayers and distributing them to lower income wage earners or taxpayers with higher basic living costs in proportion to their income.

Stabilization Effects Taxes may also be used to achieve macroeconomic objectives. At various times, tax policy has been used to encourage economic expansion, increase employment, and to assist in holding inflation in check. An example of this is the emphasis on stimulating the economy that is found in recent budgets.

Fiscal Federalism This term refers to the various procedures that are used to allocate resources among different levels of government. For 2019 - 2020, it is estimated that transfers to other levels of government will amount to $76.9 billion. This compares to transfers to persons of $100.4 billion and $152.1 billion in direct spending.

Taxation And Income Levels

General Approaches

1-27. Policy makers are concerned about the relationship between income levels and rates of taxation. Taxes can be proportional, in that a constant rate is applied at all levels of income. In theory, this is our general approach to taxing the income of corporations. For public companies, the system is based on a flat rate that is applicable to all income earned by the company. However, a wide variety of provisions act to modify the application of this rate, resulting in a situation where many Canadian companies are not subject to this notional flat rate.

1-28. As an alternative, taxation can be regressive, resulting in lower effective rates of taxation as higher income levels are reached. Sales taxes generally fall into this regressive category as lower income individuals spend a larger portion of their total income and, as a consequence, pay a greater portion of their total income as sales taxes levied on their expenditures.

EXAMPLE Consider the Werner sisters:

Gertrude Werner has income of $200,000 and spends $40,000 of this amount. She lives in a province with a 13 percent harmonized sales tax (HST) on expenditures, resulting in the payment of $5,200 in HST. This represents a 2.6 percent effective tax rate on her $200,000 income.

Ingrid Werner has income of $40,000 and spends all of this amount. She lives in the same province as her sister, resulting in the payment of $5,200 in HST. This represents a 13 percent effective tax rate on her $40,000 income.

Exercise One - 4

Subject: Regressive Taxes

Margie Jones has Taxable Income for the current year of $895,000, of which $172,000 is spent on goods and services that are subject to Harmonized Sales Tax (HST) at a rate of 13 percent. Her sister, Jane Jones, is a part-time student living in the same province and has Taxable Income of $18,000. During the current year, as a result of using some of her savings, she spends $27,500 on goods and services that are all subject to HST. Determine the effective sales tax rate as a percentage of the income of the two sisters.

SOLUTION available in print and online Study Guide.

We suggest you work Self Study Problem One-1 at this point.

1-29. In contrast to the regressive nature of sales taxes, the present system of personal income taxation is designed to be progressive, since higher rates are applied to higher levels of income. For 2019, the federal rates range from a low of 15 percent on the first $47,630 of Taxable Income to a high of 33 percent on Taxable Income in excess of $210,371.

Progressive Vs. Regressive

1-30. As noted in the preceding paragraph, the federal income tax system taxes individuals using a progressive system. The major arguments in favour of this approach can be described as follows:

Equity Higher income individuals have a greater ability to pay taxes. As their income is above their basic consumption needs, the relative cost to the individual of having a portion of this income taxed away is less than the relative cost to lower income individuals, where additional taxation removes funds required for such essentials as food and housing.

Stability Progressive tax rates help maintain after-tax income stability by shifting people to lower tax brackets in times of economic downturn and to higher brackets when there is economic expansion. The resulting decreases or increases in income taxes serve to cushion the economic swings.

1-31. There are, however, a number of problems that can be associated with progressive rates. These can be briefly described as follows:

Complexity With progressive rates in place, efforts will be made to divide income among as many individuals (usually family members) as possible. These efforts to make maximum use of the lower tax brackets necessitate the use of complex anti-avoidance rules by taxation authorities.

Income Fluctuations In the absence of relieving provisions, progressive rates discriminate against individuals with highly variable income streams. That is, under a progressive system, an individual with $1,000,000 in income in one year and no income for the next three years will pay substantially more in taxes than an individual with the same $1,000,000 total earned over four years at a rate of $250,000 per year.

Family Unit Problems Progressive tax rates discriminate against single income family units. A family unit in which one spouse makes $200,000 and the other has no Taxable Income would pay significantly more in taxes than would be the case if each spouse earned $100,000.

Economic Growth It is clear that the high tax brackets that can be associated with a progressive system can discourage both employment and investment efforts. This could serve to limit economic growth.

Tax Concessions The high brackets associated with progressive systems lead to pressure for various types of tax concessions to be made available. Because high income individuals have a greater ability to take advantage of favourable provisions in the income tax legislation, they may actually wind up paying taxes at lower effective rates. In response to the possibility that, in extreme cases, some high income individuals pay no income taxes at all, there is an alternative minimum income tax that is imposed on certain taxpayers (see Chapter 11).

Tax Avoidance And Evasion Progressive rates discourage income reporting and encourage the creation of various means to evade taxation. Evasion strategies range from simple bartering, to cash only transactions, to offshore tax havens and finally to criminal activities.

Reduced Tax Revenues There is evidence that, if tax rates are too high, the result may be reduced aggregate tax revenues. Some authorities believe that this begins to occur at tax rates between 40 and 50 percent.

We would note that, with the maximum federal rate at 33 percent, the maximum combined federal/provincial rate in most provinces exceeds 50 percent, going as high as 54 percent in some Provinces for income in excess of $210,371. While it is difficult to determine the degree to which this will encourage tax evasion, it is almost certain that maximum tax rates at this level has and will be a major factor in decisions involving significant amounts of income being moved out of Canada. Individuals with income well in excess of the maximum threshold often have great flexibility in where they reside and where they invest.

Of particular importance is the possibility of moving to the U.S., particularly with the rates established under President Trump's tax reform. In several states, including Florida, there is no state income tax. This means that income is only taxed at the federal level. For an individual with income of $210,371, the applicable rate is only 35 percent. The rate reaches a maximum of 37 percent only when the individual's income exceeds $500,000. Given this 17 point spread (54% - 37%), it is likely that many high income individuals will at least consider a change in venue.

Flat Tax Systems

1-32. While progressive tax systems continue to be pervasive, there has been a worldwide trend towards flattening rate schedules. One of the reasons for this trend is the fact that effective tax rates are not as progressive as the rate schedules indicate. As mentioned in the preceding paragraph, high bracket taxpayers tend to have better access to various types of tax concessions which can significantly reduce the effective rates for these individuals.

1-33. Given this situation, it has been suggested that we could achieve results similar to those which, in fact, prevail under the current system by applying a single or flat rate of tax to a broadened taxation base. In this context, the term base broadening refers to the elimination of tax concessions, resulting in tax rates that are applied to a larger income figure.

1-34. There is currently no flat provincial tax system in place in Canada. Alberta's 10 percent rate on the income of individuals was in place until 2015. However, faced with the financial difficulties generated by falling oil prices, the Alberta government introduced a progressive system in 2016.

We suggest you work Self Study Problem One-2 at this point.

Tax Incidence

1-35. Tax incidence refers to the issue of who really pays a particular tax. While statutory incidence refers to the initial legal liability for tax payment, the actual economic burden may be passed on to a different group. For example, certain taxes on production might be the legal liability of the producer. However, they may be partly or entirely shifted to consumers through price increases on the goods produced.

1-36. Policy makers must be concerned with this to ensure that the system is working as intended. It is generally assumed that the incidence of personal income tax falls on individuals. In addition, in their role as consumers, individuals also assume the responsibility for a large portion of the various sales taxes that are levied in Canada. The incidence of corporate taxes is more open to speculation. Shareholders may bear the burden of corporate taxes in the short run. However, most authorities believe that, in the long run, this burden is shared by employees and consumers.

Tax Expenditures

1-37. In contrast to government funding programs that provide payments to various entities in the economy, tax expenditures reflect revenues that have been given up by the government through the use of tax preferences, concessions, and other tax breaks. These expenditures may favour selected individuals or groups (senior citizens), certain kinds of income (capital gains), or certain characteristics of some taxpayers (the disabled).

1-38. In an effort to quantify the importance of these expenditures, the Department of Finance produces the publication, "Tax Expenditures And Evaluations" each year. The 2018 edition contains figures for the years 2012 through 2019 (projected). Examples of the 2012 estimates and 2019 projections of the cost of some of these expenditures include:

Tax Expenditure	2012	2019
Charitable donations tax credit	$2,365 million	$2,885 million
Tax credit for spouse	$1,635 million	$1,840 million
Partial inclusion of capital gains	$3,330 million	$7,080 million
The deduction of RRSP contributions	$12,325 million	$18,270 million
Tax free gains on principal residences	$3,900 million	$6,090 million

1-39. It is clear that such tax expenditures are of considerable significance in the management of federal finances. It is equally clear that the provision of this type of government benefit has become entrenched in our tax system. This situation can be explained by a number of factors:

- It is less costly to administer tax expenditures than it is to administer government funding programs.
- More decisions are left to the private sector so that funds may be allocated more efficiently.
- Tax expenditures reduce the visibility of certain government actions. This is particularly beneficial if some social stigma is attached to the programs. For example, a child tax benefit system is more acceptable than increasing social assistance (welfare) payments.
- Tax expenditures reduce the progressivity of the tax system. As many of the tax expenditures, such as tax shelters, are more available to higher income taxpayers, they serve to reduce effective tax rates in the higher rate brackets.

1-40. Tax expenditures are not only very substantial, they are also difficult to control. This was expressed several years ago by a former auditor general, as follows:

> A cost conscious Parliament is in the position of a team of engineers trying to design a more fuel efficient automobile. They think they have succeeded, but the engine seems to go on consuming as much gas as it did before. They cannot understand the problem until they notice that, hidden from view, a myriad of small holes have been punched through the bottom of the gas tank. This is too often the way of tax expenditures. Revenue leaks away, and MPs do not know about it until it is too late.

Qualitative Characteristics Of Tax Systems

General Concepts

1-41. Accounting standard setting bodies have established such concepts as relevance and reliability as being desirable qualitative characteristics of accounting information. While not established with the same degree of formality, it is clear that there are similar concepts that can be used to evaluate tax systems. Some of these desirable qualitative characteristics can be described as follows:

Equity Or Fairness Horizontal equity entails assessing similar levels of taxation for people in similar economic circumstances. If two individuals each have Taxable Income of $50,000, horizontal equity would require that they each pay the same amount of taxes.

In contrast, vertical equity means dissimilar tax treatment of people in different circumstances. If an individual has Taxable Income of $100,000, he should pay more taxes than an individual with Taxable Income of $50,000.

Neutrality The concept of neutrality calls for a tax system that interferes as little as possible with decision making. An overriding economic assumption is that decisions are always made to maximize the use of resources. This may not be achieved when tax factors affect how taxpayers save, invest, or consume. Taxes, by influencing economic decisions, may cause a less than optimal allocation of resources.

Adequacy A good tax system should meet the funding requirements of the taxing authority. It is also desirable that these revenues be produced in a fashion that is dependable and relatively predictable from year to year.

Elasticity Tax revenues should be capable of being adjusted to meet changes in economic conditions, without necessitating tax rate changes.

Flexibility This refers to the ease with which the tax system can be adjusted to meet changing economic or social conditions.

Simplicity And Ease Of Compliance A good tax system is easy to comply with and does not present significant administrative problems for the people enforcing the system.

Certainty Individual taxpayers should know how much tax they have to pay, the basis for payments, and the due date. Such certainty also helps taxing authorities estimate tax revenues and facilitates forecasting of budgetary expenditures.

Balance Between Sectors A good tax system should not be overly reliant on either corporate or individual taxation. Attention should also be given to balance within these sectors, insuring that no type of business or type of individual is asked to assume a disproportionate share of the tax burden.

International Competitiveness If a country's tax system has rates that are out of line with those in comparable countries, the result will be an outflow of both business and skilled individuals to those countries that have more favourable tax rates.

Conflicts Among Characteristics

1-42. In designing a tax system, many compromises are required. Examples include the fact that flexibility is often in conflict with certainty, equity requires trade-offs in simplicity and neutrality, and some taxes with very positive objectives are very non-neutral in nature. An example of this last conflict is that the rates available to small businesses are very favourable because the government believes that this attracts investment to this sector, thereby encouraging employment and the development of active business efforts. However, this may not result in the optimal allocation of resources to the business sector as a whole.

Evaluation Of The Canadian System

1-43. Canadian policy makers often refer to the preceding qualitative characteristics in discussions involving taxation policies. This would make it appropriate to consider how the current system of federal taxation stacks up against these criteria. While any comprehensive evaluation of this question goes well beyond the objectives of this text, we offer the following brief comments:

- With respect to equity, Canada continues to have situations in which high income individuals pay little or no tax and relatively low income individuals are subjected to fairly high effective rates. While the alternative minimum tax was instituted to correct this problem, inequity is unlikely to be eliminated in a tax system that attempts to accomplish as many diverse objectives as does the current Canadian system.
- As noted previously, the Canadian system has a very heavy reliance on the taxation of personal income and receives a very low portion of its revenues from the corporate income tax. Also on the low side is the contribution of the GST.
- The Canadian system has had problems with stability and dependability of revenues.

- The Canadian tax system is very complex, making compliance difficult for many taxpayers. In addition, administration of the legislation is made more difficult by the large number of provisions and the lack of clarity in their content.

  The inability to achieve a harmonized GST/HST system has made this situation much worse. As we have noted, different provinces have adopted different systems, thereby complicating inter-provincial transactions. Further, in a given province, there are significant variations in the types of goods and services that are subject to taxation within a given system.

- With respect to international competitiveness, the situation is similar for corporations and individuals vis-a-vis the United States.
  - Over the last few years, tax rates on Canadian corporations have been reduced. These reductions leave Canada with corporate rates that compare very favorably with most foreign jurisdictions. However, this situation has changed dramatically in 2018 with the Trump sponsored reduction in the maximum U.S. corporate rate from 35 percent to 21 percent.
  - Increasing the maximum federal tax rate on individuals to 33 percent in 2016 has made Canada less competitive with other countries, particularly the United States. With provincial taxes considered, several provinces tax individuals at a maximum rate of 54 percent. This compares to a maximum rate in some U.S. venues of 37 percent.

We suggest you work Self Study Problem One-3 at this point.

Income Tax Reference Materials

Introduction

1-44. To this point in our discussion of the Canadian tax system and related tax policy concepts, we have considered a variety of taxation bases as they apply at both the federal and provincial level. However, with the exception of Chapter 21 which deals with the goods and services tax, the focus of this book is on the federal taxes that are assessed on the income of individuals, corporations, and trusts.

1-45. Reference materials related to the federal income tax are very extensive. In addition to the *Income Tax Act*, there are many other sources of information. These include other legislative materials, other publications of the Canada Revenue Agency (CRA), documents related to court decisions, as well as interpretive materials from a wide variety of sources.

1-46. If presented in paper format, a complete library of these materials would run to thousands of pages and would have to be included in a large number of separate volumes. Given this, almost all tax practitioners work with an electronic database that provides for easy access through key word searches.

1-47. These electronic databases are published by several Canadian organizations, including CCH, Carswell, and CPA Canada. Through our affiliation with CPA Canada, we are able to provide you with access to their Federal Income Tax Collection (FITAC). Instructions on how to access this electronic database are available online through the MyLab for this text. FITAC includes:

- The *Income Tax Act* and *Income Tax Regulations*.
- Most CRA publications including Income Tax Folios, Interpretation Bulletins, Information Circulars, Guides, and forms.
- An electronic copy of this text, without problem material, that is searchable and has electronic links to other reference materials in the database.

1-48. A description of all of these materials will be found in the sections which follow.

Figure 1 - 2 Basic Structure Of The Income Tax Act

Part I - XIX (in **Divisions** and **Subdivisions**)	→	**Section** (1 - 281)	→	**Subsection** (Arabic numeral)	→	**Paragraph** (lower case letter)	→	**Subparagraph** (lower case Roman numeral)

The Income Tax Act

Importance

1-49. This is the most important source of information for dealing with matters related to the federal income tax. Interpretation and guidance can be found in many other sources. However, at the end of the day, this document provides the basis for any final decision related to the amount of income tax that will have to be paid by an individual, corporation, or trust.

1-50. It is a very long document, running over 2,500 pages in paper format. It is also written in a very legalistic style which, in our opinion, cannot be readily understood by most individuals. Given this, the design of our text is such that it does not require the use of the *Income Tax Act* in order to understand its content or complete the related problem material.

1-51. While the design of this text does not require the use of the *Income Tax Act* as a reference, it is still important to have some understanding of the structure of this document. One reason for this is that the organization of this book generally follows the structure of the *Income Tax Act*. In addition, you will find many references to the *Act* embedded as part of the text. There are two reasons for this:

- The most important reason for these references is to allow interested individuals to explore a particular issue to a depth that goes beyond the scope of this text. The presence of *Income Tax Act* references greatly facilitates this process.
- The use of references can also be convenient. In dealing with a particular subject, it is often more efficient to refer to a subject with a reference to the *Act* than to repeatedly use the full description of the subject.

1-52. Given these considerations, we will provide a description of the basic structure and content of this important legislation.

Structure Of The Federal Income Tax Act

1-53. Figure 1-2 diagrams the basic structure of the *Act*. As can be seen in this diagram, the major divisions of the *Income Tax Act* are referred to as Parts. Some, but not all of these Parts, contain two or more Divisions (e.g., Part I of the *Act* contains Divisions A through J). Some Divisions, but again not all of them, contain Subdivisions. For example, Division B of Part I contains Subdivisions a through k. Note that, while the Parts are numbered I through XIX, there are more than 19 Parts. This reflects the fact that when a new Part is added, it has been more convenient to attach a decimal designation to the new Part, as opposed to renumbering all of the Parts that follow the new Section. For example, Part I is followed by Part I.01, Part I.1, Part I.2, and Part I.3.

1-54. All of the Parts contain at least one Section. However, there is considerable variance in the size of the Parts. Part I.2, "Tax On Old Age Security Benefits", contains only one Section. In contrast, Part I, the largest and most important Part of the *Act*, contains Sections 2 to 180.

1-55. The Sections are labeled 1 through 281. However, as was the case with Parts of the *Act*, decimals are used to label new Sections. For example, Section 12 is followed by Section 12.1, Section 12.2, Section 12.3 (repealed), Section 12.4, Section 12.5, and Section 12.6.

1-56. Sections may be further subdivided into Subsections [designated with Arabic numerals as in Subsection 84(1)]. This is followed by Paragraphs [designated with lower case letters as in Paragraph 84(1)(b)], and by Subparagraphs [designated with lower case Roman

numerals as in Subparagraph 84(1)(b)(i)]. In some cases, the outlining process goes even further with Clauses (designated with upper case letters) and Subclauses (designated with upper case Roman numerals). Putting all of this together means that the reference:

ITA 115(1)(a)(i)(A)(I)

would be read as *Income Tax Act* Section 115, Subsection (1), Paragraph (a), Subparagraph (i), Clause A, Subclause I. Normally the relevant Part of the *Act* (Part I in this case) is not indicated in such references.

Parts Of The Act

1-57. The Parts of the *Income Tax Act* are numbered I through XVII. As noted, because of the use of decimal designations there are more than 17 Parts.

