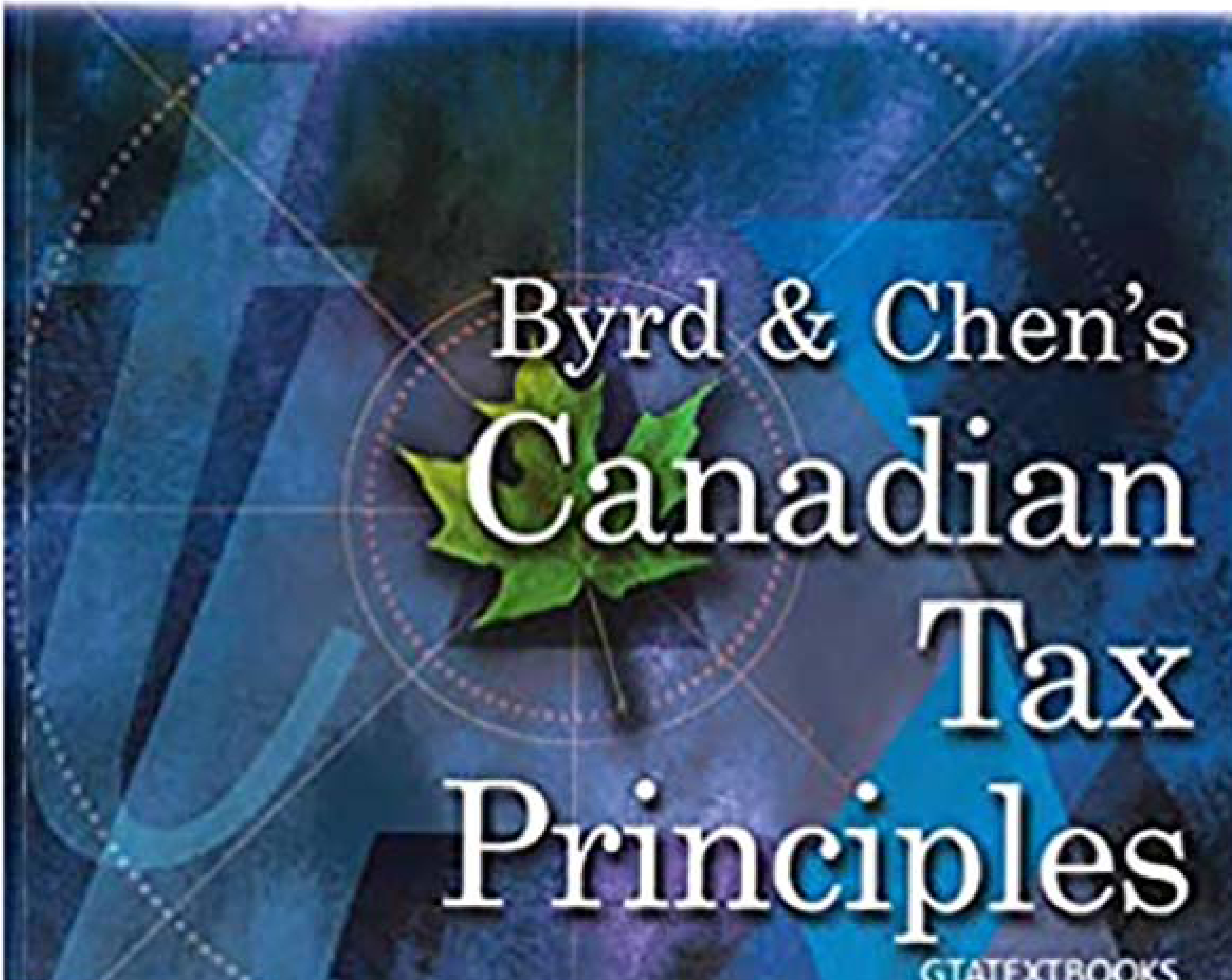
2020–2021 EDITION



Byrd & Chen's Canadian Tax Principles

GTATEXTBOOKS

Volume I

Remembering Clarence Byrd and Ida Chen

Pearson Canada grieves the loss of both Clarence Byrd and Ida Chen, the beloved authors of ***Canadian Tax Principles***. For more than 35 years, Clarence and Ida have been extensively involved in Canadian accounting education. Their book, ***Canadian Tax Principles***, has been used by thousands of instructors and students and continues to be read and relied upon by learners across the country.

Our thoughts are with their family, friends, and the education community who worked with them and knew them personally.

Husband and wife, Clarence Byrd and Ida Chen, authors of Canadian Tax Principles, *passed away on May 30, 2020, and November 6, 2019, respectively. Their impact on accounting education will not be forgotten.*

In Memoriam of Ida Chen

On November 6, 2019, Ida Chen, my wife of 43 years, died from cancer.

In our years together, Ida and I authored some 150 books on financial accounting and tax.

