CHAPTER 2

FUNDAMENTALS OF TAX PLANNING

Review Questions

1. "Tax planning and tax avoidance mean the same thing." Is this statement true? Explain.

2. What distinguishes tax evasion from tax avoidance and tax planning?

3. Does Canada Revenue Agency deal with all tax avoidance activities in the same way? Explain.

4. The purpose of tax planning is to reduce or defer the tax costs associated with financial transactions. What are the general types of tax planning activities? Briefly explain how each of them may reduce or defer the tax cost.

5. "It is always better to pay tax later rather than sooner." Is this statement true? Explain.

6. When corporate tax rates are 13% and tax rates for individuals are 40%, is it always better for the individual to transfer his or her business to a corporation?

7. "As long as all of the income tax rules are known, a tax plan can be developed with certainty." Is this statement true? Explain.

8. What basic skills are required to develop a good tax plan?

9. An entrepreneur is developing a new business venture and is planning to raise equity capital from individual investors. Her advisor indicates that the venture could be structured as a corporation (i.e., shares are issued to the investors) or as a limited partnership (i.e., partnership units are sold). Both structures provide limited liability for the investors. Should the entrepreneur consider the tax positions of the individual investors? Explain. Without dealing with specific tax rules, what general tax factors should an investor consider before making an investment?

10. What is a tax avoidance transaction?

11. "If a transaction (or a series of transactions) that results in a tax benefit was not undertaken primarily for bona fide business, investment, or family purposes, the general anti-avoidance rule will apply and eliminate the tax benefit." Is this statement true? Explain.

Solutions to Review Questions

R2-1 There is a distinction between tax planning and tax avoidance. Tax planning is the process of arranging financial transactions in a manner that reduces or defers the tax cost and that arrangement is clearly provided for in the *Income Tax Act* or is not specifically prohibited. In other words, the arrangement is chosen from a reasonably clear set of options within the Act.

In contrast, tax avoidance involves a transaction or series of transactions, the main purpose of which is to avoid or reduce the tax otherwise payable. While each transaction in the process may be legal by itself, the series of transactions cause a result that was not intended by the tax system.

R2-2 Both tax planning and tax avoidance activities clearly present the full facts of each transaction, allowing them to be scrutinized by CRA. In comparison, tax evasion involves knowingly excluding or altering the facts with the intention to deceive. Failing to report an amount of revenue when it is known to exist or deducting a false expense are examples of tax evasion.

R2-3 CRA does not deal with all tax avoidance transactions in the same way. In general terms, CRA attempts to divide tax avoidance transactions between those that are an abuse of the tax system and those that are not. When an action is considered to be abusive, CRA will attempt to deny the resulting benefits by applying one of the anti-avoidance rules in the *Income Tax Act*.

R2-4 There are three general types of tax planning activities:

- Shifting income from one time period to another.
- Transferring income to another entity.
- Converting the nature of income from one type to another.

Shifting income to another time period can be a benefit if it results in a lower rate of tax applying to the income. Even if a lower rate of tax is not achieved, a benefit may be gained from delaying the payment of tax to a future time period.

Shifting income to an alternate taxpayer (for example, from an individual to a corporation), the amount and timing of the tax may be beneficially altered.

There are several types of income within the tax system such as employment income, business income, capital gains and so on. Each type of income is governed by a different set of rules. For some types of income, the timing, the amount of income recognized, and the effective tax rate is different from other types. By converting one type of income to another, a benefit may be gained if the timing of income recognition, the amount recognized, and/or the effective tax rate is favorable.

R2-5 The statement is not true. Paying tax later may be an advantage because it delays the tax cost and frees up cash for other purposes. However, the delay may result in a higher rate of tax in the future year compared to the current year. In such circumstances there is a trade-off between the timing of the tax and the amount of tax payable.

R2-6 There is not always an advantage to transfer income to a corporation when the corporate tax rate is lower than that of the individual shareholder. While an immediate lower tax rate results, remember that the corporation may be required to distribute some or all of its after-tax income to the shareholder which causes a second level of tax. Whether or not an advantage is achieved depends on the amount of that second level of tax and when it occurs. Other factors may also be relevant such as the tax treatment of a possible business failure or sale.

