Chapter 02
Fundamentals of Tax Planning

Multiple Choice Questions

1. The CEO at Big Company Corporation has decided to sell a piece of capital equipment after the company's year-end in order to avoid paying capital gains tax this year. Which tax planning method will the CEO be using?
A. Transferring income to another entity.
B. Converting the nature of income from one type to another.
C. Shifting income from one time period to another.
D. This is a form of tax evasion and is not allowed.

Accessibility: Keyboard Navigation
Blooms: Understand
Topic: 02-05 Types of Tax Planning
Topic: 02-06 Shifting Income from One Time Period to Another
Topic: 02-07 Transferring Income to Another Entity
Topic: 02-08 Converting Income from One Type to Another

2. Which of the following scenarios illustrates a potential tax avoidance scheme?
A. Property transferred between arm's-length parties is valued at fair market value.
B. Dividends received from shares transferred from a wife to her husband are taxed in the hands of the wife.
C. A shareholder owns two corporations and undertakes legal steps in order to permit loss utilization between the two companies.
D. A man transfers property to his child at a value less than fair market value.

Accessibility: Keyboard Navigation
Blooms: Understand
Topic: 02-04 Tax Avoidance

3. The controller of Little Company Ltd. has decided to sell a piece of capital equipment after the company's year-end in order to avoid paying tax on capital gains this year. The controller is engaging in
A. tax avoidance.
B. tax evasion.
C. tax planning.
D. GAAR.

Accessibility: Keyboard Navigation
Blooms: Remember
Topic: 02-02 Tax Planning Defined

4. Certain skills are necessary for successful tax planning. One of these skills is applying the time value of money. Which of the following is FALSE regarding this skill?
A. Applying the time value of money is a tool used for wealth accumulation.
B. If a taxpayer invests $1,000 at 8% and subsequently earns $48 in after-tax income on the investment at the end of the first year, the taxpayer's tax rate is 40%.
C. If a taxpayer earns an annual return of 12% and is subject to a 40% tax rate, the annual after-tax return is 4.8%.
D. If a taxpayer invests $1,000 for one year at a rate of return of 14% and is subject to a 45% tax rate, the after-tax value of the investment will be $1,077.

(12% × [1 - .4]) = 7.2% after-tax return.

Accessibility: Keyboard Navigation
Blooms: Apply
Blooms: Understand
Topic: 02-08 Converting Income from One Type to Another

5. Which of the following statements regarding GAAR is true?
A. The purpose of GAAR is to catch tax evaders.
B. When an avoidance transaction takes place, the anti-avoidance rule is automatically applied in all circumstances.
C. Canada Revenue Agency states that "A transaction will not be an avoidance transaction if the taxpayer establishes that it is undertaken primarily for bona fide business, investment or family purposes."
D. Individuals who organize their affairs in order to pay as little tax as possible will automatically be subject to GAAR.

Accessibility: Keyboard Navigation
Blooms: Understand
Topic: 02-11 Specific Anti-Avoidance Rules

Short Answer Questions

6. Steven James earned $150,000 this year in profits from his proprietorship. The rate of tax for Canadian-controlled private corporations in his province is 13% on the first $500,000 of income. Personal tax rates (federal plus provincial) in James' province are:

On the first $47,000	24%
On the next $47,000	32%
On the next $51,000	40%
On the next $61,000	45%
On income over $206,000	50%

(*All rates are assumed for this question.*)

Steven withdraws $3,000 per month for his personal living expenses. All remaining profits are used to pay taxes and to expand the business. Steven expects the same business after-tax profits next year.

Steven is considering incorporating his business next year. If he incorporates, he will pay himself a gross salary of $48,000.

Required:

A. Determine the increase in Steven's cash flow if he incorporates his company? Show all calculations.
B. Name the type of tax planning that Steve would be engaging in if he incorporated his company.

