

CHAPTER 11

CORPORATIONS—AN INTRODUCTION

Review Questions

1. “A corporation is an artificial person separate and distinct from its owners.” Briefly explain this statement.
2. Identify the types of relationships that can exist between a corporation and its shareholders.
3. What factors may influence the value of a corporation’s common share capital?
4. Identify two ways in which a shareholder can realize a return on a share investment. Describe the relationship between them.
5. “Given the choice, individual shareholders of a corporation prefer to receive their return on investment by way of dividends, rather than from the sale of shares at a profit.” Is this statement true? Explain.
6. “A shareholder may have a primary relationship as well as secondary relationships with the corporation. The difference between the (two relationships relates to the tax treatment of income flows between the corporation and the shareholder.” Explain.
7. Corporations and individuals determine their taxable income in different ways. What are the differences?
8. How are the net capital losses and non-capital losses of a corporation affected when voting control of the corporation shifts from one shareholder to another?
9. If the shares of a corporation that has non-capital losses are about to be sold and if those losses arise from business operations, why is it important for the vendor to consider the nature of the purchaser?
10. An existing corporation that operates a profitable retail business is considering expanding its activities to include manufacturing. The expansion business can be organized in either of two basic ways. Describe them. Also, what factors must be considered when a choice is being made between the two structures?
11. How does the tax treatment of intercorporate dividends affect the relationship between dividends and capital gains when one corporation invests in shares of another corporation? (Assume that both entities are taxable Canadian corporations.)
12. Explain why the federal tax reduction of 13% or a provincial tax reduction on manufacturing and processing activities may apply to an amount that is greater than or less than the corporation’s actual income from manufacturing. Is it possible for a corporation that earns \$500,000 from retail activities and suffers a loss of \$50,000 from manufacturing activities to be eligible for the 13% manufacturing reduction?

13. What is the marginal tax rate for a public corporation in Ontario on income derived from a chain of restaurants? Show calculations.
14. Because income earned by a corporation is first subject to corporate tax and then taxed a second time when after-tax profits are distributed to individual shareholders, shareholders are entitled to claim a dividend tax credit. Does the dividend tax credit eliminate the double taxation of corporate profits? Explain.
15. The following statement appeared in the media: "There are 60,000 Canadian corporations that earned a profit for the year but incurred no income tax liability." Is it possible that this statement is true? If it is, explain the principal reasons why, and state your opinion as to whether changes to the tax system are warranted.

Solutions to Review Questions

- R11-1. By law, a corporation is recognized as an entity which has the power to act on its own behalf and enter into enforceable legal agreements. It can own property, sell and lease property, and borrow funds in the same way that an individual can. Although the corporation is owned by its shareholders, the affairs of the corporation are separate from the affairs of its owners. Therefore, property owned by the corporation is not property owned by the shareholder, and debts of the corporation are not debts of the shareholders. As a separate entity, the corporation is subject to income tax on its profits. However, when those after-tax profits are distributed to the shareholders they are again included in the shareholders income for tax purposes [ITA 12(1)(j)].
- R11-2. A shareholder can have both a primary and a secondary relationship with the corporation. Under a primary relationship, the shareholder provides equity capital to the corporation in exchange for shares. The shareholder can receive a return from the shares in the form of dividend distributions and/or share value enhancement. Under a secondary relationship, the shareholders may also act as a creditor, supplier, customer, employee, or lessor to the corporation. They can, therefore, loan money to the company in exchange for interest, lease property to the company in exchange for rent, provide services in exchange for salary and so on.
- R11-3. The following factors may influence the value of a corporation's common share capital.
- Profits earned or losses incurred by the corporation. Profits retained belong to the common shareholders and the share value increases accordingly.
 - Dividends paid by the corporation. Dividend distributions reduce the equity of the corporation and the share value declines accordingly.
 - Increases or decreases in the value of assets owned by the corporation, including tangible assets such as land and buildings, and intangible assets such as goodwill.
- R11-4. A shareholder who provides share capital to a corporation can realize a return on investment from dividends or from capital gains when shares that have increased in value are sold. The two are related because dividend payments alter the value of the shares, thereby affecting the potential capital gain (loss) on sale. If after-tax corporate profits are retained by the corporation, the value of the shares increases, which may create a capital gain if the shareholder sells the shares. On the other hand, if corporate earnings are distributed as a dividend, the value of the shares declines and reduces the amount of capital gain that would otherwise occur when the shares are sold.
- R11-5. It is not always true that a shareholder prefers a dividend over a capital gain. First of all, the shareholder may be entitled to the capital gains deduction on shares of a qualified small business corporation (QSBC), in which case a capital gain is preferable to a dividend. Both dividends and capital gains have preferential treatment (dividends - the dividend tax credit, capital gains – 1/2 taxable). The tax rate on non-eligible dividends is higher than the rate on capital gains, except in the lowest tax bracket where the opposite is usually true. The tax rate on eligible dividends is normally lower than the rate on capital gains in first two tax brackets. However, the opposite usually occurs in the top tax bracket. See Exhibit 10-8 for the actual marginal tax rates for the top income tax bracket by source for each province. Using the marginal rates developed in Chapter 10 (Exhibit 10-7) for a particular province, the rates can be compared as follows:

	<u>Capital Gains</u>	<u>Eligible Dividends</u>	<u>Non-eligible Dividends</u>
Low bracket	12%	0%	13%
2 nd bracket	16%	10%	22%
3 rd bracket	20%	21%	31%
4 th bracket	23%	28%	37%
High bracket	25%	35%	43%

Keep in mind that the timing of the tax may be different for each option. Capital gains are taxed only when the property is sold whereas dividends are taxed when received.

R11-6. In the primary relationship, dividends paid by the corporation are not deductible by the corporation when determining its income for tax purposes, but the receipt of the dividends is taxable to the shareholder. Therefore, corporate income distributed to shareholders as dividends are subject to two levels of tax. In secondary relationships, payments to the shareholder for salary, interest, and rents are all deductible for tax purposes by the corporation and fully taxable to the recipient. Because such payments reduce corporate income before tax, it effectively shifts corporate income from the corporation to the shareholder with the result being that there is only one level of tax.

R11-7. The conversion of net income for tax purposes to taxable income for corporations is different because it includes several special reductions that are not permitted for individuals. In arriving at taxable income, a corporation, in addition to deducting net capital losses and non-capital losses, can also deduct:

- dividends from taxable Canadian corporations included in net income [ITA 112(1)],
- dividends from foreign affiliate corporations included in net income [ITA 113], and
- charitable donations [ITA 110.1(1)].

A further difference is that a corporation is not entitled to the capital gains deduction which exempts \$913,630 (in 2022) of gain on certain qualified properties.

R11-8. If voting control of a corporation shifts from one shareholder or group of shareholders to another, any net capital and non-capital losses are affected as follows:

- Net capital losses are deemed to expire [ITA 111(4)(a)].
- Non-capital losses that were incurred from a business operation continue to be carried forward, but can only be offset against profits earned by the business that incurred the loss of a similar business. In addition, the loss business must be carried on at a profit or with a reasonable expectation of profit throughout the taxation year in which the losses carried forward are deducted. If the loss business is terminated before the losses are used, the loss carry-overs will not be available [ITA 111(5)].
- Non-capital losses that were incurred from ABILs and property losses, i.e., rent, are deemed to expire [ITA 111(5)].
- A deemed year end occurs at the date of the control change [ITA 249(4)]. This causes operating losses (if any) up to that date to be included as restricted non-capital losses.

- Depreciable property and capital property are deemed to be sold at FMV on the date of the control change *if* the specific property is valued *below* its tax cost [ITA 111(4), (5.1) & (5.2)]. This has the effect of triggering unrealized losses and including them in the above restrictions.

(Note: control must be acquired by an arm's length party for the above to apply [ITA 256(7)(a)])

- R11-9. A change in control from a sale of the shares will restrict the use of the loss carry-overs so that they can be used only by the business that incurred the loss or a similar business [ITA 111(5)]. If the purchaser is in a similar line of business, they can, after the share acquisition, take steps to combine their profitable operations with the acquired loss corporation.

The loss carry-overs can then be used against the future profits of the purchaser's operations. This would not be the case if the purchaser was in a different line of business. Therefore, a loss corporation has greater value to a purchaser in the same line of business that can easily use the prior losses to create tax savings. The vendor should seek out such buyers.