1-58. About 70 percent of the Sections of the *Income Tax Act* are found in Part I, which is titled "Income Tax". This Part contains Sections 2 through 180 of the *Act* and, because of its importance, we will provide a more detailed description of this Part in the following material.

1-59. Parts I.01 through XIX cover a variety of special taxes as well as rules related to matters of administration, enforcement, and interpretation. For example, Part V is titled "Tax And Penalties In Respect Of Qualified Donees" and Part XII.3 is titled "Tax On Investment Income Of Life Insurers". As the great bulk of our attention in this text will be focused on Part I of the *Act*, there is little point in providing a list of these Parts for you to read. However, if you have further interest in their content, we would refer you to the complete copy of the *Income Tax Act* that is included in the FITAC database, which can be installed from the MyLab for this text.

Part I Of The Act

1-60. Part I, the largest and most important Part of the *Income Tax Act*, is divided into eleven Divisions. Some of these Divisions are further divided into Subdivisions. The Divisions and their more significant Subdivisions are described in the following paragraphs:

Division A: "Liability For Tax" (ITA Section 2) This short Division is concerned with the question of who is liable for payment of income tax in Canada. This Division will be covered in this Chapter 1.

Division B: "Computation Of Income" (ITA Sections 3 through 108) This is the longest Division in Part I and concerns itself with the determination of Net Income For Tax Purposes. Its first five Subdivisions describe the major sources of income and deductions and are as follows:

- **Subdivision a** - "Income Or Loss From An Office Or Employment" This Subdivision deals with the ordinary wages and salaries that are earned by individuals while as an employee. The material in this Subdivision provides the basis for Chapter 3.
- **Subdivision b** - "Income Or Loss From A Business Or Property" This Subdivision deals with business income earned by corporations, trusts, and by individuals through proprietorship or partnership arrangements. Also covered in this Subdivision is property income which includes rents, interest, dividends, and royalties. The material in this Subdivision provides the basis for Chapters 5, 6, and 7.
- **Subdivision c** - "Taxable Capital Gains And Allowable Capital Losses" This Subdivision deals with gains and losses resulting from the disposal of capital property. The material in this Subdivision is dealt with in Chapter 8.
- **Subdivision d** - "Other Sources Of Income" Covered here are miscellaneous income sources, such as spousal support received and various types of pension income, that do not fit into any of the major categories dealt with in Subdivisions a, b, and c. This material is covered in Chapter 9.

- **Subdivision e** - "Deductions In Computing Income" Covered here are miscellaneous deductions such as moving expenses, child care costs, and spousal support paid. These are deductions that do not fit into any of the categories in Subdivisions a, b, and c. This material is also covered in Chapter 9.

Subdivisions a, b, and c each provide for both inclusions and deductions and, as a consequence, require the calculation of a net income figure. The deductions that are specified in Subdivisions a, b and c can only be deducted from inclusions in that same Subdivision. That is, deductions related to business income (Subdivision b) cannot be deducted from the inclusions for employment income (Subdivision a). This becomes a very important point when the inclusions in a particular Subdivision are not sufficient to support all of the available deductions in that Subdivision.

The remaining six Subdivisions of Division B do not provide new sources of income but, rather, provide additional rules related to the determination of Net Income. These remaining Subdivisions are as follows:

- **Subdivision f** - "Rules Relating To Computation Of Income" This Subdivision contains a variety of rules related to the deductibility of expenses, income attribution, and the death of a taxpayer. These rules are covered in Chapters 6 and 9.
- **Subdivision g** - "Amounts Not Included In Computing Income" This is a very specialized Subdivision, dealing with certain types of exempt income. It is not given significant coverage in this text.
- **Subdivision h** - "Corporations Resident In Canada And Their Shareholders" This Subdivision presents a number of rules related to the taxation of Canadian resident corporations. This material is covered in Chapters 12, 13, and 14.
- **Subdivision i** - "Shareholders Of Corporations Not Resident In Canada" This is a specialized Subdivision. Limited coverage is available in Chapter 20.
- **Subdivision j** - "Partnerships And Their Members" This Subdivision, dealing with rules related to partnerships, is given detailed coverage in Chapter 18.
- **Subdivision k** - "Trusts And Their Beneficiaries" This Subdivision, dealing with the taxation of trusts, is given detailed consideration in Chapter 19.

Division C: "Computation Of Taxable Income" (ITA Sections 109 through 114.2) This Division covers the conversion of Division B income (commonly referred to as Net Income For Tax Purposes, or simply Net Income) into Taxable Income for residents. For individuals, it is given initial coverage in Chapter 4, followed by more detailed coverage in Chapter 11. For corporations, the coverage is in Chapter 12.

Division D: "Taxable Income Earned In Canada By Non-Residents" (ITA Sections 115 through 116) Coverage of this material can be found in Chapter 20.

Division E: "Computation Of Tax" (Sections 117 through 127.41) This Division is concerned with determining the taxes that are payable on the Taxable Income determined in Divisions C and D. It has seven Subdivisions as follows:

- Subdivision a - Rules applicable to individuals
- Subdivision a.1 - Canada Child Benefit
- Subdivision a.2 - Working Income Tax Benefit
- Subdivision a.3 - Child Fitness Tax Credit (Repealed)
- Subdivision a.4 - School Supplies Tax Credit
- Subdivision b - Rules applicable to corporations
- Subdivision c - Rules applicable to all taxpayers

The computation of tax for individuals is largely covered in Chapter 4, with some additional coverage in Chapter 11. The corresponding material for corporations is found in Chapters 12 and 13.

Division E.1: "Minimum Tax" (Sections 127.5 through 127.55) This Division is concerned with the obligation of individuals to pay a minimum amount of tax, as well as the computation of this alternative minimum tax. This material is covered in Chapter 11.

Division F: "Special Rules Applicable In Certain Circumstances" (Sections 128 through 143.4) Much of this Division is devoted to very specialized situations (bankruptcies) or organizations (cooperative corporations). While these situations are not given coverage in this text, the Division overs two subjects that are of more general importance. These are immigration to, and emigration from, Canada which are covered in Chapter 20, and refundable dividends for private corporations which is covered in Chapter 13.

Division G: "Deferred And Other Special Income Arrangements" (Sections 144 through 148.1) This important Division covers the rules related to Registered Retirement Savings Plans, Registered Pension Plans, Deferred Profit Sharing Plans, as well as other deferred income arrangements. Detailed attention is given to this material in Chapter 10.

Division H: "Exemptions" (Sections 149, through 149.2) Covered here are exemptions for individuals and organizations such as certain employees of foreign countries, pension trusts, and charitable organizations. These topics are not given coverage in this text.

Divisions I And J: "Returns, Assessments, Payment And Appeals" and "Appeals To The Tax Court Of Canada And The Federal Court" (Sections 150 through 180) These Divisions deal with the resolution of disputes between taxpayers and the Canada Revenue Agency (CRA). Limited coverage of this material is found in Chapter 2.

Other Income Tax Legislation

1-61. While the *Income Tax Act* constitutes the major source of legislation relevant to the study of federal income tax, there are three other sources of legislative materials that are relevant. These are draft legislation, the Income Tax Regulations and a group of International Tax Treaties between Canada and other countries. A general description of these legislative materials follows.

Draft Legislation

1-62. It is traditional for the federal government to issue a Budget in the first half of each year. Budgets are presented as a Notice Of Ways And Means Motion. As such, its content is of a general nature and does not contain the actual legislative provisions that are required to implement the proposals that are being put forward. The preparation of this legislation takes a considerable period of time and, when it is completed, it is presented as draft legislation. Additional time will pass before this draft legislation is passed by Parliament.

1-63. These time lags can create a somewhat difficult situation in which returns for a particular taxation year must sometimes be filed prior to the actual passage of the legislation relevant to that year. Tax planning can be further complicated by an election call by the governing party. This may be the case in 2019. While the budget was presented on March 19, 2019, an election must be held prior to October 22, 2019. The legislation to implement this budget may never see the light of day if the Liberals were to lose their majority in Parliament.

Income Tax Regulations

1-64. Section 221 of the *Income Tax Act* allows the Governor In Council to make Regulations concerning the administration and enforcement of the *Income Tax Act*. Some of the items listed in this Section include:

- prescribing the evidence required to establish facts relevant to assessments under this *Act*;

- requiring any class of persons to make information returns respecting any class of information required in connection with assessments under this *Act*;
- prescribing anything that, by this *Act*, is to be prescribed or is to be determined or regulated by regulation; and
- defining the classes of persons who may be regarded as dependent for the purposes of this *Act*.

1-65. While these Regulations cannot extend the limits of the law, they can serve to fill in details and, to some extent, modify the statutes. For example, most of the rules for determining the amount of Capital Cost Allowance that can be deducted are established in the Regulations. Such Regulations provide an essential element of flexibility in the administration of the *Act* in that they can be issued without going through a more formal legislative process.

1-66. You should also note that references to material in the Regulations are often referred to in the *Income Tax Act* as "prescribed". For example, the rate the CRA charges on late tax payments, a "prescribed" rate of interest, is determined by a procedure that is described in Regulations 4301 and 4302.

International Tax Treaties

1-67. Canada currently has tax treaties (also known as tax conventions) with nearly 100 countries. The most important of these are the Tax Conventions with the United States and the United Kingdom. While there is considerable variation in the agreements, most of them are based on the model convention developed by the Organization For Economic Co-operation And Development (OECD).

1-68. The purpose of these treaties is twofold. First, they attempt to avoid double taxation of taxpayers who may have reason to pay taxes in more than one jurisdiction and, second, they try to prevent international evasion of taxes. In situations where there is a conflict between the Canadian *Income Tax Act* and an international tax treaty, the terms of the international tax treaty prevail.

1-69. Chapter 20 will provide additional discussion of Canada's tax treaties. Particular attention will be given to the tax treaty between Canada and the U.S.

Income Tax Application Rules, 1971

1-70. When capital gains taxation was introduced in Canada in 1972 (more than 40 years ago), a large number of transitional rules were required, primarily to ensure that the effects of the new legislation were not retroactive. These transitional rules are called the Income Tax Application Rules, 1971, and they can be of some significance in certain situations involving pre-1972 assets.

Other Sources Of Income Tax Information

Electronic Library Resources

1-71. As noted in Paragraph 1-46, most tax practitioners rely on an electronic library for their tax reference materials. Also as noted, the MyLab for this text provides access to one of these libraries — CPA Canada's Federal Income Tax Collection (FITAC).

CRA Website

1-72. The CRA has an extensive website at **www.canada.ca/en/services/taxes**. Almost all of the forms, Guides, Income Tax Folios, Interpretation Bulletins and other documents provided by the CRA that are described in Paragraph 1-73 are available on the website. The forms and publications can be viewed and printed online or downloaded to a computer in one or more formats. The website is constantly being expanded to provide more forms and publications and more personalized information on a taxpayer's various tax accounts.

CRA Publications

1-73. The CRA provides several publications to the public which, while they do not have the force of law, can be extremely helpful and influential in making decisions related to income taxes. These can be described as follows:

Income Tax Folios In 2013, the CRA introduced a new type of technical publication, called Income Tax Folios, a.k.a. IT Folios or simply Folios. Their goal is to update the information currently found in Interpretation Bulletins and to introduce improved web functionality. The Income Tax Folios are organized into seven Series with each Series divided into Folios that contain Chapters on specific topics. For example, under Series 1, Individuals, Folio 1 is Health and Medical, and Chapter 1 covers the Medical Expense Tax Credit. This Chapter is designated S1-F1-C1, which stands for Series 1, Folio 1, Chapter 1.

This is, of course, a huge project that will require a number of years to complete. As an indication of this, as of March 1, 2019, only 39 Chapters have been released. While there cannot be a direct comparison, the Interpretation Bulletins they are designed to replace number over 500.

With respect to this text, we will reference those Folios that have been issued up to March 1, 2019.

Interpretation Bulletins As noted, over 500 Interpretation Bulletins were issued by the CRA prior to 2013, though many of these have been cancelled. The objective of these Bulletins was to give the CRA's interpretation of particular sections of the law that it administers and to announce significant changes in departmental interpretation along with the effective dates of any such changes. An example of an important Interpretation Bulletin still in effect at the time of writing (March, 2019) is IT-63R5 which deals with an employee's personal use of an automobile supplied by an employer.

The CRA stopped issuing new Interpretation Bulletins in 2003, but continued to issue many revisions until 2013. The content of the existing Bulletins is being gradually replaced by the series titled Income Tax Folios (see preceding material).

Information Circulars While over 300 of these circulars have been issued, there are currently about 60 in effect. The objective of these publications is to provide information regarding procedural matters that relate to both the *Income Tax Act* and the provisions of the Canada Pension Plan, and to announce changes in organization, personnel, operating programs, and other administrative developments.

Guides And Pamphlets The CRA publishes a large number of non-technical Pamphlets and Guides that provide information on particular topics of interest to taxpayers. Examples of Pamphlets are "Canadian Residents Going Down South" (P151) and "Tax Information For People With Disabilities" (P149). Examples of Guides are "Business And Professional Income" (T4002), "Preparing Returns For Deceased Persons" (T4011), and "RRSPs And Other Registered Plans For Retirement" (T4040).

CRA News Releases, Tax Tips, And Fact Sheets The CRA publishes News Releases on a variety of subjects, such as prescribed interest rates, corporate EFILE, deferral of taxation on employee stock options, and maximum pensionable earnings. They also provide information on when monthly payments will be released under the Canada Child Benefit system and when quarterly payments will be released under the GST tax credit program. Some of the News Releases take the form of questions and answers, while others deal with the subject in some depth.

Advance Income Tax Rulings And Technical Interpretations In recognition of the considerable complexity involved in the interpretation of many portions of the *Income Tax Act*, the Income Tax Rulings Directorate of the CRA will, for a fee, provide an Advance Income Tax Ruling on how it will tax a proposed transaction, subject to certain limitations and qualifications. Advance Income Tax Rulings are available to the public, but only in severed format with much of the relevant information that may permit identification of the parties deleted. The result is that such publications are of questionable value.

The Income Tax Rulings Directorate of the CRA also provides both written and telephone Technical Interpretations to the public (other than for proposed transactions where an Advance Income Tax Ruling is required) free of charge. Such interpretations however are not considered binding on the CRA.

Income Tax Technical News Prior to 2012, the CRA issued newsletters titled *Income Tax Technical News* which provided up-to-date information on current tax issues. None have been issued since 2011 and existing newsletters are being cancelled as new Income Tax Folios are gradually incorporating their content.

Court Decisions

1-74. Despite the huge volume of information available for dealing with income tax matters, disputes between taxpayers and the CRA regularly find their way into the Canadian court system. Of the hundreds of tax cases that are reported each year, the great majority do not involve tax evasion or other criminal offences. Rather, they involve an honest difference of opinion between the taxpayer and the CRA. Common areas of litigation include:

- the deductibility of both business and employment related expenses;
- whether an individual is working as an employee or an independent contractor;
- establishing a property's fair market value;
- the question of whether a transaction took place at arm's length;
- the deductibility of support payments;
- distinguishing between profits that are capital in nature and those that are ordinary business income; and
- the deductibility of farm losses against other sources of income.

1-75. With the large number of court cases and the fact that they cover the great majority of issues that might arise in the application of income tax legislation, attention must be given to the precedents that have been established in the court decisions. While court decisions cannot be used to change the actual tax law, court decisions may call into question the reasonableness of interpretations of the ITA made by either the CRA or tax practitioners. Given the volume and complexity of court cases on income tax, we will cite only very important cases in our coverage of the various subjects in this text. However, a careful review of all relevant case material would be essential in researching any complex tax issue.

We suggest you work Self Study Problem One-4 at this point.

Liability For Part I Income Tax

Background

1-76. The *Income Tax Act* contains a number of Parts that deal with assessing taxes on various taxpayers. For example, Part VI assesses a tax on the capital of financial institutions, while Part XIII provides for a tax that is assessed largely on the property income of non-residents.

1-77. While recognizing that these other types of taxes exist, the focus of this Chapter is on Part I tax. In terms of terminology, the portion of any tax legislation that specifies who is liable to pay tax is called a charging provision. With respect to Part I tax, the relevant charging provision is found in ITA 2. There are two components to this charging provision. The first, ITA 2(1) specifies the applicability of Part I tax to residents. The second, ITA 2(3), specifies the situations where non-residents will be taxed under Part I.

1-78. In this Chapter we will give detailed consideration to the application of Part I tax to residents, including a complete discussion of the meaning of "resident". Some attention will also be given to the Part I tax liability of non-residents. Detailed consideration of this topic is available to Chapter 20, "International Issues In Taxation".

1-79. We would note that taxes assessed under other Parts of the *Income Tax Act* will be given some attention in other Chapters. In particular, Chapter 20 will deal with taxation of foreign source income of Canadian residents, as well as the application of Part XIII to non-residents.

Charging Provision For Canadian Residents

1-80. The Part I charging provision for Canadian residents is as follows:

> **ITA 2(1)** An income tax shall be paid, as required by this *Act*, on the taxable income for each taxation year of every person resident in Canada at any time in the year.

1-81. There are several terms used in this charging provision that require further explanation:

> **Person** The charging provision makes it clear that responsibility for paying the federal income tax lies with "persons". As explained in Paragraph 1-8, in contrast to its usual dictionary meaning (i.e., human being), the *Income Tax Act* uses this term to refer to individuals, corporations, and trusts. When a provision of the *Act* is directed at human taxpayers, the term "individual" is generally used.
>
> This reference establishes the fact that there are three entities which must file income tax returns — individuals, corporations, and trusts.
>
> **Resident** ITA 2(1) also establishes that Canadian residents are liable for Canadian income tax, without regard to their citizenship. This is in contrast to the situation in the United States where U.S. citizens are liable for U.S. income taxes, without regard to where they reside.
>
> While the *Income Tax Act* does not provide a definition of resident, in many cases the application of this concept is self-evident. For an individual who has lived and worked in Red Deer, Alberta for his entire life, never leaving Canada even for short vacations, it is not difficult to establish Canadian residency.
>
> However, for corporations and trusts, as well as for individuals in certain types of circumstances, determining residency can become a fairly complex process. It is also, because of the large differences in tax rates in alternative jurisdictions, a matter of some importance. Detailed consideration of the issues related to residency can be found in the next major Section of this Chapter.
>
> **Taxation Year** The term taxation year is defined in ITA 249(1). The general rule, which applies to all individuals and to most trusts, is that the taxation year is a calendar year. There are, however, two exceptions to this general rule:
>
> > **Corporations** For a corporation, the taxation year is defined as a "fiscal period". ITA 249.1 goes on to define fiscal period as a period for which accounts are made up that does not exceed 53 weeks. These definitions establish the fact that corporations are not required to use the calendar year as their taxation year.
> >
> > **Graduated Rate Estates** Without going into detail, a "graduated rate estate" is a trust that arises at the time of an individual's death. Such trusts can continue for up to 36 months after the date of death and, during that 36 month period, such trusts can use a non-calendar taxation year. For more information on this type of trust, see Chapter 19, Trusts And Estate Planning.
>
> **Taxable Income** Taxable income is defined in Section 2 of the *Act* as follows:
>
> > **ITA 2(2)** The taxable income of a taxpayer for a taxation year is the taxpayer's income for the year plus the additions and minus the deductions permitted by Division C.
>
> The process of converting Net Income For Tax Purposes into Taxable Income will be given some attention at a later point in this Chapter. However, detailed coverage will be found in Chapters 4 and 11.

