

CHAPTER 1

TAXATION— ITS ROLE IN BUSINESS DECISION MAKING

Review Questions

1. If income tax is imposed after profits have been determined, why is taxation relevant to business decision making?
2. Most business decisions involve the evaluation of alternative courses of action. For example, a marketing manager may be responsible for choosing a strategy for establishing sales in new geographical territories. Briefly explain how the tax factor can be an integral part of this decision.
3. What are the fundamental variables of the income tax system that decision makers should be familiar with so that they can apply tax issues to their areas of responsibility?
4. What is an “after-tax” approach to decision making?

Solutions to Review Questions

R1-1 Once profit is determined, the amount of income tax that results is determined by the *Income Tax Act*. However, at all levels of management, alternative courses of action are evaluated and decided upon. In many cases, the choice of one alternative over the other may affect both the amount and the timing of future taxes on income generated from that activity. Therefore, the person making those decisions has a direct input into future after-tax cash flow. Obviously, decisions that reduce or postpone the payment of tax affect the ultimate return on investment and, in turn, the value of the enterprise. Including the tax variable as a part of the formal decision process will ultimately lead to improved after-tax cash flow.

R1-2 Expansion can be achieved in new geographic areas through direct selling, or by establishing a formal presence in the new territory with a branch office or a separate corporation. The new territories may also cross provincial or international boundaries. Provincial income tax rates vary amongst the provinces. The amount of income that is subject to tax in the new province will be different for each of the three alternatives mentioned above. For example, with direct selling, none of the income is taxed in the new province, but with a separate corporation, all of the income is taxed in the new province. Because the tax cost is different in each case, taxation is a relevant part of the decision and must be included in any cost-benefit analysis that compares the three alternatives [Reg. 400-402.1].

R1-3 A basic understanding of the following variables will significantly strengthen a decision maker's ability to apply tax issues to their area of responsibility.

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| Types of Income | - | Employment, Business, Property, Capital gains |
| Taxable Entities | - | Individuals, Corporations, Trusts |
| Alternative Business Structures | - | Corporation, Proprietorship, Partnership, Limited partnership, Joint ventures, Income trusts |
| Tax Jurisdictions | - | Federal, Provincial, Foreign |

R1-4 All cash flow decisions, whether related to revenues, expenses, asset acquisitions or divestitures, or debt and equity restructuring, will impact the amount and timing of the tax cost. Therefore, cash flow exists only on an after tax basis, and, the tax impacts whether or not the ultimate result of the decision is successful. An after-tax approach to decision-making requires each decision-maker to think "after-tax" for every decision at the time the decision is being made, and, to consider alternative courses of action to minimize the tax cost, in the same way that decisions are made regarding other types of costs.

Failure to apply an after-tax approach at the time decisions are made may provide inaccurate information for evaluation, and, result in a permanently inefficient tax structure.