These books were used by tens of thousands of students, as well as by many accounting professionals.

Canadian Tax Principles has been, by far, our most successful effort. Through more than 25 annual editions, we piloted this publication from a niche product that we self-published to its position today as the most widely adopted text in Canadian university and college tax courses. We had an ongoing discussion about responsibility for this success. Ida believed that it was based on the quality of my writing, while I was equally convinced that its success resulted from her editing work on my often rough first drafts. The truth is that this publication would have had no success without the synergy resulting from our unusually complementary contributions.

While Ida's efforts were essential to the success of our publications, her contributions to our life together were even more important to me. We were best friends from the beginning of our marriage and, during the last 15 years, after my teaching was restricted to online efforts, we spent pretty much 24/7 together. We skied, hiked, climbed, and biked all over North America. We shared great food and, over the years, had several beautiful homes. Both the success of our books and the joy we found in our life together were beyond our wildest dreams.

We have lived the greatest love story that I have ever witnessed. I miss her terribly.

Clarence Byrd
May 6, 2020

In Memoriam of Clarence Byrd

I was first introduced to Clarence indirectly while working towards a Bachelor of Commerce degree in Montreal in the early eighties. I was taking an intermediate level accounting course with emphasis upon the *CICA Handbook,* consolidation accounting, and other topics that created a sense of dread in most accounting students. Unfortunately, the required textbook was not helpful in clarifying these difficult abstract concepts. The professor, recognizing the difficulty, recommended a two volume textbook written by Clarence Byrd and Ida Chen on accounting principles and concepts. I immediately purchased the books and was sold. The concepts were clearly explained in easy-to-read language, dissecting the words of the *CICA Handbook* to carefully explain step by step (with plenty of examples) these abstract concepts. Clarence and Ida had taken a complex topic and broken it down in such a way to make it easy to understand—the mark of true educators.

Flash forward 15 plus years to the late nineties and our paths would cross once again in a much more direct way. At the time I worked for the training organization of the CRA, teaching and writing courses, and became an income tax rulings officer in Ottawa shortly thereafter. I regularly read tax textbooks and other tax literature and came across a relatively new publication, *Canadian Tax Principles,* written by Clarence Byrd and Ida Chen. I read through the textbook and reached out, making recommendations as to improvements. It was a bit of a bold move, but it was well received by Clarence who reciprocated by personally reaching out to me. Clarence realized that my background with the CRA could only improve the textbook and our collaboration, which would last for more than 20 years, had begun. Ida once described our complementary skills as producing one of the finest writing teams she had ever seen. What made it all work was that Clarence, Ida, and myself were dedicated to effective quality tax education.

Over the years my wife, Michelle, and I learned firsthand that Clarence and Ida loved to entertain, and we were invited to their amazing homes in both Ottawa and Chelsea with the occasional outing to restaurants in Ottawa and Gatineau. We had become friends. Clarence would cook, Ida would make certain that everything was perfect, and the evening would finish with a song or two as Clarence, a gifted concert pianist, would tickle the keys on his Viennese-made Bosendorfer Concert Grand 290 piano with Ida accompanying him on occasion on an electric keyboard. They were good, memorable times.

My role with Clarence and Ida was as a consultant, advisor, technical reviewer, and sometimes co-author, writing a handful of chapters and some problem material. It was not unusual for me to speak to Clarence two or three times a day, particularly during annual federal budgets or unexpected changes to the income tax laws such as the Accelerated Investment Incentive property rules, trust reporting, income splitting, etc. Our collaboration led to constant discussions on what to add, what not to add, and how to go about introducing new topics in the most effective manner.

In September 2019 my wife and I visited Maui for a couple of weeks. Before leaving, Ida sent me this email…

> *We hope you and Michelle find Hawaii great, but not so great you want to move there. We really need you on the CTP project. Safe travels, Ida.*

Ida was the glue that kept it all together. She was a dynamo, a gifted organizer and administrator who could have easily fit into the fabric of the largest companies in the world. We knew that Ida had been struggling with cancer for a few years and beaten the odds more than a few times, but her passing in November of 2019 was an incredibly difficult time for my wife and I and everyone who knew her (https://ohfoundation.ca/be-inspired/symptoms-strike-and-reveal-shocking-brain-cancer-diagnosis/).

Through it all, Clarence, always a rock, began to show the signs of stress and his own medical situation worsened. Our collaboration accelerated as he was dedicated to completing what would be his final edition of *Canadian Tax Principles.* This publication held a special place in his heart. Clarence and Ida had created the textbook together from scratch and they took exceptional pride in each and every annual release.

In the final weeks before Clarence passed on Saturday, May 30, 2020, he worked furiously with a dedication to complete all the necessary steps possible to ready the textbook for publication. Our telephone conversations increased substantially during this time as our collaborative efforts took on a new urgency, purpose, and meaning. Clarence took comfort in knowing that I would pick up the reins to ensure the continuity of the successful text that both he and Ida had created together.