Charging Provision For Non-Residents

General Charging Provision

1-82. The second charging provision in the *Income Tax Act* deals with the taxation of non-residents. It is as follows:

> **ITA 2(3)** Where a person who is not taxable under subsection (1) for a taxation year
>
> (a) was **employed** in Canada,
> (b) carried on a **business** in Canada, or
> (c) disposed of a **taxable Canadian property**,
>
> at any time in the year or a previous year, an income tax shall be paid, as required by this *Act*, on the person's taxable income earned in Canada for the year determined in accordance with Division D.

1-83. As noted, we will give very limited attention to the taxation of non-residents in this Chapter. The comments in this Chapter are very general and do not take into consideration the many complexities that exist in this area. In particular, the significant influence that tax treaties with other countries can have on the taxation of non-residents is given only superficial consideration in this Chapter 1. Detailed consideration of the issues associated with the taxation of non-residents, under Part I as well as other Parts of the *Income Tax Act*, will be found in Chapter 20.

Employment Income Earned By Non-Residents

1-84. As the term is used in ITA 2(3)(a), Canadian employment income refers to income earned by a non-resident while working as an employee in Canada, generally without regard to the location of the employer. An example of this would be a U.S. citizen who is a resident of Detroit, Michigan, but is employed at an automobile plant in Windsor, Ontario. Such an individual would, in general, be subject to Canadian taxes on his employment income. However, as the individual is a non-resident, his other sources of income would not be taxed in Canada.

Business Income Earned By Non-Residents

1-85. The second situation in which non-residents are subject to Canadian taxes is specified in ITA 2(3)(b). This paragraph indicates that persons who carried on business in Canada during a taxation year are subject to Canadian taxes on that income. Many of the difficulties associated with implementing this provision are related to determining what constitutes "carrying on business in Canada". This clearly includes producing or manufacturing products in Canada. In addition, ITA 253 indicates that it includes situations where a business is offering things for sale in Canada through an employee.

1-86. This broad interpretation is, however, mitigated in those circumstances where the non-resident is a resident of a country with which Canada has a tax treaty. For example, if a U.S. corporation had sales staff selling products in Canada, ITA 253 would suggest that it should be taxed as a non-resident carrying on business in Canada. However, the Canada-U.S. tax treaty overrides ITA 253 in that this agreement exempts a U.S. enterprise from Canadian taxation unless it is carrying on business through permanent establishments in Canada.

1-87. It is also important to distinguish between those situations in which a non-resident is offering something for sale in Canada through an employee and those situations in which a non-resident is selling to an independent contractor who resells the item in Canada. In the former case, the non-resident person is carrying on business in Canada, while in the latter case the non-resident is not.

Dispositions Of Taxable Canadian Property By Non-Residents

1-88. ITA 2(3)(c) specifies the third situation in which non-residents are subject to Canadian taxation. This provision indicates that non-residents are subject to Canadian taxation on gains resulting from the disposition of "taxable Canadian property".

1-89. The concept of taxable Canadian property is discussed more completely in Chapter 20. However, you should note at this point that the major items included in taxable Canadian property are:

- Real property, a.k.a., real estate situated in Canada.
- Certain capital property and inventories of a business carried on in Canada.
- A share of an unlisted corporation, an interest in a partnership, or an interest in a trust if, at any time within the preceding 60 months, more than 50 percent of the fair market value of the share or interest was derived from certain properties including Canadian real property, Canadian resource properties and timber resource properties.
- A share of a listed corporation only if, at any time within the preceding 60 months, at least 25 percent of the issued shares of any class were owned by the non-resident taxpayer and/or non-arm's length persons, and more than 50 percent of the shares' fair market value was derived from certain properties including Canadian real property, Canadian resource properties and timber resource properties.

1-90. This provision means that, if a resident of the state of Washington sells a vacation property that he owns in Whistler, British Columbia, any gain on that sale will be subject to Canadian taxation.

1-91. To help solve the problems arising from difficulties associated with collecting taxes from non-residents, ITA 116(5) indicates that, if there is a gain from the sale of taxable Canadian property by a non-resident, the person purchasing the property is responsible for the required taxes (see Chapter 20 for a discussion of the relevant 25 percent tax withholding). Exceptions to this occur if:

- the purchaser had no reason to believe that the seller of the property was a non-resident;
- the minister has issued a clearance certificate indicating that the non-resident has made arrangements for paying the taxes.

Property Income Earned By Non-Residents

1-92. The charging provisions in ITA 2 do not cover Canadian source property income of non-residents (e.g., rents, interest, or royalties). However, this type of income is covered in Part XIII of the *Act*. The general provision in Part XIII requires a flat 25 percent tax be withheld on Canadian property income paid to non-residents. This 25 percent tax rate is usually reduced for payments to non-residents in countries where Canada has a tax treaty.

1-93. This tax is withheld at the source of income, is based on the gross amount of such income, and no provision is made for any expenses related to acquiring the income. Since this inability to deduct expenses could result in serious inequities, there are provisions that allow a non-resident to elect to file a Canadian tax return for certain types of property income under Part I of the *Act*. These Part XIII tax provisions are discussed more thoroughly in Chapter 20 which deals with international issues in taxation.

Exercise One - 5

Subject: Non-Resident Liability For Tax

Ms. Laurie Lacombe, a U.S. citizen, has Canadian employment income of $22,000. She lives in Blaine, Washington and is a resident of the United States for the entire year. Ms. Lacombe does not believe that she is subject to taxation in Canada. Is she correct? Explain your conclusion.

SOLUTION available in print and online Study Guide.

Residence

Importance

1-94. As discussed, the charging provision for Part I of the *Income Tax Act* indicates that this tax is applicable to any person that is a resident of Canada. If a person is considered a resident of Canada in a given year, that person will be subject to Part I for that year on all sources of income, regardless of where that income is earned. Alternatively, if the person is a non-resident, Part I tax will only apply to Canadian employment income, Canadian business income, and gains on the disposition of Taxable Canadian Property.

1-95. Residency status is determined by applying certain rules and guidelines that originate from jurisprudence, common law, the *Income Tax Act*, and tax treaties. These rules vary depending on whether the person is an individual, corporation, or trust. In the material that follows, we will give detailed consideration to the rules applicable to each of these categories of taxpayers.

Residence Of Individuals

General Concept

1-96. For the average Canadian individual whose job, family, dwelling place, and other personal property are all located in Canada, the concept of residence is not at all ambiguous. Such individuals would clearly be Canadian residents and, as a result, they would be liable for Canadian taxation on their worldwide income. Short departures from the country for holidays or business activities would not have any effect on this conclusion.

1-97. However, for a growing number of individuals, the question of residence is more complex. It is also an important question. As tax rates and tax rules in different countries vary tremendously, the location of a person's residence can have a significant impact on the amount of taxes that will have to be paid.

1-98. While the term resident is not specifically defined in the *Income Tax Act*, Income Tax Folio, S5-F1-C1, *Determining An Individual's Residence*, provides extensive guidance in this area. The most generally applicable statement in this IT Folio is as follows:

> **Paragraph 1.10** The most important factor to be considered in determining whether an individual leaving Canada remains resident in Canada for tax purposes is whether the individual maintains residential ties with Canada while abroad. While the residence status of an individual can only be determined on a case by case basis after taking into consideration all of the relevant facts, generally, unless an individual severs all significant residential ties with Canada upon leaving Canada, the individual will continue to be a factual resident of Canada and subject to Canadian tax on his or her worldwide income.

1-99. Paragraph 1.11 of S5-F1-C1 goes on to point out that the ties that will almost always be considered significant are:

> **Dwelling** If an individual maintains a dwelling place in Canada, it will generally result in the individual being considered a resident. One possible exception to this rule would be when an individual who leaves Canada rents out a former dwelling place to an arm's length party. In this type of situation, owning a Canadian residence may not be considered a residential tie.
>
> **Spouse Or Common-Law Partner** If an individual has a spouse or common-law partner who remains in Canada, it will generally result in the individual being considered a Canadian resident. An exception here would be when the individual was living separate or apart from the spouse or common-law partner prior to their departure from Canada.
>
> **Dependants** If an individual has dependants, such as minor children, who remain in Canada, it will generally result in the individual being considered a Canadian resident.

1-100. S5-F1-C1 also implies that, even in the absence of one of the preceding ties, an individual may still be considered to be a resident of Canada on the basis of secondary residential ties. Paragraph 1.14 contains the following examples of secondary residential ties:

- personal property in Canada (such as furniture, clothing, automobiles, and recreational vehicles);
- social ties with Canada (such as memberships in Canadian recreational or 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);
- landed immigrant status or appropriate work permits in Canada;
- 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;
- a Canadian passport; and
- memberships in Canadian unions or professional organizations.

1-101. S5-F1-C1 notes that these secondary ties must be looked at collectively and that it would be unusual for a single secondary tie to be sufficient for an individual to be classified as a Canadian resident.

Exercise One - 6

Subject: Residential Ties

At the end of the current year, Simon Farr departed from Canada in order to take a permanent position in Ireland. He was accompanied by his wife and children, as well as all of his personal property. Due to depressed real estate prices in his region, he was unable to sell his residence at a satisfactory price. However, he was able to rent it for a period of two years. He also retained his membership in CPA (Chartered Public Accountants) Ontario. After his departure, would he still be considered a Canadian resident for tax purposes? Explain your conclusion.

SOLUTION available in print and online Study Guide.

Temporary Absences

1-102. Many of the problems associated with establishing residency involve situations where an individual leaves Canada for a temporary period of time. The issue here is, under what circumstances should an individual be viewed as having retained their Canadian residency status during the period of their absence from Canada?

1-103. It is an important issue in that, if they are viewed as having retained their Canadian residency status, they will be subject to Canadian taxation on their worldwide income during the period of absence from Canada. While credits against Canadian income tax payable would usually be available for any income taxes paid in the foreign jurisdiction, the foreign taxes paid may be insufficient to cover the full Canadian tax liability.

1-104. S5-F1-C1 makes it clear that the length of the period of time during which the individual is absent from Canada is not a determining factor with respect to residency. If an individual severs all primary and secondary residential ties, it appears that he will cease to be a Canadian resident without regard to the period of his absence.

1-105. If some residential ties are retained during a temporary absence, other factors will be considered. As described in S5-F1-C1, these are as follows:

Intent The issue here is whether the individual intended to permanently sever residential ties with Canada. If, for example, the individual has a contract for employment, if and when he returns to Canada, this could be viewed as evidence that he did not intend to permanently depart. Another factor would be whether the individual complied with the rules related to permanent departures (i.e., as noted in Chapter 8, there is a deemed disposition of an individual's property at the time of departure from Canada, resulting in the need to pay taxes on any gains).

Frequency Of Visits If the individual continues to visit Canada on a regular and continuing basis, particularly if other secondary residential ties are present, this would suggest that he did not intend to permanently depart from Canada.

Residential Ties Outside Of Canada A further consideration is whether or not the individual establishes residential ties in another country. If someone leaves Canada and travels for an extensive period of time without settling in any one location, it will be considered as evidence that he has not permanently departed from Canada.

1-106. It is clear that there is considerable room for differences of opinion as to whether an individual has ceased to be a Canadian resident during a temporary absence from Canada. It is equally clear that the issue should be given careful attention by taxpayers who find themselves in this situation. The potential tax consequences of failing to deal properly with residency issues can be significant.

Exercise One - 7

Subject: Temporary Absences

Jane is a Canadian citizen who is employed by a multi-national corporation. While she has worked for many years in the Canadian office of this organization, she agreed to transfer to the corporation's office in Florida. Before leaving, she disposed of her residence and other personal property that she did not wish to move. She canceled her Alberta driver's licence and health care card, and closed all of her Canadian banking and brokerage accounts.

Because her boyfriend remained in Edmonton, she flew back to Canada at least once a month. After 26 months, she decided that between the excessive heat and humidity in Florida and the travel required to maintain the relationship with her boyfriend, she would return to Canada. At this point, her boyfriend is not her common-law partner. Would Jane be considered a Canadian resident during the 26 months that she was absent from Canada? Explain your conclusion.

SOLUTION available in print and online Study Guide.

Part Year Residence

1-107. In a year in which a person clearly commences or terminates residency in Canada, they will be taxed in Canada on their worldwide income for the part of the year in which they are resident in Canada. While the courts have indicated that establishing residence is a complex matter that involves many considerations, the date of entry will often be based on the immigration rules. However, for departures from Canada, Paragraph 1.22 of S5-F1-C1 indicates that the date on which an individual becomes a non-resident is the latest of:

- the date the individual leaves Canada,
- the date the spouse or common-law partner and/or other dependants of the individual leave Canada, and
- the date the individual becomes a resident of the country to which they are immigrating.

1-108. Situations involving part year residency require a fairly complex prorating of income, deductions, and personal tax credits. For example, an individual who is a resident of Canada for only part of the year will not be entitled to a full personal tax credit (see Chapter 4). The process for prorating such deductions and credits is specified in ITA 114 and ITA 118.91.

Exercise One - 8

Subject: Part Year Residence

Mark is a Canadian citizen and, since graduating from university, has been employed in Vancouver. He has accepted a new position in the United States and, as of February 1 of the current year flies to Los Angeles to assume his responsibilities. (He has been granted a green card to enable him to work in the U.S.) His wife remains behind with their children until June 15, the end of their school year. On that date, they fly to Los Angeles to join Mark. Their residence is sold on August 1 of the current year, at which time a moving company picks up their furniture and other personal possessions. The moving company delivers these possessions to their new house in Los Angeles on August 15. Explain how Mark will be taxed in Canada during the current year.

Exercise One - 9

Subject: Part Year Residence

Mr. Jonathan Kirsh was born in Kansas and, until the current year, had lived in various parts of the United States. On September 1 of the current year he moves to Lethbridge, Alberta to begin work at a new job. He brings his family and all of his personal property with him. However, he continues to have both a chequing and a savings account in a U. S. financial institution. Explain how Mr. Kirsh will be taxed in Canada during the current taxation year.

SOLUTIONS available in print and online Study Guide.

Sojourners And Other Deemed Residents

1-109. Individuals who are considered Canadian residents on the basis of the residential ties that we have discussed are generally referred to as factual residents. ITA 250(1) extends the meaning of resident to include certain other individuals who are considered deemed residents. As we shall see, an individual can be a deemed resident even if they do not set foot in Canada in the relevant taxation years.

1-110. There are two important tax consequences associated with deemed residents:

- Deemed residents are taxed on their worldwide income for the entire taxation year. This is in contrast to part year residents who are only subject to Canadian taxation during that portion of the taxation year that they are present in Canada.

- Deemed residents are not deemed to reside in a specific province and, as a consequence, they are not subject to provincial taxes. In order to maintain fairness with other Canadian taxpayers, ITA 120(1) requires deemed residents to pay an additional federal tax equal to 48 percent of the basic federal tax that is otherwise payable. This will result in an overall tax liability that is either lower or higher than that of a factual resident, depending on the province that is being compared.

1-111. Included on the list of deemed residents of Canada are the following:

1. Sojourners in Canada for 183 days or more.
2. Members, at any time during the year, of the Canadian armed forces when stationed outside of Canada.
3. Ambassadors, ministers, high commissioners, officers or servants of Canada, as well as agents general, officers, or servants of a province, provided they were Canadian residents immediately prior to their appointment.
4. An individual performing services, at any time in the year, in a country other than Canada under a prescribed international development assistance program of the Government of Canada, provided they were resident in Canada at any time in the 3 month period preceding the day on which those services commenced.
5. A child of a deemed resident, provided they are also a dependant whose net income for the year was less than the base for the basic personal tax credit ($12,069 for 2019).
6. An individual who was at any time in the year, under an agreement or a convention with one or more other countries, entitled to an exemption from tax on substantially all of their income in any of those countries, because at that time the person was related to, or a member of the family of, an individual who was resident in Canada.

1-112. Of these items, numbers 1 and 6 require further explanation. With respect to item 1, a sojourner is an individual who is temporarily present in Canada for a period of 183 days or more during any one calendar year. Because of ITA 250(1), this person is deemed to be a Canadian resident for the entire year.

1-113. For this sojourner rule to apply, the individual must be a resident of another country during the 183 days in question. This means that an individual who gives up his residence in another country and moves to Canada early in a taxation year will be considered a part year resident, not a sojourner. Correspondingly, a Canadian resident who leaves Canada to take up residence in another country on September 1 will not be a sojourner, despite the fact that he is in Canada for more than 183 days in the year. As noted, this is an important distinction because the sojourner is liable for Canadian tax on his worldwide income for the entire year, not just the portion of the year when he was in Canada.

1-114. S5-F1-C1 indicates that sojourning means establishing a temporary residence and would include days spent in Canada on vacation trips. However, the Bulletin makes it clear that individuals who, for employment purposes, commute to Canada on a daily basis, are not considered to be sojourning.

1-115. Item 6 refers to situations where someone is exempt from tax in a foreign country because they are related to an individual who is a Canadian resident. For example, the spouse of a Canadian diplomat working in the U.S. would be exempt from U.S. income taxes under the governing international tax treaty because she is the spouse of the diplomat. As the diplomat would be a deemed resident of Canada under item 3, the spouse would be a deemed resident of Canada under item 6.

Exercise One - 10

Subject: Individual Residency

Ms. Suzanne Blakey was born 24 years ago in Paris, France. She is the daughter of a Canadian High Commissioner serving in that country. Her father still holds this position. However, Ms. Blakey is now working in London. The only income that she earns in the year is from her London marketing job and is subject to taxes in England. She has never visited Canada. Determine the residency status of Suzanne Blakey.

SOLUTION available in print and online Study Guide.

Individuals With Dual Residency

1-116. There are situations in which the application of the normal residency rules would result in an individual being considered a resident of more than one country. For example, a member of the Canadian armed forces is deemed to be a resident of Canada, but might also be considered a resident by the country in which he is stationed.

1-117. In the absence of some mechanism for dealing with the problem, such an individual could be subject to double taxation, with each country of residence assessing taxes on the basis of their domestic legislation. In such situations, the presence of an international tax treaty becomes crucial. These bilateral treaties contain provisions, generally referred to as tie-breaker rules, which are designed to provide relief from the potential double taxation that is inherent in dual residence situations.

1-118. While there is a general presumption that the provisions of international treaties override domestic tax legislation, these tie-breaker rules are of such importance that they are formally acknowledged in Canada's *Income Tax Act*. Specifically, ITA 250(5) indicates that a person is deemed not to be a resident of Canada if the terms of a particular tax treaty make him a resident of another country and not a resident of Canada.

1-119. As an example of a typical set of tie-breaker rules, the Canada/U.S. tax treaty resolves the dual residency problem for individuals by examining a list of factors. These factors are applied in the following order:

Permanent Home If the individual has a permanent home available in only one country, the individual will be considered a resident of that country. A permanent home means a dwelling, rented or purchased, that is continuously available at all times. For this purpose, a home that would only be used for a short duration would not be considered a permanent home.