R2-7 The statement is not true. Knowing the tax rules is, of course, a major element in the tax planning process, but, it does not guarantee the expected outcome. Planning means that certain steps are taken now in preparation for certain activities that may occur in the future. However, those anticipated activities might not occur and the desired tax result may not be achieved. Tax planning also requires that one must anticipate and speculate on possible future scenarios and relate them to the current tax planning steps. Those scenarios are never certain.

R2-8 To develop a good tax plan, one must be able to:

- Understand the fundamentals of the income tax system.
- Anticipate the complete cycle of transactions.
- Develop optional methods of achieving the desired business result and analyze each of their tax implications.
- Speculate on possible future scenarios and assess their likelihood.
- Measure the time value of money.
- Place the tax issue in perspective by applying common sense and sound business judgement.
- Understand the tax position of other parties involved in the transaction.

R2-9 Yes, the entrepreneur should consider the tax position of the potential investors. They will be taking a risk in accepting the investment. If the entrepreneur knows the tax effect on the investors, of each alternative organization structure, the entrepreneur can choose the one that provides investors the most favorable tax treatment (i.e., one that reduces their after-tax loss if the investment fails, or increases their after-tax income if it succeeds). Before making the investment the investor should determine the tax impact on:

- income earned by the venture,
- income distributed to the investor,
- losses incurred by the venture,
- the loss of the investment if the venture fails, and
- the gain on the investment when it is eventually sold.

R2-10 A tax avoidance transaction is a term used within the general anti-avoidance rule (GAAR) of the *Income Tax Act*. An avoidance transaction is a transaction or series of transactions that results in a tax benefit and was not undertaken primarily for bona fide business, investment or family purposes [ITA 245].

R2-11 The statement is not true. In order for the tax benefit to be denied under the general anti-avoidance rule (GAAR), the transaction, in addition to not being primarily for *bona fide* business, investment or family purposes, must be considered to be a misuse or abuse of the income tax system as a whole. What constitutes a misuse or abuse is not always clear. However, certain avoidance transactions are permitted and others are not [ITA 245(3), IC 88-2].

Key Concept Questions

QUESTION ONE

The *Income Tax Act* contains a general anti-avoidance rule (GAAR) in section 245. Consider each of the following situations and determine whether the GAAR will likely apply. *Income tax reference: ITA 245(1),(2),(3),(4); IC 88-2.*

1. Chris transferred her consulting business to a corporation primarily to obtain the benefit of the low corporate tax rate.

2. Paul owns 100% of the shares of P Ltd. Paul provides services to P Ltd. In the current year he received no remuneration for his services because the payment of a salary to Paul would increase the amount of the loss that P Ltd. will incur in the year.

3. A Canadian-controlled private corporation pays its shareholder/manager a bonus that will reduce the corporation's income to the amount eligible for the low tax rate. The bonus is not in excess of a reasonable amount.

4. A profitable Canadian corporation has a wholly owned Canadian subsidiary that is sustaining losses and needs additional capital to carry on its business. The subsidiary could borrow the funds from its bank but could not obtain any tax saving in the current year by deducting the interest expense due to its loss situation. Therefore, the parent corporation borrows the funds from its bank and subscribes for additional common shares of the subsidiary. The parent corporation reduces its taxable income by deducting the interest expense. The subsidiary uses the funds to earn income from its business.

QUESTION TWO

John has owned all of the shares of Corporation A and Corporation B since their inception. In the current year, John had Corporation A transfer, on a tax-deferred basis, property used in its business to Corporation B. The reason for the transfer is to enable Corporation B to apply the income earned on the transferred assets against its non-capital losses.