I look back on my relationship with these two remarkable individuals with happiness that our paths crossed for a common purpose and dedication to ideals of education. Along the way on this journey my wife and I had the opportunity to enjoy their company and friendship. We think of them every day and will miss them tremendously.

Gary Donell
June 9, 2020

CLARENCE BYRD
Clarence Byrd Inc.

IDA CHEN
Clarence Byrd Inc.

With contributions by
GARY DONELL

Byrd & Chen's Canadian Tax Principles

2020–2021 EDITION

Volume I

Pearson

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Pearson Canada Inc., 26 Prince Andrew Place, North York, Ontario M3C 2H4.

ISBN 978-0-13-674537-2

ScoutAutomatedPrintCode

Pearson

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Study Guide

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

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

Each of these Study Guide chapters contains the following:

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

In addition, the Study Guide contains:

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

PREFACE

Objectives Of The Canadian Tax Principles Package

Subject Coverage

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

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

Level Of Coverage

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

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

The Need For Two Volumes

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

If there was any consensus among our users as to which subjects should be dealt with in each volume, they could be made available separately. However, virtually all of our users omit material from Volume I and include material from Volume II. Further, there is no consistent pattern as to which material is omitted and which material is included. Given this, it would not be possible to produce separate volumes that meet the needs of all of our users.

The Study Guide

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

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

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

Problem Material

For Students

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

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

Self Study Problems These problems are more complex than the Exercises and include a number of comprehensive problems. We have marked the point within the text that you should work each Self Study Problem. Solutions to the Self Study Problems are included in the Study Guide, while the problems are available on MyLab.

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

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

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

For Instructors

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

Assignment Problems These problems vary in difficulty and include the most difficult non-comprehensive problems in the text. They are found at the end of each chapter of

Canadian Tax Principles. They are sometimes adapted from professional examinations and may involve a number of different issues. Solutions to these problems are available only to instructors, through the Instructor's Resources links on MyLab.

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

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

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

MyLab Accounting

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

- **Pearson eText** This eText gives you access to the text whenever and wherever you have access to the Internet, through various devices. It contains the content of both volumes of the text and the Study Guide. The eText pages look exactly like the printed text and offer powerful functionality. You can create notes, highlight text in different colours, create bookmarks, zoom, and search.
- **NEW Data Analytics Project** With this new assignable project, students analyze a comprehensive data set and make a series of accounting decisions. This assignment is designed to prepare students for the data analytics competencies that have been included in the most recent CPA Competency Map. Students will use Excel-based tools to assess data for accuracy, then organize and filter large quantities of information to make the data appropriate for income tax calculations. Students will then incorporate income tax concepts, including the calculation of Net Income, Taxable Income, and Tax Payable using the outputs of their data analysis in Excel. This assignment also includes data visualization and incorporates tax planning concepts for a business.
- **Self Study Problems** Self Study Problems are available on MyLab, with solutions in your Study Guide. In the textbook, we have marked the point within the text that you should work each Self Study Problem.
- **Supplementary Self Study Problems** Additional Self Study Problems for each chapter, along with their detailed solutions, are available for further practice in problem solving. These are separated out by chapter.
- **EY's Federal Income Tax Collection (FITAC)** This comprehensive electronic tax research library contains the *Income Tax Act*, *Income Tax Folios*, and other official materials. In addition, it includes an electronic version of the *Canadian Tax Principles* text. Designed for reference purposes, this version provides electronic links from the text material to the various references contained in FITAC (e.g., the *Income Tax Act*). Note

however, it only includes the text and does not have the Exercises and other problem material that are provided with the printed text.

- **ProFile Tax Return Preparation Software** Intuit's professional tax preparation software, ProFile, is available free of charge to users of *Canadian Tax Principles*. You can use this software to prepare returns for individuals, corporations, and trusts and includes a large number of tax forms. This software is for educational use only and cannot be used to file tax returns.
- **Corrections** Any corrections to the text, Study Guide, or other student material are provided on MyLab throughout the year. Please check periodically to help avoid frustration.
- **Practice Examinations** A 90-minute practice examination, along with a solution and suggested marking guide, is available for each chapter. These examinations contain a variety of problems, including multiple choice, essay questions, and longer problems.
- **Power Point Presentations** There is a PowerPoint presentation for each chapter. These provide the basis for a quick review of the material covered in the chapter.
- **Glossary Flashcards** These flashcards help you test your understanding of the key terms used in each chapter.
- **2020 Tax Rates, Credits, and Common CCA Classes** This is available as a PDF file, for reference. This tax information is also available at the front of Volumes 1 and 2, and CCA classes are available in the Chapter 5 Appendix.
- **Tax Returns** The Study Guide contains tax return examples and Self Study tax software problems, along with notes to their solutions. The completed tax returns are available on MyLab, to download and use with your ProFile software, or to view in PDF files.