Centre of Vital Interests If the individual has permanent homes in both countries, or in neither, then this test looks to the country in which the individual's personal and economic relations are greatest. Such relations are virtually identical to the ties that are examined when determining factual residence for individuals.

Habitual Abode If the first two tests do not yield a determination, then the country where the individual spends more time will be considered the country of residence.

Citizenship If the tie-breaker rules still fail to resolve the issue, then the individual will be considered a resident of the country where the individual is a citizen.

Competent Authority If none of the preceding tests resolve the question of residency then, as a last resort, the so-called "competent authority procedures" are used. Without describing them in detail, these procedures are aimed at opening a dialogue between the two countries for the purpose of resolving the conflict.

Exercise One - 11

Subject: Dual Residency - Individuals

Using the tie breaker rules, determine the resident status of Dizzy and Donna for 2019 in the following two Cases:

Case 1 Dizzy Jones is an unmarried saxophone player from Los Angeles who has always lived in the U.S. He decides to spend some time in Canada and arrives in Vancouver on May 5, 2019, looking for work in various nightclubs. A friend watches his home in Los Angeles while he is gone. He lives in boarding rooms and hotels throughout his time in Canada and returns to Los Angeles on February 14, 2020.

Case 2 Donna, a U.S. citizen, lives in the state of New York. In the fall of 2018, while attending a business convention in Toronto, she met Donald. They decided to get married the following year and live permanently in the U.S. as soon as Donald could arrange his business affairs in Canada. In December, 2018, Donna took an eight month leave of absence from her job and gave notice to her landlord. On January 1, 2019, they moved in together, sharing an apartment in Toronto which was leased on a monthly basis while Donald finalized his business affairs. In August, 2019, they terminated the lease and returned to New York where they were married and purchased a house.

SOLUTION available in print and online Study Guide.

Residence Vs. Citizenship

1-120. While Canada assesses taxes on the basis of residence, some other countries base the liability for tax on citizenship. Of particular importance in this regard is the United States. There are a significant number of Canadian resident individuals who are also citizens of the U.S. In the absence of mitigating legislation, such individuals would be taxed twice on most types of income.

1-121. Fortunately, the Canada/U.S. tax treaty provides for this situation. In very simplified terms, such individuals are allowed to credit Canadian taxes paid against their U.S. tax liability. As, in many cases, Canadian taxes on individuals are higher than U.S. taxes on a given amount of income, the U.S. tax liability may be eliminated.

1-122. Despite the fact that the balance owing to the U.S. is usually nil, U.S. citizens who are Canadian residents must file a U.S. tax return each year. If this important requirement is overlooked, it can lead to significant difficulties with U.S. tax authorities.

We suggest you work Self Study Problems One-5, 6, and 7 at this point.

Residence Of Corporations

1-123. Being an artificial legal entity, a corporation does not reside anywhere in the same physical sense that the term applies to an individual. To some extent, the jurisdiction of incorporation can assist in finding an answer to the residency question. More specifically, ITA 250(4)(a) indicates that corporations which are incorporated in Canada after April 26, 1965 are deemed to be resident in Canada.

1-124. For corporations incorporated in Canada prior to April 27, 1965, ITA 250(4)(c) indicates that these corporations would also be treated as residents if at any time, in any taxation year ending after April 26, 1965:

- they were resident in Canada (under the mind and management concept discussed in the following Paragraphs), or
- carried on business in Canada.

1-125. What jurisdiction a company was incorporated in is not, however, the end of the story. If this were the case, it would be possible to escape Canadian taxation by the simple act of incorporating outside of the country. Beyond the rules described in the preceding Paragraph, a well established common law principle applies.

1-126. This is the idea that a corporation is resident in the jurisdiction in which the mind and management of the company are located. If the conclusion is that the mind and management of a corporation is in Canada, then a corporation that is not incorporated in Canada will be considered a resident for Canadian tax purposes. Note that, as this rule has been interpreted by the courts, mind and management resides where the highest functional decisions of a corporation are made, not where day-to-day decisions are made. It would appear that the most important factor in making this decision would be residence of the board of directors.

1-127. This "mind and management" criteria would also apply to a corporation that was incorporated in Canada prior to April 27, 1965. Such a corporation would become a resident if, at any time after April 26, 1965, its mind and management was located within Canada. Unlike the foreign jurisdiction corporation, which would be considered to be a Canadian resident only as long as the mind and management remained in Canada, a pre-April 27, 1965 Canadian corporation that became a resident because of the mind and management criteria would remain a Canadian resident, even if the mind and management were moved to a different jurisdiction.

Corporations - Dual Residency

1-128. As was the case with individuals, a corporation may be considered to be resident in more than one country. For example, a corporation that was incorporated in Canada after April 26, 1965 might have its mind and management located in the U.S. This would make this company a deemed resident of Canada and a factual resident of the U.S.

1-129. In situations such as this, tax treaties again become very important. In the absence of such treaties, companies could be subject to taxation in both the countries where they are considered to be resident. As an example of such treaty provisions, the Canada/U.S. tax treaty indicates that, in situations where a company is considered to be a resident of both countries, the corporation will be deemed to be a resident only in the country in which it is incorporated.

Exercise One - 12

Subject: Corporate Residency

Roswell Ltd. was incorporated in the state of New York in 2013. It carries on business in both the United States and Canada. However, all of the directors of the Company live in Kemptville, Ontario and, as a consequence, all of the directors meetings are held in Kemptville. Determine the residency status of Roswell Ltd.

Exercise One - 13

Subject: Corporate Residency

Sateen Inc. was incorporated in Manitoba in 2012. However, since 2017, all of the Company's business has been carried on outside of Canada. Determine the residency status of Sateen Inc.

Exercise One - 14

Subject: Dual Residency - Corporations

Using the tie breaker rules, determine the resident status of the corporations in the following two Cases:

Case 1 Taxco is a company incorporated in Nova Scotia in 2017 to hold investments in other Canadian companies. Taxco never carried on business in Canada. All the shareholders and members of the board of directors are residents of the U.S. All board of directors meetings are held in the U.S.

Case 2 Junkco is a company incorporated in Delaware in 2018. The majority of the members of the board of directors, however, reside in Montreal, where all board of directors meetings take place. Junkco does not carry on any business in Canada.

SOLUTIONS available in print and online Study Guide.

We suggest you work Self Study Problems One-8 and 9 at this point.

Residence Of Trusts

1-130. The residence of a trust can only be determined by examining the circumstances involved in each case. In general, however, Income Tax Folio S6-F1-C1, *Residence Of A Trust Or Estate*, indicates that, similar to the case for corporations, a trust resides where the central management and control of the trust actually takes place.

1-131. Usually the management and control of the trust rests with, and is exercised by, the trustee, executor, liquidator, administrator, heir or other legal representative of the trust. However, the residence of the trustee does not always determine the residence of a trust. For example, if trustees reside in different jurisdictions, the trust will reside where the more substantial central management and control actually takes place.

1-132. In addition, if a substantial portion of the central management and control of the trust rests with someone other than the trustee, such as the settlor or the beneficiaries of the trust, the actions of these other persons must also be considered. It is where the central management and control is factually exercised that will determine the residence of the trust.

Alternative Concepts Of Income

The Economist's View

1-133. In the past, economists have viewed income as being limited to rents, profits, and wages. In general, capital gains, gratuitous receipts, and other such increases in net worth were not included. In this context, most economists perceived income to be a net concept. That is, income is equal to revenues, less any related expenses.

1-134. In more recent times, the economist's concept of income has moved in the direction of including measures of net worth or capital maintenance. The oft cited quotation "Income is the amount that can be spent during the period and still be as well off at the end of the period as at the beginning." is perhaps as good a description of the current concept as any available.

1-135. This broader concept of income is based on the idea that income should include all increases in net economic power that occur during the relevant measurement period.

The Accountant's View

1-136. What we currently view as Net Income from an accounting point of view is the result of applying a fairly flexible group of rules that are referred to as generally accepted accounting principles (GAAP). In general, Net Income is determined by establishing the amount of revenue on the basis of point of sale revenue recognition. Then, by using a variety of cash flows, accruals, and allocations, the cost of assets used up in producing these revenues is matched against these revenues, with this total deducted to produce the accounting Net Income for the period.

1-137. If this same process is viewed from the perspective of the Balance Sheet, Net Income is measured as the increase in net assets for the period under consideration, plus any distributions that were made to the owners of the business during that period.

1-138. The current accounting model continues to value many assets at historical cost and records changes in value only when supported by an arm's length transaction. This means that many of the increases in wealth that would be included in the economist's concept of income would not be included in accounting Net Income.

1-139. However, the gap between the two approaches is gradually being narrowed as accounting standard setters show an increased willingness to incorporate fair value measurement into their pronouncements, both with respect to Balance Sheet values and with respect to inclusions in Net Income.

The Income Tax Act View

1-140. As was the case with the determination of accounting income, the *Income Tax Act* uses a complex set of rules to arrive at a figure that we will refer to as Net Income For Tax Purposes. While tax references often refer to this figure simply as Net Income, we will use the lengthier designation in order to distinguish this figure from accounting Net Income.

1-141. Net Income For Tax Purposes is made up of several different types of income and, in addition, these different types of income must be combined using what tax practitioners refer to as an ordering rule. While the detailed computation of Net Income For Tax Purposes will occupy us through most of the first half of this text, we will provide a general discussion of its various components, as well as the ordering rule for combining these components, in the next section of this Chapter.

Net Income For Tax Purposes

Structure

1-142. The procedures for determining Net Income For Tax Purposes are specified in Division B of the *Income Tax Act*. In fact, this figure is sometimes referred to in tax literature as Division B Income. Once Net Income For Tax Purposes has been established, the items specified in Division C of the *Income Tax Act* are subtracted to determine Taxable Income. This Taxable Income figure provides the basis for calculating the federal income tax that is payable by individuals, corporations, and trusts that are resident in Canada.

1-143. Net Income For Tax Purposes is made up of four basic types of income, each of which requires a separate calculation of a net amount. Each net calculation is based on a group of inclusions and deductions that are specific to that type of income. For example, net employment income is made up of inclusions for items such as wages or salaries received, along with deductions for items such as union dues and the costs of required travel. Note that if an individual had business income deductions in excess of business income inclusions, this excess could not be applied directly in the calculation of net employment income.

1-144. In addition to the net calculations required for the four types of income, Net Income For Tax Purposes includes a group of other inclusions that do not fit in the four basic income categories, as well as a group of other deductions that are not related to the major categories of income.

Components

1-145. The four types of income that are included as components of Net Income For Tax Purposes can be described as follows:

Net Employment Income (Loss) Net employment income is made up of inclusions related to the activities of individuals who are serving as employees, less deductions related to that activity. These inclusions and deductions are specified in Division B, subdivision a, of the *Income Tax Act*. While it is possible to have a negative amount (employment loss), this would be fairly unusual. Note that, unlike the situation with other types of income, only individuals can earn employment income.

Net Business Income (Loss) Net business income is made up of inclusions related to carrying on a business, less deductions related to that activity. These inclusions and deductions are specified in Division B, subdivision b, of the *Income Tax Act*. The business income rules are generally the same for individuals, corporations, and trusts.

Net Property Income (Loss) Net property income is made up of inclusions related to the holding of property, less deductions related to holding such property. Examples of property income would include interest received on debt securities, dividends received on equity securities, and lease payments received on rental property. Note that, as the term is used in tax work, property income does not include capital gains or capital losses.

As was the case with net business income, inclusions and deductions related to property income are covered in Division B, subdivision b, of the *Income Tax Act*. While there are some differences in the rules for determining property income and those for determining business income, the calculations are sufficiently similar that they are included in a single subdivision. Like business income, property income can be earned by individuals, corporations, and trusts.

Capital Gains and Capital Losses Capital gains and losses arise when an asset that has been used to produce business or property income is sold. The inclusions and deductions related to this type of income are specified in Division B, subdivision c, of the *Income Tax Act*. As was true with business and property income, capital gains and losses can arise on dispositions by individuals, corporations, and trusts.

As you may already be aware, in Canada only one-half of capital gains are taxed and only one-half of capital losses are deductible. This has created the need for the use of special terminology. More specifically:

- The term "**taxable** capital gain" is used when referring to the taxable **one-half** of a capital gain. When the term capital gain (without the taxable) is used, it is a reference to 100 percent of the gain.
- The term "**allowable** capital loss" is used when referring to the deductible **one-half** of a capital loss. When the term capital loss (without the allowable) is used, it is a reference to 100 percent of the loss.

Unlike employment, business, and property losses, a net allowable capital loss (allowable capital losses in excess of taxable capital gains) cannot be deducted against any other type of income. This will be explained in more detail in the next section.

1-146. The remaining two components of Net Income For Tax Purposes can be described as follows:

Other Sources Of Income There are some additional sources of income that do not fit into any of the basic categories of income. These inclusions, which are largely applicable to individual taxpayers, are specified in Division B, subdivision d, of the *Income Tax Act*. Examples of these subdivision d inclusions would be pension income received, spousal support received, and social assistance payments received.

Other Deductions From Income Similar to the situation with inclusions, there are some deductions that do not relate to any of the basic income categories. These deductions, which are again largely related to individuals, are specified in Division B, subdivision e of the *Income Tax Act*. Examples of these subdivision e deductions include spousal support paid, child care costs, moving expenses, and RRSP contributions.

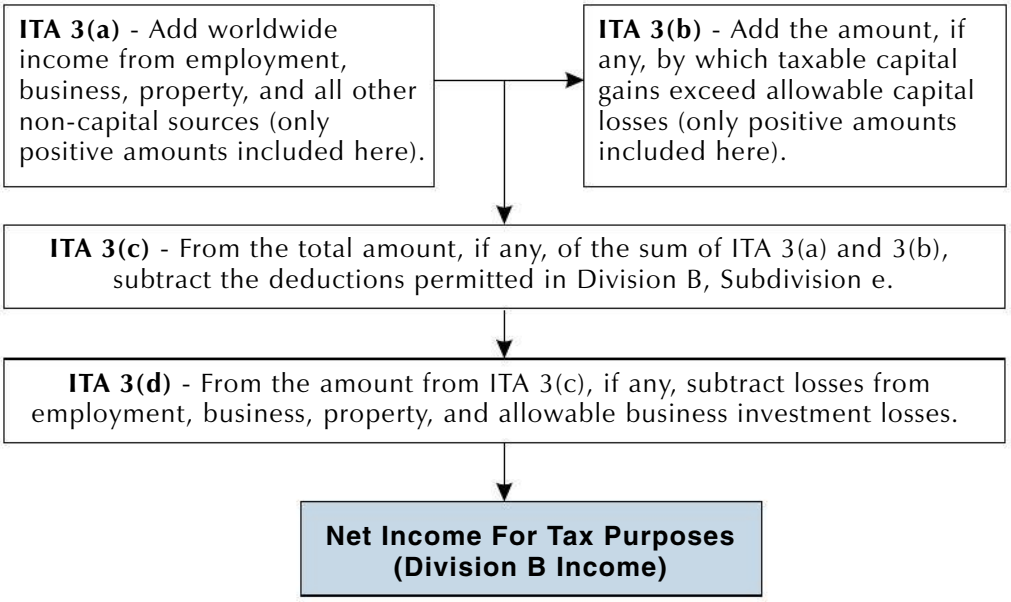
1-147. As a final point here, we would note that, if an amount received does not fall into one of these categories, it is not part of Net Income For Tax Purposes and, in general, it would not be subject to federal income tax. Examples of this would include lottery winnings, amounts inherited, and gambling profits. An “exception” to gambling profits being non-taxable could arise if the CRA concluded that an individual’s gambling activities were so extensive that the individual was carrying on a gambling business.

Combining The Components - ITA Section 3

Ordering Rules

1-148. In the previous section, we noted that four types of income are included in Net Income For Tax Purposes, along with two other components which deal with miscellaneous inclusions and miscellaneous deductions. While it would be possible to simply add up these figures, this is not the approach that is required by the *Income Tax Act*. Section 3 of the *Income Tax Act* requires that these various components be combined in a very specific manner.

Figure 1 - 3
Calculation Of Net Income For Tax Purposes



1-149. This type of Section is referred to in tax work as an ordering rule and, while we will encounter several other such rules in the course of this text, we are concerned here with Section 3 which is the ordering rule for combining the various components of Net Income For Tax Purposes. This rule is applied to individuals, corporations and trusts.

1-150. While some of the ideas involved in applying this formula will not be fully explained until later in the text, it is useful at this stage to provide the basic structure of this formula in order to enhance your understanding of how the material on the various components of Net Income For Tax Purposes is organized.

1-151. The Section 3 rules are made up of four basic paragraphs, ITA 3(a), 3(b), 3(c), and 3(d). A discussion of each of these paragraphs follows. In addition, the ITA 3 rules are presented graphically in Figure 1-3.

ITA 3(a) Sources Of Income

1-152. The ordering process begins in ITA 3(a) with the addition of all **Positive** sources of income other than taxable capital gains. This includes positive amounts of employment income, business income, property income, and other miscellaneous inclusions from Subdivision d of Division B.

1-153. Note that, while the individual components of this total are net amounts (e.g., employment income is made up of inclusions, net of deductions), the total is not a net calculation. For example, a business loss would not be deducted against a positive employment income under ITA 3(a). Rather, such losses would be deducted at a later point in the calculation of Net Income For Tax Purposes.

ITA 3(b) Net Taxable Capital Gains

1-154. To the total determined in ITA 3(a), ITA 3(b) requires that you "determine the amount, if any, by which" taxable capital gains exceed allowable capital losses. The phrase "if any" is commonly used in tax legislation to indicate that negative amounts are ignored.

1-155. It is of particular importance here, since the fact that ITA 3(b) cannot be negative establishes the very important rule that the current year's allowable capital losses can only be deducted to the extent of taxable capital gains that have been recognized in the calculation of Net Income For Tax Purposes for the current year.

EXAMPLE During the current year, an individual has dispositions that result in taxable capital gains of $12,000 and allowable capital losses of $15,000.

ANALYSIS As there is no excess of taxable capital gains over allowable capital losses, the amount that will be added under ITA 3(b) will be nil.

1-156. The $3,000 excess of allowable capital losses over taxable capital gains does not disappear. As is explained in detail in Chapters 4 and 11, current year allowable capital losses that are in excess of current year taxable capital gains can be deducted in the calculation of Taxable Income in past or future years. Note, however, that this carry over allowable capital loss deduction is limited to the amount of net taxable capital gains that are included in the Net Income For Tax Purposes of the carry over year.

1-157. Unused allowable capital losses can be carried back to any of the preceding three taxation years. This will result in an amended Tax Payable for that year and a claim for a refund. If there are not sufficient taxable capital gains in the three preceding years to absorb the unused losses, they can then be carried forward to any subsequent taxation year. In a subsequent year, they will be deducted in the calculation of that year's Taxable Income, which will reduce the taxes that will have to be paid in that year.

EXAMPLE During 2019, an individual has a Net Income For Tax Purposes of $100,000, made up of $85,000 in net employment income and $15,000 in net taxable capital gains. This individual has an allowable capital loss carry forward, technically known as a net capital loss carry forward, from 2018 of $25,000. He has had no taxable capital gains in the preceding 3 years.

