APPENDIX I
International Taxation in Canada

Solution 1 (Basic)

Andrew will be taxable on taxable income earned in Canada in 2010 because he will be deemed to have been employed in Canada under subsection 115(2). Taxable income earned in Canada will be computed under subsection 115(1) and taxable under Part I. He will need to file a Canadian income tax return to report the signing bonus of $25,000. For 2011, Andrew will not be deemed a resident as he will not sojourn in Canada 183 days or more. His $35,000 salary will be included in taxable income under subsection 115(1) and taxable under Part I. Both years he will be entitled to the personal tax credits for CPP and EI. He will not be entitled to personal tax credits available to residents, such as the basic personal amount, since less than 90% of his world income is from a Canadian source.

Employment income for Canadian tax purposes will consist of the $35,000 salary from the Toronto Metros and the $25,000 signing bonus received under subsections 5(1) and 6(3), respectively. The $3,000 paid to the agent is not deductible for Canadian tax purposes, as there is no provision for such a deduction in section 8 of the *Income Tax Act*. The $100,000 earned in England will not be subject to any Canadian tax.

In addition to federal income taxes, he will also be liable for provincial taxes in Ontario.

Solution 2 (Advanced)

(a) As Kresna is non-resident and has disposed of taxable Canadian property, she is required to file Form T2062 either before the proposed transaction is completed, or within 10 days of its completion unless the property is excluded property. [Excluded property includes treaty-exempt property.] The Canada–Kenya Tax Convention should be referred to in order to determine whether the property is treaty exempt. Payment of a withholding tax, computed at 25% of the difference between the sale price and the ACB of the property, must accompany the T2062.

Proceeds	$100,000
ACB	35,000
Gain	$ 65,000
Withholding tax required (25%)	$ 16,250

Generally, the lawyer handling the transaction will pay the withholding tax from the proceeds she receives in trust from the purchaser.

Under subsection 2(3), Kresna is taxable in Canada because she has disposed of taxable Canadian property. She should file a Canadian non-resident return as soon as is practical after the end of the year. She will declare a taxable capital gain on the sale of the property and claim a credit for the 25% withholding tax. Kresna will be liable for additional federal tax of 48% of the federal tax in lieu of provincial/territorial tax.

Proceeds	$100,000	
ACB	35,000	
Gain	$65,000	
Outlays and expenses	7,000	(real estate and legal fees)
Capital gain	$ 58,000	
Taxable capital gain	$ 29,000	(at 50%)

Federal tax at 15%	$4,350
Additional federal tax at 48% of $4,350	2,088
	6,438
Less withholding tax	(16,250)
Refund due	$ 9,812

(b) In all probability, Kresna's agent has not been remitting the 25% non-resident withholding tax to the federal taxation authorities. The withholding tax is required under subsection 212(1)(*d*). For example, assuming the property was rented for $1,000 a month, the annual withholding tax is $3,000.

Kresna should be advised to pay the assessment, but then file tax returns for the current and the past two years, reporting the net rental income. She is entitled to do this under subsection 216(1). The time limit to file is two years from the end of the taxation year, so returns can be filed for all three years. Her actual tax liability will in all likelihood be less than the withholding tax, and she is entitled to a refund of any excess tax paid.

Should the assessment be for more than three years, then any withholding tax for any other preceding years cannot be recovered.

Solution 3 (Advanced)

(A) Section 253 will deem USCO to be carrying on business in Canada in the year because it currently solicits orders through an agent in Canada through the office.

The U.S. company solicits sales in Canada, has inventory in Canada, and has an office and employees in Canada. Under common law, it is likely that USCO would be considered to be carrying on business in Canada because the Toronto office would be considered to be a "location of the operations from which profits arise".

Once USCO has three employees and an office in Canada it will still be considered to be carrying on business in Canada. As a result, it will be required to file a tax return and be taxed on its taxable income earned in Canada as calculated under subsection 115(1) and under 4(1)(*b*). This income will be subject to the general federal corporate tax rate of 38% under subsection 123(1), which applies to all corporations. Furthermore, the general deduction from tax of 10% will apply in 2010.

(B) The provincial abatement of 10% will apply if the corporation has taxable income earned in a province. Regulation 402(3) indicates that where a corporation had a permanent establishment in a particular province and no permanent establishment outside that province, the whole of its taxable income for the year is deemed to have been earned therein. The definition of permanent establishment is in Regulation 400(2) and indicates that it means a fixed place of business of the corporation including an office.

As USCO had a loss in the previous year of $4,000, the loss can be used to reduce the taxable income to $256,000. All of the $256,000 of taxable income would be considered taxable income earned in a province. As a result, the federal tax rate applicable to the income would be 18% and the provincial rate would be 13% for a total rate of 31%. Therefore, the tax owing will be $81,920.

USCO will also be required to pay branch tax under subsection 219(1) of the Act. Per subsection 219(1), the tax applies to every non-resident corporation. It will only result if the non-resident corporation earned taxable income in Canada and only if the income less taxes is not reinvested back into Canada in the form of an investment allowance as defined in Regulation 808.

Subsection 219(1) would calculate branch tax at $2,000 equal to:

25% of $8,000* calculated as:

Corporation's taxable income earned in Canada	$256,000	
Prior year's investment allowance	2,000	$258,000
Less:		
Income taxes payable under Part I and provincial tax	$ 81,920	
Investment allowance for the year (see below)	168,080	250,000
		$8,000

Investment Allowance per Regulation 808

Cost amount of each depreciable property owned in Canada used to produce income	$200,000	
Cost amount of each property that was described in the corporation's inventory	400,000	
Cost amount of each debt owing to it for a transaction by virtue of which an amount has been included in computing its income for the year	150,000	
Cost amount of allowable liquid assets	50,000	800,000
Less:		
Amount owing to purchase depreciable assets/inventory	$150,000	
Amount owing for an outlay or expense made or incurred by the corporation to the extent it was deducted in computing income for the year	400,000	
Amount of tax payable under Part I and provincially	81,920	631,920
		$168,080

* The calculation represents the income earned by the corporation for the year that was not reinvested into the branch operation.

(C) USCO has an office in Canada. An office is a permanent establishment under paragraph 2, Article V of the treaty if it is a fixed place of business under paragraph 1. Three conditions must be met:

1) There must be a place of business. The office is under the control of the U.S. company and it is at its constant disposal.
2) The place of business must be fixed. The office appears to be permanent.
3) The business of the non-resident must be carried on through the fixed place of business. Employees are carrying on the U.S. company's business through the office.

Impact on 2010 Canadian Return

There is no impact on the corporation's Part I tax liability. The Canada–U.S. Tax Convention confirms Canada's right to tax the income from carrying on business in Canada.

Article X, paragraph 6 of the Canada–U.S. Tax Convention indicates that nothing in the convention prevents Canada from imposing a branch tax on earnings of a company attributable to a permanent establishment in Canada provided that the tax does not exceed 5% of the amount of earnings not subject to branch tax in prior years. Earnings would be calculated as:

Business profits attributable to permanent establishments in Canada in the year and previous years	$260,000	
Less: Business losses attributable to such permanent establishments in the year or previous years	(4,000)	256,000
Less:		
Taxes imposed on such profits	$81,920	
Profits reinvested in Canada determined in accordance with the provisions of the laws of Canada regarding the computation of the allowance in respect of investment in property in Canada	168,080	
Exemption	500,000	(750,000)
		Nil

Therefore, USCO would not have a branch tax liability for 2010. The treaty exempts the first $500,000 of earnings not reinvested in Canada from branch tax. A treaty disclosure note would be attached to the Canadian tax return to recognize this fact (See Schedule 91 and 97 of the T2).

Solution 4 (Advanced)

Sally Juarez appears to be a non-resident for Canadian tax purposes. Sally's Canadian income tax return using 2010 figures and tax rates:

Business income (from partnership) (Note 1)	$7,000	
Business income from sale of raw land (Note 2)	60,000	
	$67,000	
Taxable capital gain on sale of real estate (Note 3)	15,000	(50%)
Total income	$82,000	
Federal tax on first $40,970 at 15%	$6,146	
Federal tax on next $40,971 at 22%	9,014	
Federal tax on last $59 at 26%	15	
	$15,175	
Personal tax credits (Note 4)	—	
Additional federal tax (Note 5)	1,332	
Provincial tax (Note 6)	7,196	
Total income tax	$23,703	
Income tax withholdings	$(7,500)	
Balance of tax owing	$16,203	

Other tax requirements

Withholding taxes (Note 7) at 25% (or tax treaty rate) on:

Dividends	$5,000
Tax at 25%	$ 1,250

Notes:

1. *Robinson*, 98 DTC 6065 (F.C.A.), held that partners carry on the business of a partnership.
2. Per paragraph 253(*c*), a person who disposes of property (other than capital property) that is real property situated in Canada is deemed to have been carrying on business in Canada in the year.
3. The gain of $15,000 on the Public Co Ltd. shares is not taxable in Canada as these are not taxable Canadian property assuming she owns < 25% of the shares of any class of the corporation and more than 50% of the value of the shares is not derived from real property situated in Canada (per March 4, 2010 federal Budget).
4. Sally is not entitled to any personal tax credits as her Canadian-source income is less than 90% of her worldwide income and there is no indication that she otherwise qualifies for personal tax credits that may be claimed by non-residents.
5. 48% of ($15,000/$82,000 × $15,175).
6. 10% of $40,970 plus 12% of ($67,000 − $40,970).
7. No withholding tax on interest or any other Canadian tax liability.

Solution 5 (Advanced)

The following details the Canadian compliance and planning issues related to Cal's move to Indonesia.

Child Support

Child support is not included in taxable income in Canada. There will be no withholding tax required from this income, nor any other Canadian tax liability.

RRSP

If Cal deregisters the RRSP before leaving Canada, the $75,000 will be included as income in his final (departure) income tax return. The income taxes on the $75,000 will be based on his marginal tax rate in that return. There is no deemed disposition of the RRSP on emigration. If he deregisters the RRSP after leaving Canada, there will be a 25% withholding tax on the $75,000, and that represents his complete tax obligation to Canada on the RRSP. He would have an option to elect to file a Part I return [ssec. 217(2)] if beneficial. [March 4, 2010 federal Budget] [Ssec. 116(1)]

GIC

The interest is not subject to withholding tax or any other Canadian tax liability.

Shares of CCPC

Any dividends that he receives from the shares while non-resident are subject to a 25% withholding tax.

Cal will be deemed to have disposed of the CCPC shares upon emigration for their fair market value of $45,000, which will lead to a capital gain of $44,000 and a taxable capital gain of $22,000 that will be included in his departure year tax return. However, Cal can elect to defer paying the tax that results from the deemed disposition rule. The election must be made on or before the balance due date for the departure year. Since security is not required for up to $100,000 of capital gains resulting from the deemed disposition rule, Cal will not be required to post security with the CRA. If the election is made, the payment of the tax in respect of the departure capital gain will be deferred without interest until the properties are actually sold. The adjusted cost base of the shares will be increased to the deemed departure amount of $45,000, so any gain or loss on the actual sale of the shares will be computed by reference to this new adjusted cost base for Canadian tax purposes. When Cal sells the shares in the future, the shares will be taxable Canadian property if more than 50% of the value of the shares is derived from real property situated in Canada. In such case, the gain will be taxed in Canada and withholdings will apply unless the gain is exempt from tax in Canada under a Treaty.

Principal Residence

The real estate will not be subject to the deemed disposition rule upon emigration.

When he rents the property, there will be a deemed disposition at fair market value under subsection 45(1) unless an election under subsection 45(2) is made. If he is a non-resident at the time, he will be required to file a T2062 request [ssec. 116(1)] and remit a 25% withholding tax on the gain from $135,000 to the fair market value at the time. This withholding tax is then used as a credit against any actual tax as calculated in the Canadian tax return. He will be able to claim the principal residence exemption for the years prior to emigration. On the sale of the property, he will be required to include any taxable capital gain or allowable capital loss on a Canadian return under paragraph 115(1)(*a*) as the property is taxable Canadian property under paragraph 115(1)(*d*). The gain will be calculated using an adjusted cost base equal to the fair market value at the time of the deemed disposition. Section 116 will apply.

The ongoing rental income is taxable when paid/credited to him. There is a 25% withholding tax on the gross rents. Alternatively, Cal can file a Canadian tax return pursuant to section 216, reporting the rental income (net of expenses excluding CCA), and pay taxes at the marginal rate. This return is separate from any other tax return he may be required to file and is due within two years of the relevant taxation year. The tax, as calculated in that return, is likely to be substantially less than the 25% withholding tax (due to recognition of expenses). He will receive a refund of the difference.

Another alternative is for Cal to file an undertaking to file a Canadian tax return within six months of the relevant taxation year. If he does this, then his brother can remit the withholding tax based on 25% of the amounts available (after expenses excluding CCA). If Cal does not file the required tax return, his brother is liable for the full 25% withholding tax (i.e., on the gross rents), although he can legally recover that from Cal.

Provincial Tax

As there is no Canadian business or employment income, there is no provincial or territorial tax due on any of the above noted income returns. Cal will pay additional federal taxes at the rate of 48% of federal tax instead of provincial tax.

Solution 6 (Advanced)

Transactions with SNI

Section 247 of the Act requires that transactions between non-arm's length persons be made under arm's length terms and conditions. Information Circular 87-2R requires a taxpayer to choose a pricing methodology that will reflect the arm's length principle and provides a hierarchy of methodologies to be considered.

Comparable Uncontrolled Price (CUP) Method

The method that provides the highest degree of comparability is the comparable uncontrolled price (CUP) method. This method is used when it is possible to find a sale of the same product by the taxpayer, or another member of the group, in similar quantities and under similar terms to arm's length parties in similar markets.

There are several possible CUPs in this circumstance:

1) The sale of drawer slides by SI to European distributors before the AOC;
2) The sale of drawer slides by SI to arm's length distributors in Canada;
3) The sale of drawer slides by SUSI to arm's length distributors in the U.S.;
4) An external comparable if one could be found; and/or
5) The sale of ergonomic products to SUSI by SI before the AOC of SUSI.

The following information would need to be verified to determine if any of these transaction streams could be used as a CUP:

1) Are the sales in similar quantities and under similar terms as sales to SNI? Could reasonable adjustments be made for differences?
2) Is SUSI selling a comparable product? Ergonomic products are unlikely to be similar enough to provide a CUP.
3) Is a competitor selling the same product to distributors? Could information be obtained on prices charged/paid by the competitor/distributor?
4) Does SNI purchase drawer slides arm's length?
5) There appears to be a market level difference. Currently SI sells to Canadian distributors who likely sell to end-users. In the non-arm's length transaction, SI is selling to SNI who is selling to distributors who sell to end-users. Therefore, it is unlikely that these transactions could be used as a CUP as it would be difficult to make appropriate adjustments for market differences. It would be necessary to confirm whether SI's distributors and SUSI's distributors sell to other distributors (this information may be difficult to obtain).

It is unlikely that any of these transaction streams are suitable internal CUPs due to market level differences. You should also check with the client to see if there is any information available on external CUPs. For example, is a competitor selling to an arm's length distributor in Europe that sells to other distributors. It would be very unlikely that the client would have this information.

Note that in the future when SNI acts as a distributor of product to the end-user, the market level difference will no longer be a factor. If the other attributes of the transactions are comparable, these streams may be an appropriate CUP in future years.

Resale Price Method

The resale price method establishes a gross margin that a taxpayer may expect as a reward for the functions performed, assets used, and risks assumed. Product differences are less important. The resale price method is more appropriate if the least complex party is a distributor. A functional analysis would likely show that SNI's distribution division is the least complex party in the transaction between SI and SNI as its activities are likely restricted to selling activities, it does not own intangibles and risk is limited to collection risk. To determine an appropriate gross margin for SNI, it would be necessary to find a margin earned by a member of the group or an arm's length enterprise in comparable uncontrolled transactions. The only apparent transaction stream in the SI group per the facts above that would provide this margin would be the purchase and resale of curtain rods by SNI. The following information would need to be verified to determine whether the gross margin percentage of 35% earned by SNI on this transaction stream would be appropriate to use for the purchase and sale of drawer slides from SI:

1) Are curtain rods sufficiently similar to drawer slides to be able to justify the use of this transaction stream as comparable?
2) Does SNI perform the same functions and assume the same risks for the distribution of the curtain rods? If not, is it possible to make adjustments to the margin for this?
3) Are the quantities of curtain rods sold similar to drawer slides or is the curtain rod distribution business just an insignificant side business?

Cost-Plus Method

The cost-plus method usually applies when the supplier of the product is the least complex party to the transaction. As SI is a full-fledged manufacturer that performs development activities, it would not be considered the least complex party suitable for the application of the cost plus methodology. It is likely that SI owns valuable manufacturing intangibles.

Note that a genuine effort to apply either of the CUP or resale price methods would be preferred as transactional profit methods are considered methods of last resort.

Profit-Split Methods

If, after further investigation, you are not satisfied that the uncontrolled transactions would provide sufficient comparability to apply the CUP or resale price methods, it would be appropriate to consider the use of a profit-split methodology. This method should be used where the operations of two or more non-arm's length parties are highly integrated making it difficult to evaluate their transactions on an individual basis and the existence of valuable and unique intangibles in both parties makes it impossible to establish the proper level of comparability with uncontrolled transactions to apply a one-sided method. As in this case, the operations of SI and SNI are not highly integrated and SNI does not appear to own any valuable intangibles, the profit-split method would not be applicable.

Transactional Net Margin Method (TNMM)

This method appears to be more appropriate than the profit-split method, as SNI does not own valuable intangibles and a one-sided analysis could be performed. With TNMM, you are attempting to compare the net profit margin of SNI to the net profit margin that would be realized by arm's length parties from similar transactions. If the curtain rod distribution transaction stream is determined to be an appropriate comparable, the resale price method should be used over this method. If not, this method may be considered. Sales would be the appropriate base for the measure of operating profit percentage as SNI would have few costs and assets due to the nature of its operations.

The client should be asked if there is any industry data/information available on operating profit margins of distributors in the furniture industry. If not, various worldwide databases are available to assist in finding comparable data. Four steps would be followed in applying this method:

1) Database search of entities with similar industry classifications.
2) Screening of entities to determine if there are comparable transactions to the tested party. For example, if any of the companies incur research and development expenses, these entities should be excluded.
3) Review detailed information (financial and textual) to determine if they have comparable transactions.
4) Make adjustments for material differences.

Recommendation: Use of the resale price method would be preferred. If the comparability of the uncontrolled transactions is questionable, it may be prudent to also do a TNMM analysis in support.

Transactions with SUSI

SUSI does not appear to incur any uncontrolled comparable transactions to the distribution transactions of ergonomic product for SI as it does not distribute product for any other entity.

The sales of ergonomic products by SI to Canadian distributors could provide a CUP. It would again be necessary to obtain information on the quantities sold, comparability of the market etc. to support the use of this CUP.

If SI is selling the ergonomic product to SUSI at the same prices and under the same terms as prior to the acquisition of the company, these pre-acquisition transactions could provide a CUP as pre-acquisition, the companies were arm's length. It would be necessary to determine if any functions, risks etc. changed after the acquisition of control to determine whether the pre-acquisition prices would be suitable CUPs at least in the short term.