Will the GAAR in ITA 245(2) apply to disallow the tax benefit? *Income tax reference: ITA 245(1),(2),(3),(4); IC 88-2.*

Solutions to Key Concept Questions

KC 2-1

[ITA: 245(2) – GAAR]

The GAAR provision in ITA 245(2) is to be used when specific anti-avoidance provisions do not suffice. For the GAAR to apply, the following four conditions must be met:

1) A tax benefit results from a transaction or part of a series of transactions [ITA 245(1) – "tax benefit" definition],

2) The transaction is an avoidance transaction, in that, it was not undertaken primarily for *bona fide* purposes other than to obtain the tax benefit [ITA 245(3) – "Avoidance transaction" definition],

3) No other provision of the Act stops the taxpayer from achieving the intended tax advantage, and

4) The transaction is an abusive transaction, in that, it can reasonably be concluded that the tax benefit would result in a misuse or abuse of the Act, read as a whole [ITA 245(4)].

The transactions described in each of the four situations:

- A tax benefit results in each case,

- The transactions have been undertaken primarily to obtain a tax benefit and are, for that reason, avoidance transactions, and

- Are not subject to any other anti-avoidance rule in the Act,

Therefore, the issue to be determined is whether the tax benefit would result in a misuse or abuse of the Act, read as a whole.

Situation 1: There is nothing in the Act that prohibits Chris from incorporating her business. The incorporation is consistent with the Act read as a whole and, therefore, the GAAR would not apply.

Situation 2: There is no provision in the Act requiring a salary to be paid to Paul and the failure to pay a salary is, therefore, not contrary to the scheme of the Act read as a whole. The GAAR would not apply to deem a salary to be paid by P Ltd. or received by Paul.

Situation 3: The Act recognizes the deductibility of reasonable business expenses which include bonuses. The payment of the bonus is not an abusive transaction and, therefore, the GAAR should not apply to the payment.

Situation 4: The borrowing by the parent corporation is for the purpose of gaining or producing income as required by paragraph 20(1)(c) of the Act. The GAAR should, therefore, not apply. In fact, CRA has indicated, in comfort letters, that where one corporation (A Ltd.) borrows from a financial institution to invest in shares of another corporation (B Ltd.) and B Ltd. re-loans the funds back to A Ltd. and charges interest at a reasonable rate, thus, shifting income from A Ltd. to B Ltd., the transactions are permissible and will not be challenged.

KC 2-2

[ITA: 245(2) – GAAR]

The GAAR provision in ITA 245(2) is to be used when specific anti-avoidance provisions do not suffice. For the GAAR to apply, the following four conditions must be met:

1) A tax benefit results from a transaction or part of a series of transactions,
2) The transaction is an avoidance transaction, in that, it was not undertaken primarily for *bona fide* purposes other than to obtain the tax benefit,
3) No other provision of the Act stops the taxpayer from achieving the intended tax advantage, and
4) The transaction is an abusive transaction, in that, it can reasonably be concluded that the tax benefit would result in a misuse or abuse of the Act, read as a whole.

In the case of John and his two corporations:

- The transaction does result in a tax benefit as using the losses will reduce tax,
- It appears that the transaction was undertaken primarily for the tax benefit, and
- There is no provision in the *Income Tax Act* prohibiting the transfer of the property on a tax-deferred basis to a related corporation nor the deduction of the losses by Corporation B,

So, the question that remains is whether the transaction is an abusive transaction.

Since the Act contains specific provisions permitting the transfer of losses between related corporations, the transfer in question is consistent with the scheme of the Act and, therefore, is not an abusive transaction. Thus, the GAAR should not apply.

However, had the transfer of a property been undertaken to avoid a specific rule, such as a rule designed to preclude the deduction of losses after the acquisition of control of a corporation by an arm's length person, such a transfer would be a misuse of the provisions of the Act and be subject to the GAAR [IC88-2].

Where the GAAR applies, the tax benefit that results from an avoidance transaction will be denied. In order to determine the amount of the tax benefit that will be denied, the provision indicates that the tax consequences of the transaction to a person will be determined as is reasonable in the circumstances.

COMPREHENSIVE CASE SOLUTIONS

NOTE:
The cases related to these solutions are on Connect. They are not printed in the text.