ANALYSIS The individual's Net Income For Tax Purposes and Taxable Income would be calculated as follows:

ITA 3(a) Employment Income	$ 85,000
ITA 3(b) Net Taxable Capital Gains	15,000
Net Income For Tax Purposes	$100,000
Net Capital Loss Carry Forward (Note)	(15,000)
Taxable Income	$ 85,000

Note The net capital loss carry forward deduction is limited to $15,000, the amount of the net taxable capital gains for the year. The remaining $10,000 ($25,000 - $15,000) is carried forward to subsequent years.

ITA 3(c) Subdivision e Deductions

1-158. The ITA 3(c) component of the calculation starts with the amount, if any, of the total from ITA 3(a) and ITA 3(b). Here again, the phrase "if any" indicates that only positive amounts will be used. If the total from ITA 3(a) and ITA 3(b) is nil, Net Income For Tax Purposes is nil and the calculation is complete.

1-159. Alternatively, if the total is positive, it is reduced by any Division B, Subdivision e deductions that are available. These deductions will be covered in detail in Chapters 9 and 10. Common examples of such deductions include:

- spousal support paid;
- moving expenses;
- child care costs; and
- RRSP contributions.

1-160. Note the importance of order here. ITA 3(c) requires that subdivision e amounts be deducted prior to business and property losses. This is important because subdivision e deductions are, in many cases, only deductible in the year to which they relate (e.g., if you cannot deduct spousal support in the current year, you cannot deduct it in a past or future year). In contrast, if you cannot use a business or property loss in the current year, it can be carried over to a past year or a future year.

ITA 3(d) Losses

1-161. ITA 3(d) begins with any positive amount carried over from ITA 3(c). From this amount, any current year losses, other than allowable capital losses, will be deducted. This would include the deduction of any current year business losses, property losses, employment losses, and allowable business investment losses (allowable business investment losses are a special type of allowable capital loss that can be deducted against any type of income). Current period farm losses are also deductible here, subject to certain restrictions that are described in Chapter 6 (see the section on Income For Farmers).

Loss Carry Overs

1-162. As we have noted, allowable capital losses that arise in the current year can only be deducted to the extent of taxable capital gains. Also as noted, other types of losses that arise in the current year can only be deducted to the extent that there is a positive total of other types of income and deductions after ITA 3(c). We have also mentioned the fact that these losses do not disappear — they can be carried back to claim a refund of taxes paid or forward to reduce future taxes payable.

1-163. Regardless of the type of loss, the carry back period is limited to the preceding 3 years. For example, a 2019 business loss can be deducted against amounts of Taxable Income that were recorded in 2016, 2017, or 2018.

1-164. In contrast, the limit on the carry forward period varies with the type of loss. In somewhat simplified form, the rules are as follows:

Carry Forward Of Allowable Capital Losses Unused allowable capital losses can be carried forward and deducted in the determination of Taxable Income in any future taxation year, but only to the extent of the net taxable capital gains, if any, realized in the carry forward year.

Carry Forward Of Listed Personal Property Losses Listed personal property is made up of specific types of personal use property (e.g. paintings or jewelry). Losses on such property can only be deducted against gains on listed personal property. While the carry back of unused amounts is the usual 3 years, the carry forward period is limited to 7 years. The deduction of any carry over is limited to gains on listed personal property in the carry over year.

Carry Forward Of Other Types Of Losses Employment, business, and property losses that cannot be used in the year in which they arise, can be carried forward and deducted in the determination of Taxable Income in any of the next 20 years. With the exception of certain types of farm losses (a type of business loss), the carry forward amounts can be applied against any type of income.

1-165. The detailed rules for this carry forward process are fairly complex, involving a number of rules that are not described in this brief summary. These rules are given detailed consideration in Chapter 11.

Net Income For Tax Purposes - Example

1-166. The following example provides an illustration of how the ITA 3 rules are applied.

EXAMPLE Jonathan Morley has the following income and loss components for the year:

Net Employment Income	$17,000
Business Loss (From Restaurant)	(21,000)
Net Property Income	9,000
Taxable Capital Gains	14,000
Allowable Capital Losses	(19,000)
Subdivision e Deductions (Spousal Support Paid)	(9,000)

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

Income Under ITA 3(a):		
Net Employment Income	$17,000	
Net Property Income	9,000	$26,000
Income Under ITA 3(b):		
Taxable Capital Gains	$14,000	
Allowable Capital Losses	(19,000)	Nil
Balance From ITA 3(a) And (b)		$26,000
Subdivision e Deductions		(9,000)
Balance Under ITA 3(c)		$17,000
Deduction Under ITA 3(d):		
Business Loss		(21,000)
Net Income For Tax Purposes (Division B Income)		**Nil**

1-167. Mr. Morley's Business Loss exceeds the amount calculated under ITA 3(c), resulting in a Net Income For Tax Purposes of nil. However, there would be a carry over of the unused business loss equal to $4,000 ($21,000 - $17,000), and of the unused allowable capital loss in the amount of $5,000 ($14,000 - $19,000).

Exercise One - 15

Subject: Net Income For Tax Purposes

For the current year, Mr. Norris Blanton has net employment income of $42,000, a business loss of $15,000, taxable capital gains of $24,000, and Subdivision e deductions of $13,000. What is the amount of Mr. Blanton's Net Income For Tax Purposes for the current year?

Exercise One - 16

Subject: Net Income For Tax Purposes

For the current year, Ms. Cheryl Stodard has interest income of $33,240, taxable capital gains of $24,750, allowable capital losses of $19,500, and a net rental loss of $48,970. What is the amount of Ms. Stodard's Net Income For Tax Purposes for the current year? Indicate the amount and type of any loss carry overs that would be available at the end of the current year.

SOLUTIONS available in print and online Study Guide.

Exercise One - 17

Subject: Net Income For Tax Purposes

For the current year, Mrs. Marie Bergeron has net employment income of $42,680, taxable capital gains of $27,400, allowable capital losses of $33,280, Subdivision e deductions of $8,460, and a business loss of $26,326. What is the amount of Mrs. Bergeron's Net Income For Tax Purposes for the current year? Indicate the amount and type of any loss carry overs that would be available at the end of the current year.

SOLUTION available in print and online Study Guide.

We suggest you work Self Study Problems One-10, 11 and 12 at this point.

Net Income To Taxable Income

1-168. Once we have determined the amount of Net Income For Tax Purposes, it must then be converted into Taxable Income by deducting the items specified in Division C of the *Income Tax Act*. This is, in fact, a fairly complex process that will be covered in detail in Chapters 4 and 11.

1-169. While we are deferring detailed coverage of this subject, it is useful as part of this overview for you to be aware of the major items that will be involved in the conversion of Net Income For Tax Purposes to Taxable Income. They are as follows:

- A deduction for losses carried over from other years.
- A deduction for social assistance and worker's compensation payments that have been included in Net Income For Tax Purposes.
- A deduction related to amounts of employment income resulting from the exercise or sale of stock options.
- A deduction related to capital gains on qualified property (the lifetime capital gains deduction).
- A deduction related to the costs of living in certain areas of the Canadian north.

Principles Of Tax Planning

Introduction

1-170. Throughout this text, there will be a great deal of emphasis on tax planning and, while many of the specific techniques that are involved can only be fully explained after the more detailed provisions of tax legislation have been covered, there are some basic tax planning principles that can be described at this point.

1-171. Our objective here is simply to provide a general understanding of the results that can be achieved through tax planning so that you will be able to recognize the goal of more specific tax planning techniques when they are examined. In addition, this general understanding should enable you to identify other opportunities for tax planning as you become more familiar with this material.

1-172. The basic goals of tax planning can be summarized as follows:

- Tax avoidance or reduction.
- Tax deferral.
- Income splitting.

1-173. While these classifications can be used to describe the goals of all tax planning arrangements, such arrangements seldom involve a clear cut attempt to achieve only one of these goals. For example, the principal reason for making contributions to a Registered

Retirement Savings Plan is to defer taxes until later taxation years. However, such a deferral can result in the taxpayer avoiding some amount of taxes if he is taxed at a lower rate in those later years.

Tax Avoidance Or Reduction

1-174. The most desirable result of tax planning is to permanently avoid the payment of some amount of tax. This very desirability is probably the most important explanation for the scarcity of such arrangements and, while the number of possibilities in this area is limited, they do exist.

1-175. An outstanding example of tax avoidance is the capital gains deduction that is available on the disposition of qualified farming or fishing property, and qualified small business corporation shares. For 2019, the deduction limit for dispositions of shares of qualified small business corporations is $866,912. There is an additional amount for farm or fishing properties of $133,088, providing a total of $1,000,000 for all such qualified properties. These capital gains can be received by an individual taxpayer on a completely tax free basis. For individuals in a position to enjoy the benefits of this provision, it is one of the best tax avoidance mechanisms available (see Chapter 11 for a detailed discussion of this provision).

1-176. Other forms of complete tax avoidance can be found in the employee benefits area, in that some types of benefits can be given to employees without being considered taxable. These would include an employer's contributions to disability and private health care insurance, and the provision of discounts to employees on products or services normally sold by the employer (see Chapter 3).

1-177. Additional opportunities in this area require more complex arrangements. Such arrangements involve the use of trusts and private corporations and cannot be described in a meaningful manner at this stage of the material.

Tax Deferral

1-178. The basic concept behind tax planning arrangements involving the deferral of tax payments is the very simple idea that it is better to pay taxes later rather than sooner. This is related to the time value of money and also involves the possibility that some permanent avoidance of taxes may result from the taxpayer being taxed at a lower marginal income tax rate at the time the deferred amounts are brought into taxable income.

1-179. Such deferral arrangements may involve either the delayed recognition of certain types of income or, alternatively, accelerated recognition of deductions. As an example of delayed recognition of income, an employer can provide a benefit to an employee in the form of contributions to a registered pension plan. Such benefits will not be taxed in the year in which they are earned. Rather, they will be taxed at a later point in time when the employee begins to receive benefits from the registered pension plan.

1-180. As an example of expense acceleration, the ownership of a rental property may allow the owner to deduct its capital cost at a rate that is usually in excess of any decline in the physical condition or economic worth of the building. While this excess deduction will normally be added back to the taxpayer's income when the building is sold, the payment of taxes on some part of the rental income from the property has been deferred.

1-181. Deferral arrangements are available in a number of different situations and currently represent one of the more prevalent forms of tax planning.

Income Splitting

General Idea

1-182. Progressive rates are built into Canadian federal income tax legislation. This means that, in general, the taxes payable on a given amount of taxable income will be greater if that amount accrues to one taxpayer, than would be the case if that same total amount of taxable income is split between two or more people. While not technically a form of income splitting,

the same effect can be achieved by having a given sum of taxable income taxed in the hands of an individual in a low tax bracket rather than an individual in a high tax bracket.

1-183. This does not mean that it would be advantageous to give part of your income away to perfect strangers. What it does mean is that, within a family or other related group, it is desirable to have the group's aggregate taxable income allocated as evenly as possible among the members of the group.

Example

1-184. The tax savings that can be achieved through income splitting are among the most dramatic examples of the effectiveness of tax planning. For example, if Mr. Jordan had taxable income of $841,484 (this is four times $210,371, the bottom threshold of the highest federal tax bracket in 2019 of 33 percent), his basic federal tax payable in 2019 would be $256,986 (this simplified calculation does not take into consideration the various tax credits that would be available to Mr. Jordan).

1-185. Alternatively, if Mr. Jordan was married and the $841,484 could be split on the basis of $420,742 to him and $420,742 to his wife, the federal taxes payable would total $236,282 [(2)($118,141)], a savings of $20,704 ($256,986 - $236,282).

1-186. If we carry this one step further and assume that Mr. Jordan is married and has two adult children, and that the $841,484 in taxable income can be allocated on the basis of $210,371 to each individual, the total federal taxes payable will be reduced to $194,876 [(4)($48,719)]. This represents a savings at the federal level of $62,110 ($256,986 - $194,876) when compared to the amount of taxes that would have been paid if Mr. Jordan alone had been taxed on the entire $841,484.

1-187. When we add provincial effects, the potential savings could be close to $100,000, a substantial reduction on income of $841,484. Making this savings even more impressive is the fact that it is not a one shot phenomena but, rather, a savings that could occur in each year that the income splitting plan is in effect.

Note To Students You will learn how to calculate the tax payable amounts shown in the preceding paragraphs in Chapter 4 of the text.

Problems With Income Splitting

1-188. While income splitting can be one of the most powerful planning tools available to taxpayers, there are several problems associated with implementing such arrangements:

- Splitting income with children often involves losing control over assets, a process that is emotionally difficult for some individuals.
- Splitting income involves decisions as to which family members are worthy of receiving benefits and how much those benefits should be.
- The 2018 expansion of the applicability of the Tax On Split Income (TOSI), a high rate tax assessed on certain types of income received by related individuals, can make income splitting very difficult in some situations. This tax is described in Chapter 11.

Exercise One - 18

Subject: Tax Planning

Mr. Stephen Chung, a successful flamenco dancer, has decided to make contributions to an RRSP in the name of his spouse, the mother of his twelve children, rather than making contributions to his own plan. What type of tax planning is involved in this decision? Explain your conclusion.

SOLUTION available in print and online Study Guide.

Exercise One - 19

Subject: Tax Planning

Mr. Green's employer pays all of the premiums on a private dental plan that covers Mr. Green and his family. What type of tax planning is illustrated by this employee benefit? Explain your conclusion.

SOLUTIONS available in print and online Study Guide.

Additional Supplementary Self Study Problems Are Available Online.

Abbreviations To Be Used

1-189. In our writing, we try to avoid using abbreviations because we believe that there is a tendency in accounting and tax writing to use so many of them that the material can become unreadable. However, in the tax area, some sources are so commonly cited that it is clearly inefficient to continue using their full description. As a result, in the remainder of this text, we will use the following abbreviations on a regular basis:

Abbreviation	Meaning
CRA	Canada Revenue Agency
CCA	Capital Cost Allowance (see Chapter 5)
CCPC	Canadian Controlled Private Corporation
GAAP	Generally Accepted Accounting Principles
GST	Goods and Services Tax
HST	Harmonized Sales Tax
IC	Information Circular
IT	Interpretation Bulletin
ITA	Federal *Income Tax Act*
ITF S#-F#-C#	A Chapter in an Income Tax Folio that is part of a Series
RPP	Registered Pension Plan
RRSP	Registered Retirement Savings Plan
TFSA	Tax Free Savings Account
TOSI	Tax On Split Income
UCC	Undepreciated Capital Cost (see Chapter 5)

Key Terms Used In This Chapter

1-190. The following is a list of the key terms used in this Chapter. These terms, and their meanings, are compiled in the Glossary Of Key Terms located at the back of the Study Guide.

Advance Tax Ruling
Allowable Capital Loss
Business Income
Capital Asset
Capital Gain/Loss
Capital Tax
Consumption Tax
Customs Duties
Deemed Resident
Division B Income
Dual Resident
Employment Income
Fiscal Period
Flat Tax System
Goods And Services Tax
GST
Harmonized Sales Tax (HST)
Head Tax
Income
Income Splitting
Income Tax
Income Tax Application Rules
Income Tax Folios
Income Tax Regulations
Income Tax Technical News
Individual
Information Circulars
Interpretation Bulletins
Net Income For Tax Purposes
Non-Resident
Ordering Rule
Part Year Resident
Person
Progressive Tax System
Property Income
Property Tax
Qualitative Characteristics
Regressive Tax System
Residential Ties
Resident
Sojourner
Tariffs
Tax Base
Tax Deferral
Tax Expenditure
Tax Incidence
Tax Planning
Taxable Canadian Property
Taxable Capital Gain
Taxable Entity
Taxable Income
Taxation Year
Tie Breaker Rules
Transfer Tax
Value Added Tax

References

1-191. For more detailed study of the material in this Chapter, we would refer you to the following:

ITA 2(1)	Tax Payable By Persons Resident In Canada
ITA 2(3)	Tax Payable By Non-Resident Persons
ITA 3	Income For Taxation Year
ITA 114	Individual Resident In Canada For Only Part Of Year
ITA 115	Non-Resident's Taxable Income In Canada
ITA 116	Disposition By Non-Resident Person Of Certain Property
ITA 118.91	Part-Year Residents
ITA 118.94	Tax Payable By Non-Resident (Tax Credits)
ITA 248(1)	Definitions (Taxable Canadian Property)
ITA 249	Definition Of "Taxation Year"
ITA 250(1)	Person Deemed Resident
S5-F1-C1	Determining An Individual's Residency Status
S6-F1-C1	Residence of a Trust or Estate
IT-168R3	Athletes And Players Employed By Football, Hockey And Similar Clubs
IT-420R3	Non-Residents - Income Earned In Canada

Problems For Self Study (Online)

To provide practice in problem solving, there are Self Study and Supplementary Self Study problems available on MyLab Accounting.

Within the text we have provided an indication of when it would be appropriate to work each Self Study problem. The detailed solutions for Self Study problems can be found in the print and online Study Guide.

We provide the Supplementary Self Study problems for those who would like additional practice in problem solving. The detailed solutions for the Supplementary Self Study problems are available online, not in the Study Guide.

The .PDF file "Self Study Problems for Volume 1" on MyLab contains the following for Chapter 1:

- 12 Self Study problems,
- 5 Supplementary Self Study problems, and
- detailed solutions for the Supplementary Self Study problems.

Assignment Problems

(The solutions to these problems are only available in
the solutions manual that has been provided to your instructor.)

Assignment Problem One - 1

(Application Of General Tax Principles)

Many of the provisions of the *Income Tax Act* are written in very general terms. For example, ITA 18 lists a number of general characteristics that must apply before a particular expense can be deducted in the computation of business income.

Required: Indicate the situations in which such generally worded provisions of the *Income Tax Act* will be overridden.

Assignment Problem One - 2

(Conflicting Objectives)

The tax systems of various countries are designed to meet a variety of objectives. In addition to raising revenues, we call on our tax systems to provide fairness, to have the characteristic of simplicity, to meet social or economic goals, to balance regional disparities, and to be competitive on an international basis. While it would be a fairly simple matter to design a system that would meet any single one of these objectives, we frequently encounter conflicts when we attempt to create a system that meets several of these objectives.

Required: Discuss the possible conflicts that can arise when a tax system is designed to meet more than a single objective.

Assignment Problem One - 3

(Application Of Qualitative Characteristics)

In the United States, President Trump has reduced the tax rate on corporations from 35 percent to 21 percent.

Required: Evaluate the reduction of the tax rate on corporations in the United States on the basis of the qualitative characteristics of tax systems that are listed in your text.

Assignment Problem One - 4

(Application Of Qualitative Characteristics)

The city of Elysium is located on an island in the Nirvana River. Because of its very desirable climate, it has attracted wealthy immigrants from all over the world. These immigrants have either built palatial new homes on the river waterfront, or moved into luxurious residences, largely in high-rise buildings in the city's core.

In general, real estate values on the island are among the highest in the world. In order to protect their extremely orderly environment, the residents have prevented the development of any reasonably priced housing. To help maintain this environment the city has a large, well trained security force.

The economic activity on the island consists of financial services, haute cuisine restaurants, and retail shops which feature high-end products from all over the world. Because of the high real estate cost, staff for these operations must live off island and commute on a daily basis.