The resale price method could only be applied if information on gross margins of a distributor with similar functions, assets used and risks assumed in the industry were available. The cost plus method is inapplicable as SUSI is the least complex party and SI is the supplier of the product. The profit split method is not appropriate per discussion above. The TNMM should be used if the potential comparable transactions noted above are not appropriate. Information on profit margins earned by companies in the same industry would need to be obtained.

Solution 7 (Advanced)

If the CRA was to audit Ergold Ltd., the following adjustments and tax liabilities would result:

Year Ended December 31	Adjusted Taxable Income	Adjustment	Tax Liability	10% of Gross Revenue	Penalty 10% of Adjustment
2008	$150,000	$ 350,000	$45,000	$300,000	$35,000
2009	$325,000	$ 725,000	$97,500	$650,000	$72,500
2010	$475,000	$ 1,325,000	$142,500	$950,000	$32,500
		$2,400,000	$285,000		$240,000

The 10% penalty will apply because the transfer pricing adjustment for each year is greater than the lesser of 10% of gross revenue and $5,000,000, per subsection 247(3). Furthermore, if Ergold Ltd. is not using transfer prices that are based on the arm's length principle and cannot support those prices through documentation, the company is subjecting itself to potential audit and substantial tax ($285,000) and interest liabilities. [Note that the tax could be offset if adjustments to reduce income in Sweden are accepted by the Swedish equivalent of the CRA]. Furthermore, if there is a tax audit, the company could incur considerable professional expenses defending itself, not to mention the time involved in going through the competent authority process.

Furthermore, it should be pointed out that the tax returns for Ergold would have required the company to file T106 forms that would be used to determine if a tax audit should be performed. The company's losses along with the T106 form indicating that all purchases are non-arm's length would very likely trigger an audit. Anytime the CRA audits a company that has non-arm's length transactions, field auditors will request contemporaneous documentation at the outset of the audit, per an October 2006 memorandum.

The Canadian company has effectively overpaid for goods it received. The overpayment will be considered a subsection 15(1) benefit to the shareholder and would be deemed to be a dividend under paragraph 214(3)(*a*). It will be subject to Part XIII tax unless the CRA agrees to waive the withholding tax. The Canada–Sweden tax treaty would reduce the withholding tax rate to 5% ($120,000 = 5% of $2,400,000). Per TPM-02 and IC 87-2R, the CRA may waive the withholding tax when:

1) The taxpayer agrees in writing to the transfer pricing adjustment;
2) The transaction is not abusive (a transaction is considered abusive if the above penalty applies i.e., no contemporaneous documentation is available and/or GAAR or a recharacterization has applied), and
3) The Swedish company repays the amount to the Canadian company immediately or agrees to do so in writing (the repayment must be in the form of either a) an offset to an intercompany account in the year of the adjustment, b) a creation of a shareholder loan account, or c) an offset to a downward adjustment).

Therefore, without contemporaneous documentation, Ergold could not get a waiver for the tax. Interest would apply to the Part XIII withholding tax. With contemporaneous documentation, a waiver may be possible if intercompany balances exist or through the creation of a shareholder loan. If intercompany balances exist, any interest deduction would need to be adjusted if a repatriation were made. If a shareholder loan were created, subsections 15(2) and 15(9) would need to be considered.

Advantages of a Transfer Pricing Study

1) Minimize interest and penalties of prior years if a voluntary disclosure is made.
2) Minimize future tax liabilities by correcting transfer pricing problems now.
3) Increase the efficiency of a CRA audit.
4) If the CRA does adjust, a waiver of the Part XIII tax could be obtained.

Solution 8 (Advanced)

The deduction for the interest expense of $458,808 on outstanding debts to specified non-residents will be limited under subsection 18(4).

Subsection 18(4) applies where interest on the debt is otherwise deductible. As the loan is used to purchase manufacturing equipment, the interest is deductible under paragraph 20(1)(*c*). The provision applies to interest paid or payable on outstanding debts to specified non-residents (a debt payable to a specified non-resident shareholder on which interest is deductible). The U.S. corporation is a specified non-resident shareholder as it holds 25% or more of the shares of the Canadian company.

The formula to determine the non-deductible portion is as follows:

A × (B – 2 × (C+D+E))

$458,808 × ($5,886,962 – 2 × ($1,260,548 + Nil + $341,667))/$5,886,962

= $209,067

B — This is the average of all amounts for each calendar month ending in the year that is the greatest total amount at any time in the month of the corporation's outstanding debts to specified non-residents.

Jan	6,000,000	
Feb	5,966,952	
March	5,933,687	
April	5,900,203	
May	5,866,499	
June	5,832,573	
July	6,364,051	[600,000 + 5,764,051]
Aug	5,801,951	
Sept	5,840,101	
Oct	5,878,502	
Nov	5,878,502	
Dec	5,380,524	
Average of above	5,886,962	

The July balance includes the additional loan of $600,000. The highest outstanding loan balance for the month would have been just before the repayment of the $600,000 loan.

Note that the increase in outstanding debts to non-residents in July resulted in a higher average and a higher non-deductible interest amount even though only a small amount of interest was paid on this short-term loan.

Note that the missed interest payments become part of the outstanding balance because interest is paid or payable in respect of these balances (see Technical Interpretation Document Number 9315680, May 31, 1993).

C — The retained earnings of the corporation at the beginning of the year.

E — This is the average of all amounts for each calendar month ending in the year that is the corporation's paid-up capital (PUC) at the beginning of the calendar month that ends in the year. [300,000 x 11 + 800,000]/12 = 341,667.

Because of averaging, the PUC increase has little impact on the amount of deductible interest. A conversion earlier in the year or a higher conversion would have been advisable. Note that a conversion on December 31 would have no impact on the calculation for 2009 as it is the PUC at the beginning of the month that is important.

Per subsection 84(1), the conversion of the debt to paid up capital will not result in a deemed dividend as the paid up capital increased by the same amount as the increase in assets less the liabilities increase.

Solution 9 (Advanced)

Receivable from Ronal Argentina Ltd.

As Ronal Argentina Ltd. is non-arm's length with Ronal Inc., and is not a foreign affiliate of Ronal Canada Ltd., it is connected with a shareholder for purposes of subsection 15(2).

Subsection 15(2) does not apply to a loan that is repaid within one year after the end of the taxation year of the lender, per subsection 15(2.6). As Ronal Ltd. made the loan in its December 31, 2007 taxation year-end, to meet the exception, the loan must have been repaid by December 31, 2008.

Ronal Canada Ltd. has a 2007 liability for the Part XIII tax that should have been withheld on the loan because of paragraph 214(3)(*a*). The withholding liability would be 25% under subsection 212(2) of the Act. Under the Canada–Argentina Tax Convention, the withholding tax on dividends would be reduced to 15%. Ronal Ltd. has a liability for $615,000 for withholding tax that should have been remitted January 15, 2008. Interest and a 10% penalty would apply to the failed withholdings.

Per subsection 227(6.1), where a loan has been subject to Part XIII tax under paragraph 214(3)(*a*) and the non-resident repays the loan to the Canadian company, the withholding tax (but not the interest) on the withholding tax will be refunded. [Note that if subsection 80.4(2) instead of subsection 15(2) had applied to the loan, no refund of Part XIII tax would have been received on repayment of the loan.]

As the loan was repaid in 2011, section 17 must be considered. The 1% interest rate on the loan may be considered to be less than a reasonable amount. As a result, Ronal Canada Ltd. would have an imputed interest benefit each year the loan was outstanding computed at the prescribed rate (see Reg. 4301(c)) less the actual interest received on the loan of 1% (October 1, 2007 to January 2011).

None of the exceptions in subsections 17(7), 17(8), or 17(9) apply. Ronal Argentina Ltd. is not a controlled foreign affiliate ("CFA") of Ronal Canada Ltd. per subsection 17(15) and it is a related to Ronal Canada Ltd.

Receivable from Ronal Germany Ltd.

Subsection 15(2) will not apply to this debt as it is likely to be repaid within one year of the end of the taxation year-end in which it was incurred. Subsection 80.4(2) will not apply because of subsection 80.4(3). It may be possible to argue that the loan was not received by virtue of shareholdings as required under subsection 80.4(2).

Section 17 will not apply to this amount owing in the 2007 taxation year-end. The receivable is not likely to be outstanding for 12 months.

Receivable from Ronal Switzerland Ltd.

Subsection 15(2) and subsection 80.4(2) would not apply to this receivable because, under subsection 15(2.1) and subsection 80.4(8), a person connected to a shareholder does not include a foreign affiliate of the corporation. Per subsection 95(1), Ronal Switzerland Ltd. would be considered a foreign affiliate of Ronal Canada Ltd.

Ronal Canada Ltd. would be required to include an amount of imputed interest in income in its 2009, 2010, and 2011 taxation year-end under subsection 17(1) because the amount was outstanding for more than 12 months. The interest inclusion would be calculated using the prescribed rates for the year. However, there is an exception in subsection 17(8) of the Act which indicates that subsection 17(1) does not apply to a corporation resident in Canada for an amount owing to the corporation by a non-resident person if the person is a CFA of the corporation throughout the period in the year during which the amount is owing as long as:

(1) The amount owing arose as a loan or advance of money to the affiliate that the affiliate used throughout the period that began when the loan was made to the end of the year (or repayment) for the purpose of earning income from an active business, or

(2) The amount arose in the course of an active business carried on by the affiliate throughout the period that began when the amount owing arose and ended at the end of the year.

Because the amount owing did not arise from a loan or advance of money (1) will not apply. However, it is likely that (2) will apply as it appears that Ronal Switzerland Ltd. carried on an active business for the period the amount owing was outstanding during the year and the payable arose in the course of that active business. Ronal Switzerland is a CFA under subsection 17(15) and subsection 95(1).

Investment in Ronal Luxembourg

Under subsection 17(2), Ronal Germany will be deemed to owe $5,000,000 to Ronal Canada Ltd. as of January 15, 2009.

As Ronal Canada Ltd. would not have any interest included in income from the $5,000,000 investment or any FAPI income on the amount, an imputed interest benefit would result in the 2009 and 2010 tax years since the amount owing would be considered to be outstanding for more than a year.

Subsection 17(3) indicates that subsection 17(2) does not apply if the NR person receiving the loan and the NR lender are both controlled foreign affiliates (CFAs) of Ronal Canada Ltd. If the share investment by Ronal Canada Ltd. resulted in the company having *de jure* control over Ronal Luxembourg Ltd., the company would meet the definition of a CFA in subsection 17(15). However, Ronal Germany Ltd. is not a CFA of Ronal Canada Ltd. If it were possible to make both Ronal Germany Ltd. and Ronal Luxembourg Ltd. CFAs, the loan would not be considered to be owing to Ronal Canada Ltd. for purposes of subsection 17(1) from that point forward.

Any investment in shares of the two companies should have a purpose other than to avoid the implications of section 17, otherwise subsection 17(14) will apply and the share investment would be disregarded. For example, it is likely that the issuance of a class of nominal value voting stock would be disregarded for purposes of applying the exception in subsection 17(3).

Solution 10 (Advanced)

[ITA: 12(1)(*k*), 95(1), 95(4), 113(1), 113(1)(*b*), 113(1)(*c*), 126(1), 126(1.2); ITR: 5900(1), 5900(1)(*d*), 5901, 5907(1), 5907(11), 5907(11.2)(*a*)]

Part A

A foreign affiliate is a non-resident corporation in which the taxpayer's equity percentage is not less than 1%, and the total of the equity percentages in the corporation of the taxpayer and each person related to the taxpayer is not less than 10%. Equity percentage is the total of the person's direct equity percentage plus the person's equity percentage in any corporation multiplied by the corporation's direct equity percentage in the corporation. Direct equity percentage is the percentage determined by looking at the percentage of issued shares of each class owned by the person and taking the highest percentage.

U.S. Co. is a foreign affiliate of A Co. A Co. has an equity percentage in U.S. Co. of 6% (direct equity percentage) plus 8% (100% × 8%) (equity percentage × direct equity percentage) = 14%. Therefore, A Co.'s equity percentage in U.S. Co. is not less than 1%. The total equity percentages in U.S. Co. of A Co. and related taxpayer B Co. is 14% and, therefore, not less than 10%.

U.S. Co. is a foreign affiliate of B Co. B Co. has an equity percentage in U.S. Co. of 8% (direct equity percentage). Therefore, B Co.'s equity percentage in the company is not less than 1%. The total of B Co. and A Co.'s equity percentages in U.S. Co is 14% and, therefore, the equity percentage in U.S. Co. of B Co., and each person related to B Co., is not less than 10%.

Taiwan Co. is a foreign affiliate of A Co. but not C Co. A Co. has an equity percentage in Taiwan Co. of not less than 1% and 10%. Taiwan Co. is not a foreign affiliate of C Co. because although C Co. has an equity percentage of not less than 1% in Taiwan Co.; in combination with related companies C Co. does not have not less than 10% ownership in Taiwan Co.

Part B

Dividends from a share of a foreign affiliate of a Canadian corporation are included in Division B income. Offsetting deductions in computing taxable income will be available to A Co. for dividends received from U.S. Co. and Taiwan Co. Similarly, offsetting deductions will be available to B Co. for dividends received from U.S. Co.

Taiwan Co. is not a foreign affiliate of C Co. Therefore, a Division C deduction will not be available. The dividends will be included in income and a foreign tax credit for the withholding tax can be claimed.

Part C

Dividends from US Co.

Exempt surplus is computed as the exempt earnings less exempt losses of an affiliate for any of its taxation years ending in the period starting with the first day of the taxation year in which it last became a foreign affiliate. Exempt earnings include an affiliate's net earnings for the year from an active business carried on in a designated treaty country. A country is a designated treaty country where Canada and the country have entered into a comprehensive agreement or convention for the elimination of double taxation or a comprehensive tax information exchange agreement (TIEA). A company must be a resident of the designated treaty country under both Canadian common-law principles (mind and management) and under the treaty. U.S. Co. appears to meet both criteria and would be a resident of the U.S. Net earnings are defined as the earnings for the year from that active business minus the portion of any income or profits tax paid in respect of those earnings.

As Canada has a treaty with the U.S., U.S. Co. has exempt earnings and its exempt surplus at the time the dividend was received would have been $720,000 ($900,000 − $180,000). (It would be necessary to ensure that the earnings of the company meet the definition of earnings, i.e., computed in accordance with U.S. law, and appropriate adjustments are made. Also note that surplus balances are maintained/accumulated in the foreign currency. A Division C deduction is available to both A Co. and B Co. for the dividends received from U.S. Co., as 100% of the dividends would be considered to have been paid out of exempt surplus. (Note that if some of the whole dividend had been paid from taxable surplus, the dividends received by A Co. and B Co. would have each had an exempt surplus and taxable surplus portion.)

	A Co.	*B Co.*	
Dividend Income Inclusion	$36,000	$48,000	ITA: 12(1)(*k*)
Division C Deduction	(36,000)	(48,000)	ITA: 113(1)(*a*)
Impact on Taxable Income	Nil	Nil	

The dividends received by each of A Co. and B Co. would have been subject to withholding tax at a rate of 15% under the Canada–U.S. Treaty, as neither company owned at least 10% of the voting stock of the company paying the dividends. A foreign tax credit for non-business foreign tax withheld on dividends from a foreign affiliate paid to the taxpayer is not available where the taxpayer is a corporation.

Dividends from Taiwan Co.

As Taiwan does not have a treaty or TIEA with Canada, Taiwan Co. is not a resident of a designated treaty country. As a result, the exempt surplus of the company will be nil. The taxable surplus of the affiliate consists of its taxable earnings for any taxation year ending in the period beginning with the first day of the taxation year of the affiliate in which it last became a foreign affiliate. Taxable earnings include an affiliate's net earnings for the year from an active business it carried on in a country. Net earnings are defined as earnings from the active business less any income or profits tax paid in respect of those earnings. Therefore, Taiwan Co.'s taxable surplus when the January 31, 2011 dividends were paid would have been $400,000 ($500,000 − $1 00,000) and the associated underlying foreign tax would have been $100,000. The whole dividend of $222,000 would have been paid out of taxable surplus, and the dividends received by A Co. would be entirely from taxable surplus.

The Division C deduction for A Co. for the underlying tax is the lesser of:

a) The underlying foreign tax applicable to the dividend of $24,629 [$222,000/$400,000 × $100,000 = $55,500 × $35,520/$222,000 × (1/.265 − 1)], and
b) The dividend out of taxable surplus of $35,520

The Division C deduction for the withholding tax is the lesser of:

a) The non-business income tax paid by the corporation applicable to the dividend of $4,021 [$35,520 × 3% × 1/.265], and
b) The dividend out of taxable surplus less the deduction for the underlying tax per above of $9,249 [35,520 − $26,271]

A Co. will have had the following income inclusion for 2010:

Dividends received	$35,520
113(1)(*b*) Deduction	(24,629)
113(1)(*c*) Deduction	(4,021)
Taxable income	$ 6,870
Federal tax at 26.5%	$ 1,820

The income from which the dividends are paid is effectively taxed at the Canadian corporate tax rate when distributed. Double tax is eliminated by providing a deduction for the underlying and withholding tax paid to Taiwan. Rather than using a credit mechanism, the elimination of double tax is achieved through a deduction from income for the underlying and withholding tax converted using the RTF.

The result is equivalent to what would have occurred under a credit system if A Co. was taxed on the pre-tax income out of which the dividend were paid with credits for the underlying and withholding taxes as follows:

Pre-tax business earnings in Taiwan ($35,520/80%)	$44,400
Federal tax at 26.5%	11,766
Less FTC underlying tax (20% of $44,400)	(8,880)
Less FTC withholding tax	(1,066)
Net Canadian tax	$ 1,820

Note that if the foreign tax exceeds the Canadian federal tax, no excess deduction is allowed and no carryforward or carryback is available. Similar to the credit system, the income is taxed at the higher of the Canadian and foreign tax rates.

Because Taiwan Co. is not a foreign affiliate of B Co., no Division C deduction is available in relation to the dividends received. As a result, the $19,980 of dividends will be included in income and subject to regular corporate tax rates. A foreign tax credit would be provided for the withholding tax paid of $599. No foreign tax credit is available for the underlying tax.

Part D

Dividends received from U.S. Co.

The Division C deduction available for dividends from a foreign affiliate paid out of exempt surplus reflects an exemption method to eliminate double taxation. Jurisdiction to tax the dividend rests exclusively with the U.S. The rationale for this method is that it presumes that countries that have a treaty with Canada have taxed the income from which the dividend was paid at an equivalent rate of tax to the tax that would have been paid in Canada had the income been earned in this country. Therefore, the system should do exactly what the credit system would do, but it is an easier system to implement than trying to provide an indirect tax credit for the underlying tax of the U.S. company. As some of Canada's treaty partners do not impose tax rates as high as

Canada, this can cause incentive to invest in lower tax countries. A credit system would prevent this possibility but is more difficult to administer. Canada only allows an exemption method for dividend income arising from active business income of a foreign affiliate in a treaty country or a country with which Canada has entered a TEIA.

Dividends Received from Taiwan Co. by A Co.