Solution to COMPREHENSIVE CASE ONE

Comparison of two employment offers received by John Smith

1) Offer of employment from ABC Co.

   a. Salary of $45,000 is included in income when received [ITA 5(1)]

   b. Stock option: The option is "in the money" at the date of grant; exercise price = $20; value at grant date = $25.

      If ABC Co is not a Canadian-controlled private corporation (CCPC):

      - there will be an employment income inclusion on the exercise date to the extent the value at the exercise date exceeds $20 [ITA 7(1)]
      - the stock option deduction will not be available [ITA 110(1)(d)]
      - John will have a capital gain or loss on the disposition of the shares based on the difference between the selling price and the value at the date of exercise

      If ABC Co is a CCPC:

      - the employment income inclusion is deferred until the date of disposition [ITA 7(1.1)]
      - if John does not dispose of the ABC Co shares within two years after acquiring them, John is entitled to the stock option deduction which is equal to ½ of the stock option employment benefit [ITA 110(1)(d.1)]
      - John will have a capital gain or loss on the disposition of the shares based on the difference between the selling price and the value at the date of exercise

   c. Home purchase loan: John will have an imputed interest benefit included in his employment income. The benefit is calculated by multiplying the loan principal by the prescribed rate of interest. The benefit is reduced by the 1% interest paid by John, provided the interest is paid by 30 days after the end of the calendar year.

      If the prescribed rate increases, the loan benefit will continue to be calculated using the 2% prescribed rate in effect at the time the home purchase loan was received (for a period of five years) [ITA 80.4].

   d. Private health services plan: The annual premium for prescription drugs, dental, and vision coverage does not result in a taxable benefit [ITA 6(1)(a)].

e. Tax deductions: John will be able to claim the following deductions relating to his car in computing his employment income.

CCA	$25,000 (includes HST) x 15% (CCA rate in the first year; 30% thereafter)	$ 3,750	8(1)(j)
Interest	Lesser of : (i) Amount paid $3,000 (ii) $300 per 30-day period = $3,600	3,000	8(1)(j) 67.2
Gasoline		5,000	8(1)(h.1)
Insurance		2,000	8(1)(h.1)
		$13,750	
	Employment usage 33%	$4,583	

2) Offer of employment from DEF Co.

a) Salary of $60,000 is included in income when received [ITA 5(1)].
b) The group term life insurance premiums are included in income [ITA 6(4)].
c) The fitness club membership results in a taxable benefit [ITA 6(1)(a)].
d) The phone is a capital asset and therefore CCA cannot be claimed for the purposes of computing employment income.
e) Taxable benefit with respect to the car is calculated below for 2018 and 2019.

	2018	**2019**
Monthly lease payments	$700	$700
	x 2/3	X 2/3
Number of months car available	1	12
Standby Charge	$467	$5,600
Personal kilometers	1,200	14,400
Operating benefit at $0.26 per personal km.	$312	$3,744
TOTAL	$769	$9,344

The reduced standby charge is not available because the car is not used primarily for employment purposes.

The employment offer that provides John with the greatest amount of disposable income after tax should be accepted.

Discussion with Bob Johnson, CFO of GHI Inc.

Stock-based compensation is not deductible [ITA 7(3)(b)].

The bonuses declared by GHI Inc. in 2017 will not be deductible in 2017 because they were not paid in 2017 or by June 29, 2018 (180 days [ITA 78(4)]. The bonuses will be deductible in 2018 or when paid.

Solution to COMPREHENSIVE CASE TWO

Part 1

Ursula's employment income for 2018 is $177,583. Below are the details.