To accommodate residents of the island, the city operates a large heliport. This allows the residents of the island to quickly access a nearby airport where most maintain at least one private jet.

Until recently, the only other access to the island was via a city operated ferry. This service was provided free of charge by the city. While it was rarely used by the residents of Elysium, the staff of the various businesses on the island relied on it for access to their jobs.

Last year, the city completed a four lane bridge to access the island. In order to finance the tremendous cost of this project, there is a $10 toll for each trip across the bridge. To ensure that the bridge produces adequate revenues, the city has canceled the ferry service.

Required: Evaluate the $10 toll on the basis of the qualitative characteristics of tax systems that are listed in your text.

Assignment Problem One - 5

(Residency After Departure From Canada)

Mr. Valone is a U.S. citizen. However, since obtaining permanent residence status in 2005, he has been employed on a full time basis in London, Ontario. His employer is a Canadian subsidiary of a multi-national corporation that operates in a number of different countries. The head office of the company is in the United States.

Mr. Valone has been very successful in his position with the Canadian subsidiary. Based on this, he has been offered a promotion which involves a significant increase in salary. However, this promotion is conditional on his moving to the company's head office in Philadelphia no later than March 1, 2019. Given the sizable increase in remuneration, Mr. Valone finds this offer too good to pass up.

As he is a U.S. citizen, he has no difficulty getting the appropriate documentation to establish his residency in the U.S. He relinquishes his Canadian driver's licence, as well as his provincial health care card. As required by his employer, he is at his desk in the new work location in the U.S. on March 1.

Mr. Valone and his spouse have two children who are attending a private school in London. The current semester at this school lasts until June 15, 2019. In order to provide continuity in their education, Mrs. Valone decides that she and children will remain in Canada until the current semester is finished. They depart on June 20, 2019.

The real estate market in London has been somewhat slow of late. As a consequence, the Valone's house is not sold until October 5, 2019.

Required: For purposes of assessing Canadian income taxes, determine when Mr. Valone ceased to be a Canadian resident and the portion of his annual income which would be assessed for Canadian taxes. Explain your conclusions.

Assignment Problem One - 6

(Residency After Departure From Canada)

Mr. David Hamilton was a long-time resident of Canada. On January 13, 2016, he departed from Canada to work in Qatar. The work was done under a contract of employment with an American company that was operating in Qatar.

1. Mr. Hamilton did not obtain resident status in Qatar or in any other country. He did not have a postal address in Qatar.

2. Mr. Hamilton obtained a work permit in Qatar that was valid until August 13, 2019.

3. After the work permit expired, Mr. Hamilton had to leave Qatar. He subsequently returned several times to meet with friends and business associates there.

4. Mr. Hamilton's Canadian driver's licence expired in August, 2015 and was not renewed.

5. After taking intensive driving courses, Mr. Hamilton acquired a driver's licence in Qatar in December, 2016 that was valid for 5 years.

6. Mr. Hamilton gave up his Canadian health card in 2017.

7. Mr. Hamilton had two sons who remained in Canada. One of the sons, Harold, had significant health issues.

8. Mr. Hamilton kept a credit card, bank account, an RRSP and investments in Canada when he began work in Qatar.

9. Mr. Hamilton continued to hold a Canadian passport.

10. He visited Canada four times in 2016 and three times during 2017. Each visit was for 2 weeks. His visits were largely to see his sons and mother. The relationship with his wife was strained before he left for Qatar and deteriorated significantly afterwards. This led to their divorce in 2017. After his son Harold advised him to follow his dream of leaving Canada, he began the process of permanently leaving Canada. To this end, on July 1, 2017, he gave his share of the family home to his wife and closed all of his Canadian financial accounts. He paid regular support payments after the divorce occurred.

11. During his visits to Canada, he stayed in hotels and used rented vehicles.

12. In 2016, Mr. Hamilton's accountant filed a tax return for him as a resident of Canada.

13. Mr. Hamilton is well respected in his profession and considered to be a very responsible employee.

Despite filing a tax return in 2016 as a resident of Canada, Mr. Hamilton believes that he gave up his Canadian residency on January 13, 2016 and wishes to revise his 2016 tax return to reflect this.

Required: Determine whether Mr. Hamilton is a resident of Canada. If you conclude he is not, provide the date that he ceased to be a Canadian resident. Provide reasons for your conclusion.

Assignment Problem One - 7

(Residency Of Individuals - 5 Cases)

For each of the following individuals, determine their residency status for the year ending December 31, 2019. In addition, indicate what components of their income would be subject to Part I taxation in Canada, either as a resident or a non-resident. Provide the basis for your conclusions. Your answer should not take into consideration the influence of International Tax Treaties.

Case A Gary Short is a Canadian citizen who has lived and worked in Calgary, Alberta all of his life. In January, 2019, he is offered a significant promotion if he will accept a position in Australia. On accepting this position, he establishes residency in that country on February 1. However, because his children wish to finish the school year in Canada, his children and his wife do not join him until June 30, 2019. Because of the poor real estate market in his Calgary neighbourhood, his former residence is rented out under a long term residential lease beginning July 1.

Case B Sarah Sloan is a U.S. citizen who lives in Detroit, Michigan. During 2019 she is employed five days per week in Windsor, Ontario. She commutes to Windor on a daily basis. Her 2019 salary is $86,000 (Canadian). In addition, she has $900 (Canadian) of interest on a savings account with a Detroit bank.

Case C Byron Long is a citizen of France. However, having established landed immigrant status in Canada, he has worked in this country for over 15 years. On the unexpected death of his spouse, he receives an insurance payment of $2 million. He decides to use a large part of this payment for an extensive round-the-world cruise. He arranges a two year leave of absence from his job and sails from Canada on July 1, 2019. He sells the family residence, but retains all of his Canadian banking and brokerage accounts.

Case D Hilda Stein is married to a member of the Canadian armed forces who is stationed in Germany during the year 2019. She is a German citizen and has never visited Canada. During 2019, because her husband is a member of the Canadian armed forces, she is not subject to taxation in Germany.

Case E Jessica Segal has always lived in Canada. She has been asked by her Canadian employer to spend part of 2019 starting on August 1 and all of 2020 and 2021, working in the company's Frankfurt office. Her employment contract requires her to return to Canada on January 5, 2022. Jessica sells her condo and furniture and reluctantly gives her beloved dog to her brother. She moves to Frankfurt in July, 2019.

Assignment Problem One - 8

(Residency Of Corporations - 4 Cases)

Each of the following cases provides information about an individual corporation. For each case, indicate whether the corporation would be considered a Canadian resident for the current year. Explain your conclusions.

Case A The Allor Company was incorporated in North Dakota in 1999. Currently, however, the head office of the corporation is in Regina, Saskatchewan. As all of the directors of the corporation are residents of this Canadian city, all of the meetings of the board of directors are held in Regina.

Case B Kodar Ltd. was incorporated in Canada in 2005. However, as its directors have come to hate Canadian winters, they have all moved permanently to the southern United States. Because of this, they hold all of their Board of Directors meetings in Phoenix, Arizona.

Case C The Karlos Company was incorporated in Minnesota in 1998. The two directors lived in Winnipeg, Manitoba and for several years, all of the Board of Directors and shareholders meetings were held in Winnipeg, Manitoba. In early 2005, the directors were replaced by residents of St. Paul, Minnesota. After this, all of the Board of Directors and shareholders meetings were held in St. Paul.

Case D Bradlee Inc. was incorporated in Canada in 1961. While it operated in Canada for a number of years, all of its operations, management and directors relocated to the United States in 2008.

Assignment Problem One - 9

(Residency Of Individuals And Corporations)

Pertinent facts are given for a different individual or corporation in each of the Parts of this problem. For each Part, indicate whether or not this individual or corporation would be considered a Canadian resident for income tax purposes during the 2019. Briefly explain your conclusion.

A. Brian Palm was born in Kanata, Ontario. In January, 2019, after a record snowfall had paralyzed the area, Brian concluded he was not prepared to continue dealing with Ontario winters. He wound up his Canadian affairs and, on July 31, 2019, he moved to Palm Beach Florida. He has vowed to never set foot in Canada again.

B. Gunter is married to Rachel, who is a member of the Canadian armed forces serving in Germany. Except for a brief visit to Rachel's home town of Dartmouth, Nova Scotia, Gunter has never been to Canada. Gunter is exempt from taxation in Germany because he is the spouse of a deemed resident of Canada.

C. Sarah is a U.S. citizen living in Bloomfield Hills, Michigan. Most of her personal belongings are located in her parent's home in that city. However, throughout 2019, she has spent at least four days of every week living with her boyfriend in Windsor, Ontario. They plan to be married at some future date.

D. Martha is a U.S. citizen who, until 2018, had lived and worked in Canada as a landed immigrant for over 20 years. After winning $1.2 million playing black jack at the Montreal Casino, on August 28, 2018, she left Canada on a 2 year pleasure trip that will take her to virtually every country in the world. Her husband and children, all Canadian citizens, continue to live at the family home in Laval, Quebec.

E. Bronson Inc. was incorporated in Ontario in 1962. Until 1993, its only director resided in that province. In that year, the director was replaced by an individual resident in Corning, New York.

F. Ubex Ltd. was incorporated in Delaware in 1985. Until 1998, all of the directors of the corporation lived in Moncton, New Brunswick. During this period, the Board of Directors meetings were held in that city. Beginning in 1999, all of the directors have been residents of Green Bay, Wisconsin and all of the Board of Directors meetings have been held in Wilmington, Delaware.

Assignment Problem One - 10

(Residency/Dual Residency - Individuals)

Determine the residency status of the individuals in the following Cases. Use the tie-breaker rules found in the Canada/U.S. tax treaty where appropriate.

Case A Ty Breaker is a citizen of the United States. He is a professional athlete, a successful entrepreneur and very single. During 2019, he plays for a Canadian soccer team and, as a consequence, he spends 194 days in Canada. Because of his extensive travel, he stores his few personal items in his mother's basement and lives in short term rentals of hotel suites in both Canada and the U.S. As he owns corporations in both countries, he has office space in both Canada and the U.S. In previous years, Ty has played for a U.S. soccer team and has spent less than 100 days per year in Canada.

Case B Jordan Marsh is a U.S. citizen who does construction work as an independent contractor. He has a home in Kalispell, Montana which he has owned for many years. As work has been slow in that city in recent years, he decides to temporarily move to Lethbridge after hearing work is plentiful there. He moves on March 31, 2019. He does not sell his Kalispell residence as his brother needs a temporary home while he renovates. Jordan lives in a Lethbridge hotel until February 12, 2020. By this time he has realized that the work situation is worse in Lethbridge than it was in Kalispell. Given this, he returns to Kalispell.

Assignment Problem One - 11

(Alternative Views Of Income)

Distinguish between the accountant's, the economist's, and the *Income Tax Act* views of income.

Assignment Problem One - 12

(Net Income For Tax Purposes - Two Cases)

Karla Gomez is a Canadian resident who lives in Toronto. In the following two Cases, different assumptions are made with respect to the amounts and types of income she will include in her tax return for the current year. Information is also provided on the deductions that will be available to her for the year.

Case One Karla had net employment income of $62,350. Unfortunately, her unincorporated flower shop suffered a net business loss of $115,600. In contrast, she had a very good year in the stock market, realizing the following gains and losses:

Capital Gains	$97,650
Capital Losses	5,430

Also during the current year, Karla made deductible contributions of $4,560 to her RRSP.

Case Two Karla had net employment income during the year of $45,600, as well as net business income of $27,310 and a net rental loss of $4,600. As part of a divorce agreement from a previous year, Karla paid spousal support of $600 per month to her former common-law partner, Lucretia Smart for the entire year. She realized the following results in the stock market during the year:

Capital Gains	$31,620
Capital Losses	41,650

While Karla does not gamble on a regular basis, she enjoys the ambiance of the local casino. Given this, two or three times a year, she spends an evening dining and gambling with friends there. In March of this year, she got very lucky, winning $46,000 by hitting a slot machine jackpot.

Required: For each Case, calculate Karla's Net Income For Tax Purposes (Division B income) for the current year. Indicate the amount and type of any loss carry overs that would be available at the end of the year.

Assignment Problem One - 13

(Net Income For Tax Purposes - Four Cases)

The following four Cases make different assumptions with respect to the amounts of income and deductions of Frank Denham for the current year:

	Case A	Case B	Case C	Case D
Employment Income	$58,200	$82,600	$46,700	$33,400
Income (Loss) From Business	(12,300)	(8,400)	(62,300)	(46,200)
Rental Income (Loss)	5,400	12,200	2,600	(18,300)
Taxable Capital Gains	31,600	15,600	11,600	23,100
Allowable Capital Losses	(12,400)	(23,400)	(10,700)	(24,700)
Subdivision e Deductions	(4,100)	(5,400)	(11,600)	(5,600)

Required: For each Case, calculate Mr. Denham's Net Income For Tax Purposes (Division B income). Indicate the amount and type of any loss carry overs that would be available at the end of the current year, or state that no carry overs are available.

CHAPTER 2

Procedures And Administration

Introduction

2-1. This Chapter begins with a brief overview of the administration of the Canada Revenue Agency (CRA). This is followed by a description of filing and tax payment procedures applicable to individuals, corporations, and trusts.

2-2. This material on filing and tax payment procedures will be followed by a description of the assessment and reassessment process, including the various avenues that can be followed in appealing unfavourable assessments. Attention will also be given to issues related to tax avoidance and tax evasion, collection and enforcement procedures, and taxpayer relief provisions.

Administration Of The Department

2-3. The CRA has the responsibility for carrying out the tax policies that are enacted by Parliament. In carrying out these policies, the chief executive officer of the CRA is the Commissioner of Revenue. The duties of the Minister of National Revenue, as well as those of the Commissioner of Revenue, are described in the *Act* as follows:

> **ITA 220(1)** The Minister shall administer and enforce this Act and the Commissioner of Revenue may exercise all the powers and perform the duties of the Minister under this Act.

2-4. The Minister of National Revenue is responsible for the CRA and is accountable to Parliament for all of its activities, including the administration and enforcement of program legislation such as the *Income Tax Act* and the *Excise Tax Act*. The Minister has the authority to ensure that the CRA operates within the overall government framework and treats its clients with fairness, integrity, and consistency.

2-5. The CRA has a Board of Management consisting of 15 members appointed by the Governor in Council, 11 of whom have been nominated by the provinces and territories. The Board has the responsibility of overseeing the management of the CRA, including the development of the Corporate Business Plan, and the management of policies related to resources, services, property, personnel, and contracts. The Commissioner of the CRA, who is a member of the CRA Board, is responsible for the CRA's day-to-day operations.

2-6. Unlike the boards of Crown corporations, the CRA Board is not involved in all the activities of the CRA. In particular, the CRA Board has no authority in the administration and

enforcement of legislation, which includes the *Income Tax Act* and the *Excise Tax Act*, for which the CRA remains fully accountable to the Minister of National Revenue. In addition, the CRA Board is denied access to confidential client information.

2-7. Following the ministerial mandate found in ITA 220(1), ITA 221(1) provides that the Governor in Council has the power to make Income Tax Regulations for various specific purposes or for the purpose of carrying out other provisions of the *Income Tax Act*. Unlike the provisions of the *Income Tax Act*, these Regulations may be passed by Order-In-Council without ratification by Parliament. They generally become effective when they are published in the Canada Gazette.

Returns And Payments - Individuals

Requirement To File - ITA 150

2-8. ITA 150(1) is a general rule that requires all persons (individuals, corporations, and trusts) to file a tax return. Although ITA 150(1.1)(b) exempts individuals from filing tax returns except where certain conditions are met, there are still other provisions in the *Income Tax Act* that require returns to be filed. The CRA website lists many reasons why an individual would be required to file an individual tax return (Form T1), the most common reasons being if, in the year, the individual:

- has Tax Payable;
- is requested by the CRA to file a tax return;
- has disposed of a capital property, or realized a taxable capital gain;
- and his spouse or common-law partner have elected to split pension income; or
- has to contribute to the Canada Pension Plan or pay Employment Insurance premiums.

2-9. In addition to these requirements for residents, non-resident individuals must generally file a T1 tax return if, during the year, they have a taxable capital gain or dispose of a Taxable Canadian Property (See Chapter 20, International Issues In Taxation for more details.)

2-10. Even when there is no requirement to file, if an individual is entitled to a refund, it will only be available if a return is filed. Further, it is beneficial for others to file, especially low income taxpayers, in order to be eligible for income-based benefits such as the Canada Child Benefit, the GST credit and the Guaranteed Income Supplement. If they fail to file, they will not receive these amounts, even if they qualify.

2-11. Individuals can either file a paper form or, alternatively, use an electronic filing method. The advantage of electronic filing for the taxpayer, particularly if he is entitled to a refund, is that the return will be processed more quickly. For the CRA, electronic filing eliminates the possibility of errors in the process of transferring information from paper forms to their electronic records. While supporting documents (e.g., a charitable donation receipt) cannot be included with an electronic filing, the CRA has the right to request that such receipts be provided. Such requests are fairly common, particularly when large amounts are involved.

2-12. The CRA website has detailed coverage of the two alternatives for electronic filing. Both EFILE and NETFILE are automated transmission services that permit the filing of tax returns online. The main difference between them can be described as follows:

> **NETFILE** allows a taxpayer to file their own personal income tax return directly to the CRA online through the use of a CRA certified tax software program. It is intended for use by those who prepare their own tax returns. This system can be used by almost all Canadian resident individuals.
>
> **EFILE** allows tax preparation service providers who are registered with the CRA to file tax returns for clients online. It is designed for those who prepare and file tax returns for clients. The NETFILE system cannot be used to file returns for clients.

2-13. CRA's filing statistics for the 2017 personal tax filing season covering the period from February 12, 2018 to September 9, 2018 are shown in the following table. There has been a

significant decline in the percentage of taxpayers using paper filing over the 5 years.

Filed During	Electronically Filed	Paper Filed	Total T1 Returns
2018	25,245,885 (88%)	3,627,413 (12%)	28,873,298
2017	24,217,401 (86%)	3,869,830 (14%)	28,087,231
2016	23,507,132 (85%)	4,177,253 (15%)	27,684,385
2015	23,383,313 (81%)	5,397,643 (19%)	28,780,956
2014	21,936,593 (78%)	6,162,087 (22%)	28,296,680

2-14. Of the total 2017 returns electronically filed during 2018, 16,625,029 were filed under the EFILE program, while 8,573,660 were filed using NETFILE.

Due Date For Individual Returns

General Rule

2-15. As noted in Chapter 1, individuals must use the calendar year as their taxation year. This means that for every individual, the taxation year ends on December 31. Given this, ITA 150(1)(d)(i) indicates that, in general, individuals must file their tax return for a particular year on or before April 30 of the following year. Although the filing due date is extended to the next business day if the due date falls on a weekend, we will use April 30 (or June 15 if applicable as explained in the following material) as the due date in our examples and problems.

Individuals Who Are Partners Or Proprietors

2-16. Recognizing that individuals who are involved in an unincorporated business may need more time to determine their income for a taxation year, the *Income Tax Act* provides a deferral of the filing deadline. If an individual, and/or his cohabiting spouse or common-law partner, carried on a business during the year, ITA 150(1)(d)(ii) extends the due date for filing to June 15 of the calendar year following the relevant taxation year.