The mechanism used in Part B above is partly a deduction method and partly a credit method of eliminating double taxation. The deduction method allows a deduction for taxes paid to the foreign jurisdiction against income earned by the corporation, whereas the credit method allows a credit for the tax paid to the foreign jurisdiction against the Canadian tax liability on the income. The Division C deductions are equivalent to providing a tax credit for the underlying tax and withholding tax related to the dividend received. This method becomes very complex as it is necessary to determine the creditable portion of underlying tax for each dividend that is paid.

Dividends Received from Taiwan Co. by B Co.

The mechanism used in Part B above is a credit method of eliminating double taxation. There is a credit provided for the withholding tax but not for the underlying tax resulting in double tax.

Part E

A subsection 113(1) deduction is only available to a corporation. If individuals had received the dividends from U.S. Co., there would have been a Division B income inclusion for the dividends and a foreign tax credit for the withholding tax on the dividends. No credit for the underlying foreign tax would be available.

APPENDIX II
Short Questions and Discussion Notes

CHAPTER 2
Liability for Tax

Short Questions

(1) Will Canadian residents who earn investment income in another country be taxed in both countries on the same amount of income?

(2) Mr. Smith went to Kuwait to work in the oil fields for an American company. He left his family (wife and three minor children) in Canada, and was away for three years. During this period he would visit Canada for vacations but would not stay more than four weeks during any one year. Is Mr. Smith a non-resident?

(3) Ms. Jones and her family have decided to move to Arizona in order for her to take up a lucrative one-year contract. They have sold their house and possessions in Canada and are renting a house in the U.S. They have also indicated to the bank, their clubs and their friends that they are becoming non-residents of Canada. At the end of the one-year contract they plan to travel for six months before returning to Canada. Will they be non-residents?

(4) If an individual were to leave Canada on September 30 of this year (breaking all ties with Canada) for a five-year contract in the U.K., then would he or she still be considered to be a resident of Canada throughout this year since he or she lived here for over 183 days in the year?

(5) If an individual were to leave Canada on September 30 of this year (breaking all ties with Canada) and move to Buffalo, then would he or she be considered to be a non-resident even though he or she continued to carry on his or her business in St. Catharines through a company incorporated in Ontario after he or she left?

(6) A client, who is resident in Canada, decides to set up a company in the U.S. to carry on business there. In doing so she wants to maintain control over the operations and, therefore, she is the President and the sole director and makes all important decisions. All other employees are resident in the U.S. Is this U.S. company resident in Canada or the U.S.?

(7) If a person is considered to be resident in Canada by the Canadian authorities and in the U.S. by the U.S. authorities, then will that person be subject to tax in both countries?

Discussion Notes for Short Questions

(1) Yes. They will pay tax in the foreign jurisdiction based on the investment income earned there and also include the same amount in their Canadian income. However, they can obtain a foreign tax credit in Canada [ssec. 126(1)] for the income tax paid in the foreign country.

(2) Probably not. It appears that Mr. Smith has not made a “clean break” from Canada. He has a “continuing state of relationship” in Canada since his wife, children and family home are still here.

(3) Probably. Significant residential ties involving dwelling, spouse and dependants have been cut and so have some secondary ties. If there is evidence that her return to Canada was foreseen at the time of her departure (e.g., a contract for employment upon return to Canada), the CRA will presume that she did not sever all residential ties on leaving Canada [IT-221R3. par. 11].

(4) No, he or she would be considered a part-year resident [sec. 114]. The sojourning rules [ssec. 250(1)] only apply to persons who are non-residents and who sojourn in Canada for a period of 183 days or more in a year.

(5) No. Since the business is being carried on in Canada by a corporation, the individual is not carrying on business in Canada. Therefore, he or she will be subject to the part-time resident rules [sec. 114] and taxable on his or her world income up to September 30. From October 1, he or she would only be taxed in Canada on his or her income from employment, carrying on business and from the sale of taxable Canadian property [ssec. 2(3)].

(6) Under the common law principles the "central management and control" would reside with the directors and officers and, therefore, be in Canada. Reference to the Canada–U.S. tax treaty would be necessary to avoid any double taxation.

(7) No. Paragraph 2 of Article IV of the Canada–U.S. tax treaty provides tie-breaking rules to follow when a person is considered to be resident of both countries. This prevents double taxation.

CHAPTER 3
Employment Income

Short Questions

(1) When determining whether a person is employed or self-employed, one of the tests used is the "economic reality test." What does this test involve?

(2) A director of a corporation is considered to be an employee of the corporation for tax purposes and the director's fees are income from employment. Comment.

(3) If an employer were to pay the premiums for an individual disability policy (i.e., for the president of the company), then there would not be a taxable benefit as a result of subparagraph 6(1)(*a*)(i) and any disability benefits received from the plan would not be taxable under paragraph 6(1)(*f*). Comment.

(4) Mr. Chow is the VP Marketing for Compusale Inc., a computer company. He and his wife are taking a company-paid trip to a trade show in Hawaii at which he will be working. His wife is not an employee of the company but she will be in charge of hospitality for Compusale Inc. at the show. She will spend the hours from 1:00 pm until 9:00 pm each day on this assignment getting things organized while her husband is in the company booth. She will spend the mornings on the beach. Do you think that Mrs. Chow's expenses will be a taxable benefit to Mr. Chow?

(5) Mr. Benton, the President of Publicco Ltd., travels extensively on company business. It is the company policy to pay him a meal allowance of $100 per day and $200 for hotel while he is on the road. The standard salesperson's allowances are $40 for meals and $100 for hotel. Comment on the reasonableness of the President's allowances.

(6) XYZ Co. leases a car for its salesperson at a monthly lease cost that includes insurance. How should the company deal with the insurance cost when calculating the taxable benefit for the salesperson?

(7) Mr. Tse is a stock broker working in downtown Toronto. He arrives at the office early in the morning to read the papers and organize his day. Throughout the day he is on the telephone calling clients and prospective clients. He occasionally takes clients out for lunch or dinner while he is downtown. He is required by his employer to pay his own entertaining expenses. Can he deduct these entertainment expenses on his personal tax return?

(8) Name and describe the two basic types of pension plans.

(9) Ms. Betty is a salesperson for XYZ Ltd. She is paid a travel allowance of $250 per month with a reconciliation done at the end of the year to make sure that it is actually calculated based on the company policy of $0.40 per km. How will this be treated for tax purposes?

(10) Ms. Jones is a salesperson for an office supply company. She has bought a computer for the client management aspect of her business. It is a portable, so she can take it with her to the office and home. Assuming she otherwise meets the conditions to claim expenses under paragraph 8(1)(*f*), can she deduct CCA on this computer?

Discussion Notes for Short Questions

(1) The economic reality test examines several economic factors and draws from them an inference as to the nature of the relationship. In particular, four dimensions have been advanced involving:

(a) control,

(b) ownership of the tools,

(c) chance of profit, and

(d) risk of loss.

In cases where the taxpayer supplies neither funds nor equipment, takes no financial risks, and has no liability, an employer-employee relationship is implied.

(2) The definition of "employee" in subsection 248(1) includes an "officer" and the definition of "officer" includes a corporate director. Paragraph 6(1)(*c*) includes director's fees in income under Subdivision a.

(3) The exclusion under paragraph 6(1)(*a*) provides for "group" sickness or accident insurance plans. A plan taken out for one individual would not qualify for this exclusion of the premium paid by the employer. However, any disability benefit the president receives under this plan would not be taxable since the contributions are paid by the president through the fact that he or she paid tax on the taxable benefit [IT-428, par. 20].

(4) Given that she has specific responsibilities to carry out and that she will be working a full day (8 hours) performing her duties, it is unlikely that her travel costs will be a taxable benefit. IT-470R, paragraph 15, indicates that there is no employment benefit to the employee if the spouse was, in fact, engaged primarily in the business activities on behalf of the employer.

(5) The word "reasonable" is not defined in the Act and, therefore, must be applied to the particular facts of the situation. It is not unreasonable that the President should receive a larger allowance while on the road than a salesperson, since he is representing the company and must present a certain image. The difficulty is determining when the "reasonable" amount is exceeded. If the allowance is in excess of what top-rate meals and hotel rooms cost, then it would be considered unreasonable and the full allowance would be included in his income [spar. 6(1)(*b*)(vii)]. He would then be able to claim his expenses [par. 8(1)(*h*)].

(6) The cost of the insurance should be excluded from the calculation of the standby charge [ssec. 6(2)]. However, the operating cost benefit [par. 6(1)(*k*)] would cover the insurance.

(7) In order to meet the conditions of paragraph 8(1)(*f*), he must "ordinarily be required to carry on the duties of his employment away from his employer's place of business." In this case it does not appear that there is such a requirement since he spends virtually all of his time in his office. Therefore, he would not be able to deduct his expenses.

(8) Defined benefit plans guarantee a predetermined amount of retirement income based on a flat amount per year of service or a percentage of the employee's earnings over a defined period. These plans are funded by actuarially determined contributions by the employee and/or the employer.

Money purchase plans provide whatever pension income the contributed funds in the plan can purchase through the acquisition of an annuity. No predetermined amount of pension income is guaranteed under these plans. Benefits will depend upon the actual contributions, the investment return of the plan and annuity rates at the date of purchase.

(9) According to IT-522R, this method is acceptable and she will not have an income inclusion if:

(a) there is a beginning-of-the-year agreement stating that she will get a stated amount per kilometre for business travel;

(b) there is a year-end accounting for the difference between the payments and the business travel times $0.40; and

(c) the amounts paid are reasonable.

Generally, the per kilometre charges will be considered reasonable as long as they are within the rates set out by the CRA, i.e., $0.52 for the first 5,000 km and $0.46 on the remaining.

(10) Paragraphs 8(1)(*j*) and (*p*) are the only provisions that will allow an employee to deduct CCA. These paragraphs are restricted to automobiles, aircraft and musical instruments. It does not allow the deduction of CCA on computers. Therefore, according to subsection 8(2), CCA on the computer will not be allowed.

CHAPTER 4
Income from Business: General Concepts and Rules

Short Questions

(1) In their manufacturing process, Canco uses specialized parts. These parts are identical, but each has its own serial number. As they are received, they are put into storage compartments in front of the existing inventory. As they are used, the ones closest to the front are taken first. When Canco calculates its year-end inventory it uses the LIFO method in arriving at the inventory value. Canco uses the same for tax purposes and feels that this is correct. Comment.

(2) ServiceCo is in the business of selling service contracts to customers and then providing the service as needed over the term of the contract. The customers pay for the service contract at the beginning of the contract. ServiceCo believes that it does not have to record these receipts as income when the cash is received but only over the term of the contracts. Comment.

(3) A client is about to relocate to a new office tower. The new landlord is offering large incentives to attract long-term tenants and has offered your client a cash payment of $100,000 in order to move in. The tenant

is then required to do his or her own leasehold improvements. Your client has heard from some friends that the inducement will be treated as a tax-free receipt and that the courts have accepted this position. Comment.

(4) A client is in the business of developing and selling tax shelters. In order to market his products he has joined the local golf club most frequently used by doctors and dentists. As a result of the contacts made there he has been able to double his sales volume. Based on these results, he feels that his club dues are deductible as a business expense. Comment.

(5) During the year a business client made donations to both charities and to political parties. Both types of donations yielded additional business to the client. The client's accountant has advised it that all donations must be added back to income to arrive at net income for tax purposes. Comment.

(6) In order to fund the buy-sell provisions of a shareholder agreement the company has taken out a life insurance policy on the lives of each of the shareholders and is paying the premiums on a monthly basis. Since it is a business expense the premiums are deductible. Comment.

(7) In order to support its bank loan, the company is required by the bank to provide life insurance as collateral. Since the premiums are a business expense they are deductible. Comment.

(8) A client went to a convention that cost her $3,000 for three days. The cost was inclusive of all meals and accommodation. Since nothing was separated in the convention fee for meals and accommodation, she can deduct the full cost. Comment.

(9) A client had an employee who stole $30,000 of cash from it over a period of six months. Is this a deductible expense to the business? Comment.

(10) Based on past experience, your client has found that 10% of its sales are returned for a refund within 60 days. At the end of each month an accounting reserve is set up for these returns. History has shown the reserves to be accurate. Can these same reserves be claimed for tax purposes? Comment.

(11) Any reserve that is allowed as a deduction in one year must be taken into income in the next year. Comment.

(12) If your client pays a fee to an accounting firm to help it prepare cash flow projections and a proposal to successfully obtain bank financing for expansion, is the fee deductible? Comment.

Discussion Notes for Short Questions

(1) While the LIFO method is generally not acceptable as an *assumption* about inventory values for income tax purposes, it is acceptable if this method actually best matches the flow of inventory through the business. Alternatively, by using the specific identification method Canco could arrive at the same inventory value. Refer to IT-473R.

(2) The cash receipts must be included in income in the year received [par. 12(1)(*a*)]. A reserve may then be claimed for amounts that relate to services to be provided in a future period [par. 20(1)(*m*)].

(3) The amount will have to be included in income [par. 12(1)(*x*)], unless an election to reduce capital cost [ssec. 13(7.4)] or cost [ssec. 53(2.1)] is available.

(4) Even though the club dues were incurred to earn income from his business, they are not deductible since they are specifically disallowed [par. 18(1)(*l*)].

(5) The charitable donations are disallowed to the extent they were not incurred to earn income. [par. 18(1)(*a*)] So, if they were incurred to earn income, then they will be deductible. The political donations, on the other hand, are specifically disallowed [par. 18(1)(*n*)] and, therefore, are not deductible in computing income for tax purposes, regardless of the fact that they were incurred to earn income. A limited tax credit is allowed for federal political contributions.

(6) Since life insurance proceeds are not included in income on death, the premiums are not an expense incurred to earn income and are, therefore, not deductible, [par. 18(1)(*a*)]

(7) Paragraph 20(1)(*e*.2) permits a deduction in respect of life insurance premiums where the policy is assigned as collateral to a lender who is in the business of lending money. The deduction is based on the lesser of the premiums paid and the net cost of pure insurance.

The deduction is calculated as the lesser of:

(a) the premiums paid under a life insurance policy in respect of the year where:
  - (i) the policy is assigned to the institution in the course of borrowing;
  - (ii) the interest on the loan would be deductible;
  - (iii) the assignment is required by the institution; and

(b) the net cost of pure insurance.

The deduction, further, must reasonably be considered to relate to the amount owing from time to time under the borrowing.

(8) If meal costs are not specified, then subsection 67.1(3) deems the cost to be $50 per day for meals. This is then subject to the 50% limitation [ssec. 67.1(1)].

(9) In IT-185R, the CRA allows employee thefts as expenses unless it is a senior employee who committed the theft. However, in the court case, *Cassidy's Limited (formerly Packer Floor Coverings Ltd.) v. M.N.R.*, 89 DTC 686 (T.C.C.), defalcation by a senior employee was allowed.

(10) Paragraph 18(1)(*e*) specifically disallows reserves of any kind unless they are specifically allowed somewhere else in the Act. There are no reserves in section 20 which would allow a deduction for this reserve since it is based on a contingency and not a known liability.

(11) Each reserve allowed under subsection 20(1) has a corresponding income inclusion under subsection 12(1). In subsequent years a new reserve may be claimed depending on the provisions of the reserve provision itself and the facts of the situation.

(12) Paragraph 20(1)(*e*) would not allow an immediate deduction. Instead, the fees would be deductible evenly over a 5-year period including the year the expense was incurred.

CHAPTER 5
Depreciable Property and Eligible Capital Property

Short Questions

(1) Whenever an asset is sold the full amount of the proceeds is credited to the CCA class. Comment.

(2) If a CCA class is in a negative balance at any time in the year then this negative balance will have to be brought into income. Comment.

(3) On December 1, Mr. Luigi buys his first rental property and immediately begins to rent it out. The CCA that he is otherwise entitled to claim will be prorated for the fact that he only owned the building for 31 of the 365 days in the year. Comment.

(4) A construction corporation moved some heavy equipment into northern Ontario for a special project. At the end of the project they abandoned the equipment at the site since the cost of removal exceeded the cost of replacement. The equipment will forever remain in its class since it has not been disposed of. Comment.

(5) There can be no recapture or terminal loss on automobiles that cost over $30,000 plus HST. Comment.

(6) CCA is a discretionary deduction and, therefore, may be claimed or not claimed at the discretion of the taxpayer. However, if it is claimed, then the full amount must be claimed. Comment.

(7) If a building is sold for less than its capital cost then a capital loss will be realized. Comment.

(8) A business made some leasehold improvements, costing $10,000, to their offices in year 3 of a five-year lease. There is one renewal period of five years. What is the maximum CCA that they can claim in year 3 based on these additions?

(9) A corporation bought a franchise on June 1, for $20,000. The franchise term is for 10 years. The year-end of the corporation is December 31. What class is this asset in and how much CCA can be claimed? (Ignore the effects of leap years.)

(10) A corporation bought a franchise on June 1, for $20,000. The franchise is for an indefinite term. The year-end of the corporation is December 31. What class is this asset in and how much CCA can be claimed?

(11) A client had a fire in their warehouse. They received insurance proceeds of $50,000 of which they used $45,000 to repair the damage and the balance of $5,000 was taken into income. Their controller agreed that this was the proper treatment. Comment.

(12) A personal tax client has come to you and told you that she cannot afford to buy a house based on her own income. However, she has bought a duplex and is living in one half and renting out the other half. On the sale of the duplex she thinks she will be able to claim it all as her principal residence. Comment.

(13) Fifteen years ago, Mr. Jones established his own unincorporated electronics business that manufactures electronic controls. He has come to tell you that he has just sold one of his trademarks for $60,000 and that his lawyer told him that the sale would be treated as a capital gain in the company. Comment.

Discussion Notes for Short Questions

(1) The proceeds, up to a maximum of the original cost, are credited to the class. If proceeds exceed original cost then there will be a capital gain.

(2) The negative balance will only have to be brought into income if the balance is still negative at the end of the fiscal year. If a new asset is acquired at a cost high enough to bring the class into a positive balance then CCA can be claimed in the year on this positive balance.

(3) As an individual earning property income, Mr. Luigi is considered to have the full calendar year as his taxation year. Thus, there is no proration of CCA. However, he will be subject to the half-net-amount rule [Reg. 1100(2)].

(4) In IT-460, the CRA takes the position that property that is abandoned is actually disposed of for proceeds equal to nil. This becomes important when trying to claim a terminal loss on the disposal of the last asset since, if all the assets of the class have not been disposed of, a terminal loss cannot be claimed.

(5) Subsections 13(2) and 20(16.1) provide that recapture and terminal loss rules do not apply to automobiles costing over $30,000 plus HST. Each of these autos is in a separate class, Class 10.1 [Reg. 1101(1*af*)].

(6) The word "may" in paragraph 20(1)(*a*) makes it a discretionary deduction. However, in Regulation 1100(1) the phrase "not exceeding" is used to allow any amount of CCA from nil to the maximum to be claimed at the discretion of the taxpayer.

(7) Subparagraph 39(1)(*b*)(i) denies a capital loss on depreciable property. When the proceeds are less than the capital cost they are credited to the CCA class.