A) Excess cash as a proprietorship:

Pre-tax Profits	$150,000
Tax: 24% 47,000 $11,280 32% 47,000 15,040 40% 51,000 20,400 45% 5,000 2,250 (Assume federal plus provincial rates)	(48,970)
After-tax profits	$101,030
Living expenses withdrawn	(36,000)
Available for expansion	$65,030

Excess cash as a corporation:

Profits before salary	$150,000
Salary	(48,000)
Corporate pre-tax profits	102,000
Tax: 13% × 102,000	(13,260)
After-tax profits (Available for expansion)	$88,740
Excess cash available for expansion ($88,740 - $65,0303)	$23,710

C) Transferring income from one entity to another (individual to corporation)

Accessibility: Keyboard Navigation
Blooms: Apply
Blooms: Understand
Topic: 02-02 Tax Planning Defined
Topic: 02-07 Transferring Income to Another Entity

7. Part A: List the three key factors of cash flow.

Part B: List the six skills required for tax planning as suggested in the textbook.

Part A:
Three key factors of cash flow

1. Amount of money coming in
2. Amount of money going out
3. Timing

Part B:
Six skills required for tax planning

1. Anticipation
2. Flexibility
3. Speculation
4. Applying the 8^{th} Wonder of the World
5. Perspective
6. Global approach

Accessibility: Keyboard Navigation
Blooms: Remember
Topic: 02-08 Converting Income from One Type to Another
Topic: 02-12 The General Anti-Avoidance Rule - GAAR

8. Andrew has $10,000 to invest. He wants to put his money in a one-year investment earning an annual interest rate of 12%. Andrew is in a 42% tax bracket.

Required:

a) Calculate the total value of Andrew's investment, after-tax, at the end of the year.
b) Calculate the amount of taxes Andrew will have to pay on his investment.

a) $10,000 + (($10,000 × 12) × (1 - .42)) = $10,696
b) $10,000 × .12 × .42 = $504

Accessibility: Keyboard Navigation
Blooms: Apply
Topic: 02-08 Converting Income from One Type to Another

9. Match each of the following terms with the most accurate example. Use each example only once.

TERMS:

Tax evasion
Tax planning
Tax avoidance

EXAMPLES:

A. An individual is seeking a beneficial outcome, and therefore, applies an application that is not specifically prohibited by law.
B. A business is seeking a beneficial outcome, and therefore, does not report a portion of revenue earned during the year.
C. Two unrelated companies take steps to become related in order to shift income from the profitable business to the company with losses.

An individual is seeking a beneficial outcome, and therefore, applies an application that is not specifically prohibited by law. **Tax planning**
A business is seeking a beneficial outcome, and therefore, does not report a portion of revenue earned during the year. **Tax evasion**
Two unrelated companies take steps to become related in order to shift income from the profitable business to the company with losses. **Tax avoidance**

Accessibility: Keyboard Navigation
Blooms: Understand
Topic: 02-03 Tax Evasion
Topic: 02-04 Tax Avoidance
Topic: 02-05 Types of Tax Planning

10. For each of the three examples listed below (1-3), identify the category of tax planning (A-C) that has been applied.

1. Jack has run a successful proprietorship for the past four years, and has now decided to incorporate his company.
2. Karen has decided not to pay herself a dividend from her corporation, (of which she is the sole shareholder), but has chosen to sell a portion of her shares to an associate instead.
3. XYZ Corporation has chosen to delay the recognition of a discretionary reserve until the following year.

A. Shifting income from one time period to another
B. Shifting income from one entity to another
C. Shifting income from one type of income to another.

1. B. Shifting income from one entity to another
2. C. Shifting income from one type of income to another
3. A. Shifting income from one time period to another

Accessibility: Keyboard Navigation
Blooms: Understand
Topic: 02-05 Types of Tax Planning
Topic: 02-06 Shifting Income from One Time Period to Another
Topic: 02-07 Transferring Income to Another Entity
Topic: 02-08 Converting Income from One Type to Another

Canadian Income Taxation: Planning and Decision Making- 2018-2019 Edition

Exam Case Questions

Cases 1 – 4 address materials from the first ten chapters. Cases 5 – 10 cover both personal and corporate tax issues, though the cases have been designed to allow instructors to delete paragraphs that may be more advanced in nature, thus tailoring each case to the material that has been covered in class. Case 11 addresses the sale of a corporation.