- R11-10. The existing profitable retail corporation can expand its new manufacturing activity by using a separate corporation to house the new activity, or it could operate the manufacturing operation as a division of the existing corporation. In addition to any legal and administrative considerations, the following tax items should be considered when making the choice:

- If the new manufacturing operation should incur losses, they could not be immediately used if a separate corporation structure was used, as those losses would belong to the new corporation as a separate taxpayer. However, under a division structure, any losses from the manufacturing operation could be immediately offset against the retail profits creating additional cash flow from tax savings. This cash flow could be used to help fund the cost of the expansion. If the new venture fails, the divisional structure leaves the existing corporation fully liable for the obligations, whereas the separate corporation structure may limit the liability.
- The alternate structures will have an impact on the amount of income that is subject to the Manufacturing and processing profits (M&P) deduction (13%) [ITA 125.1(1)]. The general tax reduction (13%) [ITA 124.4] is applicable to other types of income. Therefore, most corporate income is subject to a net federal tax rate of 15%. Certain provinces have special rates for manufacturing and processing income. It is the possibility of provincial tax savings that makes the allocation of M&P income important.

Under the separate corporation structure, the maximum profit eligible for the reduction is the actual manufacturing profits earned. However, when the operations are combined in the same corporation with the profitable retail activity, the manufacturing profits available for the M&P deduction is determined by an arbitrary formula -- based on the ratio of manufacturing capital and labour to total capital and labour of the combined operating profit [Reg. 5200]. This formula may produce an arbitrary manufacturing income for tax purposes that is greater than or less than actual. The magnitude of this difference can be estimated and once determined should be considered as part of the decision process.

R11-11. The owner of shares of a corporation can realize a return on that investment from dividends and/or capital gains when the shares are sold. The payment of dividends reduces the value of the share and therefore reduces the potential capital gain on the shares. With respect to corporate shares, dividends and capital gains are closely related.

However, when one corporation invests in shares of another corporation, the consequence of the capital gain/dividend relationship is altered. Dividends received by a corporation from another Canadian corporation can be deducted from the recipient's net income when arriving at taxable income thereby providing a tax-free return on investment [ITA 112(1)]. In comparison, if dividends are not paid, allowing the share value to grow, the capital gain on the future sale of shares will be taxable to the investor corporation. This difference in tax treatment is significant and creates a strong incentive for dividend returns compared to capital gains. This is quite different than the relationship of dividends and capital gains where the shareholder is an individual. (Certain refundable taxes may be applicable to particular dividends received by a private corporation - see Chapter 13).

R11-12. The 13% federal tax reduction on manufacturing profits may apply to an amount that is different from the actual manufacturing profits because manufacturing profit for purposes of the tax calculation is based upon an arbitrary formula as follows: [Reg.5200]

$$\frac{\begin{array}{c} \text{Manufacturing} \\ \text{Capital} \end{array} + \begin{array}{c} \text{Manufacturing} \\ \text{Labour} \end{array}}{\begin{array}{c} \text{Total} \\ \text{Capital} \end{array} + \begin{array}{c} \text{Total} \\ \text{Labour} \end{array}} \times \text{Total business profits}$$

The above formula arbitrarily allocates a portion of the total business profits as "manufacturing profits" based upon the ratio of manufacturing capital and labour to total capital and labour of the whole corporation. For example, assume that the ratio in the above formula is 20% (i.e. MC + ML is 20% of TC + TL) and the corporation's profits are as described in the question.

Retail profits	\$500,000
Manufacturing loss	<u>(50,000)</u>
Total profits	<u>\$450,000</u>

For tax purposes, the manufacturing profits would be \$90,000 (20% of \$450,000) even though the manufacturing activity actually suffered a loss of \$50,000. The arbitrary formula converted \$140,000 of retail profits into manufacturing profits eligible for the 13% M&P deduction (and certain provincial and territorial reductions) (\$90,000 + \$50,000 loss = \$140,000). The availability of the small business deduction may limit the use of the M&P deduction (see Chapter 13)

R11-13. The marginal tax rate is 26.5% calculated as follows:

Federal rate	38.0%
Less federal abatement	(10.0)
General tax reduction	<u>(13.0)</u>
Federal tax	15.0
Provincial tax	
Exhibit 11-7	<u>11.5</u>
Combined rate	<u>26.5%</u>

A portion of the restaurant profits may be considered as manufacturing and processing income because the conversion of raw food into cooked meals represents a processing activity [ITA 125.1(3)]. Therefore, the tax rate on income of this nature (based on the arbitrary formula) may be reduced due to a provincial reduction of 1.5%.