(8) Regulation 1100(1)(*b*) and Schedule III provide for CCA on leasehold improvements as follows:

50% × the lesser of:

(a) $^1/_5$ × $10,000 = $2,000

(b) $10,000/(3 + 5) = $1,250

CCA = $625 (i.e., 50% of $1,250)

(9) Franchises with limited lives are in Class 14. CCA is claimed based on a proration of the cost over the life, in days (ignoring leap years), of the franchise. Therefore, the CCA would be:

$$\frac{\$20{,}000}{(365 \times 10)} \times 214 = \$1{,}173$$

Regulation 1100(2) excludes Class 14 from the half-net-amount rule. However, since the CCA is prorated on a daily basis in Class 14, an acquisition during the year may not get the full CCA.

(10) Since the franchise is for an indefinite term, it is not a Class 14 asset. Instead, it is an eligible capital expenditure and is subject to the rules in section 14. Three-quarters of the cost is added to the CEC pool and is depreciated at 7% on the declining balance.

(11) The $45,000 should be treated as an offset to expenses or effectively as an income inclusion [par. 12(1)(*f*)]. The extra $5,000 that was not spent should not be treated as income. Instead, it should be treated as proceeds of disposition paragraph (*f*) of the definition of "proceeds of disposition" in subsection 13(21).

(12) She will be deemed to have disposed of the rental portion of the duplex for proceeds equal to the proportion of use that was rental [par. 13(7)(*d*)]. This will give rise to potential recapture and capital gain that is not eligible for the principal residence exemption.

(13) Trademarks are eligible capital property. Of the $60,000 of proceeds, only 75% is credited to the CEC pool. If there is a negative balance then the total of $^2/_3$ of the negative balance net of all previous CECA claims plus all previous CECA claims, must be taken into income as "business" income in the year of sale [ssec. 14(1)]. Alternatively, he may elect under 14(1.01) to treat the gain as a capital gain to offset any capital losses. He cannot claim the capital gains exemption on this gain, since the property sold does not qualify.

CHAPTER 6
Income from Property

Short Questions

(1) The dividend gross-up and tax credit were introduced to provide an incentive to Canadian individuals to invest in the stock market. Comment.

(2) "Income from property" includes capital gains since they arise from the sale of property. Comment.

(3) Individual taxpayers have three options for reporting interest income. They can report it on the cash basis, the receivable method or the accrual method. Comment.

(4) Mr. Watson sold a piece of property to Mr. Holmes in an arm's-length transaction at fair market value. Mr. Watson took back a note with no interest being charged and is concerned that subsection 16(1) will apply to deem part of the repayment to be interest income. Comment.

(5) Bill and Betty have been living together for 15 years and have three children together. They have never married. Bill has loaned Betty $50,000 interest free from an inheritance he received so she can earn some income. Comment.

(6) Ms. Jones owns all of the shares of Jones Co. She has had the company valued and 50% of the shares are worth $100,000. Since her husband has inherited that amount she is going to sell him 50% of her shares for $100,000 cash. She intends to report the gain on her tax return and have her husband pay tax on any dividends paid by the company. Comment.

(7) A client has just come up with what he thinks is a clever plan for avoiding the attribution rules. He is going to lend his mother, who lives in the U.K., $100,000 and she in turn will lend the money to his 12-year-old son. His son will invest the money and earn interest income that will be taxed in his son's hands. Comment.

(8) Mrs. Campbell has heard that she can make the attribution rules work for her. She proposes to start up a company and wants to own all the shares herself but she also wants to split income with her husband. She thinks that she can buy 50% of the shares herself and have her husband buy the other 50% of the shares with his own money. He would immediately give her the shares for no consideration. Once dividends are declared, 50% of her dividends would be attributed to her husband under section 74.1. What do you think?

(9) Mom has been saving her child tax benefit cheques in a bank account for her daughter. Someone has just told her that she does not need to report the interest earned on this account as income but that her daughter could. She knew there were rules against this and wants your advice.

(10) Mr. Smith borrowed $300,000 at the bank to buy common shares in Smith Ltd., which in turn bought 30 acres of raw land for development at some time in future. Is the interest fully deductible to Mr. Smith?

(11) A tax client has just told you that she has sold a rental property that she has owned for a number of years. Because of the large amount of recapture that she was faced with, she decided to buy another apartment to bring the class back into a positive balance. Comment.

Discussion Notes for Short Questions

(1) The gross-up and tax credit mechanism was introduced to integrate corporate and personal income to leave the individual indifferent as to whether he or she earned business or investment income through a corporation or directly. See Chapter 12 of the text.

(2) Capital gains are specifically excluded from income from property [ssec. 9(3)]. Also, capital gains and income from property are under two different subdivisions of the Act.

(3) For investment contracts, interest income must be reported on the accrual basis annually under subsection 12(4).

(4) Since the transaction took place at fair market value and assuming that Mr. Watson and Mr. Holmes are dealing at arm's length, it is doubtful that the CRA would be successful in imputing an interest component under subsection 16(1). If the purchase price were in excess of fair market value then the CRA would have a greater chance of successfully converting some of the capital gain into interest income.

(5) Attribution will apply to this loan since Betty is Bill's spouse or common-law partner [ssecs. 74.1(1), 248(1)].

(6) In order to avoid the attribution rules, subsection 74.5(1) requires that she and her husband will not only have to complete the transaction at fair market value but they will also have to complete a joint election under subsection 73(1) not to have the rollover apply in order to avoid the attribution rules.

(7) On the surface, the attribution rules of subsection 74.1(2) will not apply since the grandmother is not resident in Canada. However, subsection 74.5(6) provides an anti-avoidance rule that will catch this “back-to-back” loan arrangement and have the interest income earned by his son taxed in your client’s hands.

(8) On the surface, it works. But the artificial transaction rules in subsection 74.5(11) would apply to cause the attribution rules to be ignored since one of the main reasons for this transaction is to reduce the amount of tax that would be paid.

(9) Normally, the attribution rules would apply. However, subsection 74.1(2) provides that the income attribution rules do not apply to a child tax benefit transferred or loaned to a child and allows the interest to be taxed in the hands of the child.

(10) The ACE denies interest expense that can reasonably be considered as interest on borrowed money used in respect of or for the acquisition of land, but the disallowed interest is added to the cost base of the shares [par. 18(3)(*b*), 53(1)(*d*.3)].

(11) Regulation 1101(1ac) requires each rental building purchased after 1971 and costing $50,000 or more be placed in a separate CCA class. Thus, if those two conditions are met, the new building she is buying will not go into the same pool and the recapture will not be deferred.

CHAPTER 7
Capital Gains: Personal

Short Questions

(1) Mr. Trent retired a number of years ago and decided that he did not want to spend winters in Canada. He sold his house in Waterloo and moved into an apartment for seven months of the year. For the other five months he lived in a villa in Spain that he bought after he sold his house. He now wants to sell the villa and buy a property in Arizona. He has come to you to see whether he can claim the principal residence exemption on the villa. Comment.

(2) Mr. Platzer, who has been saving coins since he was a child, has now decided to sell a particularly valuable set that he bought for $100 many years ago. There are five coins in the set and each is worth $800 for a total selling price of $4,000. The coin dealer that he is selling them to suggested that he sell him each coin for $800 instead of the set for $4,000, in order to avoid a capital gain. What do you think?

(3) Mrs. Amos likes to buy old books and furniture. She very rarely sells any of her pieces and is not considered to be a trader. However, this year she has sold an antique stool for a loss of $2,000 and an old 1917 *Income War Tax Act* for a gain of $4,000. Her only previous transaction was the sale of another old book for a loss of $3,000 six years ago. What will her capital gain be for the year from these transactions?

(4) Mr. Evans has been investing in the stock market for many years and has already used up his capital gains exemption. It is now December and he is trying to minimize his tax liability for the year. In July he sold some shares to realize a capital gain of $20,000. He does not want to pay tax on this gain so he wants to sell his shares of PubCo. that are doing poorly and realize an offsetting loss. However, he is certain that the PubCo. shares will increase in value again and wants to buy them back again in early January. Comment.

(5) How are stock dividends treated for tax purposes?

(6) Ms. Rose bought a summer cottage in 1996 and used it herself for the next 10 years. In the years 2006 to 2009 she travelled extensively and was unable to use her cottage at all. In fact, she rented it out to an unrelated family for the entire four years. In 2010, she again began to use the cottage personally. Comment on the tax issues involved.

(7) When her husband died suddenly, Mrs. Jones found that she needed extra income to support herself. She proceeded to make a permanent apartment on the second floor of her house. She added a separate entrance, a bathroom, a kitchen and had the utilities separately metered. The costs were considerable but she was confident she would be able to make a profit very quickly. Comment on the tax issues.

(8) Mr. Carter has worked all his life to build up the value of his privately-owned company. Having started from nothing, his shares are now worth $10 million. He would like to leave the country but does not feel that he can because of the huge amount of tax that he would have to pay on the accrued gain on the shares. Discuss.

(9) Mr. King has been a non-resident of Canada and just last month moved to Canada to live. While abroad, he bought some shares on the New York Stock Exchange at a cost of $10,000 and now wants to sell them for $50,000. However, he is concerned about the amount of tax that he will have to pay on his $40,000 gain. He has come to you for advice. Can you help him?

(10) Mr. O'Malley wants his wife to benefit from and pay tax on the future appreciation in the value of some shares that he owns. These shares originally cost $5,000 and are now worth $12,000. He is going to sell them to her in exchange for a note for $12,000 with interest at 8%. Discuss whether he can achieve his goal.

(11) Mrs. Reilly has sold shares that she owned to her husband. She elected under subsection 73(1) not to have the rollover apply and he paid her cash for the shares. She originally paid $6,000 for the shares; they are now worth $16,000 and he paid her $15,000 in cash. What are the tax consequences to Mr. and Mrs. Reilly?

Discussion Notes for Short Questions

(1) The definition of principal residence [sec. 54] does not restrict the location of a principal residence to Canada. The claim of the principal residence exemption is restricted to Canadian residents [spar. 40(2)(*b*)(i)]. In this case, Mr. Trent has not changed his resident status and therefore he would be able to claim the principal residence exemption on the Spanish villa.

(2) Subsection 46(3) provides that, when the coins are all sold to the same person or related people, they will be treated as being sold as a set and he will have a capital gain of $3,000 on the transaction. If he sold each coin to a separate arm's length dealer then he would have been able to use the $1,000 rule to eliminate the full gain.

(3) The antique stool is not listed personal property (LPP) according to the definition in section 54. However, it is still PUP and, as such, the loss is disallowed [spar. 40(2)(*g*)(iii)]. The rare book, on the other hand, does meet the definition of LPP and the gain is subject to tax. However, in determining Division B income, the current gain of $4,000 is reduced by the previous loss of $3,000 and $^1/_2$ of this net amount is considered to be the "taxable net gain" from listed personal property [ssecs. 41(1) and (2)]. Losses on LPP can be carried back three years and forward seven years to be applied against gains from LPP. It should be noted that these carryovers are applied within the calculation of the capital gain in Division B and not under Division C as other loss carryovers are.

(4) If Mr. Evans buys the shares of PubCo. back within 30 days of selling them in December, then he will have a superficial loss [sec. 54]. This loss will be denied [spar. 40(2)(*g*)(i)] and added to the cost base of the replacement shares [par. 53(1)(*f*)].

(5) The stock dividend is treated in the same way as a cash dividend. The increase in paid-up capital is considered to be a dividend [ssec. 82(1)] and the grossed-up amount is included in income. The cost base of the shares received is equal to the increase in paid-up capital [ssec. 52(3)].

(6) When she began to rent out the cottage in 2006 she had a change in use [ssec. 45(1)] and the deemed disposition and potential capital gain (unless the cottage was her principal residence) that go along with it. Then in 2010 she had another change in use that would cause her to have another deemed disposition and potential capital gain. However, she could have elected under subsection 45(2) not to have a change in use in 2006. This would have left the property as personal-use property without the deemed disposition. As a result, when the property was changed back to personal use in 2010, there would not have been a change in use at that time either. In order to have the rules in subsection 45(2) apply she would have had to elect in 2006 when the first change in use occurred (unless the cottage was her principal residence) and, under subsection 45(4) and regulation 1102(1)(*c*), she could not have claimed any CCA on the cottage.

(7) Since she has made significant structural changes to the house, the CRA takes the position [IT-120R6, par. 30], that she will have a partial change in use of the house and a disposition [par. 45(1)(*c*)] of that portion of the house represented by the second floor. She will be able to claim CCA on the rental space. On the eventual disposition of the entire property the principal residence exemption will only apply to the portion she lives in. The second floor will be disposed of in the same manner as a rental property.

(8) The rules causing a deemed disposition on leaving the country do apply to an unlisted share of the stock of a corporation resident in Canada [ssec. 128.1(4)].

(9) Mr. King is deemed to acquire the shares at their fair market value at the time he entered the country [ssec. 128.1(1)]. This should give him a cost base of $50,000 and eliminate his accrued capital gain.

(10) In order to transfer property to his wife and avoid the attribution rules he must follow the attribution rules [ssec. 74.5(1)] and have the sale take place at fair market value, have interest charged at the lesser of the prescribed rate and the commercial rate, and elect [ssec. 73(1)] not to have the spousal rollover take place. In this case the interest rate may be too low and no mention is made of the [ssec. 73(1)] election out of the rollover. Therefore, the attribution rules are not avoided and income splitting is not achieved, unless it can be established that the interest rate is at least equal to the lesser amount, above, and that the [ssec. 73(1)] election was made not to have the automatic rollover apply.

(11) Since Mrs. Reilly elected out of the rollover in subsection 73(1) she will be taxed on the $10,000 capital gain (subsection 69(1) applies to deem the proceeds to be equal to fair market value). However, since she did not meet the condition of paragraph 74.5(1)(*a*), i.e., she did not receive fair market value consideration, the

attribution rules will continue to apply. The cost base of the shares to Mr. Reilly will be the $15,000 that he paid for the shares since section 69 does not adjust his cost base. Therefore, there will be double taxation on the $1,000 difference between $16,000 and $15,000.

CHAPTER 8
Capital Gains: Business Related

Short Questions

(1) Opco, which has a December 31 year-end, sold the warehouse it used in its business this year and started to use rented space. How long do they have to replace the warehouse in order to defer the tax on the one that was sold?

(2) Opco has been operating in downtown Toronto for the past 25 years. It has decided to sell its land and building and move its operations to London, Ontario where it is less expensive. They sold their land for $2 million and the building for $500,000. These had a cost of $100,000 in total. The property they bought in London cost $1 million for the land and $1.5 million for the building. It would appear that they will have a significant capital gain on both the land and building with the only full deferral available on the building. Can you suggest a method that will give them the full deferral on both the land and the building?

(3) Dealco originally bought its land and building for $500,000 each. The land has now gone up in value to $1.3 million while the building has no value in its current location. No CCA has ever been claimed on the building. A purchaser has now come along and has offered Dealco $1.3 million if they will demolish the building and leave the land clear. Dealco thinks that this is a great idea since, of the $800,000 gain on the land, only $400,000 is taxable and this will be offset by the $500,000 terminal loss on the building. What do you think?

(4) Your friend Ralph bought a rental property some years ago. He paid $50,000 for the land and $150,000 for the building. Unfortunately, the property values in the area have not gone up and, due to the recession, have in fact gone down. He has to sell the property to meet other commitments and his proceeds will be $40,000 for the land and $130,000 for the building. Since he has been operating at a loss he has not claimed any CCA yet. He is upset that all he will get is a capital loss on the sale and he will not be able to use this loss to reduce his income and help reduce his tax. Comment.

(5) Acme Co. has just bought a new piece of equipment in the U.S. for use in its Canadian plant. The equipment cost $75,000, the shipping cost $10,000 and the installation cost $5,000. The controller wants to capitalize the $75,000 and expense the balance of the costs for tax purposes. As the auditor on the engagement you have been asked for your views on how the expenditures should be treated for tax purposes.

(6) Ms. Andrews has just sold her rental property for a capital gain of $200,000. However, in order to do so she has had to take back a demand promissory note of $300,000 until the purchaser can get mortgage financing which the purchaser expects to do early next year. Can Ms. Andrews do anything to defer her tax liability?

(7) Earlier in the year Mr. Barnes had sold the shares of his small business corporation to his son and had taken back a term note for equal principal payments over 15 years. Mr. Barnes has already used up his capital gains exemption and is glad that he took back the note since he can now defer tax on the gain over the next 15 years. Comment.

(8) Mrs. Blidge has sold her shares in her qualified small business corporation and realized a gain of $300,000. In the process she took back a term note that is payable equally over five years. She does not know whether to claim the capital gains exemption to eliminate the full amount of the gain now or to claim a reserve to bring the gain into income over the next five years and use her exemption in each of the next five years. She has come to you for your expert advice.

(9) Ms. Sleigh had taken advantage of the housing market in her city by putting $10,000 down on a new house which was to be built in two years. By the time the house closed it had gone up in value by $60,000. She and her family moved into the house for one month and then sold it and realized the gain. They then moved back into their old house. When she came to have you prepare her personal tax return she said that she could claim the principal residence exemption on the new house. Comment.

Discussion Notes for Short Questions

(1) They have to replace the warehouse before the later of 12 months after the initial year and the end of the first taxation year after the initial year [par. 44(1)(*d*)]. If the sale closed this year, then they have until December 31 of next year to replace the property. The initial year is the year that the "amount has become receivable as proceeds of disposition" [ssec. 44(1)].

(2) An election is allowed to reallocate proceeds from land to building [ssec. 44(6)]. In order to obtain a full deferral, $1 million of proceeds could be reallocated from land to building to defer the full gain.

(3) The proceeds will be reallocated from the land to the building to the extent of the terminal loss (TL) [ssec. 13(21.1)]. As a result, the proceeds on the building will be $500,000 and the proceeds on the land will be $800,000. Under the proposal the effect on taxable income was ($100,000) ($400,000 TCG — $500,000 TL) whereas the effect is now $150,000 ($150,000 TCG — nil TL).

(4) The Act does not allow a capital loss on the sale of depreciable property [spar. 39(1)(*b*)(i)]. Instead, he will be able to claim a terminal loss of $20,000 on the sale of the building [ssec. 20(16)] and a capital loss of $10,000 on the sale of the land. Even though there is a terminal loss on the building, there is no reallocation of proceeds since there is not a capital gain on the land [ssec. 13(21.1)].

(5) "Cost" is not defined for tax purposes but it would normally include all of the costs necessary to obtain the equipment, deliver it and install it in the plant. All of these costs relate to getting the equipment ready for use.

(6) She cannot claim a reserve [spar. 40(1)(*a*)(iii)] based on amounts that are payable to the taxpayer after the end of the year, since the note payable on demand may become due to the taxpayer before the end of the year.

(7) Where shares of a small business corporation are transferred to a child, the reserve rules change so that the $^1/_5$ is changed to $^1/_{10}$ to allow the gain to be brought into income over 10 years instead of five years [ssec. 40(1.1), spar. 40(1)(*a*)(iii)].

(8) She can either claim the full exemption now or, if she claims the reserve, claim the exemption each year as she brings the gain into income. However, there is usually no advantage to claiming the reserve if the full amount of the gain will be exempt from tax. (One exception may be if she will be subject to alternative minimum tax (discussed in Chapter 10) by bringing the full amount of the gain into income in the first year.)