Employment Income calculation		**Comments**
Salary	$180,000	5(1) - taxed when received
EI/CPP/ income tax	-	Not deductible; must get all 3 correct
RPP (employee portion)	(8,000)	8(1)(m)
Gym membership	-	Not deductible 8(2)
Golf membership	2,500	6(1)(a); used for recreation so employer is not primary beneficiary
Group term life insurance	900	6(4)
Private health insurance	-	6(1)(a)(i)
RPP (employer portion)	-	6(1)(a)(i)
Commission	10,000	5(1) - taxed when received
Bonus	-	5(1) - taxed when received
Champagne	-	T4130; non-cash gifts and awards under $500 are not taxable
Gift card	200	T4130; cash and cash equivalent gifts/awards taxable (even if under $500)
Samantha salary	(6,000)	6(1)(i)
Rachel salary	-	67; amount is not reasonable since no work is performed
Car Lease payments	(3,254)	8(1)(h.1) and 67.3; max is $800/month plus tax ($800*1.13*6) prorated for 60% employment usage
Standby charge	3,797	$70,000*1.13*2%*6*((1,667*6*40%)/(1,667*6))
Operating benefit	1,040	Lesser of [$0.26 x 1,667 x 40% x 6] and half of standby charge
Spouse airfare	2,000	6(1)(a)
Employee operating costs	(3,600)	8(1)(h); Prorated for 60% employment usage
Transportation	(5,000)	8(1)(h)
Sales expenses	-	Ursula is better off claiming car and travel expenses under 8(1)(h)/(h.1) rather than sales expenses (lease costs, operating costs, transport, 50% of meals, and advertising & promo) under 8(1)(f) because of the commission income limitation ($10,000).
Tablet	-	Capital expenditure
Stock option benefit	3,000	7(1); calculated as ($18-$15) x 1,000
Employment income	$177,583	

Part 2

Deco's business income for tax purposes for the 2018 taxation year is $6,696,580. The detailed calculation is below.

	Business income	Comments
Accounting income	$5,268,000	9(1)
Donation	10,000	18(1)(a)
Amortization	1,100,000	18(1)(b)
Stock based compensation	400,000	7(3)
Commissions	-	will be paid within 180 days of year end
Bonuses	-	will be paid within 180 days of year end
Golf memberships	37,500	18(1)(l)
Interest paid to CRA	4,750	18(1)(t)
Financing fee	5,680	20(1)(e); add back 80% since 100% was deducted for accounting
Remaining interest expense	-	20(1)(c)
Site investigation	-	20(1)(dd)
Client meals/ entertainment	51,750	67.1(1); add back 50% since 100% was deducted for accounting
Holiday party	-	67.1(2)(f)
Landscaping	-	20(1)(aa)
Warranty accrual	1,000,000	18(1)(e)
Actual warranty claims	(650,000)	
Foreign advertising to Canadians	200,000	19(1)
Audit fee	-	ordinary expense incurred to earn income
General corporate legal fees	-	ordinary expense incurred to earn income
Legal fees re: overdue receivables	-	ordinary expense incurred to earn income
Legal fees re: issuance of shares	(20,000)	20(1)(e); was not deducted for accounting purposes, but deductible for tax purposes over 5 years
Travel costs (meals)	400	67.1(1); add back 50% since 100% was deducted for accounting
Allowance for doubtful accounts	200,000	18(1)(e); not based on specific doubtful accounts
CCA	(983,500)	See calculation below
Recapture	100,000	See calculation below
Terminal loss	(150,000)	See calculation below
Loss on disposal of assets	122,000	
Business income	$6,696,580	

Capital cost allowance (CCA) is determined as follows:

Class	1	8	10	12	10.1	Total
Rate	6%	20%	30%	100%	30%	
Opening UCC	$5,000,000	$3,200,000	$400,000	-	-	
Additions	300,000	325,000	-	-	$30,000	
Disposals (at lower of cost and proceeds)	-	(25,000)	(250,000)	$(100,000)	-	
Net additions (additions less disposals)	300,000	300,000	-	-	30,000	
Half year CCA on net additions	(9,000)	(30,000)	-	-	(4,500)	$(43,500)
Full rate CCA on opening UCC	(300,000)	(640,000)	-	-	-	(940,000)
Recapture (terminal loss)	-	-	(150,000)	100,000	-	(50,000)
Closing balance	$4,991,000	$2,830,000	-	-	$25,500	$(1,033,500)