Recent Changes

2020 COVID-19

The tax system in Canada, as in many countries, is premised on regular tax reporting, regular withholdings, remittances, and payment obligations all based upon a normal functioning economy. The Canada Revenue Agency (CRA) is mandated to ensure the continuity and smooth operation of the tax system, which includes the disbursement of benefits such as the GST/HST credits and the Canada Child Benefit, an audit function to ensure the accuracy of tax reporting, and many other complementary functions such as Collections, Appeals, and Objections. The CRA administers both the *Income Tax Act* (ITA) and *Excise Tax Act* (ETA) and provides administrative positions for a multitude of issues all with the purpose of upholding its mandate and the integrity of the Canadian tax system.

The March 11, 2020, announcement by the World Health Organization (WHO) declaring a pandemic changed the lives of Canadians as COVID-19 found its way into Canadian homes and institutions. Aside from the devastating impact on Canadian lives the necessary action to contain the virus effectively shut down a significant part of the Canadian economy, resulting in millions of Canadians unable to work as businesses shut down. We no longer had a smooth functioning economy, and both the Federal and provincial governments were called on to address the unprecedented financial impact upon Canadians.

The Federal government quickly rose to the challenge by instituting targeted financial assistance measures. We all have become familiar with acronyms such as the CERB (Canadian Emergency Response Benefit), the CEWS (Canadian Emergency Wage Subsidy), and the CESB (Canadian Emergency Student Benefit) to name but a few. In the interim Canadians found themselves facing income tax reporting obligations such as the standard April 30 deadline for filing individual income tax returns, instalment payments for both income tax and GST/HST, various tax withholding obligations, etc. In step with the Federal government announcements, the CRA issued numerous releases delaying the filing of individual tax returns, payment obligations for outstanding amounts owing for 2019, delayed instalment payments for 2020, and a promise that no interest or penalties would be charged until the extended times had lapsed. The audit and appeals functions came to an abrupt halt for the most part as CRA employee efforts were redirected to dealing with COVID-19 related matters. There remains a plethora of additional, albeit temporary, administrative changes that the CRA has announced to give some breathing room to Canadians as we all struggle with this unprecedented pandemic in modern times. Most of these announcements are supported by new legislation.

Given the temporary nature of these government initiatives and administrative changes by the CRA it is our view that providing detail of the numerous COVID-19 measures would not further the fundamental understanding of *Canadian Tax Principles* and as a result we have opted not to include coverage of these measures within the textbook. We would direct any of our readers who seek additional detailed information to visit the CRA website specifically at https://www.canada.ca/en/revenue-agency/campaigns/covid-19-update.html, which provides all the necessary and continually updated tax related information concerning COVID-19.

2018 Fall Economic Statement

One of the most important relatively recent income tax changes was announced on November 21, 2018, when the Department Of Finance released the Accelerated Investment Incentive (AccII) provisions as part of its fall economic statement. The new supportive legislation considerably revises the manner in which capital cost allowance (CCA) is calculated with respect to depreciable property acquired from November 21, 2018, to December 31, 2027. In comparison to the pre-November 21, 2018, system the new rules generally triple the normal CCA claims in the year of purchase for most depreciable property acquired before January 1, 2024. The incentives are reduced for depreciable property acquired from January 1, 2024, to December 31, 2027. In simple terms this new CCA system allows a larger first year CCA claim without changing the total CCA that can be claimed.

The details of these relatively new rules are discussed in Chapter 5 titled "Capital Cost Allowance". Since CCA is an important topic in income tax these changes affect almost every subsequent Chapter.

2019 Economic and Fiscal Update

In recent years it has become common for the Federal government to release an Economic and Fiscal update typically, since 2011, in November. The title of the releases has not always remained the same – in 2018 the release was titled the "Fall Economic Statement", as mentioned above. In any case, since 2016 the Federal government has used the annual fall release to introduce selective changes to the income tax system often targeted at the "middle class". The 2019 update was released December 16, 2019, and included a change to the personal tax credits that would increase the Basic Personal Amount that had been previously indexed and announced at $12,298 for 2020 to $13,229 with plans to further increase the amount to $15,000 by 2023. The additional $931 of credit amount for 2020 would be automatic for individuals with Net Income of $150,473 or less, nil for those individuals with Net Income of $214,368 or higher, and prorated for individuals with Net Income between those two thresholds.

The details of the additional credit amount are discussed in Chapter 4 titled "Taxable Income And Tax Payable For Individuals".

The 2020 Federal Budget?

Complications

The Federal government, in early March 2020, announced that the 2020 budget would be released March 30, 2020. Shortly thereafter the pandemic announcement by the WHO quickly brought to an end plans to go ahead with that budget. In May 2020 Prime Minister Trudeau announced that there were no plans to release a budget this year given the circumstances. In June the government announced a July 8 release date for an "Economic and Fiscal Snapshot" that appears to be designed to disclose the financial and economic affairs of the country following the unprecedented expenditure programs to assist Canadians throughout the pandemic. As a result we find ourselves in an interesting position without any significant tax changes that would typically accompany an annual Federal budget. There are, of course, plenty of changes to incorporate the numerous indexed amounts that are adjusted each year.