(9) The CRA stated [IT-120R6, par. 5] that a taxpayer may designate any residence as his or her principal residence as long as he or she lives in the home for a short period during the year and his or her intention is not to make a profit on the residence's disposition. In this case her intention seems to be to make a profit since she moved in for such a short time and then moved back to her old house. The issue then becomes whether the gain is an income or a capital gain. This transaction could well be considered an adventure in the nature of trade and fully taxed.

CHAPTER 9
Other Sources of Income and Deductions in Computing Income

Short Questions

(1) Mr. Jones had been fired from his job as controller of a large manufacturing company for consistently not performing his duties. Mr. Jones admitted that he had not performed his job up to the necessary standard but he still took his former employer to court for wrongful dismissal. In court he won his case on a technicality and was awarded $50,000 as damages with no award for back pay. Mr. Jones was delighted with the award since he would not have to include damages in income, whereas he would have had to include an award for back pay in his income. Comment.

(2) Andy and Sara agreed to a separation agreement that requires Andy to pay $1,500 per month to Sara as an allowance for her maintenance and also to pay $500 per month directly to the financial institution that holds the mortgage on her home. Comment on the deductibility of these payments.

(3) Sally received a loan from her employer to pay for her expenses while she returned to university. The agreement was that if she returned to work for her employer when she graduated the loan would be forgiven. If she did not return to work for her employer the loan would have to be repaid in full. How would this be treated for tax purposes?

(4) Hugo was in an accident last year and has been receiving payments from Workers' Compensation. He is now trying to complete his tax return and is going to ignore these payments and not include them in his return at all. Is this correct?

(5) Last year Wally, age 20, received a personal injury award settlement of $1,500,000 for a car accident he was in two years earlier. He earned $150,000 of interest income on this award during the year and now he wants to know how much tax he will have to pay on it.

(6) What are the major advantages of an RRSP?

(7) Joe can contribute up to $12,000 to his RRSP for the year. He does not have that much cash but he does have stocks worth that much. He has heard that he can contribute these shares into his RRSP. Given that he

wants to keep the same stocks and that these particular shares qualify, what are some of the tax consequences of this transfer?

(8) Mrs. Little's employer was cutting staff, and as part of the process offered a generous retirement package made up of a retiring allowance and pension benefits. Mrs. Little and her husband discussed the matter and decided that after 30 pre-'96 years with the company she wanted to do something else so she accepted the offer. During the first year of her retirement her only income consisted of $30,000 as a retiring allowance and $45,000 of pension income. How much of this can she contribute to an RRSP and receive a deduction for?

(9) For normal RRSP contributions, an individual has until 60 days after December 31 to make his or her contribution and still have it deductible for the year. Why does the same 60-day extension not exist for the year in which the individual turns 71?

Discussion Notes for Short Questions

(1) The definition of "retiring allowance" [ssec. 248(1)] includes an amount received "in respect of a loss of an office or employment of a taxpayer, whether or not received as, on account or in lieu of payment of, damages or pursuant to an order or judgment of a competent tribunal." So, even though he received damages, the amount must be included in income [spar. 56(1)(*a*)(ii)]. This amount is eligible for transfer to an RRSP within the limits imposed by paragraph 60(*j*.1).

(2) Under this agreement, the monthly fees paid to the financial institution do not qualify as an allowance since Sara does not have any discretion as to the use of the amount and the amount is in addition to the spousal maintenance payment specified in the agreement.

(3) According to IT-340R, the loan would not be included in income when received. Instead, it would only be included in employment income in the year that it is forgiven [ssec. 6(15)]. Presumably, Sally would be assessed a deemed interest benefit [ssec. 80.4(1)] during the period of the loan. Then, if the principal amount of the loan is included in her income, she could amend prior years' returns to exclude the deemed interest benefit from income [par. 80.4(3)(*b*)].

(4) Workers' Compensation payments are included in net income [par. 56(1)(*v*)]. Therefore, the payments should be included on his tax return. However, the same amount is deducted in arriving at taxable income [par. 110(1)(*f*)]. Thus, there is no effect on taxable income. However, the income inclusion may reduce the amount of the personal tax credit that a related person might try to claim.

(5) Income earned or capital gains realized on a personal injury award settlement is not taxable until the year after the year in which the individual turned 21 years of age [par. 81(1)(*g*.1)].

(6) The two major advantages of an RRSP relate to tax deferral. One major advantage of an RRSP is that the income earned on the funds within the plan can be accumulated tax free until the funds are withdrawn from the plan. A second advantage is the deduction for the contribution of the funds to the plan. While this initial deduction may be offset to some extent by the tax on the withdrawal of the funds from the plan, the tax is deferred for what may be a long period of time.

(7) The following are some of the tax consequences of transferring shares to an RRSP:

- (a) the plan will need to be a self-administered plan in order to accept the assets being transferred, and
- (b) the shares will be deemed to be disposed of at fair market value on the transfer to the RRSP. Any capital gains will be recognized at the time of the transfer. Any capital losses will be denied [spar. 40(2)(*g*)(iv)].

(8) Based on 30 pre-'96 years of service, she should be able to contribute the full $30,000 to her RRSP as a retiring allowance [par. 60(*j*.1)]. In addition, she could make a contribution to either her or her husband's RRSP based on her earned income in the prior year adjusted for her pension adjustment. Neither the retiring allowance nor the pension income could be categorized as "earned income" so no further contribution could be made on this basis either in the current or the next year.

(9) By the end of the year in which an individual turns 71, he or she has to either cash in the plan, transfer it to an RRIF or purchase a retirement annuity. As a result, as at December 31 of that year, the RRSP ceases to exist and there is nothing to which a contribution can be made within the 60 days following the year.

CHAPTER 10
Computation of Taxable Income and Taxes Payable for Individuals

Short Questions

(1) Ms. X earns $20,000 of employment income and has come to you to talk about her investment income. She earns $1,000 of dividend income from a Canadian-resident public corporation in the year. She wants you to tell her what her marginal tax rate is on this dividend income.

(2) Mr. Y earns $20,000 of employment income and has come to you to talk about his investment income. He earns $1,000 of interest income in the year. He wants you to tell him what his marginal tax rate is on this interest income.

(3) Ms. Z earns $20,000 of employment income and has come to you to talk about her investment income. She realized $1,000 of capital gain in the year. She wants you to tell her what her marginal tax rate is on this capital gain.

(4) Art Smith is an executive in the top tax bracket who collects antique cars. These antiques are capital property, not inventory, to him. He is planning to donate one of these cars to a local charity to be used in one of their fund-raising events. The value of the car is $20,000 and his cost of the car is $2,000. He knows there are special rules for the donation of capital property, but he does not know if these rules will help him. He has already made donations of $5,000. What is your advice?

(5) Ms. Lee found that when she did her personal tax return her personal credits far exceeded her federal tax. Her federal tax was $900 and yet she had a basic personal credit of $1,557 as well as charitable donation credits of $400. Is there anything she can do to maximize her potential benefits from this situation?

Discussion Notes for Short Questions

(1) Her marginal tax rate on dividend income would be:

Cash dividend	$ 1,000
Gross-up @ 44%	440
Taxable dividend	$ 1,440
Federal and provincial tax @ 25%	$ 360
Dividend tax credit ((18% + 12%) of $1,440)	(432)
Total tax	$ Nil

Marginal tax rate on dividends is nil/$1,000 = nil. The excess dividend tax credit of $72 (i.e., $432 − $360) can be used to reduce income tax on other sources of income.

(2) His marginal tax rate on interest income would be:

Interest earned	$ 1,000
Federal and provincial tax @ 25%	$ 250

Marginal tax rate on interest is $250/$1,000 = 25%

(3) Her marginal tax rate on capital gains would be:

Capital gain	$ 1,000
Taxable capital gain ($^1/_2$)	$ 500
Federal and provincial tax @ 25%	$ 125

Marginal tax rate on capital gain is $125/$1,000 = 12.5%.

(4) Subsection 118.1(6) allows an individual to designate the proceeds of the capital property at anywhere between the cost and the fair market value, in this case between $2,000 and $20,000. Looking at the alternatives:

(a) If he designates $2,000 he will report no net income on the disposition since his proceeds equal his cost. However, he will receive a donation receipt for $2,000 which is worth an incremental federal credit of $2,000 × 29% = $580.

(b) If he designated $20,000 as the proceeds, he would report a capital gain of $18,000 and include $^1/_2$ or $9,000 in income as a taxable capital gain. He would have additional federal tax of 29% x $12,000 = $3,480. He will also receive a donation receipt for $20,000 which will generate a federal credit of $20,000 × 29% = $5,800. On a net federal basis he would have a net federal credit from this alternative of $2,320 (i.e., $5,800 – $3,480).

On a net basis, he would be further ahead to designate the full $20,000 as the proceeds.

(5) Under the ordering rules for personal credits [sec. 118.92], the basic credit must be claimed before the charitable donation credit. Since neither of these credits is refundable, Ms. Lee will be unable to receive a refund for this year. However, she can carry her donations forward for five years so she should not claim any donations this year, but carry them forward to see if she can claim them at a later time.

CHAPTER 11
Computation of Taxable Income and Tax After General Reductions for Corporations

Short Questions

(1) In its current fiscal year, Smithco has had a business loss of $20,000 and a taxable capital gain of $30,000. The corporation also has the following loss carryovers from the previous year: a non-capital loss of $20,000 and an adjusted net capital loss of $20,000. The owner-manager has asked you to explain to him how he has to apply the losses and what the company's loss carryforward will be.

(2) Mr. Smith has just bought the shares of a company that has a non-capital loss carryover. This carryover includes a loss on a rental property. He is anxious to amalgamate the loss company with his company to use up these losses. Comment on the plan.

(3) Mr. Elliott owned all the outstanding common shares of XYZ Co. until May 1 of this year, when he sold 50% of these shares to Mr. Ng as part of his plan to retire. There are no other shares outstanding. Does subsection 249(4) apply to deem a year-end at the time he sold the shares? Explain.

(4) Retail Co. has been having difficulty making money lately and the owner, Mr. Ed, has decided to sell the company to a competitor. One of Mr. Ed's problems is that his inventory has declined in value due to cheap imports. However, the purchaser sees this as a benefit since Mr. Ed valued his inventory at cost for both accounting and tax purposes. Once the purchase takes place, the purchaser will implement a tax plan to use these accrued inventory losses as a deduction against the income of his profitable company. Comment on the tax issues. Ignore any accounting issues.

(5) Pop Eye has the largest spinach store in the province. In order to assure himself of a constant supply of the best spinach, he has bought a spinach processor that has been in financial difficulty in recent years and has some non-capital losses that are about to expire. Pop plans to combine the two companies on a tax-free basis two months after the acquisition in order to use the losses of the processor against his retail profits. Comment on the plan.

(6) On December 31 of last year, all the shares of RustyCo were acquired and a deemed year-end took place. RustyCo has non-capital losses of $50,000 being carried forward. During this year, the company realized profits of $20,000 from the same business, a rental profit of $10,000 and a taxable capital gain of $15,000. How much of the loss carryover balance can be applied this year? Explain why.

(7) Holdco had bought 25% of the shares of Opco five years ago for $500,000. Over the period of ownership it has received dividends of $150,000, including $40,000 of capital dividends. Holdco has just sold these shares for $300,000 and is using the $200,000 capital loss to offset a $300,000 capital gain on another sale. Comment on the tax effects in the year the shares are sold.

(8) Hi Tech is a company that has recently gone to the public market for financing and its shares are now trading over-the-counter in Toronto. The majority of the shares are still held by the founder who is a resident of London, Ontario. The controller has just panicked when he realized that the company needs to be a CCPC in order to get the SR&ED investment tax credits. He has asked you to determine whether it is still a CCPC. What do you think?

(9) You are reviewing the working papers of one of your corporate clients that is in the electronics business. You have just noticed that the corporation has expensed the cost of some scientific equipment. While it is not material for financial statement purposes you are wondering whether these expenses should be capitalized for tax purposes since paragraph 18(1)(*b*) specifically denies this type of deduction. Is there any way you can justify the deduction?

Discussion Notes for Short Questions

(1) Under Division B, the business loss is applied against the taxable capital gain to bring Division B income down to $10,000. Then either the net capital losses or the non-capital losses can be applied against this net income. The choice is based on which carryover is the more restrictive, given the circumstances and future expectations of the company. If non-capital losses are the better choice, then the $20,000 of net capital losses carried forward can be deducted against the $30,000 of net taxable capital gains in the year. Although this procedure would have no effect on taxable income, the non-capital losses will be increased by the net capital loss claimed, thereby reinstating $10,000 of the $20,000 business loss in the year. As a result, net capital losses would be fully absorbed and non-capital losses available for carryforward would equal $30,000 (i.e., $20,000 + $10,000).

(2) On the acquisition of control any loss from property expires since this loss is not a loss from a business [par. 111(4)(*a*)]. His only hope is that the acquired company has some assets with accrued gains to which paragraph 111(4)(*e*) could apply to create income to offset this property loss in the deemed year-end.

(3) A deemed year-end takes place when there has been an acquisition of control over the voting rights of the corporation. In this case there has been a change in control since Mr. Elliott used to control the company and now it is controlled by both Mr. Elliott and Mr. Ng. However, even though Mr. Ng has not acquired voting control of the corporation, which is a requirement for subsection 249(4) to apply, the group of Mr. Elliott and Mr. Ng has acquired control and, thus, the acquisition of control rules could apply.

(4) On the acquisition of control, a year-end is deemed to have occurred on the day immediately before the acquisition of control. Since there is a deemed year-end the inventory has to be valued for tax purposes. Inventory has to be valued at the lower of cost and market or in any other manner as allowed by regulation [ssec. 10(1)]. Regulation 1801 allows inventory to be valued at market as long as all inventory is valued this way. Since the value of the inventory has gone down in value Retail Co. will have to recognize the inventory loss in the deemed year-end immediately before the acquisition of control. Unless Retail Co. can offset this loss through a paragraph 111(4)(*e*) election, the loss will form part of the non-capital losses and can only be used against income from the "same business" or from the sale of similar products.

(5) At the time Pop acquired control there was a deemed year-end of the processing company [ssec. 249(4)]. This would cause one year of the non-capital loss carryover period to expire. Also, consideration has to be given to whether the two companies sell similar products. IT-206R, paragraph 3, indicates that these two businesses could be considered to be one business since they are vertically integrated businesses and, therefore, the losses of the processor could be applied to the income of the retailer. Keep in mind that in cases of significant dollar value, you may not want to rely totally on the Interpretation Bulletin to justify "a similar product or service." You will want to also build up a business case for this position.

(6) Pre-acquisition losses can only be applied against income from the "same business" or from the sale of similar products [par. 111(5)(*a*)]. In this case, the only income from the same business is the $20,000. The rental profits and the taxable capital gain are not income from a business and therefore cannot be offset.

(7) Although Holdco has held these shares for greater than 365 days (i.e., 5 years), Holdco owns more than 5% of the shares of Opco. Subsection 112(3) would apply to cause the capital loss on the sale to be reduced by both the dividends deductible under subsection 112(1) and the capital dividends. In this case, the capital loss of $200,000 would be reduced by $150,000 to $50,000. This reduced loss could then be applied to the $300,000 capital gain otherwise realized.

(8) In order to be a CCPC, the company has to be Canadian-controlled. In this case, Hi Tech qualifies, since it is controlled by an Ontario resident. In addition, Hi Tech also has to be a private corporation which is defined in paragraph 89(1)(*f*) where one of the criteria is that it is not a public corporation. A public corporation is defined [par. 89(1)(*g*)] to include any company which has any class of shares trading on a designated stock exchange in Canada. Section 262 provides for a list of these stock exchanges. However, in this case, Hi Tech is not listed on a designated stock exchange since its shares are only trading over the counter. Therefore, Hi Tech would not be considered to be a public corporation, unless it has elected to be one [par. 89(1)(*g*)], and would still be considered to be a CCPC.

(9) If the equipment is to be used in "scientific research and experimental development" then paragraph 37(1)(*b*) will allow the deduction of capital expenditures. Subsection 37(6) then deems the amount deducted to have been claimed as CCA and the asset to be in a separate class. This will provide for the sale of the asset to generate immediate recapture. A deduction for capital expenditures for buildings is specifically denied [par. 37(7)(*f*)].

CHAPTER 12
Integration for Business and Investment Income of the Private Corporation

Short Questions

(1) Ms. Jones inherited $2 million from her mother and has transferred the capital to a company that she has incorporated. Her intention is to spend 40 hours a week investing this money to earn interest income on first and second mortgages. Given the high level of activity, will this income qualify for the small business deduction?

(2) Mr. X owns 100% of Holdco Ltd. which in turn owns 100% of three operating companies. Each of these operating companies carries on an active business primarily in Canada. Holdco Ltd. employs Mr. X and charges each of the operating companies $40,000 as management fees for Mr. X's time. Mr. X gets paid from Holdco Ltd. and is the president and chairman of each of the operating companies as well as Holdco Ltd. Discuss how Holdco Ltd. will be taxed.

(3) Describe the three different types of control found in the association rules.

(4) Mr. Al owns 45% of the shares of Holdco which in turn owns all the shares of Opco. Discuss whether Mr. Al owns any shares in Opco for purposes of the associated company rules.

(5) What is the relevance of the term "specified class" in section 256?

(6) When considering whether to incorporate, one should determine whether there will be any tax savings or tax deferral. If someone is considering the incorporation of active business income, how can he or she achieve tax deferral through the use of a company? What will be the amount of the deferral assuming he or she is in the top tax bracket? Also assume a provincial rate of 10% for corporations.

(7) What tax rules prevent an individual from deferring a significant amount of tax on interest income by flowing it through a corporation?

(8) Mr. Boss owns all the shares of Opco Ltd., a CCPC carrying on an active business in Canada. In recent years Opco Ltd. has done very well and its income is well in excess of the business limit. Last year he incorporated Rentco Ltd. to own land and building that is rented to Opco Ltd. The rent charged to Opco Ltd. amounts to $80,000 per year. How will this rental income be taxed in Rentco Ltd.?

(9) Why did the government introduce the rules in subsection 129(6) to deem what would otherwise be investment income to be active business income?

(10) Comment on the statement that "no tax is payable on dividends received from connected corporations."

(11) A number of years ago a reorganization was undertaken and now Aco Ltd. owns voting preferred shares in Bco Ltd. These preferred shares have 70% of the votes and are now only worth 7% of the value. The other shares of Bco Ltd. are owned by an unrelated party. Are Aco Ltd. and Bco. Ltd. connected?

(12) A number of years ago a reorganization was undertaken and now Cco Ltd. owns voting preferred shares in Dco Ltd. These preferred shares have 10% of the votes and are now worth 20% of the value. The other shares of Dco Ltd. are owned by an unrelated party. Are Cco Ltd. and Dco Ltd. connected?

Discussion Notes for Short Questions

(1) Since the corporation is earning interest income and does not have more than five full-time employees throughout the year it will be considered to be a "specified investment business" [par. 125(7)(*e*)]. Even though she spends all of her time on this activity it will still not qualify for the small business deduction. However, the income will qualify for the refundable tax treatment.

(2) Holdco Ltd. could be considered to be a "personal services business" since Mr. X performs the services and is a specified shareholder of the corporation. However, there is an exception from this definition if Holdco Ltd. is associated with each of the payer companies. In this case they are associated. Therefore, Holdco Ltd. is not a "personal services business" and, since it is not a "specified investment business," it will be eligible for the small business deduction. Keep in mind that it will have to share the small business deduction with all of the operating companies since they are associated.