2-17. An interesting feature of this provision is that, while the return does not have to be filed until June 15, payment of all taxes owing is required by the usual date of April 30. Any amounts that are not paid by April 30 will be assessed interest until the outstanding balance is paid. The relevant interest rate is described later in this Chapter.

Exercise Two - 1

Subject: Individual Tax Payment Date

Brandon Katarski's 2019 Net Income includes business income. When is his 2019 tax return due? By what date must his 2019 tax liability be paid in order to avoid the assessment of interest on amounts due?

SOLUTION available in print and online Study Guide.

Deceased Taxpayers

2-18. As will be discussed in Chapter 9, there are many tax related complications that arise when an individual dies. In order to provide the deceased individual's representatives with sufficient time to deal with these complications, the *Act* indicates the following:

> **ITA 150(1)(b)** ... in the case of an individual who dies after October of the year and before the day that would be the individual's filing due date for the year if the individual had not died, by the individual's legal representatives on or before the day that is the later of the day on or before which the return would otherwise be required to be filed and the day that is 6 months after the day of death;

2-19. For an individual whose filing due date is April 30, this provision means that if death occurs between November 1 of the previous year and April 30 of the current year, the return for the previous year does not have to be filed until six months after the date of death.

EXAMPLE A single individual who is not involved in an unincorporated business dies on March 1, 2020 without having filed a 2019 return.

ANALYSIS The due date for the 2019 return is September 1, 2020, six months after the individual's death. The due date for the 2020 final return is April 30, 2021.

2-20. The provision works somewhat differently for an individual who has a June 15 filing due date due to business income. If such an individual dies between November 1 and December 15 of a taxation year, the later of six months after the date of death and the normal filing due date, will be the normal filing date of June 15. This means that for decedents who would normally have a June 15 filing due date, the six month extension is available if they die between December 16 of a taxation year and June 15 of the following year.

EXAMPLE An individual whose wife owns an unincorporated business dies on May 2, 2020 without having filed a 2019 tax return.

ANALYSIS The due date for the 2019 return is November 2, 2020, six months after the individual's death. The due date for the 2020 final return is June 15, 2021.

Exercise Two - 2

Subject: Deceased Taxpayer Filing Date

Sally Cheung dies on February 15, 2020. Sally's only income for 2019 and 2020 was from investments. Her husband's Net Income for these years included income from an unincorporated business. Her representatives must file her 2019 and 2020 tax returns by what dates? Explain your answer.

SOLUTION available in print and online Study Guide.

Withholdings For Income Tax - ITA 153

Salaries And Wages

2-21. A large portion of the income taxes paid by individuals employed in Canada is collected through source deductions. Under ITA 153, any individual who earns employment income will have the estimated taxes on this income withheld from gross pay through payroll deductions made by their employer. The tax withheld is related to the amount of the individual's income, with the required withholdings intended to cover the tax payable on this income. However, it would be unusual for such withholding to be exactly equal to the taxes payable for the year. As a consequence, most individuals will either owe taxes and be required to file a tax return or, alternatively, be entitled to a refund that can only be obtained by filing a tax return.

2-22. The amount withheld by an employer is based on a form that is filled out by each employee, Form TD1, "Personal Tax Credits Return". This form lists personal and other credits that are available to an individual and asks the employee to indicate which of these he will be claiming.

2-23. Also on Form TD1, an individual can request to have the amount withheld increased beyond the required amount. An individual might choose to do this if his employment income withholding is based on rates in a low tax rate province, but his residence is in a high tax rate province (e.g., an individual who works in Alberta, but lives in Saskatchewan). Another situation where this might be desirable would be if an individual received large taxable spousal support payments as these are not subject to withholding. In either of these cases, requesting additional withholding would allow the individual to pay extra taxes each pay period and avoid a large tax liability on filing, or the requirement to pay instalments.

2-24. A different type of problem can arise when an employed individual has significant deductions from income, losses, or non-refundable tax credits not listed on the TD1, that can

be used to offset the taxes on employment income.

> **EXAMPLE** Monica Kinney has annual employment income that places her in the middle of the 29 percent tax bracket. Her employer would base her withholdings on her estimated employment income for the year. However, if Monica makes annual deductible spousal support payments of $20,000, her Taxable Income will be reduced by this amount, resulting in a reduction in federal Tax Payable of $5,800 [($20,000)(29%)]. If provincial income taxes are taken into consideration, a further reduction in income taxes payable would be available.

2-25. In this situation, Monica can request a reduction in the amount of tax withheld by her employer by using Form T1213, "Request To Reduce Tax Deductions At Source". As long as the deductions (e.g., payroll deductions for an RRSP), losses (e.g., rental loss) or tax credits (e.g. for charitable donations) can be documented in a reasonable fashion, the CRA will normally authorize the employer to reduce the tax withheld from the employee's remuneration.

Withholdings By Other Payers

2-26. In addition to requiring employers to withhold specified amounts from the salaries and wages of employees, ITA 153 contains a fairly long list of other types of payments from which the payer must withhold prescribed amounts. These include:

- retiring allowances
- death benefits
- payments from Registered Retirement Savings Plans
- payments from Registered Education Savings Plans
- distributions under retirement compensation arrangements

2-27. In addition to payments listed in ITA 153, withholding is required on certain payments to non-residents. While the general rate of tax on the Canadian source income of non-residents is established in ITA 212 as 25 percent, the amount that will actually be withheld is usually modified by international tax treaties. For a more complete discussion of this type of withholding, see Chapter 20, International Issues In Taxation.

Instalment Payments For Individuals - ITA 156

Basis For Requiring Instalments

2-28. As discussed in the previous section, amounts to be applied to future tax liabilities must be withheld by the payer from certain types of income. Such income includes employment income, as well as other less common sources.

2-29. For many individuals, particularly those earning employment income, the withholding of taxes constitutes the major form of tax payment in any taxation year. However, in situations where an individual has large amounts of income that are not subject to withholding (e.g., self-employment income or investment income), quarterly instalment payments may have to be made towards the current year's tax liability.

2-30. In the *Income Tax Act*, the requirement for paying instalments is stated in terms of when instalments are not required. Specifically, no instalments are required if:

> **ITA 156.1(2)(b)** The individual's net tax owing for the particular year, or for each of the 2 preceding taxation years, does not exceed the individual's instalment threshold for that year.

2-31. In provinces other than Quebec, "net tax owing" is the amount, if any, by which the total federal and provincial tax owing for a particular year, exceeds all tax withheld for that year. An "individual's instalment threshold" is defined in ITA 156.1(1) as $3,000. In Quebec, net tax owing only includes federal taxes and the instalment threshold is $1,800.

2-32. While the legislation is based on when instalments are not required, it is usually more useful to give guidance in terms of when instalments are required. The requirement could be restated as follows:

You are required to make instalment payments for 2019 if your **net tax owing** is more than $3,000:

- in 2019; **and**
- in **either** 2018 **or** 2017.

Note that **net tax owing** is not equal to **Tax Payable** if any income tax has been withheld.

Due Dates For Individuals

2-33. For individuals required to pay instalments, the quarterly payments are due on March 15, June 15, September 15, and December 15.

Determining Amounts Of Instalments

2-34. In simple terms, the required instalments will be based on the net tax owing for the current year, the preceding year, or a combination of the first and second preceding years. The *Canada Pension Plan Act* and the *Employment Insurance Act* provide for instalments on the same basis as that of the *Income Tax Act*. Since the CRA administers the Canada Pension Plan (CPP) and Employment Insurance (EI), where an individual has CPP contributions and/or EI premiums payable on self-employed income (see Chapter 3), the instalments are based on the total of net tax owing plus any CPP contributions and EI premiums payable.

2-35. In determining the amount to be paid as instalments, individuals have a choice of three alternatives for calculating the required quarterly instalments as follows:

Alternative 1 - Current Year One-quarter of the estimated net tax owing (not Tax Payable) for the current taxation year [ITA 156(1)(a)(i)].

Alternative 2 - Preceding Year One-quarter of the net tax owing for the immediately preceding taxation year [ITA 156(1)(a)(ii)].

Alternative 3 - Second And First Preceding Year The first two instalments (March 15 and June 15) based on one-quarter of the net tax owing for the second preceding taxation year. The remaining two instalments (September 15 and December 15) equal the excess of the net tax owing for the preceding year over one-half of the net tax owing for the second preceding year [ITA 156(1)(b)], divided by two. Note that one-half of the net tax owing for the second preceding year is the amount that should have been paid in the first two instalments under this approach.

In effect, in almost all situations, Alternative 3 requires the same total instalments as Alternative 2. However, if the net tax owing in the second preceding year is less than the net tax owing in the preceding year, there is some amount of tax deferral.

2-36. The individual taxpayer can select the most advantageous of these alternatives. The basic rules for this selection are as follows:

- If the net tax owing is lowest in the current year, Alternative 1 is best.
- If the net tax owing is lowest in the preceding year, Alternative 2 is best.
- If the net tax owing is lowest in the second preceding year:
  - and the net tax owing in the first preceding year is higher than the current year, Alternative 1 is best.
  - and the net tax owing in the first preceding year is lower than the current year, Alternative 3 is best. While the total amount of the instalments will be the same as in Alternative 2, their present value will be less because of the reduced amount for the first two payments.

CRA's Instalment Reminders

2-37. The CRA wants to ensure that individuals who are required to pay instalments have received an Instalment Reminder. If an individual is registered for the MyAccount service (see Paragraph 2-91), the CRA emails a notification that there is new online mail, otherwise the Instalment Reminders are sent by mail. Taxpayers are assured that, if they pay the amounts

specified in these reminders by the due dates, no interest will be assessed for late instalments.

2-38. The amounts specified in these Instalment Reminders are based on Alternative 3. The reason that the CRA has adopted this approach is based on information availability:

Alternative 1 The CRA would not know the current year's Tax Payable until April 30 or June 15 of the following year. This would be too late for advising a taxpayer as to any of the current year's instalments under this approach.

Alternative 2 The CRA would not know the previous year's Tax Payable until April 30 or June 15 of the current year. This would too late for advising a taxpayer as to the first required instalment for the current year and, in the case of June 15 filers, too late to provide information on the second required instalment for the current year.

2-39. Given this situation, Alternative 3 is the only approach that could be used by the CRA to provide taxpayers with instalment information that would unequivocally avoid any assessment of interest.

2-40. While using the amounts specified in the Instalment Reminder is a risk free solution to remitting instalments, it may not be the best answer for an individual taxpayer.

EXAMPLE Ali Kern, a self-employed general contractor, had Taxable Income in both 2017 and 2018 that was in excess of $200,000. Unfortunately, in early 2019 he was in a serious accident and could not work all year. His business experienced significant losses which ultimately resulted in a Taxable Income of nil.

ANALYSIS The CRA's Instalment Reminders would base its calculations on the high levels of income for 2017 and 2018. Paying these amounts would be a very poor choice as it would, in essence, constitute an interest free loan to the government. As Ali knew early in the year that he would have little or no income, his best choice would be to make no instalments based on his estimated current year net tax owing of nil.

2-41. However, if an individual does not pay the amounts calculated in the CRA's Instalment Reminders, the taxpayer is basing some or all of his payments on estimates. If his estimates are too low, he will be assessed interest on any insufficient instalments.

Example Of Instalments For Individuals

2-42. A simple example will serve to illustrate the alternative approaches to calculating instalments.

EXAMPLE Mr. Hruba is not subject to any withholding and has the following amounts of net tax owing:

2017	$20,000
2018	32,000
2019 (Estimated)	24,000

ANALYSIS The use of alternative 1 based on the 2019 estimate of $24,000 would result in quarterly instalments of $6,000 ($24,000 ÷ 4), totaling $24,000 for the year.

Alternative 2, based on the 2018 figure of $32,000 is the worst alternative. The quarterly instalments would be $8,000 ($32,000 ÷ 4), totaling $32,000 for the year.

Under alternative 3 (used in the CRA's Instalment Reminders), instalments 1 and 2 would each be $5,000 ($20,000 ÷ 4). However, instalments 3 and 4 would each be $11,000 [($32,000 - $10,000) ÷ 2], resulting in a total of $32,000.

This analysis would suggest that alternative 1 provides the best solution. While the first two payments under alternative 3 are somewhat lower ($5,000 vs. $6,000), the total amount under alternative 1 is significantly lower ($24,000 vs. $32,000).

2-43. The CRA will calculate interest based on each instalment that should have been paid using the payment option that requires the least amount of interest to a specific date. The CRA will then calculate interest based on the instalments that were paid. If the former amount

exceeds the latter, the individual will be assessed interest on the difference, provided the amount involved exceeds $25. Note that contra interest as explained in Paragraph 2-46 could also be relevant in calculating the applicable interest.

Exercise Two - 3

Subject: Individual Instalments

Marlene Carter, a resident of Ontario, had net tax owing for 2017 of $3,500, net tax owing for 2018 of $4,000, and expects to have net tax owing for 2019 of $1,500. Is she required to make instalment payments for 2019? If so, what would be the minimum quarterly payment and when would they be due?

Exercise Two - 4

Subject: Individual Instalments

John Lee, a resident of Newfoundland, had net tax owing for 2017 of $3,500, net tax owing for 2018 of $1,500, and expects to have net tax owing for 2019 of $4,500. Is he required to make instalment payments for 2019? If so, what would be the minimum quarterly payment and when would they be due?

Exercise Two - 5

Subject: Individual Instalments

At the beginning of 2019, the following information relates to Jesse Forbes:

Year	Tax Payable	Amounts Withheld
2017	$53,000	$52,000
2018	59,000	52,000
2019 (Estimated)	64,000	60,000

Is Jesse required to make instalment payments during 2019? If he is required to make instalment payments, indicate the amounts that would be required under each of the three alternative methods of calculating instalments. Indicate which alternative would be preferable.

SOLUTIONS available in print and online Study Guide.

We suggest you work Self Study Problem Two-1 at this point.

Interest

When Interest Is Charged

2-44. Interest is assessed on any amounts that are not paid when they are due. For individuals, this would include:

- Any balance owing on April 30th of the current year for the taxes of the preceding year. We would remind you that the amount owing is due on April 30th, without regard to whether the taxpayer's filing due date is April 30 or June 15.
- Any portion of a required instalment payment that is not remitted on the required instalment due date.
- On some penalties. For example, interest is charged on penalties for late filing (see following discussion of this penalty).

2-45. Compound daily interest is charged on these amounts. In the case of amounts owing on April 30th, the start date for interest is May 1, with the accrual continuing until the amounts are paid. For deficient instalment amounts, the interest clock starts ticking on the date the instalment is due. This accrual would continue until an offset occurs (see next paragraph) or the due date for the balance owing. At this latter date, further interest would be based on the amount owing at that date.

2-46. A further important point here is that interest accrued on late or deficient instalments can be offset by making instalment payments prior to their due date, or by paying an amount in excess of the amount required (creating contra interest). Note, however, if early or excess payments are made when there is no accrual of interest owed on late or deficient instalments, the government will not pay interest to the taxpayer on the excess.

Prescribed Rates Of Interest

2-47. There are a number of provisions in the *Income Tax Act* which require the use of an assumed rate of interest. What we refer to as the prescribed base rate is an annual rate that is calculated each quarter, based on the effective yield on three month Government of Canada treasury bills during the first month of the preceding quarter. The CRA announces this prescribed base rate for each quarter a few weeks before the start of the quarter.

2-48. Many years ago there was a single prescribed rate. However, the government felt that this rate was sufficiently low that too many taxpayers chose not to make required tax payments. To try to solve this problem, on amounts owing to the government, 4 percentage points were added to the prescribed base rate as described in the preceding paragraph. At the same time, a third rate was established for amounts owed to taxpayers.

2-49. As a result, there are now multiple prescribed interest rates and ITR 4301 contains the calculations for these rates. The rates that concern us here are:

Base Rate This rate, described in Paragraph 2-47, is applicable for all purposes except amounts owing to and from the CRA (e.g., the determination of the taxable benefit for an employee who receives an interest free loan from an employer). For the first and second quarters of 2019, this rate was 2 percent.

Base Rate Plus 2 Percent This rate is applicable when calculating interest on refunds to individuals and trusts, but not corporations. For the first and second quarters of 2019, this rate was 4 percent.

Interest rates on short term investments are much lower than the prescribed rate plus 2 percent. To prevent corporations from overpaying instalments to take advantage of the higher interest rates paid by the CRA, the rate on amounts owed to corporations is only the base rate and does not include the extra 2 percent.

Base Rate Plus 4 Percent This rate is applicable when calculating interest on late or deficient instalments, unpaid source deductions, and other amounts owing to the CRA by all taxpayers. For the first and second quarters of 2019, this rate was 6 percent. Note that amounts paid to the CRA under this provision are not deductible for any taxpayer.

2-50. Many individuals are faced with the choice of either making their instalment payments or, alternatively, paying off other types of liabilities that they have accumulated. In many cases, the interest rate on other debts is higher than 6 percent.

EXAMPLE Jasmine Ho has determined that her March instalment for 2019 will be $7,500. She owes $7,500 on her Visa credit card for personal expenditures. Jasmine does not have the funds to pay both the credit card debt and her tax instalment.

ANALYSIS The annual interest rate that will be charged on her Visa balance is likely to be around 20 percent. This compares to a current rate on late tax instalments of 6 percent. Without regard to financial planning issues, Jasmine would clearly reduce her interest costs by paying off the credit card debt, as opposed to making her instalment payment.

Penalties

Late Filing Penalty

2-51. If the deadline for filing an income tax return is not met, the CRA assesses a penalty. For a first offence, this penalty amounts to 5 percent of the tax that was unpaid at the filing due date, plus 1 percent for each complete month (part months do not count) the unpaid tax is outstanding up to a maximum of 12 months. This penalty would be in addition to interest on the amounts due. If there are no taxes owed on the due date, or if the taxpayer is entitled to a refund, the late filing penalty would be nil.

2-52. If the taxpayer has been charged a late filing penalty in any of the three preceding taxation years, the CRA can double the penalty on the second offence to 10 percent of the tax owing, plus 2 percent per month up to a maximum of 20 months. This will happen if the second late filed return is filed after the CRA has already sent a demand to file that return.

2-53. In terms of tax planning, the penalty for late filing is sufficiently severe that individuals should make every effort to file their income tax returns no later than the deadline (April 30 or June 15), even if all of the taxes owing cannot be paid at that time. This is of particular importance if they have filed late in one of the three preceding years.

2-54. This point is sometimes forgotten when the previous offence resulted in a negligible penalty. The penalty for a second offence will double, even if the amount involved in the first penalty was very small.

Late Or Deficient Instalments Penalty

2-55. There is no penalty for late payment of income taxes or on moderate amounts of late or deficient instalments. However, there is a penalty when large amounts of late or deficient instalments are involved. This penalty is specified in ITA 163.1 and is equal to 50 percent of the amount by which the interest owing on the late or deficient instalments exceeds the greater of $1,000 and 25 percent of the interest that would be owing if no instalments were made. As this penalty does not kick in unless the amount of interest exceeds $1,000, it would only apply to fairly large amounts of late or deficient instalments.