In addition it has become standard practice that Federal budgets introducing tax changes generally apply those changes to the immediately following or later years. As a result, the 2020 taxation year for example is impacted much more as a result of the 2019 Federal budget than it would have been by a 2020 Federal budget. We discuss this in the next section.

Previously Announced Measures

There are several measures that were announced in previous budgets that are still working their way through the system in 2020. They can be described as follows:

Employee Stock Options In the 2019 Federal budget the government announced that draft legislation would be released to address perceived unfairness in the taxation of employee stock options, particularly the 50 percent stock option deduction that results in only one-half of stock option employee benefits included in income. The government identified that their primary concern was that employee stock options were being used to compensate wealthy executives of large mature companies when in their view such tax deferred compensation should be limited to CCPCs and non-CCPCs in the start-up or emerging phase of their existence.

Draft legislation was released June 2019 giving interested persons a six month consultation period to provide feedback to the Department of Finance by December 2019. The government subsequently indicated that revised legislation would accompany the 2020 Federal budget, which as we have seen has been postponed with no future date in sight. As a result the taxation of employee stock options remains unchanged at the moment.

New Trust Reporting Requirements In the 2017 Federal budget the government announced their intention to enhance the information requirements for both resident and non-resident trusts. Details were released when the 2018 Federal budget was tabled February 27, 2018. The new reporting requirements will apply to the 2021 taxation year of most trusts, require the completion of a T3 return even though one may not have previously been required, and the completion of a new information schedule that will oblige the trust (subject to penalties) to identify all trustees and beneficiaries. In addition the trust will be required to identify persons who have the ability to exert control or override trustee decisions with respect to allocations of income and capital.

As a rule trusts have historically only been required to file a tax return (T3) if they owe tax or have made distributions of income or capital to beneficiaries. The new information reporting requirements will now oblige trusts to file an income tax return to provide the additional information beginning with the 2021 taxation year. Certain trusts, however, are exempted from these new reporting requirements. Notable exemptions include trusts that have been in existence less than three months, have less than $50,000 of assets, Graduated Rate Estates, Qualified Disability Trusts, and RRSP trusts.

2020 Content

The March 19, 2019, budget contained a fairly large number of proposals that were of varying importance. The following lists many of the changes that are relevant to this textbook.

Personal Tax Measures

- Provisions designed to prevent mutual funds from utilizing certain methods to allocate capital gains or income to unit holders on the redemption of their units that inappropriately defer tax or convert ordinary income into capital gains. The new rules apply to taxation years beginning on or after March 19, 2019.
- A new Canada training credit that will become available in 2020 (see Chapter 4).
- An increase in the Home Buyers' Plan withdrawal limit from $25,000 to $35,000 as of March 20, 2019 (see Chapter 10).
- A modification of the change in use rules for multi-unit residential properties to expand the scope of the elective options to defer tax to include partial changes of use. The elective options previously only applied where all of the property use changed. The new rules apply to partial changes of use occurring after March 19, 2019 (see Chapter 8).
- An expansion of the types of annuities that can be used by certain registered plans to fund retirement income beginning with the 2020 taxation year (see Chapter 10).
- Changes to the rules for Registered Disability Savings Plans beginning 2021 (with a transitional rule back to March 19, 2019) where a beneficiary becomes ineligible because of temporarily failing to qualify for the disability tax credit.
- Changes to the rules for kinship care providers to allow them to qualify for certain tax incentives for children in their care even though they receive financial assistance. Changes are retroactive to January 1, 2009.
- Removal of the requirement that donations of Canadian cultural property be of national importance in order to qualify for enhanced charitable donations treatment. Amendment applies as of March 19, 2019.
- Amendments effective October 17, 2018, for the medical expense tax credit to reflect the new rules on the legalization of cannabis and the introduction of the *Cannabis Act*.
- Modification of the rules to restrict tax-free transfers from Registered Pension Plans to Individual Pension Plans beginning March 19, 2019.
- New rules, beginning in 2019, to impose the highest tax rate where a TFSA is considered to be carrying on a business and to expand the list of those jointly responsible for the tax.