'Required' questions have been provided with the cases, though instructors may choose to omit these and simply request that reports be written for the individuals and or the businesses.

Case One addresses concepts found in Chapters 3, 4, 6, and 9.

Case Two addresses concepts found in Chapters 3, 4, 5, 8, and 10.

Case Three addresses concepts found in Chapters 3, 8, 9, and 10.

Case Four addresses concepts found in Chapters 7, 8, 9, and 10.

Case Five addresses concepts found in Chapters 3, 4, 5, 6, 9, 10, 11, and 13.

Case Six addresses concepts from Chapters 5, 6, 8, 10, 12, and 13.

Case Seven addresses concepts from Chapters 3, 4, 5, 6, 7, 8, 9, 10, and 11.

Case Eight addresses concepts from Chapters 3, 4, 5, 6, 7, 8, 9, 10, 11, 12, 14, and 15.

Case Nine addresses concepts from Chapters 3, 4, 5, 7, 8, 10, 13, 14, and 19.

Case Ten addresses concepts from Chapters 5, 7, 10, and 12.

Case Eleven addresses concepts from Chapter 18.

Exam Case One

It is March of 20x5 and George White has asked you to help him with his 20x4 taxes. During your meeting with George you learn the following:

George is thirty years old, divorced, and has an eight-year-old son from his former marriage. He pays $500 a month in child support.

George lives in City A, where he is a salesman for a large manufacturing plant. He receives a base salary of $4,000 per month plus a commission of 1% on the sales he makes in the month. His sales were $50,000 every month in 20x4.

George moved to City A from City B on December 1st of 20x3 when he was promoted and transferred with his company to the office in City A. George's tax deductible moving expenses totaled $9,500. He did not receive a reimbursement from his employer. He was able to claim $4,500 of this expense on his 20x3 tax return. George took out a $120,000 mortgage to purchase his new home. His interest payments were $8,400 in 20x4.

In order to perform his work duties, George is required to drive his own vehicle and pay for his expenses, for which he is not reimbursed. However, he does receive an allowance of $400 each month which is treated as unreasonable for tax purposes. George purchased a new car in 20x3 which he uses seventy-five percent of the time for business purposes. The undepreciated capital cost of the vehicle at the beginning of 20x4 was $28,000. Total costs to operate the vehicle are $800 per month. Interest expense on his car loan is $200 per month.

George spends $300 per month on suits for work. He also updates his cell phone regularly and typically spends $500 per year on a new phone. George's cell phone bill is $80 per month, of which twenty-five percent is for personal use.

George takes his files home with him at the end of the day and reviews his sales calls in his home office. He then returns the files to his office at his place of employment in the morning prior to leaving for the day to make sales calls. George's monthly total expense for his home insurance, property taxes, maintenance, and utilities is $1,000. His home office occupies ten percent of the square footage in his home.

George maximizes his RRSP contribution each year. His earned income in 20x3 was $42,000 which consisted of $6,000 in commissions.

Required:

(Use tax rules applicable for 2018.)

a) Calculate George's minimum net income for tax purposes for 20x4. Use the aggregating formula from Section 3 of the Income Tax Act to show your answer.

b) Indicate why any items have been omitted from your calculations.

Solution:

a)

ITA 3(a):

Employment income:

Salary (12 x $4,000)		$48,000	
Travel allowance (12 x $400) (unreasonable)		4,800	
Commissions (12 x $50,000 x .01)		6,000	
		$58,800	
Salesperson expenses:			
Phone expense ($80 x 12)	$ 960		
Automobile operating costs			
12 x $800	$9,600		
	$10,560		
Employment portion 75% x $10,560	$7,920		
Limited to commission income		(6,000)	
Other automobile costs:			
Capital cost allowance			
30% x $28,000	$8,400		
Interest on car loan			
$200 x 12	2,400		
	$10,800		
Employment portion 75% x $10,800		(8,100)	
Employment income			$44,700

ITA 3(c):