Exercise Two - 6

Subject: Penalties And Interest For Individuals

Despite the fact that her net tax owing has been between $3,000 and $4,000 in the two previous years, and is expected to be a similar amount during 2019, Mary Carlos has made no instalment payments for 2019. While her normal filing date would be April 30, 2020, she does not file her 2019 return or pay the balance owing until July 20, 2020. What penalties and interest will be assessed for the 2019 taxation year?

SOLUTION available in print and online Study Guide.

Due Date For Balance Owing - Living Individuals

2-56. If the combination of amounts withheld and instalments paid falls short of the total taxes payable for the taxation year, there will be a balance owing. For living individuals, ITA 248(1) defines the "balance due date" as April 30, without regard to whether the taxpayer qualifies for the June 15 filing due date because of business income.

Deceased Taxpayers - Balance Due Dates And Final Returns

Balance Due Dates - Deceased Taxpayer

2-57. The due date for the amount owing for the year of death is generally April 30th of the year following death. However, if the taxpayer is eligible for the six month extension of the filing due date for the current or previous year's return, the balance due date for that return is

also extended to the revised filing due date.

EXAMPLE Before filing her 2019 tax return, Joanne Rivers dies on March 31, 2020. For 2019 and 2020, her income was from her business. No instalments were required. There is a balance owing for both years. What are the due dates for these amounts?

ANALYSIS Her 2019 return will be due on September 30, 2020, six months after her death. Any balance owing for 2019 will be due at that time. Although her final return for 2020 will be due on June 15, 2021, any balance owing for 2020 will be due on April 30, 2021.

Final Returns - Special Rules Applicable At Death

2-58. Dealing with the death of a taxpayer is a very complex area of tax practice. In fact, for an individual with a substantial estate and/or a number of beneficiaries, it usually requires the services of a tax practitioner who specializes in the area. Complete coverage of this subject goes well beyond the scope of this general text.

2-59. However, we will provide some coverage of a few of the more important issues that arise when an individual dies. For example, in Chapter 9 we discuss the deemed disposition of capital assets at death and in Chapter 11 we cover the special rules that apply to net capital losses in the year of death.

2-60. Additional filing issues related to the deceased taxpayers, such as returns to be filed and available credits, are covered in an Appendix to Chapter 11.

Returns And Payments - Corporations

Due Date For Corporate Returns - ITA 150

2-61. Unlike the case with individuals, the taxation year of a corporation can end on any day of the calendar year. This makes it impossible to have a uniform filing date and, as a consequence, the filing deadline for corporations is specified as six months after the fiscal year end of the company.

2-62. Under ITA 150(1)(a), corporations (other than corporations that are registered charities) that are resident in Canada at any time in the year, carry on business in Canada, have a taxable capital gain, dispose of Taxable Canadian Property, or would be subject to Canadian tax if not for an international tax treaty, are required to file a corporate tax return, Form T2, within this specified period. Information from the financial statements must accompany this form, along with other required schedules.

Filing Alternatives For Corporations

Paper Vs. Electronic Filing

2-63. ITA 150.1(2.1) indicates that prescribed corporations must file their returns electronically. They do not have the option to paper file. For this purpose, prescribed corporations are those that have gross revenues in excess of $1 million. Corporations with gross revenues of $1 million or less can choose to paper file or to file their return electronically.

Use Of Functional Currency

2-64. If a Canadian enterprise has foreign operations, it is likely that some of their records will be maintained in a foreign currency. If these records are translated into Canadian dollars in order to file the required return, there may be a problem. The use of some translation procedures can introduce what many analysts believe are distortions in the reported results.

2-65. To correct this situation, ITA 261 allows the determination of Canadian tax liabilities on the basis of financial statements prepared in the corporation's functional currency. For this purpose, functional currency is defined as follows:

"**functional currency**" of a taxpayer for a taxation year means the currency of a country other than Canada if that currency is, throughout the taxation year,

(a) a qualifying currency; and
(b) the primary currency in which the taxpayer maintains its records and books of account for financial reporting purposes.

2-66. ITA 261 provides the following definition of qualifying currency:

"**qualifying currency**" at any time means each of
(a) the currency of the United States of America;
(b) the currency of the European Monetary Union;
(c) the currency of the United Kingdom;
(d) the currency of Australia; and
(e) a prescribed currency.

2-67. You should also note that the term "functional currency" has a different meaning in the *Income Tax Act* than it does in Canadian and International Financial Reporting Standards. Financial reporting standards use this term to refer to the currency of the primary economic environment in which the corporation operates, without regard to the currency in which the corporation keeps its records.

Instalment Payments For Corporations

Instalment Threshold

2-68. Corporations are generally required to make monthly instalment payments throughout their taxation year. However, this requirement is eliminated if either the estimated Tax Payable for the current year or the Tax Payable for the preceding taxation year does not exceed $3,000 (combined federal and provincial). In addition, special rules apply to some "Canadian Controlled Private Corporations", or CCPCs. While CCPCs will be defined more precisely in Chapter 12, at this point we would note that a CCPC is a private corporation that is controlled by residents of Canada and does not have any of its shares traded in public markets. The special instalment rules applicable to these CCPCs will be discussed beginning at Paragraph 2-71.

Calculating The Amount - General Rules (Excluding Small CCPCs)

2-69. When instalments are required, they must be paid on or before the last day of each month, with the amount being calculated on the basis of one of three alternatives. As laid out in ITA 157(1)(a), these alternatives are as follows:

1. **Current Year** - 12 instalments, each based on 1/12 of the estimated tax payable for the current year.

2. **Preceding Year** - 12 instalments, each based on 1/12 of the tax that was payable in the immediately preceding year.

3. **Second And First Preceding Year** - 2 instalments, each based on 1/12 of the tax that was payable in the second preceding year, followed by 10 instalments based on 1/10 of the amount by which the taxes paid in the immediately preceding year exceeds the sum of the first two instalments.

2-70. Choosing between these alternatives is usually a relatively simple matter. The choice should be the instalment base that provides the minimum total cash outflow or, in those cases where alternative bases result in the same total cash outflow, the alternative that provides the greatest amount of deferral. For businesses that are experiencing year to year increases in their taxes payable, the third alternative will generally meet this objective. Note, however, the total cash outflow under the third alternative will usually be the same as the total cash outflow under the second alternative.

EXAMPLE The Marshall Company, a public company, estimates that its 2019 taxes payable will be $153,000. In 2018, the Company paid taxes of $126,000. The corresponding figure for 2017 was $96,000.

ANALYSIS The choices for instalment payments for Marshall Company would be:

1. 12 instalments of $12,750 each ($153,000 ÷ 12) totaling $153,000.
2. 12 instalments of $10,500 each ($126,000 ÷ 12) totaling $126,000.
3. 2 instalments of $8,000 each ($96,000 ÷ 12) and 10 instalments of $11,000 each [($126,000 - $16,000) ÷ 10] totaling $126,000.

While the cash outflows under alternative 3 total the same amount as those under alternative 2, alternative 3 would be selected because the first two payments are smaller and provide a deferral to the last 10 payments.

Calculating The Amount - Small CCPCs

2-71. "Small" CCPCs are allowed to pay instalments on a quarterly basis. ITA 157(1.2) defines a small CCPC as one for which:

- the Taxable Income of the corporation and its associated corporations does not exceed $500,000 during the current or the previous taxation year;
- the Taxable Capital Employed In Canada of the corporation and its associated corporations does not exceed $10 million for the current or previous year;
- an amount has been deducted under ITA 125 (the small business deduction) for the current or previous year; and
- a perfect compliance record has been maintained with respect to payments and filings (for GST, source deductions and income taxes) during the last 12 months.

2-72. For CCPCs that meet this definition, ITA 157(1.1) provides three alternatives for calculating instalments:

1. **Current Year** - 4 instalments, each based on 1/4 of the estimated tax payable for the current taxation year.
2. **Preceding Year** - 4 instalments, each based on 1/4 of the tax that was payable in the immediately preceding taxation year.
3. **Second And First Preceding Year** - 1 instalment based on 1/4 of the tax that was payable in the second preceding taxation year, followed by 3 instalments based on 1/3 of the amount by which the taxes paid in the immediately preceding taxation year exceeds the first instalment.

2-73. The payments are required on or before the last day of each of the fiscal quarters.

Exercise Two - 7

Subject: Corporate Instalments

Madco Ltd. is not a small CCPC. It has a December 31 year end. For 2017, its tax payable was $32,000, while for 2018, the amount was $59,000. For 2019, its estimated tax payable is $74,000. What would be the minimum instalments for 2019 and when would they be due? How would your answer differ if Madco Ltd. was a small CCPC?

SOLUTION available in print and online Study Guide.

Exercise Two - 8

Subject: Corporate Instalments

Fadco Inc. is not a small CCPC. It has a November 30 year end. For the taxation year ending November 30, 2017, its tax payable was $102,000, while for the 2018 taxation year, the amount was $54,000. For the 2019 taxation year, its estimated tax payable is $17,000. What would be the minimum instalments for 2019 and when would they be due? How would your answer differ if Fadco Inc. was a small CCPC?

SOLUTIONS available in print and online Study Guide.

Due Date For Balance Owing - Corporations

2-74. Regardless of the instalment base selected, any remaining taxes are due within two months of the corporation's fiscal year end. An exception is made in the case of Canadian controlled private corporations (CCPCs) that have claimed the small business deduction in the current or preceding taxation year. For these corporations, the due date is three months after their fiscal year end, provided their Taxable Income did not exceed $500,000 for the previous year. To qualify for this deferred due date, the corporation only has to be a CCPC. It does not have to be a "small" CCPC as described in Paragraph 2-71.

2-75. Note that the final due date for payment is earlier than the due date for filing returns. For example, a company with a March 31 year end that is not eligible for the small business deduction would not have to file its tax return until September 30. However, all of its taxes would be due on May 31. This means that this final payment will often have to be based on an estimate of the total amount of taxes payable.

Exercise Two - 9

Subject: Corporate Due Date

The taxation year end for Radco Inc. is January 31, 2019. Indicate the date on which the corporate tax return must be filed, as well as the date on which any final payment of taxes is due.

SOLUTION available in print and online Study Guide.

Interest And Penalties For Corporations

2-76. The basic rules for interest on corporate balances owing or receivable are generally the same as those applicable to individuals. These were covered beginning in Paragraph 2-44. However, as described in Paragraph 2-48, interest paid to corporations on overpayments is calculated at the regular rate, not at the higher rate applicable to individuals and trusts.

2-77. Note that it is especially important that corporations avoid interest on late tax or instalment payments. Since corporations can usually deduct any interest expense that they incur, the payment of non-deductible interest on late tax payments represents a high cost source of financing. For example, if a corporation is paying taxes at a rate of 25 percent, interest at a non-deductible rate of 5 percent is the equivalent of a deductible interest rate of 6.7 percent [5% ÷ (1 - .25)]. Many corporations, particularly those that are publicly traded, are able to access financing at rates that are lower than this.

2-78. The previously covered penalties applicable to individuals for late filing of returns and for large amounts of late instalments (see Paragraphs 2-51 and 2-55) are equally applicable to corporations. In addition to the penalties applicable to individuals, ITA 235 contains a further penalty applicable to large corporations. It calls for a penalty equal to .0005 percent

per month of a corporation's Taxable Capital Employed In Canada. This will be assessed for a maximum period of 40 months.

2-79. This is a fairly harsh penalty in that, unlike the usual penalties that are based on any additional tax payable at the time the return should have been filed, this penalty is based on the capital of the enterprise, without regard to earnings or tax payable for the year. For example, CNR has December 31, 2017 Shareholders' Equity (roughly the equivalent of Taxable Capital Employed In Canada) of $16,656 billion. If the .0005 percent penalty was applied to this balance for 40 months, the total penalty would be $3,331,200.

We suggest you work Self Study Problems Two-2, 3, and 4 at this point.

Returns And Payments - Trusts

Types Of Trusts

2-80. As defined in the Glossary to this text, a testamentary trust is a trust that arises on, and as a consequence of, the death of an individual. All other trusts are referred to as inter vivos trusts.

Filing Requirements

2-81. In general, a trust must file a trust income tax return (a.k.a., T3), if it:

- has Tax Payable for the year;
- is requested by the CRA to file a tax return;
- has disposed of a capital property during the year; or
- has a taxable capital gain during the year.

2-82. There are other reasons for filing listed in the T3 Trust Guide. However, none are of sufficient importance to deal with here.

Due Dates For Returns

2-83. In general, all inter vivos and testamentary trusts, other than graduated rate estates, must use the calendar year as their taxation year. A testamentary trust designated as a graduated rate estate can use a non-calendar fiscal period for the duration of its limited life. All trusts must file their tax returns within 90 days of the end of their taxation year.

Payment Of Taxes

2-84. Legislation generally requires that all trusts, except graduated rate estates, make instalment payments. However, it does not appear that the CRA intends to enforce this requirement.

2-85. With respect to determining the amount of the instalments, the rules in ITA 156(1) cover both individuals and trusts. This means that, as was discussed in Paragraph 2-35 for individuals, trusts have three alternatives for calculating instalment amounts and the due dates are March 15, June 15, September 15 and December 15.

2-86. Any balance owing when the return is filed must be remitted with the return. Stated alternatively, the balance is due 90 days after the end of the trust's taxation year, generally March 31.

Interest And Penalties

2-87. For both testamentary and inter vivos trusts, interest on late final balance payments is calculated using the same rules as those applicable to individuals. In addition, late filing penalties for trusts are the same as those for individuals. However, it is the administrative practice of the CRA not to assess interest or penalties on late instalments.

We suggest you work Self Study Problem Two-5 at this point.

Income Tax Information Returns

2-88. ITA 221(1)(d) gives the CRA the right to require certain taxpayers to file information returns in addition to the returns in which they report their taxable income. These information returns are described in Part II of the Income Tax Regulations and must be filed using a prescribed form. Common examples of these returns and the related prescribed form would be as follows:

- **T3** This form is used by trustees (which includes trustees of some mutual funds) and executors to report the allocation of the trust's income.
- **T4** This form is used by employers to report remuneration and taxable benefits paid to employees and the various amounts withheld for source deductions.
- **T5** This form is used by organizations to report interest, dividend, and royalty payments.
- **T4RSP** This form is used by trustees to report payments out of Registered Retirement Savings Plans.

Books And Records

2-89. As indicated in IC78-10R5, "Books And Records Retention/Destruction":

> Books and records have to be kept for the period or periods provided by subsections 230(4) to (7) and section 5800 of the *Income Tax Regulations* ...

2-90. While for many of these documents, the specified retention period is 6 years, there are many variations in the length of the retention period, with both longer and shorter periods being specified in the sources cited in Paragraph 2-89.

Assessments And The CRA My Account Service

CRA Website - My Account Service

2-91. The CRA invests considerable resources on continual improvements to its website and electronic services. The goal is to reduce costs and provide faster, more efficient services to taxpayers. For example, the Auto-Fill My Return service allows individuals and authorized representatives to automatically fill in parts of a current year income tax return. The CRA website contains the My Account service which is a secure online portal that allows registered individuals to see many of their tax accounts online and manage their tax information. There is a similar My Business Account service available for businesses. The CRA website contains a list of its ever expanding electronic services. For the My Account service, the available information includes access to Notices of Assessment, RRSP and TFSA contribution limits, instalments paid and payable and many other past and present balances.

Notice Of Assessment

2-92. After a tax return has been filed, the CRA runs a number of tests on the return, such as verifying the eligibility for various deductions (e.g., RRSP deductions) and tax credits (e.g., age credit). After processing a return, the CRA completes a Notice of Assessment which contains the amount, if any, of taxes to be paid or refunded, an explanation of any changes it has made to the return, and any interest and penalties that were assessed. For individuals, it also contains additional information such as the taxpayer's RRSP deduction limit. For individuals, the Notice of Assessment is available online in the My Account service, often within a few weeks of filing. A somewhat longer period is normally required for corporate income tax assessments and more complicated individual returns. The CRA will mail out the Notice of Assessment unless the taxpayer has opted instead to have e-mail notification as soon as it is available to be viewed online.

Notice Of Reassessment

2-93. The Notice of Assessment does not free the taxpayer from additional scrutiny of the return. The CRA is under pressure to issue Notice of Assessments quickly so the initial

assessment is not based on an in-depth review of the return. A more detailed review of many returns is done after the Notice of Assessment has been completed. The CRA has a matching program that compares information the CRA has received from third parties, such as employers and financial institutions with the relevant returns. The CRA will issue a Notice of Reassessment with a revised amount payable or refunded and an explanation if a change is made to a taxpayer's return for any reason such as amounts not matching or duplicate claims on a spouse's return. Like the Notice of Assessment, the Notice of Reassessment can be viewed online if the taxpayer has registered for the My Account service.

2-94. The normal reassessment period is the period that ends 3 years after the date on the Notice of Assessment for individuals, most trusts, and Canadian controlled private corporations. This normal reassessment period is extended to 4 years for other corporations because of the greater complexity that may be involved in the review process. There are a number of exceptions to this normal 3 year reassessment period that include the following:

- Reassessment can occur at any time:
  - if the taxpayer or person filing the return has made any misrepresentation that is attributable to neglect, carelessness or willful default, or has committed any fraud in filing the return or in supplying information,
  - if the taxpayer has filed a waiver of the 3 year time limit.
- Reassessment can occur outside the normal reassessment period:
  - if an individual or testamentary trust has requested a reduction in taxes, interest, or penalties. The ability to use this provision is limited to 10 years after the particular year in question,
  - when reassessment within the normal period affects a balance outside of this period,
  - in situations where the taxpayer is claiming certain specified deductions. An example of this would be a listed personal property loss being carried back to claim a refund of taxes paid.

Refunds

2-95. When tax has been withheld from income and/or instalments have been paid, the CRA's Notice of Assessment may show that there has been an overpayment of income tax. In this situation, the taxpayer is entitled to a refund of any excess payments and, in the great majority of cases, such refunds are sent without any further action being taken. If, for some reason, the refund is not made, the taxpayer can apply for it in writing within the normal reassessment period. However, if there are other tax liabilities outstanding, such as amounts owing from prior years, the CRA has the right to apply the refund against these liabilities.

2-96. A further point here is that refunds will not generally be made if the return is filed more than 3 years after the end of that year (e.g., a refund on a 2015 tax return that is filed in 2019 will not be paid in the normal course of events).

2-97. Interest is paid on overpayments of income tax at the prescribed rate (see Paragraph 2-49). For individuals, interest at the prescribed base rate, plus 2 percentage points, begins to accrue on the later of two dates:

- 30 days after the balance due date (generally, April 30); or
- 30 days after the return is filed.

2-98. For an individual with business or professional income, the normal filing date would be June 15. If such an individual was entitled to a refund and waited until this date to file, interest would not begin to accrue until 30 days after June 15.

2-99. For corporations, interest on refunds at the prescribed base rate, without the additional 2 percentage points, begins to accrue at the later of two dates. These are:

- 120 days after the corporate year end; or
- 30 days after the corporation's tax return is filed (unless it is not filed prior to the due date, in which case the due date is applicable).