Business Tax Measures

- New rules that add two new depreciable property classes (54 and 55), which will provide for a first year write-off of 100 percent for zero emission vehicles purchased between March 19, 2019, and December 31, 2023; 75 percent for zero-emission vehicles purchased in 2024 and 2025; and 55 percent for purchases made in 2026 and 2027. (Chapter 5).
- Removal of the taxable income constraint for determining the amount of scientific research expenditures that are eligible for the enhanced 35 percent refundable investment tax credit. The change applies to taxation years ending after March 18, 2019 (see Chapter 14).
- Changes in the rules to correct an anomaly that would have resulted in certain farming and fishing income from qualifying for the small business deduction. This change is retroactive to 2016.
- Several provisions to enhance government support for Canadian journalism. These include:
    - a non-refundable tax credit of up to $500 for digital news subscriptions for 2020 to 2024 (see Chapter 4);
    - a refundable labour credit for salaries paid to "eligible newsroom employees" beginning January 1, 2020 (see Chapter 12); and
    - a provision that extends qualified donee status to registered journalism organizations also beginning January 1, 2020.

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

Acknowledgments

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

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

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

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

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

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

It's Our Fault

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

Clarence Byrd, Clarence Byrd Inc.
Ida Chen, Clarence Byrd Inc.
February 2020

2020 Rates, Credits, And Other Data

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

Information Applicable To Individuals

Federal Tax Rates For Individuals

Taxable Income In Excess Of	Federal Tax	Marginal Rate On Excess
$ -0-	$ -0-	15.0%
48,535	7,280	20.5%
97,069	17,230	26.0%
150,473	31,115	29.0%
214,368	49,645	33.0%

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

Reference

118(1.1) **Basic Personal Amount (BPA)** There are three alternatives dependent upon Net Income. (1) For individuals with Net Income of $150,473 or less the BPA is $13,229, (2) for individuals with Net Income of $214,368 or higher the BPA is $12,298, and (3) for individuals with Net Income between $150,474 and $214,367 the BPA is calculated as $13,229 – [$931][(Net Income – $150,473) ÷ $63,895]

118(1)(a) **Married Persons** 15% the of **BPA** for the individual

118(1)(a) **Spousal** 15% of the **BPA** for the individual and:

if the spouse of the married individual is dependent because of a mental or physical infirmity, there is an additional amount of $2,273 added to the **BPA**. The total of these two amounts ($15,502) is reduced by the income of the individual's spouse.

118(1)(b) **Eligible Dependant** 15% of **BPA** for the individual and:

if the dependent person is dependent because of a mental or physical infirmity, there is an additional amount of $2,273 added to the **BPA**. The total of these two amounts ($15,502) is reduced by the income of the dependent person.

118(1)(b.1) **Canada Caregiver For Child Under 18** 15% of $2,273 ($341).

118(1)(c) **Single Persons** 15% of the **BPA**.

118(1)(d) **Canada Caregiver** 15% of $7,276 ($1,091), reduced by 15% of the dependant's income in excess of $17,085.

118(2) **Age** 15% of $7,637 ($1,146). The base for this credit is reduced by the lesser of $7,637 and 15% of the individual's net income in excess of $38,508. Not available when income is more than $89,421. If the individual cannot use this credit, it can be transferred to a spouse or common-law partner.

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

118(10) **Canada Employment Credit** 15% of up to $1,245. This produces a maximum credit of $187.

Other Common Federal Personal Credits (Various ITA)

118.01 **Adoption Expenses Credit** 15% of eligible expenses (reduced by any reimbursements) up to a maximum of $16,563 per adoption. This results in a maximum credit of $2,484.

118.02 **Digital News Subscriptions** 15% of the lesser of $500 and the cost of qualifying subscription expenses.

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

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

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

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

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

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

A = The first $200 of eligible gifts.
B = The lesser of:
- Total gifts, less $200; and
- Taxable Income, less $214,368.

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

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

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

B is the total of an individual's medical expenses for him- or herself, his or her spouse or common-law partner, and any of his or her children who have not reached 18 years of age at the end of the year.
C is the lesser of 3% of the individual's Net Income For Tax Purposes and $2,397 (2020 figure).
D is the total of all amounts each of which is, in respect of a dependant of the individual (other than a child of the individual who has not attained the age of 18 years before the end of the taxation year), an amount determined by the formula:

E - F, where:

E is the total of the dependant's medical expenses
F is the lesser of 3% of the dependant's Net Income For Tax Purposes and $2,397 (2020 figure).

118.3 **Disability - All Ages** 15% of $8,576 ($1,286). If not used by the disabled individual, it can be transferred to a person claiming that individual as a dependant.

118.3 **Disability Supplement - Under 18 And Qualifies For The Disability Tax Credit** 15% of $5,003 ($750), reduced by the total of amounts paid for attendant care or supervision in excess of $2,930 that are deducted as child care costs, deducted as a disability support amount, or claimed as a medical expense in calculating the medical expense tax credit.

Education Related Credits

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

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

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

118.7 **Employment Insurance** 15% of amounts paid by employees up to the maximum Employment Insurance premium of $856 (1.58% of $54,200). This produces a maximum tax credit of $128 [(15%)($856)].

118.7 **Canada Pension Plan** 15% of 4.95 percent of contributions. The maximum credit base for all individuals is $2,732 [(4.95%)($58,700 - $3,500)]. This produces a maximum tax credit of $410 [(15%)($2,732)].