(3) (a) Legal ("*de jure*") control means the ownership of such a number of shares as carries with it the right to a majority of the votes in the election of the Board of Directors. Legal control flows through a corporation. For example, if Mr. X controls Holdco with 55% of the votes and Holdco in turn controls Opco with 55% of the votes, then Mr. X controls Opco.

(b) Actual ("*de facto*") control extends the concept of control to situations where "at any time the controller has any direct or indirect influence that, if exercised, would result in control in fact of the corporation" [ssec. 256(5.1)].

(c) Deemed control extends the meaning *of* "*de jure*" and "*de facto*" control. Paragraph 256(1.2)(*b*) extends the meaning of control to a group of persons even though one of the group may have *de jure* control already. Paragraph 256(1.2)(*c*) also extends the meaning of control to a person who owns more than 50% of the fair market value of all the outstanding shares of the corporation or more than 50% of the fair market value of the common shares of the corporation. Subsection 256(1.4) deems both control and ownership where certain options and rights are in place to acquire shares or cause the corporation to buy back shares of the corporation. Often these rights are found in the shareholder agreement.

(4) Paragraph 256(1.2)(*d*) deems Mr. Al to own his proportionate share of the shares of Opco that he owns through Holdco. In this case, Mr. Al would be deemed to own 45% of the shares of Opco. The proportions in paragraph 256(1.2)(*d*) are based on the proportion that the fair market value of the shares that Mr. Al owns in Holdco is of the total fair market value of all shares of Holdco.

(5) This term is defined in subsection 256(1.1) and is applicable to subsection 256(1) where this type of share is excluded from consideration when determining ownership of shares. One might then be concerned that subsection 256(1.2) could apply to deem control. However, subsection 256(1.6) deems the specified class of shares to be ignored for purposes of subsections 256(1.2) and (1.4) and instead to be considered as debt of the corporation. This, however, still leaves the question of whether control in fact [ssec. 256(5.1)] applies.

(6) Tax deferral is what is achieved by having the income taxed in the company and leaving the after-tax cash in the company rather than taking it out as dividends. In order to determine the amount of the deferral you need to compare the tax paid in the company with the tax he or she would have paid if he or she had earned the income directly. On income eligible for the small business deduction (using a theoretical provincial tax rate of 10%) the corporation would have paid 21% tax. If one had earned this income personally and been taxed at the top rates, the individual would have paid 46% (i.e., 29% + 17%)). Thus he or she will achieve a tax deferral of 25% (46% – 21%) by leaving the after-tax cash in the company instead of taking it out as a dividend.

(7) By initially taxing interest income at the top corporate tax rates the Act minimizes the tax deferral available. If, for example, the highest personal tax rate is 46% (see (6) above) and the highest corporate tax rate hovers around 42% plus the 6 $^{2}/_{3}$% ART, then there is no deferral available.

(8) Ordinarily the rental income would be taxed as investment income at the full rates (i.e., 38% + 6$^{2}/_{3}$%) with part of this being classified as refundable Part I tax (i.e., 26$^{2}/_{3}$%) and added to the Refundable Dividend Tax on Hand account resulting in a theoretical rate of 18% after a dividend refund of 26$^{2}/_{3}$%. However, since the two companies are associated and the rent is being deducted against the active business income of Opco, an associated corporation, subsection 129(6) will deem the rental income to be active business income and not eligible for the refundable tax treatment. Opco and Rentco are associated since they are both controlled by Mr. Boss [par. 256(1)(*a*)].

(9) The government is concerned that companies earning active business income in excess of the business limit of $500,000 will convert active business income that would otherwise be taxed at the top corporate rates into property income eligible for the refundable tax system through interest and rental charges.

(10) Dividends received from corporations resident in Canada are included in net income [ssec. 82(1)] and are deducted [ssec. 112(1)] in arriving at taxable income. As a result, they are not taxable under Part I.

However, Part IV tax applies to dividends that are deducted [ssec. 112(1)], other than dividends from connected corporations, unless the payer corporation received a dividend refund. If the payer corporation received a dividend refund then the recipient corporation will pay Part IV tax equal to its proportion of the dividend refund. Thus, the only time Part IV tax is payable on dividends from connected corporations is when the payer received a dividend refund.

(11) Aco Ltd. and Bco Ltd. are connected [ssec. 186(4)]. While Aco Ltd. does not own more than 10% of votes *and* value, Aco Ltd. does control Bco Ltd. [ssec. 186(2)], as a result of its having 70% of the votes.

(12) Cco Ltd. and Dco Ltd. are not connected [ssec. 186(4)]. Cco Ltd. does not own *more than* 10% of votes *and* value and Cco Ltd. does not control Dco Ltd. [ssec. 186(2)].

CHAPTER 13
Planning the Use of a Corporation and Shareholder-Manager Remuneration

Short Questions

(1) Mr. Big is the sole shareholder of a very successful private corporation. In order to prevent double tax he has just declared a bonus from the company to himself in the amount of $800,000 which is in addition to his salary of $72,000. Discuss the deductibility of this bonus.

(2) Discuss whether there are any benefits to having the ability to declare a bonus in one calendar year and not pay it until the following calendar year.

(3) Ms. Leeper owns all the shares of Opco Ltd. and has declared and paid a large bonus to herself in each of the past five years. She has taken the money and personally bought a building that she is renting back to the company at an annual rent of $50,000. The company has a December 31 year-end. Is there any way that Ms. Leeper can defer the reporting of the $50,000 per year of rental income while the company is deducting the rent expense annually? Explain why or why not.

(4) Dad owns all the shares of both Opco Ltd. and Realco Ltd. Opco Ltd. is carrying on an active business and Realco Ltd. owns the real estate and rents it to Opco Ltd. Is there any way that Realco Ltd. can defer the reporting of the rental income while Opco Ltd. is deducting the rental expense annually? Explain why or why not.

(5) On December 31 of last year, the fiscal year-end of the company, a bonus was declared payable to the plant managers in the amount of $10,000 in total. This is considered to be a reasonable amount. However, since the company did have some cash flow constraints the directors' resolution stated that the bonus was only payable if, as or when the cash was available in the corporation. On May 31 of this year, the cash became available and the bonus was paid. Discuss the deductibility of the bonus accrual at the December 31 year-end of the previous year.

(6) Mom and Dad did an estate freeze four years ago and all three of their adult children became common shareholders along with a long-time employee. Two of the three children are active in the company and the third lives in another province and has no interest in the company. The long-time employee has just retired and the three children have bought her shares with the help of an interest-free loan from the company. Discuss the tax implications of the loan to the children.

(7) On May 31, 2008, Opco Ltd. loaned its sole shareholder, Mr. Bolt, $100,000 to buy a boat. $50,000 of this loan was repaid on May 31, 2009 and the balance was repaid on May 31, 2010. Opco Ltd. has an April 30 year-end. With hindsight, what are the tax implications of this transaction?

(8) Mr. Moyer, as president, decided to move his corporation from Dundas to London, Ontario in order to improve his quality of life. As a result of the move he decided to borrow $100,000 from the corporation to buy a house in Arva, just outside the city. The loan is to be repaid over 15 years with no interest being charged. None of the other employees received such a loan. What are the tax implications to Mr. Moyer from this loan?

(9) Ms. Shaker borrowed $100,000 from her company on February 1 of last year to invest on the stock market. She repaid the loan on December 1 of this year. The year-end of the company is December 31. What are the tax implications to Ms. Shaker?

(10) Mr. Shantz, who owns a construction company, has used a slow period in the construction industry to have some of his men build a boathouse at his cottage. Most of the materials were those left over from other construction jobs and the men were otherwise not busy. Mr. Shantz did not reimburse the company for any of the costs on the basis that it really did not cost the company anything extra. Comment.

(11) Mr. Scott, who is the President and sole shareholder of Scott's Tax Practice Inc., has taken a loan from the company to buy a cottage for use by himself and his family during the summer months. He has had a note drawn up to repay the loan over 20 years with no interest. All other employees of the corporation are eligible for similar loans on similar terms. Comment.

(12) Ms. Kelly is the sole shareholder and President of her own company which has a December 31 year-end. She has borrowed money from the company over the past year for personal purposes and cannot afford to repay the loan by the end of the fiscal year. She decides that she will take out a short-term loan at the bank, repay the shareholder advances in December and then reborrow from the company in January to pay off the bank. Comment.

(13) If a holding company is used to collect tax-free dividends from a connected small business corporation, what impact might this have on the ability of the individual shareholders of Holdco to claim the $750,000 of capital gains exemption?

(14) Big Bob started a company 20 years ago and built up the value of the family business which is a small business corporation. On his death, he left all the shares to his daughter, Little Bobbi. After one year of struggling she decided that she would like to start a different business, so she sold shares of the family business. Will the shares she is selling be qualifying small business corporation shares?

(15) Mrs. Jones owns all the shares of an SBC, Opco Ltd. Five years ago her husband incorporated a separate company, Rentco Ltd., that bought the land and building that is now used in the business. Rentco Ltd. charges rent to Opco Ltd. for the use of the property. Rentco Ltd. and Opco Ltd. are not associated. Mr. Jones has just received a generous offer for all the shares of Rentco Ltd. and he has come to you to see how much capital gains exemption he is entitled to. Advise him.

Discussion Notes for Short Questions

(1) No expense is deductible unless it is reasonable in the circumstances [sec. 67]. In this case it may be argued that the bonus is of such a magnitude that it is unreasonable compared to his normal salary. On the other hand, you could argue that his normal salary is kept unreasonably low and his bonus is part of his regular compensation. In addition, the CRA may not care since he will end up paying more tax on the bonus than the corporation would have paid on the same income.

The deduction may also be challenged if there is no legal obligation to pay the bonus. The legal liability might occur if the bonus is calculated based on a written company compensation system. The liability might also be established if there was a directors' resolution approving the bonus in the first place.

(2) The major benefit would be the ability to choose to have the bonus taxed in whichever year the personal tax rate is lower. In addition, there may be a tax deferral advantage in that the corporation gets the benefit of the deduction in the fiscal year it is accrued and the bonus is subject to tax in the return for the calendar year in which it is paid. However, this advantage would be reduced by the fact that tax is required to be withheld at the corporate level at the time the bonus is paid.

(3) The company may deduct the rent expense annually as long as the accrued liability is paid before the end of the second taxation year after the end of the fiscal year in which it is accrued [ssec. 78(1)]. Alternatively, the corporation and Ms. Leeper can file an election (by the due date of the tax return for the third taxation year) to treat the accrued amount as income to Ms. Leeper on the first day of the third taxation year.

(4) Since the rental income is being earned by a corporation, the rental income has to be reported on the accrual basis by Realco. Therefore, there is no way to defer the reporting of the rental income.

(5) As at December 31, there was no legal liability for the bonus since it was only payable "if, as or when the cash is available." Therefore, the accrual is not deductible. In order to be deductible, a liability must be established and the liability cannot be contingent on some future event.

(6) Since the two children are shareholders, subsection 15(2) would apply to include the loans in their income in the year the loans were made, unless they were repaid within one year from the end of the Opco Ltd. year-end [ssec. 15(2.6)]. The exception in paragraph 15(2.4)(*c*) does not apply, since the shares were acquired from a long-time employee and not issued by the corporation. In addition, that exception would not apply if the children were acting in their capacity as shareholders, rather than as employees [par. 15(2.4)(*e*)].

(7) For 2008, Mr. Bolt will include $50,000 in income [ssec. 15(2)] through an *amended* return, since this part of the loan was not repaid within one year of April 30, 2009 (the corporation's year-end), as required by subsection 15(2.6), and the loan did not meet one of the exceptions in subsection 15(2.4). In addition, section 80.4 will apply to deem an interest benefit based on the $100,000 for the days outstanding in 2008. A similar calculation would be required for 2009, based on the outstanding amount during the particular time period (i.e., $100,000 and $50,000). However, when the amended return is filed for 2008 for the subsection 15(2) inclusion of $50,000, the imputed interest thereon can be reversed out [ssec. 80.4(3)]. Mr. Bolt would get a deduction in 2010 for the $50,000 repaid on May 31, 2010 [par. 20(1)(*j*)].

(8) Although the exception in paragraph 15(2.4)(*b*) is met and *bona fide* arrangements have been made for repayment within a reasonable time and he is an employee, it appears that Mr. Moyer received the loan in his capacity as a shareholder. Therefore, the loan must be included in income [par. 15(2.4)(*e*)].

(9) Even though the exceptions in paragraphs 15(2.4)(*c*) and (*e*) are not met, this loan will not have to be taken into income since it was repaid on or before December 31 of the year following the year in which the loan was made. However, section 80.4 will apply to deem an interest benefit in each of the two years. This deemed

interest benefit will also be eligible for a deduction as interest expense since she borrowed to earn investment income. This deduction is provided through section 80.5 and paragraph 20(1)(*c*).

(10) Mr. Shantz will likely have a benefit added to his income under subsection 15(1) equal to the value of the work that was done and the materials that were used, since it is clear that he did receive a benefit from his company. This will be income from property and not a dividend.

(11) Since Mr. Scott is a shareholder who received a loan, subsection 15(2) needs to be considered. Since he owns all of the shares, he is a specified employee, he cannot use the exception in paragraph 15(2.4)(*a*). However, paragraph 15(2.4)(*b*) provides an exception for loans to "employees" who borrow to acquire a dwelling for their habitation. As President, Mr. Scott is an employee and the cottage does qualify as a dwelling for his habitation under IT-119R4. Therefore, he will not have to include the principal amount of the loan in income, since he can be considered to have received the loan because of his employment rather than his shareholdings, other employees are eligible for similar loans, and *bona fide* arrangements were made at the time of the loan for repayment within a reasonable period (i.e., 20 years). There will be a deemed interest benefit under section 80.4.

(12) These transactions will probably be considered to be a series of loans and repayments and if the loan were effectively outstanding over two year-ends it would be included in her income under subsection 15(2). Although the loan was paid off by the end of the fiscal year and did not show up on the financial statements, the intention was that the loan remain outstanding. Subsection 15(2.6) contemplates a series of loans and repayments and IT-119R4 comments on it.

(13) The accumulation of cash in a holding company without using that cash to invest in active business assets or shares or debt of connected small business corporations may cause the holding company to no longer qualify as a "small business corporation" since the corporation may not have "all or substantially all of the fair market value of its assets" invested in qualified assets.

(14) The shares must meet the Holding Period Test in order to be QSBC shares. In this case they will qualify since, even though she only held the shares for one year, a related person, her father, owned the shares for 20 years before that. See paragraph (*b*) of the QSBC share definition in subsection 110.6(1).

(15) The definition of small business corporation includes assets used in an active business carried on by a corporation related to it [ssec. 248(1)]. In this case, even though Opco and Rentco are not associated, they are related [par. 251(2)(*b*)]. Therefore, since he has held the shares for over two years and all the assets are used in an active business of a related corporation for the past five years the shares should qualify as QSBCS.

CHAPTER 14
Rights and Obligations Under the Income Tax Act

<u>Short Questions</u>

(1) Mr. Lyons has come to you to prepare his personal tax return. After you have finished, he tells you that he probably will not file the return by April 30 since he does not have the money to pay his tax liability. He does not have any proprietorship business income. What advice do you have for him and why?

(2) Mr. Kuntz was required to make quarterly instalments for last year. However, due to poor cash flow he was unable to make any payments until he filed his tax return in April of this year. What interest charges and penalties will he be faced with?

(3) Four, five and six years ago, Mr. Cameron had a number of real estate transactions. He did not report any of these since he could not bring himself to pay all the tax that was owing. He is now breathing a sigh of relief since these transactions are now beyond the three-year reassessment period. What do you think?

(4) One of your dentist clients has overpaid her instalments for the year and has come to you in January of the following year to see if she will be able to collect interest from the CRA on these overpaid instalments. What do you think?

(5) On the Edge Inc. has lost money in past years and now some of the non-capital loss carryforwards are about to expire. It has always been in the manufacturing business and its bad debts have been high. Is there anything On the Edge Inc. can do to preserve some of those losses that are about to expire?

(6) Ms. Chai is in serious cash flow trouble in her company Red Inc. In order to prevent exceeding her bank line of credit she is planning to defer payment of the employee payroll withholdings to the CRA. What advice do you have for her?

Discussion Notes for Short Questions

(1) While he will be charged interest on the unpaid taxes [sec. 161], by filing the return he will be able to avoid the late filing penalty of 5% of the unpaid taxes plus 1% per month for up to 12 months [ssec. 162(1)]. Therefore, he should file by April 30 to avoid these penalties. He can pay his tax liability later.

(2) Interest is imposed on deficient instalments from the day the instalment should have been made until the earlier of the day it was actually made and April 30 of the following year [ssec. 161(2)]. In addition, a penalty may be imposed equal to 50% of the amount by which the interest charged under section 161 exceeds the greater of $1,000 and 25% of the interest that would have been charged under section 161 in respect of all instalments if no instalments had been made for that year [sec. 163.1].

(3) the CRA is allowed to reassess at any time if there is any misrepresentation attributable to neglect, carelessness or wilful default [par. 152(4)(*a*)]. In this case they would be able to reassess those years given that he knew about the income and chose not to report it.

(4) Interest is levied at the prescribed rate plus an additional 2% on overpayments of tax by non-corporate taxpayers [ssec. 164(3)] from the latest of:

(a) the day the overpayment arose,

(b) 30 days after the day on which the return was or would have been due (i.e., April 30th), and

(c) 30 days after the day the return was actually filed.

Therefore the recommendation to your client should be to file her tax return by April 30 in order to start the clock.

(5) In order to reduce the loss carryovers it may be possible to go back to those prior years and amend the returns to reduce the discretionary deductions such as CCA [par. 20(1)(*a*)] and the allowance for doubtful debts [par. 20(1)(*l*)]. This action will take these “accrued losses” and allow them to be effectively carried forward indefinitely within the CCA pools and the accounts receivable. However, the CRA will only allow these prior year revisions to take place if there is no change to the taxes payable in those prior years. This policy is outlined in IC 84-1.

(6) Any person who fails to remit the employee withholding is liable for a penalty of 10% of the tax that should have been remitted together with interest [ssec. 227(9)]. If there is a second or further occurrence, then the penalty increases to 20%. In addition, the directors may be personally liable for the unpaid withholding taxes [sec. 227.1].

CHAPTER 1
Introduction

Solution 1 (Basic)

The following summary is discussed in more detail below:

Case	*Topic*	*Part*	*Division*	*Subdivision*	*Provision*
(A)	Person..	XVII	—	—	subsection 248(1)
(B)	Donation by individual...........................	I	E	a	subsection 118.1(3)
(C)	Balance-due day.....................................	XVII	—	—	subsection 248(1)
(D)	Life insurance premiums........................	I	B	a	subsection 6(4)
(E)	Capital dividend.....................................	I	B	h	subsection 83(2)
(F)	Income tax instalments for individual.....	I	I	—	subsection 156(1)
(G)	Qualified small business corporation share	I	C	—	subsection 110.6(1)
(H)	Information return for dividends............	—	—	—	Reg. Part II, paragraph 201(1)(*a*)
(I)	Definition of testamentary trust..............	I	B	k	subsection 108(1)
(J)	Employee loan..	I	B	f	subsection 80.4(1)
(K)	Disposition of non-depreciable capital property..	XVII	—	—	subsection 248(1)
(L)	RRSP administration fees.......................	I	B	b	paragraph 18(1)(*u*)
(M)	Limit on deductible expenses.................	I	B	f	section 67
(N)	Taxable dividends received by Canadian corporation...	I	C	—	subsection 112(1)
(O)	RRSP excess contributions.....................	X.I	—	—	subsection 204.1(1)

(A) Person — Part XVII, subsection 248(1): The term is used throughout the Act, so it is likely to be found in the interpretation section. The definition is similar to many in the Act in that it does not tell you exactly what a person is; it tells you what a person includes.