R11-14. The dividend tax credit is designed to reduce or eliminate double taxation that would otherwise occur when after-tax corporate profits are distributed as dividends to shareholders who are individuals. The federal dividend tax credit, together with the corresponding provincial dividend tax credit, reduces the shareholder's personal tax in recognition of the fact that the corporation has already paid tax on its corporate income. However, this reduction makes the assumption that the corporate tax rate is approximately either 27.5% or 13%. If the corporate tax rate is higher than these assumed rates (27.5% and 13%), an element of double taxation will occur. If the corporate rate is lower than these assumed rates, an element of tax savings will occur. Provincial tax rates vary widely. Thus, the element of double tax or tax savings depends on the province in which the income is earned. There is some amount of double taxation when business income **not** eligible for the small business deduction is passed through a corporation, for all provinces and territories, except one. [Text – Appendix A].

R11-15. Yes, it is possible for corporations to earn income in a year but pay no tax in that year. There are two primary reasons why this may occur:

- The corporation may have suffered losses in previous or subsequent years which are carried forward or back and deducted against the profits of the year in question. This reduces the corporation's net income when arriving at its taxable income and no tax is payable [ITA 111(1)(a)]. Therefore, although there is net income for the year there is no taxable income.
- The corporation may simply be a holding corporation that owns shares of another corporation. For example, the corporation in question may own all of the shares of its subsidiary corporation that in turn operates an active business. The subsidiary corporation earns business income and pays tax on that income. When the after-tax profits are transferred to the parent corporation as dividends, the parent corporation has dividend income but can deduct that amount in arriving at taxable income, thereby paying no tax [ITA 112(1)].

It is the authors' opinion that no changes to the tax system are warranted. The carry forward of unused losses seems fair and equitable. Individuals are also entitled to the same treatment. Also, taxing intercorporate dividends would magnify the amount of double taxation as profits that have already been taxed would be taxed again and again as they pass from one corporation to another. Although, it can be argued that a fully refundable tax on intercorporate dividends could avoid excessive taxation (see the discussion on refundable dividend taxes in Chapter 13).

The process of publicly comparing corporate taxes to net income for the year, rather than to taxable income, is misleading and is usually stressed for political reasons rather than for tax reasons.

Key Concept Questions

QUESTION ONE

A Canadian corporation with a December year end has incurred the following losses:

	<u>Amount</u>	<u>Year Incurred</u>
Non-capital loss	\$10,000	2021
Non-capital loss	\$12,000	2020
Net capital loss	\$16,000	2008

Determine the expiry date for each of the above losses.

CPA Competency 6.2.2 Taxes payable for a corporation– loss carry overs. Income tax reference: ITA 111(1)(a),(b).

QUESTION TWO

Moon Corp., a Canadian public corporation, has correctly computed its income (loss) for the current taxation year.

Income from property including dividends of \$12,000 received from taxable Canadian corporations		\$ 50,000
Taxable capital gains	\$18,000	
Allowable capital losses	<u>(8,000)</u>	10,000
Loss from business		<u>(100,000)</u>
		<u>\$ (40,000)</u>

Moon Corp. contributed \$5,000 to various charities in the current year. Moon Corp. has net capital losses of \$15,000 available. These losses were incurred last year.

Determine Moon Corp.'s maximum non-capital loss for the current taxation year.

CPA Competency 6.2.2 Taxes payable for a corporation– loss carry overs. Income tax reference: ITA 110.1(1), 111(8), 112(1).

QUESTION THREE

Nelson Ltd. has net income for tax purposes of \$300,000 for the current taxation year. Included in this amount are dividends of \$20,000 received from taxable Canadian corporations and taxable capital gains of \$15,000. During the year, Nelson Ltd. donated \$40,000 to the Canadian Cancer Society. Nelson Ltd. has non-capital losses of \$10,000 (incurred last year) and net capital losses of \$18,000 (incurred in 2001) available.