122.51 **Refundable Medical Expense Supplement** The individual claiming this amount must be over 17 and have earned income of at least $3,714. The amount is equal to the lesser of $1,272 and 25/15 of the medical expense tax credit. The refundable amount is then reduced by 5% of family Net Income in excess of $28,164. Not available when family income is more than $53,604.

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

122.91 **Canada Training Credit** The lesser of training amount limit and 50% of eligible training costs incurred in the previous year.

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

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

ITA 82 and ITA 121

Dividend Tax Credit

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

Other Data For Individuals

ITA 82

Dividend Gross Up

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

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

Chapter 4

OAS Clawback Limits The tax (clawback) on Old Age Security (OAS) benefits is based on the lesser of 100% of OAS benefits received, and 15% of the amount by which "threshold income" (Net Income For Tax Purposes, calculated without the OAS clawback) exceeds $79,054.

Chapter 4

EI Clawback Limits The tax (clawback) on Employment Insurance (EI) benefits under the *Employment Insurance Act* is based on the lesser of 30% of the EI benefits received, and 30% of the amount by which "threshold income" exceeds $67,750 (1.25 times the maximum insurable earnings of $54,200). For this purpose, "threshold income" is Net Income For Tax Purposes, calculated without the OAS or EI clawbacks.

Chapter 9

Child Care Expenses The least of three amounts:

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

Chapter 10

RRSP Deduction Room For 2020, the addition to RRSP deduction room is equal to:

- the lesser of $27,230 and 18% of 2019 Earned Income,
- reduced by the 2019 Pension Adjustment and any 2020 Past Service Pension Adjustment,
- and increased by any 2020 Pension Adjustment Reversal.

Chapter 11

Lifetime Capital Gains Deduction For 2020, the deduction limit for dispositions of shares of qualified small business corporations is $883,384. There is an additional amount for farm or fishing properties of $116,616, providing a total of $1,000,000 for such properties.

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

Information Applicable To Individuals And Corporations

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

Year	Quarter	Base Rate	Owing From*	Owing To
2017	All	1%	3%	5%
2019	I	1%	3%	5%
2019	II to IV	2%	4%	6%
2020	**I, II**	**2%**	**4%**	**6%**

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

Automobile Deduction Limits

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

CCA Rates See Appendix to Chapter 5.

Quick Method Rates (GST Only)

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

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

Information Applicable To Corporations

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

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

Reference 89(1) **General Rate Income Pool** A CCPC's General Rate Income Pool (GRIP) is defined as follows:

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

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

A. Net Canadian active business income.

B. Taxable Income, less:

1. 100/28 times the ITA 126(1) credit for taxes paid on foreign non-business income, calculated without consideration of the additional refundable tax under ITA 123.3 or the general rate reduction under ITA 123.4; and
2. 4 times the ITA 126(2) credit for taxes paid on foreign business income, calculated without consideration of the general rate reduction under ITA 123.4.

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

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

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

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

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

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

B. Taxable Income, less the sum of:

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

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

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

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

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

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

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

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

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

1. the amount determined by the formula

A - B, where

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

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

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

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

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

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

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

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

Beginning Balance The balance in the Eligible RDTOH at the end of the preceding taxation year.

Additions

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

Deduction Deducted from this total would be any dividend refund claimed from the Eligible RDTOH account in the previous taxation year.

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

Beginning Balance The balance in the Non-Eligible RDTOH at the end of the preceding taxation year.

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

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

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

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

Tax Related Web Sites

GOVERNMENT

Canada Revenue Agency www.canada.ca/en/revenue-agency
Department of Finance Canada www.canada.ca/en/department-finance.html

CPA FIRMS

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

OTHER

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

CHAPTER 1

Introduction To Federal Taxation In Canada

The Canadian Tax System

Alternative Tax Bases

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

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

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

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

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

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

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

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

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

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

1-2. At one time or another, some level of Canadian government has used, or is still using, all of these bases for taxation. For example, the Canadian federal government currently has, in addition to income taxes on corporations, individuals, and trusts, such taxes as the goods and services tax (GST), an alcoholic beverages tax, special transaction taxes, a gasoline tax, as well as others.

1-3. In terms of the tax bases that are being used 7, Figure 1-1 (following page) provides the 2019/2020 distribution of Federal Revenues by source.

Figure 1 - 1 Federal Government Revenues By Source

	Percent Or Total Revenues
Personal Income Tax	50.3
Corporate Income Tax	13.7
GST	12.0
Other Sources	9.1
Employment Insurance Premiums	6.5
Other Excise Taxes	3.6
Non-Resident Income Tax	2.9
Custom And Import Duties	1.9
Total	100.0

1-4. Figure 1-1 makes it very clear that the dominant form of Canadian taxation at the federal level is the income tax that is levied on individuals. More than 50 percent of federal revenues come from this source.