Other deductions:

Moving expenses (carry-forward portion from 20x3: $9,500-4,500)	(5,000)
RRSP contribution	
Lesser of: 18% x $42,000 (20x3 earned income)	
Limit: $26,230 (2018)	(7,560)
Net income for tax purposes (20x4)	$32,140

b) The following items have been omitted from the calculations:

a. Child support is not a deductible expense.
b. Clothing is not a deductible expense.
c. The cell phone purchase is a capital outlay, so denied as an expense, and CCA is not allowed on this type of capital asset for an employee.
d. Home office expense: George would have to perform more than 50% of his duties from this office, or he would have to use the office exclusively to earn income on a regular and continuous basis to meet with clients. He has not met either of these tests.
e. Personal mortgage interest is not a deductible expense.

Exam Case Two

It is February 1st, 20x8 and Chloe and Bart have come to ask you some questions regarding their 20x7 tax returns. The couple lives in a common-law relationship. Bart is a chef at a luxury hotel and Chloe is an electrician in a nearby city.

Bart's remuneration (salary) in 20x7 was $84,000. The following information is available from Bart's 20x7 T4 slip:
Deductions from pay:

CPP and EI	3,452
Registered Pension Plan Contribution	2,000
Income tax deducted	25, 000

Bart's employer contributes an equal portion to Bart's RPP. Bart is also provided with a company car for use during the entire year. The car is leased by the hotel. Lease payments are $550 per month. The hotel pays $400 per month for the operating costs of the vehicle. Bart drove the car a total of 22,000 kilometres last year. 9,000 of these were for personal travel. Bart also earned $3,000 in 20x7 from the restaurant's tip pool. His employer did not report the tips on Bart's T4.

Bart withdrew $10,000 from his RRSP in 20x7. Both Bart and Chloe contribute to their TFSAs each year. They each have a balance of $8,000 in their TFSAs, bearing 3% annual interest.

Chloe earns $65,000. She is waiting for her T4 from the electrical company to arrive in the mail, so will address some other issues at this point in time which she believes might affect her 20x7 taxes.

1) She sold a small piece of land in 20x7 (which is capital in nature) for $68,000. The land originally cost $50,000. Selling costs were $800. She received $35,000 of the proceeds in 20x7 and will receive the remainder of the funds this year (20x8).

2) Chloe began a small farming operation on the couple's acreage in 20x7. Her farm revenue totaled $5,000 in 20x7 and her expenses were $17,000. She has never farmed before, but her business looks promising and she expects a significant increase in sales in 20x8.

Required:

(Use tax rules applicable for 2018.)

a) Calculate Bart's minimum net income for tax purposes, and taxable income, for 20x7. Show your work using the statutory formula from Section 3 of the Income Tax Act.

b) Calculate Bart's federal tax liability for 20x7.

c) Calculate the 20x7 tax consequences from Chloe's two issues.

Solution:

a)

ITA 3(a)	
Employment income:	
Remuneration	$84,000
Gratuities	3,000
Standby charge	1,980
[($550 x 2/3 x 12) x 9,000/20,004]	
Operating benefit	
Lessor of $2,340 ($9,000 x .26)	
and $990 ($1,980 x .5)	990
RPP contribution	(2,000)
Employment income	$87,970
ITA 3(c)	
Other income:	
RRSP withdrawal	$10,000
Net income for tax purposes	$97,970
Taxable income	$97,970
(Amounts are rounded)	

b) Federal tax liability

$ 97,970.00			
$ 46,605.00	0.15		$ 6,991
$ 46,603.00	0.205		$ 9,554
$ 4,762.00	0.26		$ 1,238
$ 97,970.00			$ 17,782
NON-REFUNDABLE TAX CREDITS			
BASIC		$ 11,809	
CPP/EI		$ 3,452	
EMPLOYMENT		$ 1,195	
	0.15	$ 16,456	$ 2,468
FEDERAL TAX LIABILITY			$ 15,314

c) 1. Capital gain on sale of land

Proceeds $68,000 – Adjusted cost base $50,000 – Selling costs $800 = Capital gain of $17,200

Less capital gain reserve: lesser of:				
33,000	x	17200	$ 8,347	
68,000				
0.8	x	17200	$ 13,760	
				$ 8,347
Capital gain				$8,853
Taxable capital gain				$4,426

Chloe will have a taxable capital gain this year of $4,426 (rounded) due to the deferral of a portion of the proceeds.