Determine Nelson's taxable income for the current taxation year.

CPA Competency 6.2.2 Taxes payable for a corporation– taxable income adjustments. Income tax reference: ITA 110.1(1), 111(1)(a), (b), 112(1).

QUESTION FOUR

Loser Ltd. has non-capital losses of \$60,000 from business operations and net capital losses of \$40,000 (both incurred two years ago). On October 1 of the current year, the shares of Loser Ltd. were acquired by an arm’s-length person.

Determine the tax implications for Loser Ltd.

CPA Competency 6.6.3 Income tax implications of the purchase and sale of a CCPC – acquisition of control. Income tax reference: ITA 111(4), (5), 249(4).

QUESTION FIVE

On November 1st of the current year, X Ltd. purchased 80% of the shares of Y Ltd. from an unrelated person. Details of the assets owned by Y Ltd. at that time are summarized below:

	<u>Class 1</u>	<u>Class 8</u>	<u>Class 12</u>	<u>Class 14.1</u>
Fair market value	\$400,000	\$20,000	\$ 5,000	\$ 3,000
Cost	300,000	30,000	25,000	10,000
UCC	275,000	27,000	0	3,500

Determine the adjustments required to the tax values of the assets owned by Y Ltd. and the effect on Y’s business income for its taxation year ended October 31.

CPA Competency 6.6.3 Income tax implications of the purchase and sale of a CCPC – acquisition of control. Income tax reference: ITA 111(5.1), 249(4).

QUESTION SIX

On April 1st of the current year, Carl Morris purchased 60% of the shares of P Ltd. from an unrelated person. Details of the inventory and other assets owned by P Ltd. at that time are summarized below.

	<u>FMV</u>	<u>Cost</u>
Investment in A Ltd.	\$ 10,000	\$24,000
Inventory	50,000	30,000
Land	100,000	80,000
Building (UCC \$75,000)	120,000	90,000

Determine the tax implications for P Ltd.

CPA Competency 6.6.3 Income tax implications of the purchase and sale of a CCPC – acquisition of control. Income tax reference: ITA 10(1); 111(4)(a),(c),(d),(e); 249(4).

QUESTION SEVEN

Free Corp. is a Canadian public corporation that operates a retail store in Ontario. Free Corp.’s taxable income for the current year is \$100,000.

Determine the federal tax payable for the current year.

CPA Competency 6.2.2 Taxes payable for a corporation– elements of taxes payable. Income tax reference: ITA 111(4), 123(1), 124(1), 123.4(2).

QUESTION EIGHT

Easy Corp., a Canadian public corporation, carries on business in Canada and in United States. The revenue and salaries allocated to the permanent establishment in each location are as follows for the current year:

	<u>Revenue</u>	<u>Salaries</u>
Canada	\$ 8,000,000	\$ 600,000
United States	<u>2,000,000</u>	<u>400,000</u>
Total	<u>\$10,000,000</u>	<u>\$1,000,000</u>

Easy Corp. has taxable income of \$600,000 for the current year.

Determine the federal tax payable for Easy Corp. for the current year.

CPA Competency 6.2.2 Taxes payable for a corporation– elements of taxes payable. Income tax reference: ITA 123(1), 124(1), 123.4(2); Reg. 402.

QUESTION NINE

Gold Corp., a Canadian public corporation, carries on business in Canada. For the current year, Gold Corp. has manufacturing and processing profits (M&P) of \$300,000, calculated in accordance with prescribed rules. Gold Corp. has total taxable income of \$1,000,000.

Determine the federal tax payable for the current year, assuming the maximum Manufacturing and Processing deduction is claimed.

CPA Competency 6.2.2 Taxes payable for a corporation– elements of taxes payable. Income tax reference: ITA 123(1), 124(1), 123.4(2), 125.1.

QUESTION TEN

Manu Corp. is a Canadian public corporation that carries on manufacturing and distribution operations in British Columbia. Manu Corp.'s taxable income for the current year is \$900,000. The balance sheet shows that the cost of all depreciable property owned by Manu Corp. at the end of the year is \$1,100,000. Of this amount, \$800,000 is used in the manufacturing business. The income statement shows income from the manufacturing operations of \$300,000, income from the wholesaling operations of \$500,000 and investment income of \$100,000. The total payroll for the year is \$2,200,000, of which \$1,000,000 is paid to employees directly involved in manufacturing activities.