1-5. Running a distant second is income taxes on Canadian corporations at 13.7 percent of federal revenues, closely followed by GST collections at 12 percent. These two sources have been moving closer together as GST collections have become a more important source.

1-6. Employment insurance revenues at 6.5 percent of the total are also important. Taken together, non-resident revenues, customs duties, and excise taxes, provide 8.4 percent of the total. Other revenues consist of revenues from Crown corporations, fuel charges, other programs, and net foreign exchange.

Taxable Entities In Canada

Federal Income Tax

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

- Individuals (human beings)
- Corporations
- Trusts

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

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

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

GST

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

1-12. Under GST legislation, the concept of a person is much broader, including individuals, partnerships, corporations, estates of deceased individuals, trusts, charities, societies, unions, clubs, associations, commissions, and other organizations. Chapter 21, "GST/HST" includes detailed coverage of the goods and services tax and the harmonized sales tax.

Exercise One - 1

Subject: Taxable Entities For Income Tax Purposes

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

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

Exercise One - 2

Subject: Taxable Entities For GST Purposes

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

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

SOLUTIONS available in print and online Study Guide.

Federal Taxation And The Provinces

Personal Income Taxes

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

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

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

- Each province can apply different rates and surtaxes to as many tax brackets as it wishes.
- More importantly, each province is able to set different provincial tax credits to apply against provincial Tax Payable. While most provinces have provincial credits that are similar to credits that are established at the federal level, the value of these credits varies considerably at the provincial level. For example, the basic personal credit is over $10,000 higher in the province with the highest amount than it is in the province with the lowest figure.

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

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

Exercise One - 3

Subject: Federal And Provincial Taxes Payable

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

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Corporate Income Taxes

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

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

GST, HST, And PST

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

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

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

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

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

1-25. The various provincial sales tax regimes have left Canada with a fragmented sales tax system. The effective rates range from 5 percent (GST only) to 15 percent (HST rate).

Tax Policy Concepts

Taxation And Economic Policy

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

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

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

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

Fiscal Federalism This term refers to the various procedures that are used to allocate resources among different levels of government. These transfers are approaching $80 billion per year. While this is less than transfers to persons and direct spending by the Federal government, it is still a very significant amount.

Taxation And Income Levels

General Approaches

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

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

EXAMPLE Consider the Werner sisters:

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

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

Exercise One - 4

Subject: Regressive Taxes

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

SOLUTION available in print and online Study Guide.

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

1-29. In contrast to the regressive nature of sales taxes, the present system of personal income taxation is designed to be progressive, since higher rates are applied to higher levels of income. A low Federal rate of 15 percent applies to roughly the first $50,000 of Taxable Income, with the rate increasing to 33 percent as Taxable Income approaches $215,000.

Progressive Vs. Regressive

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

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

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

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

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

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

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

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

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

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

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

We would note that, with the maximum federal rate at 33 percent, the maximum combined federal/provincial rate in most provinces exceeds 50 percent, going as high as 54 percent in some provinces for income approaching $250,000. While it is difficult to determine the degree to which this will encourage tax evasion, it is almost certain that maximum tax rates at this level has and will be a major factor in decisions involving significant amounts of income being moved out of Canada. Without resorting to tax evasion, high income individuals have great flexibility in relocating their income.

Of particular importance is the possibility of moving to the U.S. The maximum Federal rate in that country is around 35 percent, and there are several states, including Florida, that have no income tax. This means that income is only taxed at the Federal level.

The maximum Federal rate is around 35 percent in the U.S. Further, this rate is not reached until the individual's Taxable Income exceeds one-half million dollars. For some individuals this could involve an annual tax savings of hundreds of thousands of dollars.

It is not surprising that some research has found that when the Canadian maximum Federal rate was increased from 29 percent to 33 percent, the change resulted in reduced revenues.

Flat Tax Systems

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

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

1-34. There is currently no flat provincial tax system in place in Canada. At one time, the Province of Alberta had such a system. However, this was replaced by a progressive system in 2016.

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

Tax Incidence

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

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

Tax Expenditures

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

1-38. In an effort to quantify the importance of these expenditures, the Department of Finance produces the publication, "Tax Expenditures And Projections" each year. Using this source, some examples of these costs are found in Figure 1-2:

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

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

Figure 1 - 2 Tax Expenditures
2013 Actual and 2020 Projections (Millions Of Dollars)

	Actual 2013	Projected 2020
Low Rate For Small Corporations	2,950	5,575
Accelerated Investment Incentive For CCA	NA	3,005
Non-Taxation Of Gains On Principal Residences	4,160	5,915
Registered Retirement Savings Plans	13,435	17,515
Basic Personal Tax Credit	31,055	38,410

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

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

Qualitative Characteristics Of Tax Systems

General Concepts

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

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

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

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

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

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

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

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

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

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

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