2. Farming income loss

Revenue	$ 5,000
Expenses	($17,000)
Net loss for tax purposes	($12,000)

Since farming is not Chloe's chief source of income, the amount of her losses will be restricted. She will be allowed to deduct $7,250*:

$2,500 + 50% ($12,000 - $2,500) = $7,250
*(Restricted farm loss cannot exceed $17,500)

The $4,750 difference between this year's $12,000 loss and the allowable deduction of $7,250 can be carried back three years or forwards twenty years and applied against Chloe's farming income. (Since she did not farm prior to 20x7, the loss will be carried forward.)

Exam Case Three

It is February 1st of 20x8 and Frank and Betty have come to you for assistance with their 20x7 tax return. They are a married couple and have two children. Frank works full-time and Betty is a graduate student. Frank earned $90,000 in 20x7. They ask you the following three questions:

<u>Q1. What was our residency status in 20x7?</u>

Frank and Betty and their two children, aged 12 and 7, returned to Canada in January of 20x8 following an eight-month sailing trip in the southern hemisphere where Frank was performing oceanic research for his employer. He has worked for the same company out of the Vancouver office for twelve years.

The family only resided in Canada for the first five months of 20x7 (totaling 151 days) and they are wondering if their residency status has been affected.

<u>Q2. How do we report the fees we paid for our 12-year-old child?</u>

The couple's 12-year-old child attended boarding school prior to the sailing trip. The cost of the boarding school was $8,000.

<u>Q3. If we sell our home and cottage, how do we know which home is the principal residence?</u>

In addition to their family home, the couple owns a cottage which they usually visit in the summer. They are considering selling both properties this year (20x8) and moving to New Zealand. Their family home originally cost $150,000 and is now valued at $300,000. The cottage cost $160,000 and has a current market value of $260,000. The couple has owned the house for ten years and the cottage for five years.

Required:

(Use tax rules applicable for 2018.)

a) Inform the couple's question regarding their residency – *'Does the fact that they were only in Canada for 151 days in 20x7 affect their residency status?'*

b) Discuss how the boarding school costs incurred for their child will be handled on the couple's tax returns. (Do not calculate amounts; just describe the treatment of the items.)

c) Address the couple's question regarding principal residence, calculating the number of years that each property would be designated as the principal residence if they were to sell both homes this year. Show your work to justify your answers. (Do not calculate any taxable amounts.)

Solution:

a) Frank and Betty will be considered full-time residents for all of 20x7. They were fully expecting to return to Canada following their sailing trip, which was in fact, a work venture for Frank. The couple maintained a "continuing state of relationship" with Canada [ITA 250(3); Income Tax Folio S5-F1-C1]. Some other factors that would support full-time residency are: the maintenance of their home in Canada, continuing economic ties (employment), and the length of time in Canada prior to leaving.

   The fact that they only lived in Canada for 151 days in 20x7 does not affect their status as the 'more than 182 day' rule applies to those who do not typically have a continuing state of relationship to Canada.

b) Boarding school: Child care costs are a type of 'other expense' which may be deducted directly against income sources in the aggregate formula (ITA 3(c)). Child care costs are usually deducted from the income of the lower income spouse. However, since Betty was a student while the child attended boarding school, Frank is able to make the deduction (within the prescribed limits of not more than $5,000 or 2/3 of Frank's earned income) on his tax return (ITA 63; Income Tax Folio S1-F3-C1).

c) Selling the house and cottage: Both homes will have periods designated to them as the 'principal residence'.

   In order to minimize the taxable income, it is important to determine the capital gain per year of each property.