Determine the federal manufacturing and processing deduction for the current year.

CPA Competency 6.2.2 Taxes payable for a corporation– elements of taxes payable. Income tax reference: ITA 125.1; Regs. 5200, 5201, 5202.

Solutions to Key Concept Questions

KC 11-1

[ITA: 111(1)(a),(b) – Expiry dates for losses]

Generally, non-capital losses expire after 20 years. Net capital losses have an indefinite carry forward.

The \$10,000 non-capital loss incurred in 2021 expires in 2041.

The \$12,000 non-capital loss incurred in 2020 expires in 2040.

The \$16,000 net capital loss can be carried forward indefinitely.

KC 11-2

[ITA: 110.1(1), 111(8), 112(1) – Non-capital loss]

Moon Corp's maximum non-capital loss for the current year is \$62,000.

Net income (loss)	\$(40,000)
Dividends from taxable Canadian corporations	(12,000)
Donations (limited to 75% x net income)	0
Net capital losses (limited to net taxable capital gains)	<u>(10,000)</u>
Non-capital loss for the year	<u>\$(62,000)</u>

At first it may seem odd that net capital losses are included in calculating the non-capital loss for the year. If no net capital losses were utilized, the net taxable capital gain of \$10,000 (\$18,000 taxable capital gain less \$8,000 allowable capital loss) would be reduced from \$10,000 to zero by applying \$10,000 of the \$100,000 loss from business since that business loss can offset any source of income. This would reduce non-capital losses available for carry-forward. If a net-capital loss is applied instead, the taxable capital gain is offset by the net capital loss as opposed to the business loss, so this increases the non-capital loss for the year.

KC 11-3

[ITA: 110.1(1), 111(1)(a),(b), 112(1), 127(3) – Taxable income, Political tax credit]

Nelson Ltd.'s taxable income is \$215,000.

Net income	\$300,000
Dividends from taxable Canadian corporations	(20,000)
Donations (limited to 75% x net income)	(40,000)
Net capital losses (limited to net taxable capital gains)	(15,000)
Non-capital losses	<u>(10,000)</u>
Taxable income	<u>\$215,000</u>

KC 11-4

[ITA: 111(4), (5), 249(4) – Acquisition of control]

Control of Loser Ltd. has been acquired by an unrelated party on October 1st. This has the

following tax implications:

- Loser Ltd.'s year-end is deemed to end immediately before the acquisition of control, September 30. This counts as a taxation year for purposes of determining the expiry date of the non-capital losses. Loser Ltd. can select a new year-end for tax purposes.
- The net capital losses are deemed to have expired immediately before control was acquired, September 30th.
- The non-capital losses that resulted from a business operation continue to be carried forward but can be utilized only against income generated from the business that incurred the loss or against income of a business that is similar to the business that incurred the loss. The business that incurred the loss must be carried on at a profit or with a reasonable expectation of profit throughout the taxation year in which the losses are deducted.

KC 11-5

[ITA: 111(5.1),(5.2), 249(4) – Acquisition of Control]

Depreciable property is deemed to have been sold immediately before the acquisition of control at its fair market value if that value is below the tax value [ITA 111(5.1),(5.2)].

Class 1 – no adjustment; FMV is not below the tax value.

Class 8 – UCC is reduced from \$27,000 to \$20,000.

Class 12 – no adjustment; FMV is not below the tax value.

Class 14.1 – UCC is reduced from \$3,500 to \$3,000.

The reduction to the UCC of Class 8 (\$7,000) and Class 14.1 (\$500) will decrease Y Ltd.'s business income (or increase the business loss) for the taxation year ended October 31 by \$7,500.

KC 11-6

[ITA: 10(1), 111(4)(c),(d),(e), 249(4) – Acquisition of Control]

P Ltd.'s taxation year is deemed to end on March 31, immediately before Carl acquired control. P Ltd. can select a new year-end for tax purposes [ITA 249(4)].

The assets of P Ltd. are deemed to have been sold at their market value immediately before Carl acquired control if that value is below the tax cost [ITA 111(4)(c)].