(B) Donation by an individual — Part I, Division E, Subdivision a, subsection 118.1(3): Tax credits are found in Division E. Credits that are particular to individuals are found in Subdivision a of Division E.

(C) Balance-due day — Part XVII, subsection 248(1): The term has application to all tax filers and, therefore, should be found in the interpretation section. However, the term has a different meaning depending on the type of tax filer. For trusts and individuals, specific timing is provided. For corporations, the provision refers to section 157.

(D) Group term life insurance premiums paid by employer — Part I, Division B, Subdivision a, subsection 6(4): Payments made on behalf of an employee by an employer likely result in income from employment. Subdivision a includes the provisions for calculating income from employment.

(E) Capital dividend — Part XVII, subsection 248(1): The term is found in subsection 248(1) but a definition is not actually provided, only a reference. It refers to another section — Part I, Division B, Subdivision h, subsection 83(2): Capital dividends are tax-free distributions by a corporation to its shareholders, so the provision is likely to be found in Part I, Division B, Subdivision h that deals with corporations and their shareholders.

(F) Income tax instalments for an individual — Part I, Division I, subsection 156(1): The information that is required deals with payments to the CRA; therefore this information should be found in Division I dealing with returns, assessments, payment and appeals. [Some students may also identify subsection 155(1) as dealing with farmers and fishermen.]

(G) Qualified small business corporation share — Part I, Division C, subsection 110.6(1): The capital gains deduction that is available for qualified small business corporation shares is a deduction that is available in computing taxable income and is therefore found in Division C.

(H) Filing information return for dividends paid — Regulations Part II, subsection 201(1): The Regulations provide important detail regarding a number of the income tax rules. In order to ensure that individuals are advised of the information required to be reported on their personal tax returns (and to allow the CRA to ensure that the income is reported), corporations are required to file slips such as T5s for dividends paid.

(I) Testamentary trust — Part I, Division B, Subdivision k, subsection 108(1): The phrase describes a trust so it is likely that the definition will be found in Subdivision k dealing with trusts. Section 108 contains definitions for the subdivision.

(J) Interest-free loan benefit — Part I, Division B, Subdivision f, subsection 80.4(1): Since the amount relates to an employee, it might be expected that the provision would be found in section 6 (in fact the provision that requires an income inclusion is found in subsection 6(9)). However, the actual calculation of the amount of income is found in Subdivision f which contains rules related to the calculation of income.

(K) Disposition of non-depreciable capital property — Part XVII, subsection 248(1): The term "disposition" is used throughout the Act, so it is likely to be found in this definition section.

(L) Limit on deduction of RRSP administration fees — Part I, Division B, Subdivision b, paragraph 18(1)(*u*): At one time, when the fees were deductible, they were considered a carrying charge deductible in computing income from property. Therefore, the restriction on the deduction is found in section 18 which provides a list of items that are specifically not deductible in computing income from business or property.

(M) Limit on deductible expenses — Part I, Division B, Subdivision f, section 67: The restriction on the amount of deductible expenses applies throughout the Act. Therefore, the provision is found in general rules for computing income that are found in Subdivision f.

(N) Corporate dividend deduction — Part I, Division C, subsection 112(1): The concept deals with a deduction that is available to a corporation. It might be expected to be found in Division B, Subdivision b dealing with the calculation of income from property. However, in this case, the deduction is not considered to reduce income from property but is a general deduction available in computing taxable income.

(O) Excess RRSP contributions — Part X.I, subsection 204.1(1): This is a special tax that is found in the Act and applies when an individual has contributed more to an RRSP than is allowed by the Act. In this case, the special tax is intended to discourage people from taking advantage of the benefits of an RRSP beyond those that are provided for in the rules.

Solution 2 (Advanced)

Division B — Sec. 3					
Par. 3(*a*)	*Subdivision a: Employment income*				
	Sec. 5	Salary		$ 12,000	
	Sec. 5	Gratuities		12,100	
	Sec. 5	Bonus		500	
	Par. 6(1)(*a*)	Board and lodging		8,000	$ 32,600
	Less:				
	Par. 8(1)(*i*)	Union dues			100
					$ 32,500
	Subdivision b: Business or property income				
	Par. 12(1)(*c*)	Interest on Canada Savings Bonds		$ 775	
	Sec. 9	Rental revenue		6,000	
	Less:				
	Sec. 9, par. 18(1)(*a*)	Maintenance on rental property	$ 1,100		
	Sec. 9, par. 18(1)(*a*)	Property tax on rental property	1,000		
	Par. 20(1)(*a*)	Capital cost allowance	1,200		
	Par. 20(1)(*c*)	Mortgage interest	2,500	(5,800)	975
	Subdivision d: Miscellaneous sources				
	Par. 56(1)(*a*)	Employment insurance		$ 600	
	Par. 56(1)(*a*)	Retiring allowance		800	1,400
					$ 34,875
Par. 3(*b*)	*Subdivision c: Net taxable capital gains*				
	Par. 38(*a*)	Taxable capital gains		$ 3,750	
	Par. 38(*b*)	Allowable capital losses		(4,500)	Nil
					$ 34,875
Par. 3(c)	*Subdivision e: Miscellaneous deductions*				
	Par. 60(*o*)	Expense of objection to tax assessment		$ 65	
	Sec. 62	Moving expense		1,700	
	Sec. 63	Child care expense		1,800	(3,565)
					$ 31,310
Par. 3(*d*)	Losses from non-capital sources:				
	Sec. 9	Business: fitness instruction fees		$ 2,000	
	Less:				
	Sec. 9, par. 18(1)(*a*)	Business: expenses of earning fitness instruction fees	$ 900		
	Par. 20(1)(*a*)	Capital cost allowance	1,300		
	Par. 20(1)(*c*)	Business: Interest on borrowed funds	75	2,275	$ (275)
	Division B income				$ 31,035
Division C:	Deductions — Sec 111.1				
	Par. 111(1)(*a*)	Non-capital losses			(600)
Taxable income					$ 30,435

Division E: Basic federal tax — Sec. 118.92

Tax before credits		$ 4,565
Sec. 118	Personal credits	(1,557)
Sec. 118.7	CPP contribution credit	(126)
Sec. 118.7	EI premium credit	(53)
Ssec. 118(10)	Canada Employment tax credit	(158)
Sec. 118.2	Medical expense credit	(9)
Sec. 118.1	Charitable donations credit	(26)
Basic federal tax		$ 2,636

Solution 3 (Basic)

Division A of Part I of the Act consists of section 2 of the Act. Section 2 consists of three subsections.

Subsection 2(1):

"taxable income" — This is defined in subsection 2(2).

"taxation year" — Subsection 249(1) contains the definition of a taxation year. For corporations, the taxation year is the *fiscal period* of the corporation; for individuals, the taxation year is the *calendar year*.

"fiscal period" — This is also a defined term, found in subsection 249.1(1).

"corporation" — This word is part of a defined term in subsection 248(1), "corporation incorporated in Canada".

"individual" — Subsection 248(1) defines individual as *a person*, other than a corporation,

"person" — This is also defined in subsection 248(1). This is expanded below.

"calendar year" — This is not defined in the Act. However, the *Interpretation Act* defines the term in paragraph 37(1)(*a*) to mean a period of twelve consecutive months commencing on January 1.

"person" — The definition of person is found in subsection 248(1). Section 248 is an interpretation section and many of the words and terms used in the Act, which require definition, are found in this section. Person is defined to include any body corporate and politic, and the heirs, executors, administrators or other legal representatives of such body.

"resident" — Although the Act includes a definition of deemed residents (subsections 250(1) and (4)), the word "resident" is not itself defined in the Act. Canadian residents are taxed on their worldwide income. As this term is fundamental to establishing a liability for Canadian tax, there have been many court cases centred on the issue of residency. The common law principles which have evolved from these cases are the basis for the interpretation of this word. Residency is more fully discussed in Chapter 2.

"Canada" — Section 255 defines Canada to include certain sea beds adjacent to the coasts, as well as the airspace above the geographic boundaries of Canada.

Subsection 2(2):

As mentioned above, subsection 2(2) is itself a definition. This subsection is for the purpose of defining "taxable income."

"taxpayer" is found in subsection 248(1). This is any person, whether or not liable to pay tax.

"income for the year" — Section 3 contains the blueprint for the calculation of income. The term "income," however, is not defined. Section 3 states: "The income of a taxpayer for a taxation year for the purposes of this Part is his *income* determined by the following rules ..." In order to determine income under section 3, one has to first know what income is. As income is not defined, we again must turn to jurisprudence and common language. Again, there are numerous court cases over the issue of what constitutes income.

Subsection 2(3):

"employed" — Subsection 248(1) defines this word as performing the duties of an office or employment.

"business" — Subsection 248(1) defines this word to include a profession, calling, trade, manufacture, or undertaking of any kind whatever, and an adventure or concern in the nature of trade. The definition excludes an office or employment.

"carrying on a business in Canada" — Section 253 provides an extended meaning of this term, as it applies to non-residents. This provides a number of criteria to expand when a business will be considered to be conducted in Canada. However, the term "carrying on a business" is not, itself, defined. Therefore, although we have an extended meaning of this term legislated by the Act, we will not find a legislated definition of the term itself. Again, there have been numerous cases disputing whether a business was carried on.

"disposed" — Although the term disposed is not itself defined, "disposition" is defined in subsection 248(1) to be, in paragraph (a), any event or transaction which entitles the taxpayer to "proceeds of disposition." "Proceeds of disposition" is, itself, a defined term found in subsection 13(21) and section 54.

"taxable Canadian property" — This is defined in subsection 248(1) and is quite a lengthy definition. Taxable Canadian property includes, among other items, real property situated in Canada, shares of private Canadian companies, and certain partnership interests and trust interests which derive their value principally from these former two types of property.

"taxable income earned in Canada" — Subsection 248(1) defines this term to mean taxable income determined in accordance with Division D of Part I, but in no case can this ever be less than nil.

A review of section 2 clearly emphasizes the importance of understanding the terms used throughout the Act. In many examples, the Act will expand upon terms or provide computational rules for certain terms, but does not extend to providing a statutory definition of the term itself. This is one of many reasons why interpretation of the statute remains, at times, an imprecise practice. It also demonstrates that, while the Act is the cornerstone for the taxation system, it cannot be studied in isolation as it draws meaning from other external sources.

CHAPTER 2
Liability for Tax

Solution 1 (Basic)

(a) As Anthony has made a fresh start in Canada on March 1, 2010, he is considered a part-year resident. Accordingly, he will be taxed on his worldwide income from March 1 to December 31. Prior to March 1, he would only pay tax on income from Canadian sources.

(b) Lubie has a continuing state of relationship with Canada. In particular, all of her income is earned in Canada and she crosses the border each day. She also carries on active trading in Canada as well. All of the facts support that Lubie has a continuing state of relationship with Canada; therefore, she is a resident in Canada for tax purposes. The 183-day sojourner rule would not apply because Lubie does not stay overnight. She will also be taxed in the United States; therefore, she will have to apply for a foreign tax credit on her U.S. return.

(c) Although Ephran spent over 183 days in Canada before severing all of his ties, he is still considered a part-year resident. This is because he made a clean break from Canada and does not plan to return. Accordingly, he will be taxed on his worldwide income from January 1 to July 30, 2009. After July 30, he will only be taxed on income from Canadian sources. (An argument could also be made that Ephran made a clean break from Canada on May 1, 2010.)

(d) Julia has a strong continuing state of relationship with Canada even though she is a U.S. citizen. Accordingly, she will be considered a resident of Canada and taxed on her worldwide income. Citizenship is irrelevant to a person's resident status in Canada, but Julia will also be taxable in the United States. Consequently, Julia will be taxed in both Canada and the United States and will need to apply for a foreign tax credit.

Solution 2 (Advanced)

[Reference: *Glow v. The Queen*, 92 DTC 6467 (F.C.T.D.)]

(A) Full-time resident: taxed in Canada on worldwide income for the whole year;

Criterion: continuing state of relationship with Canada; i.e., ties;

Evidence:

— born, raised and educated in Canada,
— agreed to short-term contract abroad,
— contract provided for living expenses, indicating the temporary nature of the stay abroad,
— fees under the contract were paid to the client's Canadian corporation,
— he continued as a shareholder, director and officer of the Canadian corporation,
— he maintained an interest in the activities of the Canadian corporation,
— he maintained a Canadian bank account,
— he owned a rental property in Canada,
— he arranged a rental on a month-to-month basis to allow him to resume his habitation of the residence on short notice,
— he stored his major furnishings and winter clothing in Canada, indicating an intention to return,
— he retained credit cards issued in Canada and his RRSP accounts,
— he maintained his health coverage in Canada,
— he did not extend his visa in Nigeria, indicating an intention to return,
— he did not pay income tax in Nigeria, indicating a lack of permanence in his stay there,
— his girlfriend returned to Canada, spending only a fall term and a summer in Nigeria with him, indicating a lack of permanence in his stay,
— he returned to Canada, leaving nothing in Nigeria.

(B) Deemed full-time resident of Canada: taxed in Canada on worldwide income for the whole year;

Criterion: sojourned in Canada for an aggregate of 183 days or more in the year [par. 250(1)(*a*)];

Evidence:

— when he was in Canada until July 1976, he was not sojourning, despite being in Canada more than 183 days in that year,
— therefore, deemed residence is not a possibility in this particular case for 1976.

(C) Part-year resident in 1976: taxed in Canada on worldwide income for the part of the year while resident;

Criterion: "clean break", i.e., severed ties in July 1976;

Evidence:

— the Canadian bank account was only to avoid foreign exchange difficulties and to maintain his rental property,
— no withholding of income tax on his fees,
— he intended to establish an international consulting business abroad and to that end attempted to promote such a business in Nigeria,
— he intended to sell his rental property in Canada when market conditions were right and to this end he arranged a rental on a month-to-month basis to facilitate a sale,
— he moved his personal effects to Nigeria,
— he sold his car,
— he cancelled his auto insurance and a gasoline company credit card,
— he was accompanied to Nigeria by his girlfriend who stayed with him when not in school,
— he rented an apartment in Nigeria because more permanent accommodation was not available,
— he obtained a Nigerian driver's licence,
— he maintained two bank accounts and cars in Nigeria,
— he joined clubs in Nigeria,
— he had an office in Nigeria,

- — his business cards identified him as a consultant to the Nigerian government,
- — the credit cards he kept could be used internationally,
- — he maintained his health coverage in Canada only because it was a requirement of his contract.

(D) Non-resident: taxed in Canada on Canadian-source income;

Criterion: employed in Canada, i.e., performed services of employment in Canada;

Evidence:

- — after leaving in July 1976, he was not providing services of employment in Canada,
- — therefore, non-resident taxable in Canada is not a possibility in this case.

(E) Conclusion:

- — while the client stated an intention to establish residence abroad, he was not successful in doing so:
  - — in fact, he returned immediately at the termination of a short-term contract,
  - — he did not sever his major ties to Canada or establish strong ties abroad,
  - — his ties to Nigeria were merely those necessary to sustain a lifestyle while there;

OR

- — on the other hand, it could be argued that
  - — he made an effort to establish a consulting practice abroad and the lack of business was unforeseen and beyond his control,
  - — he attempted to integrate himself into Nigerian society by living there and joining clubs,
  - — his lack of more permanent housing was due to market conditions beyond his control.

Solution 3 (Advanced)

[Reference: *Lee v. M.N.R.*, 90 DTC 1014 (T.C.C.)]

(A) Full-time resident of Canada after a "fresh start": taxed in Canada on worldwide income for the whole year;

Criterion: "a continuing state of relationship", i.e., continuing ties with Canada after a "fresh start";

Evidence of residence:

- although U.K. passport indicated residence in U.K., can be resident in more than one place,
- room in parent's house maintained for his use before his marriage, but not likely after that time,
- married in Canada to a person who continued to reside in Canada,
- supported his wife who was wholly dependent on him in Canada,
- his wife bought a house in Canada with funds which he provided,
- house mortgaged in Canada with a guarantee provided by the client,
- he provided an affidavit with the mortgage in which he swore that he was not a non-resident,
- he regularly returned to Canada
  - length of stay is not determining (see *Thomson* case),
- the use of the term "visitor" by immigration officials does not mean that the term is applied with the same meaning under the Act,
- income from his employment was deposited to a Canadian bank account,
- he never filed or paid income tax anywhere
  - it must be assumed that every person has at all times a residence (see *Thomson* case),
- the mortgage on his first wife's house in Britain and the Caribbean bank account may have been simply a foreign investment of a resident of Canada,
- after the period in question, i.e., 1981 to 1983
  - he purchased a car,
  - he obtained a Canadian driver's licence,
  - he obtained a Canadian visa,
  - he became a landed immigrant.

(B) Deemed full-time resident of Canada for the years in question: taxed in Canada on worldwide income for the whole year;

Criterion: sojourned in Canada for an aggregate of 183 days or more in a year [par. 250(1)(*a*)];

Evidence:

- he may have been sojourning when he regularly returned to Canada,
- but he was out of the country more than 183 days per year.

(C) Part-year resident in Canada after a "fresh start" and not resident before that time: taxed on worldwide income for the part of the year after the "fresh start";

Criterion: "fresh start" preceded by a period of non-residence;

Evidence of non-residence:

- history in England,
- U.K. passport held throughout the period in question
  - passport indicates residence in U.K.,
- parents maintain a room in England available for his use at any time,
- affidavit on which he swore that he was not a non-resident was not for income tax purposes but for Ontario land transfer tax,
  - the concept of a non-resident for the transfer tax may differ from that for income tax,
- on his entry to Canada, the length of his stay was limited by the setting of a date for his departure,
- immigration officials considered him to be a visitor on stamping his passport,
- he was employed on a full-time basis outside of Canada
  - he indicated that he did not want to work in Canada,

- — he was acquitted of failure to file a 1981 tax return in Canada, likely because he was not required to file,
- — he was not allowed to work in Canada,
- — he could not join OHIP, pay El, maintain an RRSP or join a pension plan in Canada,
- — he held a mortgage in Britain on his first wife's house,
- — he had a bank account in the Caribbean,
- — the bank account in Canada may have been for convenience or an investment like any other that a non-resident might make in Canada.

(D) Non-resident throughout the period in question: taxed on Canadian-source income;

Criterion: employed or carried on business in Canada;

Evidence:

- — during the period in question he was neither employed nor carried on business in Canada.