House	Cottage
$300,000 - $150,000 = $150,000 Capital Gain	$260,000 - $160,000 = $100,000 Capital Gain
Years owned = 10	Years owned = 5
Capital gain per year = $15,000	Capital gain per year = $20,000

The capital gain on the cottage should be eliminated first as it is the highest gain per year of the two properties. Due to the "1+" in the numerator of the formula to reduce the capital gain on a principal residence, the cottage will be designated as the principal residence for four years and the house will be designated as the principal residence for six years (ITA 40(2)(b), 40(6)).

Exam Case Four

Albert is retired and he has come to seek your assistance with his 20x8 tax return. He would like to know if he will have to repay any of his Old Age Security (OAS) income. Albert's wife is 58 and is in a high tax bracket, so Albert does not split his income with her.

Albert received the following income in 20x8:

Canada Pension Plan (CPP)	$ 7,000
Old Age Security (OAS)	$ 5,000
Pension from his former employer	$50,000
Eligible dividend income	$20,000
Non-eligible dividend income	$ 8,500

Albert would also like to discuss the following with you:

Albert's son, Martin, opened a restaurant three years ago. At that time, Albert invested $100,000 through a common share purchase. The two agreed that Albert would sell his shares to an agreed upon third party shortly after his retirement. Business has been very successful for Martin, and Albert's shares now have a market value of $750,000. (Albert has never claimed his capital gains exemption.)

Martin's restaurant is a Canadian controlled private corporation (CCPC). There is currently a $500,000 mortgage on the building. All of the company's assets other than the long-term investment are used in active business. The asset values have remained constant for the past three years. Only Martin and Albert have held shares in the company. The fair market values of the company's assets are provided here:

Cash (for operations)	$ 20,000
Inventory	$ 50,000
Passive investment	$400,000
Furniture	$200,000
Equipment	$500,000
Building	$800,000
Total Assets	$1,970,000

Required:

(Use tax rules applicable for 2018.)

a) Inform Albert as to whether or not he will have to repay a portion of his Old Age Security pension, and calculate the amount, if any.

b) Discuss the tax implications of selling Albert's shares back to Martin.

Solution:
a)
Albert earns more than the 20x8 threshold for Old Age Security pension recipients, and as such will be subject to the OAS repayment.

OAS			$5,000	
Other pensions			$50,000	
Eligible dividends	20,000	1.38	$27,600	
Non-eligible dividends	8,500	1.16	$9,860	2018
Net income for tax purposes			$92,460	
Less OAS repayment			$75,910	2018
Excess income over OAS base			$16,550	
Multiply x 15%			15%	
Old Age Security repayment			$2,483	

b)
If Albert sells his shares he will have a capital gain of $650,000 ($750,000 - $100,000). This will result in a taxable capital gain of $325,000. However, if the corporation is a qualified small business corporation (QSBC) (ITA 110.6(1), 110.6(2.1)), Albert can claim up to $848,252 of the lifetime capital gain exemption ($424,126 net taxable capital gains) which would effectively reduce his taxable capital gain to Nil*.

The corporation is not currently a QSBC, however, since it does not meet the small business corporation (SBC) test of 90% or more of the fair market value of the assets being used in active business. The assets used in active business total $1,570,000 ($1,970,000 - $400,000 investment). Therefore, only 79.7% (1,570,000/1,970,000) of the assets are currently used in active business.

Cash	$20,000	$20,000
Inventory	$50,000	$50,000
Investment	$400,000	
Furniture	$200,000	$200,000
Equipment	$500,000	$500,000
Building	$800,000	$800,000
Total Assets	$1,970,000	$1,570,000
		79.7%

Since the corporation does meet the 24 month test of the QSBC rules whereby a) no shares were held by an unrelated person and b) greater than 50% of the fair market value of the assets were used in active business during the past 24 months, it is possible for Martin to increase the percentage of the FMV of his company's assets used in active business prior to the sale of the shares. For example, he could liquidate a portion of his investment and pay down his mortgage to increase the percentage of the fair market value of the assets used in active business to 90% or greater.

(*Albert will also want to determine if the alternative minimum tax will apply when he decides to sell his shares.)