Investment in A Ltd. – the cost is reduced from \$24,000 to \$10,000 and that \$14,000 write-down is deemed to be a capital loss for the year deemed to have ended on March 31 [ITA 111(4)(d)].

Inventory – no adjustment is required since the FMV is not below the cost [ITA 10(1)].

Land & building – no adjustment is required since the FMV is not below the cost.

The \$7,000 ($\$14,000 \times \frac{1}{2}$) allowable capital loss on the investment becomes a net capital loss and expires on March 31 if unused [ITA 111(4)(a)]. P Ltd. can elect to recognize all or a portion of the accrued gains and recapture on assets [ITA 111(4)(e)]. Unless there are non-capital losses expiring, P Ltd. should not elect to recognize recapture. It would be beneficial for P Ltd. to elect

to recognize a \$14,000 capital gain on the land to offset the expiring capital loss. To do this, P Ltd. elects to recognize proceeds of \$94,000 (\$80,000 + \$14,000) for the land. By making the election, the ACB of the land is increased to \$94,000.

KC 11-7

[ITA: 123(1), 124(1), 123.4(2) – Corporate tax calculation]

ITA 123(1)	Basic federal tax - \$100,000 x 38%	\$38,000
ITA 124(1)	Federal abatement - \$100,000 x 10%	<u>(10,000)</u>
		28,000
ITA 123.4(2)	General tax reduction - \$100,000 x 13%	<u>(13,000)</u>
	Federal tax	<u>\$15,000</u>

KC 11-8

[ITA: 123(1), 124(1), 123.4(2); Reg. 402 – Federal Abatement]

Since Easy Corp carries on business outside of Canada, the taxable income earned in Canada must be calculated before the federal abatement can be calculated. Foreign business income does not qualify for the federal abatement.

Taxable income earned in Canada is calculated in a prescribed manner as follows [Reg 402]:

$$\frac{1}{2} (\% \text{ of Revenue allocated to Canada} + \% \text{ of Salaries allocated to Canada}) \times \$600,000$$

$$= \frac{1}{2} (80\% + 60\%) \times \$600,000$$

$$= 70\% \times \$600,000 = \$420,000$$

Therefore \$420,000 being 70% of taxable income is earned in Canada.

ITA 123(1)	Basic federal tax - \$600,000 x 38%	\$228,000
ITA 124(1)	Federal abatement - \$420,000 x 10%	<u>(42,000)</u>
		186,000
ITA 123.4(2)	General tax reduction - \$600,000 x 13%	<u>(78,000)</u>
	Federal tax	<u>\$108,000</u>

KC 11-9

[ITA: 123(1), 124(1), 123.4(2), 125.1 – Corporate tax calculation]

ITA 123(1)	Basic federal tax - \$1,000,000 x 38%	\$380,000
ITA 124(1)	Federal abatement - \$1,000,000 x 10%	<u>(100,000)</u>
		280,000
ITA 125.1	M&P deduction \$300,000 x 13%	(39,000)
ITA 123.4(2)	General tax reduction (\$1,000,000 - \$300,000) x 13%	<u>(91,000)</u>
	Federal tax	<u>\$150,000</u>

KC 11-10

[ITA: 123(1), 124(1), 123.4(2), 125.1; Reg. 5200, 5201, 5202 – M&P deduction]

Before determining the M&P deduction, it is necessary to derive the M&P profit in accordance with the prescribed rules.

Manufacturing capital (MC)

$$\text{Manufacturing depreciable property } \$800,000 \times 10\% \times 100/85 = \underline{\$94,118}$$

Total capital (TC)

$$\text{Total depreciable property } \$1,100,000 \times 10\% = \underline{\$110,000}$$

$$\text{Manufacturing labour (ML)} = \$1,000,000 \times 100/75 = \underline{\$1,333,333}$$

$$\text{Total labour (TL)} = \underline{\$2,200,000}$$

$$\text{Adjusted business income} = \$300,000 + \$500,000 = \underline{\$800,000}$$

$$\text{M\&P profit} = \frac{\text{MC } \$94,118 + \text{ML } \$1,333,333}{\text{TC } \$110,000 + \text{TL } \$2,200,000} \times \$800,000 = \underline{\$494,355}$$

$$\text{M\&P deduction} - 13\% \times \$494,355 = \underline{\$64,266}$$