(E) Conclusion:

- — he cannot be deemed a full-time resident, because he does not meet the criterion,
- — if he is held to be a non-resident throughout the period in question, he will not be taxable in Canada because he has no Canadian-source income,
- — therefore, either he made a "fresh start" at some point in the period or he was a non-resident throughout the period,
  - — his ties to Canada appear to have begun with his marriage in June of 1981 and the subsequent purchase of a matrimonial home to which he returned regularly,
  - — at least, he could be considered to have become a resident in September of 1982 when he swore that he was not a non-resident.

Note: A conclusion for non-resident is acceptable, if an argument for a weighing of the facts in that direction is presented.

Solution 4 (Advanced)

[Reference: *Dale Boston v. The Queen*, 98 DTC 1124 (T.C.C.)]

(A) Full-time resident of Canada: taxed in Canada on worldwide income for the whole year(s) in question;

Criterion: "a continuing state of relationship", i.e., continuing ties with Canada

Evidence of residence:

- during the entire period in question his wife and 3 children (including one minor child) remained in Canada;
- he had the family home in Edmonton available to him throughout the entire period in question as his wife and youngest son continued to reside in this home;
- he remained on the payroll of the Canadian subsidiary of Exxon;
- his monthly pay was deposited into his Edmonton bank account;
- he remained a member of the pension plan of the Canadian subsidiary of Exxon;
- he did maintain some Canadian investments:
  - his 50% interest in the family home in Edmonton,
  - a 50% investment in rental property which his wife purchased after his move to Malaysia because she thought it would be a good investment,
  - his RRSP,
  - his company savings plan, and
  - a few personal shares in Canadian public companies.

(B) Deemed full-time resident of Canada for the years in question: taxed in Canada on worldwide income for the whole year(s) in question;

Criterion: sojourned in Canada for an aggregate of 183 days or more in a year [par. 250(1)(*a*)]

Evidence:

- he may have been sojourning when he came to Canada for brief periods during 1990 and 1992;
- but in neither of these years did he sojourn for a period in aggregate of 183 days; visits were 14 days in each of 1990 and 1992 and no days during 1989 and 1991, 1993 and 1994 and 1995 prior to his return during the summer.

(C) Part-year resident in Canada in year of "clean break" or resident before the time: taxed on worldwide income for the part of the year prior to the "clean break".

Criterion: "clean break", i.e., severed ties in September 1988

Evidence:

- his employer obtained a work permit for him in Malaysia;
- he sold his car in Canada;
- he cancelled his Canadian provincial health plan;
- his employer obtained private health insurance for him;
- he closed all of his existing bank accounts at the Royal Bank;
- he opened a savings account at the Bank of Nova Scotia because this bank had a branch in Kuala Lumpur, the capital of Malaysia;
- although he was paid by the Canadian subsidiary of Exxon, the cost of his pay was transferred from the Canadian subsidiary to Exxon International;
- no Canadian income taxes were withheld at source on his salary;
- he allowed his membership in the Edmonton Petroleum Club to lapse;
- he allowed his participation in the Model Guided Plane Association to lapse;
- although his wife remained in Canada, their marriage was unstable throughout the period in question and thus her presence in Canada cannot be considered a strong tie;
- he was employed in Malaysia in a senior managerial capacity;
- he hoped to stay on after the initial three years and in fact did remain for close to another four years;

- — he maintained a dwelling in Malaysia in which he slept, took his meals, and kept his personal effects;
- — he joined the local Malaysian yacht club;
- — he opened Malaysian bank accounts and obtained local Malaysian credit cards;
- — he purchased a car in Malaysia and obtained a Malaysian driver's licence;
- — he did not come back to Canada at all in 1989 or 1991 or for the period 1993 through the summer of 1995; he returned only briefly during 1990 and 1992.

(D) Non-resident throughout the period in question: taxed on Canadian-source income;

Criterion: employed or carried on business in Canada

Evidence:

- — during the period in question, he was neither employed nor carried on business in Canada;
- — although his pay was from a Canadian subsidiary of Exxon, his employment was outside of Canada.

(E) Conclusion:

- — he cannot be a deemed full-time resident, because he does not meet the 183-day criterion;
- — if he is held to be non-resident throughout the period in question, he will not be taxable in Canada because he has no Canadian-source income;
- — therefore, either he made a "clean break" at some point or he was a full-time resident throughout the period;
- — his ties to Canada quite clearly appear to have been severed in September 1988 when he moved to Malaysia to commence his new position;
- — he may have re-established ties to Canada in the summer of 1995 when he retired from Exxon and returned to Canada or in July 1997 when his employment in Thailand ended;
- — for the period from September 1988 through the summer of 1995 he appears to have been a non-resident of Canada.

Solution 5 (Basic)

(a) Since ABI is incorporated in Canada after 1965, the company will be taxed on its worldwide income throughout the fiscal year regardless of where its operations and control occur.

(b) Even though Nickel Company is incorporated outside of Canada, the facts indicate that the corporation's "mind and management" reside in Canada. The fact that all of the directors and the president live in Canada, maintain all of the books and records in Ontario, and meet in Toronto for their monthly director's meetings, clearly indicates the mind and management of the corporation is in Canada. Accordingly, it will be taxed on its worldwide income throughout the year.

(c) Saffron Ltd. is considered a resident of the United States for tax purposes. The corporation would be taxable in the United States. Since the sales are direct, and no branch exists in Canada, the corporation is not subject to any income tax in Canada.

Solution 6 (Basic)

(A) Full-time residence → taxed on worldwide income:

- (i) where "central management and control actually abides",
  - — central management and control in Korea,
    - — general manager and other active officers live in Korea and have their offices there,
    - — directors live in Korea;
- (ii) on the other hand,
  - — company had a bank account in Canada,
  - — company used the services of a Canadian investment dealer and a Canadian lawyer,
  - — purchase and sale transactions were made in Canada.

(B) Deemed residence under subsection 250(4) → taxed on worldwide income:

- (i) must be incorporated in Canada,
  - — cannot be deemed resident because incorporated in United States.

(C) Non-resident → taxed only on Canadian-source income [par. 2(3)(*b*)]:

- (i) must "carry on business in Canada",
  1. definition of "business" includes "an undertaking of any kind whatever and an adventure in the nature of trade" [ssec. 248(1)],
     - — purchase and sale of aviation fuel could be an adventure in the nature of trade;
  2. definition of "carrying on a business" includes offering anything for sale in Canada [par. 253(*b*)],
     - — sale of shares and aviation fuel would both be included in the extended meaning of carrying on of business in Canada;
  3. in the *Tara* case, the Court stated that an adventure in the nature of trade does not in itself constitute "carrying on a business in Canada" within the meaning of the words "carrying on business" (see also IT-459, par. 3),
     - — the transaction could be considered to be part of the larger activity and, therefore not an isolated transaction; the purchase of fuel was part of the usual business that it was actively carrying on
     - — to carry on something involves continuity of time or operations as contemplated in the ordinary sense of a "business"; the purchase transaction in question was one of many of that nature over time
     - — the activities must be engaged in on a continuing basis, rather than as an isolated transaction to fall within paragraph 253(*b*).

(D) Effect of Canada–Korea Income Tax Convention → possible exemption from tax:

- (i) business profits not earned from a permanent establishment in Canada are not taxed in Canada,
  1. even if considered to be carrying on a business in Canada, insufficient evidence to substantiate a permanent establishment as defined in Article 5,
     - — nothing more than a bank account, temporarily rented storage facilities, and arrangements with an investment dealer and a lawyer.

(E) Conclusion:

- (i) not resident in Canada because central management and control appear to be in Korea,
- (ii) it may be considered to have carried on business in Canada,
  - — however, the tax that would otherwise be paid from the carrying on of business is exempted by the Canada–Korea Income Tax Convention, because it did not carry on business through a permanent establishment in Canada.

Solution 7 (Advanced)

(A) Full-time residence — Taxed on worldwide income:

- where "central management and control" abides;
  - central management and control abides in the U.S.;
    - controlling shareholder, Board of Directors in the U.S.;
    - U.S. is major market; Canada is incidental;
- on the other hand;
  - company had a bank account in Canada;
  - had an employee in Canada;
  - short-term supply contracts made in Canada;
    - but contracts more promotional; longer-term contracts required U.S. approval.

(B) Deemed residence — Taxed on worldwide income [ssec. 250(4)]:

- must be incorporated in Canada;
    - WCG incorporated in the U.S.; therefore, cannot be deemed resident.

(C) Non-resident — Taxed only on Canadian-source income [par. 2(3)(*b*)]:

- must carry on business in Canada;
  - activities mostly promotional;
  - but did conclude one short-term contract in Canada;
  - business includes an adventure in nature of trade;
    - activity may be considered an adventure in nature of trade because of isolated sale, marketing effort for one product;
  - possible argument that adventure in nature of trade does not constitute "carrying on" a business, because of lack of continuity.

(D) Effect of Canada–U.S. Income Tax Convention:

- even if carrying on a business in Canada, business profits must be from a permanent establishment in Canada to be taxable in Canada;
- no business address in Canada; only employee with short-term accommodation in Canada.

(E) Conclusion:

- not resident in Canada because of central management and control in the U.S.;
- unlikely to be considered to have carried on business in Canada;
  - event may be adventure in nature of trade, but no continuity;
  - no Canadian permanent establishment so Treaty exempts the corporation from Canadian taxation of any business profits.

Solution 8 (Advanced)

[Reference: *Capitol Life Insurance Company v. The Queen*, 84 DTC 6087 (F.C.T.D.)]

(A) Full-time resident: taxed in Canada on worldwide income for the whole year:

(i) "where central management and control actually abides",

- central management and control in Denver,
- all corporate meetings as well as all levels of management took place in the United States,
- Canadian operations were not kept separately from U.S. operations, no Denver personnel were charged with Canadian operations and there were no special Canadian claim forms or procedures,
- all investments were administered and managed in Denver,

(ii) on the other hand,

- certificates listed the Canadian head office of Capitol as being in Don Mills, Ontario,
- the chief agent countersigned the cheques on Capitol's general bank account.

(B) Deemed full-time resident: taxed in Canada on worldwide income [ssec. 250(4)]:

(i) must be incorporated in Canada,

- cannot be deemed resident because incorporated in the United States.

(C) Non-resident: taxed in Canada on Canadian-source income [par. 2(3)(*b*)]:

(i) must "carry on business in Canada", as evidenced by:

- the authority and duties of the chief agent,
- the federal and provincial registrations and licensing,
- the powers of attorney deposited with the federal and provincial departments of insurance,
- the operating Canadian bank accounts,
- listing of Don Mills, Ontario as the Canadian head office of Capitol,
- the moneys on deposit in Canada pursuant to a special trust,
- the wording change to the agreements to refer to "a premium collection fee" on the insistence of the Canadian insurance authorities,
- the brochure was issued to Canadians,

(ii) on the other hand,

- all of these activities resulted from the requirement to comply with the superintendent of insurance and would not have otherwise existed, except for the Canadian banking facilities which were maintained to expedite the transfer of funds,
- the maintenance of registration under FICA served to avoid duplications in provincial jurisdictions with respect to such matters as the amount of deposits required to be maintained to guarantee the fulfillment of obligations,
- the completion of contracts with a Canadian company, Associates, does not constitute doing business in Canada, as the contracts were made in the United States,
- the individuals whose lives and health were covered by the insurance were Canadians. However, it was Associates who was insured, not the individuals.

(D) Effect of Canada–U.S. Income Tax Convention:

- business profits must be attributable to a permanent establishment in Canada to be taxable in Canada,
- there was no permanent establishment in Canada.

(E) Conclusion:

- not resident in Canada, as central management and control were exercised in Denver,
- had not carried on business in Canada, as insurance policies were all signed in the United States and all other activities in Canada were undertaken to comply with insurance regulations, except for the nature of the deposits to the Canadian accounts (which was a minimal level of activity).

Advisory Case

Case 1: Transfer to France

—ADVISORY CASE DISCUSSION NOTES

This is a planning situation. The students are to recommend planning points that would support the desired result of the family being non-resident.

There are two main issues in this case. The first is whether Sally and Harry will be able to support non-resident status given their circumstances. The second is, if they can argue non-resident status, what their date of "clean break" is.

Non-Resident Status

In order for the members of this family to plan to become non-residents, they need to support their argument that they have severed ties to Canada, and they need to establish that they have become residents of France.

To sever ties to Canada, Sally and Harry need to plan around the following main issues:

Length of stay in France: The family is going to be in France for at least two years, but that may be extended. Clearly, the shorter the stay, the greater the risk that they will not be able to successfully defend non-resident status if challenged.

Golf club: Given that Sally and Harry do not want to give up their golf club membership, they will need to see if the club has a non-resident membership status that would allow them to keep their membership, pay lower annual fees, and clearly indicate to the CRA and others that they have left. However, a stronger case for non-residency could be made if they gave up their membership altogether. It should be noted that the golf club "non-resident" classification probably also applies to those who have moved to, for example, another province.

Home: While it is clearly best for them to sell their home to establish a break in ties, they are reluctant to do this. If they wish to keep it, they should rent the property to a third party. In Interpretation Bulletin IT-221R3, in paragraph 6, the CRA states:

> Where an individual who leaves Canada keeps a dwelling place in Canada (whether owned or leased), available for his or her occupation, that dwelling place will be considered to be a significant residential tie with Canada during the individual's stay abroad. However, if an individual leases a dwelling place located in Canada to a third party on arm's length terms and conditions, the CCRA will take into account all of the circumstances of the situation (including the relationship between the individual and the third party, the real estate market at the time of the individual's departure from Canada, and the purpose of the stay abroad), and may not consider the dwelling place to be a significant residential tie with Canada except when taken together with other residential ties (see ¶17 for an example of this situation and see ¶9 for a discussion of the significance of secondary residential ties).

If they do decide to keep the house, then this will increase their risk of being considered residents of Canada.

Harry is on leave, he did not resign: Harry's circumstances must be considered in this case. He is not planning to resign from his teaching position; instead, he is taking an unpaid leave. This indicates a less permanent move. It would be a stronger argument for non-resident status if he did resign.

Family ties: Sally and Harry's extended family ties are clearly still in Canada. There is nothing they can do about this.

Visits back to Canada: They will need to be careful how often they come back to Canada on visits, and how long they stay. The more frequent the trips, and the longer the stays, the weaker the non-resident argument. Remember, the courts can view the next few years to determine whether the family severed their residential ties this year.

Other issues: Sally and Harry should also do the following:

1. Advise those authorities who administer drivers' licenses and medical coverage that they are now non-residents.
2. Close out their Canadian bank accounts or tell the bank that they are non-residents so withholding tax can be deducted from interest payments.
3. Move their investments to France and make sure their advisers are notified of their non-resident status.
4. Indicate on their tax returns the date of ceasing to be resident (see Date of clean break, below).

Establishing residency in France: For the family to be considered non-residents of Canada, they need to have established residential ties somewhere else—in this case, in France. The CRA, in paragraph 14 of Interpretation Bulletin IT-221R3, states:

> Where an individual leaves Canada and purports to become a non-resident, but does not establish significant residential ties outside Canada, the individual's remaining residential ties with Canada, if any, may take on greater significance and the individual may continue to be resident in Canada. However, the fact that an individual establishes significant residential ties abroad does not, in and by itself, mean that the individual is no longer resident in Canada, as the Courts have held that it is possible for an individual to be resident in more than one place at the same time for tax purposes.

Renting a furnished apartment may be appropriate for Sally when she first arrives, but she should find more permanent accommodations when the family arrives.

Date of clean break

Assuming the family can successfully argue that they have become non-resident, you need to determine what day they officially achieved this status. Sally is to be in France on May 15, so, if she leaves May 10, is that the date? Alternatively, Harry and the children will leave, say, July 15, so is that the date?

The CRA, in Interpretation Bulletin IT-221R3, at paragraph 15, states:

> It is a question of fact to be decided with regard to all of the circumstances of the case on what date a Canadian resident individual leaving Canada becomes a non-resident for tax purposes. Generally, the CCRA will consider the appropriate date to be the date on which the individual severs all of his or her residential ties with Canada, which will usually coincide with the latest of the dates on which
>
> (a) the individual leaves Canada,
>
> (b) the individual's spouse or common law partner and/or dependants leave Canada (if applicable), or
>
> (c) the individual becomes a resident of the country to which he or she is immigrating.

The first two of the three dates set out above are easy to determine in this case. The third may be more difficult and is discussed above.

This is not a particularly significant issue in that if you are arguing between May 10 and July 15—it is only about two months, and it only affects the tax return in the year of departure.

Conclusion

There is always a risk that the CRA and the courts will not agree with Sally and Harry's filing position that they are non-resident. All the adviser can do is arrange the given facts in the best way to minimize the risk. In this case, the risks of reassessment centre on the following issues:

1. Keeping the home
2. Length of stay in France
3. Establishing residential ties in France

Case 2: Move to Chile

—ADVISORY CASE DISCUSSION NOTES

In this case, it is necessary to determine Jennifer's residency status for tax purposes. Since residency is not defined in the Act, it is necessary to consider the facts underlying each case.

As a full-time resident of Canada, Jennifer would be taxed on her worldwide income over the two-year period. The facts that support this status are:

(1) Jennifer's Canadian background and her permanent return to Canada at the end of the two years;

(2) her return visits to Canada;

(3) Jennifer retained a Canadian bank account and her Canadian American Express credit card;

(4) she kept substantial assets (i.e., furniture and car) in Canada;

(5) her family and social ties remained in Canada;

(6) she maintained her provincial health care policy; and

(7) her intentions to stay in Chile were not clear (i.e., unfinished Canadian degree, fiancé remaining in Canada, not learning the native language, and not integrating into Chilean society).

As a deemed full-time resident of Canada, Jennifer would be taxed on her worldwide income throughout each year. However, there are no facts supporting this residency status as she did not sojourn in Canada for more than 182 days in either of her two years spent in Chile.

As a part-year resident of Canada, Jennifer would be taxed on her worldwide income for the portion of the year that she was considered a full-time resident. However, a clean break must be established for Jennifer to be given part-year status. The facts supporting a clean break include:

(1) she cancelled her student club memberships and abdicated her position as chair;

(2) her sole source of income was from a Chilean source;

(3) she moved most of her personal and household belongings to Chile;

(4) her contract contained the option to extend her position for more than two years; and

(5) she cancelled her Canadian chequing account and her Canadian Visa card.

As a non-resident of Canada, Jennifer would be taxed only on her Canadian-source income. Since Jennifer's income for the two years will be from Chilean sources, she would not be liable for Canadian tax. The facts that support non-resident status are the same as the ones supporting her clean break for part-year residency. If it is concluded that she made a clean break at a point in time, then she will be considered to be a non-resident after that time.

Conclusion

In all probability, the courts would rule that Jennifer is a full-time resident of Canada. The reasoning behind this decision is two-fold: she did not sever all her ties to Canada, nor did she attempt to integrate into Chilean society. The facts supporting this conclusion may outweigh the facts supporting her intentions to make Chile her permanent residence. Consequently, she will be taxed on the income she earned in Chile during her two-year stay. However, as a result of international tax treaties, Jennifer will most likely be eligible for a foreign tax credit for the amount of tax she has had to pay to the Chilean government and her Canadian taxes payable will be reduced by the amount of the credit. An actual case, with facts much like those in the above case in which the Court came to a similar decision, is *Glow v. The Queen*, 92 DTC 6467 (F.C.T.D.).