CHAPTER 13

THE CANADIAN-CONTROLLED PRIVATE CORPORATION

Review Questions

1. Explain why a Canadian corporation whose voting share capital is owned 50% by Canadian residents and 50% by non-residents is classified as a Canadian-controlled private corporation.

2. Canadian-controlled private corporations differ from public corporations in the rate of tax, the extent of double taxation, and the degree of secondary relationships with shareholders. Briefly describe these differences.

3. "A business that derives its income from selling personal services (plumbing repairs, for example) cannot be viewed as earning active business income." Is this statement true? Explain. How is a personal services business different from an active business?

4. Why may a Canadian-controlled private corporation that earns business income of $100,000 in year 1 and $500,000 in year 2 (total: $600,000) pay less tax than a corporation earning $50,000 in year 1 and $550,000 in year 2 (total: $600,000)?

5. In question 4, what might the latter corporation be able to do to ensure that it pays the same amount of tax as the first corporation? If these options are, in fact, available, what other factors must be considered before a decision is made to take such actions?

6. "The use of the small-business deduction by a Canadian-controlled private corporation does not result in a tax saving; rather, it creates a tax deferral." Explain.

7. Interest income and/or rental income earned by one Canadian-controlled private corporation may be treated as specified investment business income. At the same time, income from the same source(s) earned by another Canadian-controlled private corporation may be treated as active business income. Why is this? And to what extent will the rate of tax applied to that income be different for the two corporations?

8. Identify and briefly explain the mechanism that is used to reduce the incidence of double taxation when specified investment business income is distributed by a Canadian-controlled private corporation to its shareholders.

9. Does double taxation occur when a Canadian-controlled private corporation earns capital gains and distributes those gains as dividends to individual shareholders? Explain.

10. "An investor can achieve a tax deferral on portfolio dividends received from public corporation shares if those shares are owned by the individual's private corporation." Is this statement true? Explain.

11. There are several advantages to deferring tax by utilizing the small-business deduction. Briefly state two of them.

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12. A Canadian-controlled private corporation can obtain a tax deferral from the small-business deduction. Will the corporation's owner always benefit from investing the extra cash flow that results, regardless of the type of return that may be received from the investment? Explain.

13. Briefly state the advantages and disadvantages of earning investment income in a Canadian-controlled private corporation.

14. Why may it be worthwhile for a corporation to pay an additional salary or bonus to its shareholder/manager, even though that person does not require additional funds?

15. Is it possible for a shareholder to obtain personal use of corporate funds without first declaring a dividend or salary? Explain.

16. Individual A is about to acquire 30% of the shares of a new corporation (a Canadian-controlled private corporation) that will carry on an active business. The remaining 70% of the shares will be owned by X Corporation, a company that also owns an active business. What concern should individual A have regarding the tax treatment of the new corporation's income?

17. Corporation A, a Canadian-controlled private corporation, earns 8% of its net active business income from providing technology services to Corporation B. A's total active business income is $400,000 and is eligible for the small business deduction. For the upcoming taxation year, A's income from B is expected to increase. Corporation A owns 2% of B's common voting shares. What concern should A have regarding the tax implication of the expected increase in income from providing services to B?

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Solutions to Review Questions

R13-1. A Canadian-controlled private corporation is defined as a Canadian private corporation that is not controlled directly or indirectly, in any manner whatever, by one or more non-residents or by one or more public corporations. In this particular case, even though the corporation is not actually controlled by Canadians (50%) it is also not controlled by non-residents (50%). Therefore, by definition, the corporation is a Canadian-controlled private corporation [ITA 125(7)].

R13-2. Basic differences between public corporations and Canadian - controlled private corporations:

Rates of Tax - The rates of tax applicable to a public corporation and a CCPC differ in several ways. In a CCPC the first $500,000 of annual active business income is eligible for the small business deduction [ITA 125(1)] of 19% reducing federal taxes to 10.5%. In most provinces, the provincial rate is also reduced for this income. A CCPC pays an additional 10 ⅔% refundable tax on its investment income [ITA 123.3] and is entitled to a refund of Part I tax equal to 30 ⅔% of its investment income. As well, dividends from non-connected corporations are subject to a 38 ⅓% Part IV tax [ITA 186(1)] which is not the case for public corporations.

Double Taxation – The Canadian tax system is intended to be integrated; the combined tax rate - corporate plus shareholder tax on the dividend distribution - approximates the individual shareholders' personal rate of tax. This is achieved by the dividend gross-up and tax credit. As well for CCPCs, integration tools include the small business deduction on active business income, the refund mechanism on property income and taxable capital gains [ITA 129(1)], and the special tax-free distribution as a capital dividend of certain non-taxable income such as one-half of capital gains [ITA 83(2)].

In some cases, the integration is not perfect and results in an overall tax cost or tax savings. Where a tax cost occurs, this is referred to as double taxation. At the high corporate rate (27%) some double taxation occurs. This rate applies to all income earned by a public corporation and business income over $500,000 earned annually by a CCPC.

Secondary Relationship - A secondary relationship exists when a shareholder also acts in another capacity with the corporation such as a creditor lending funds to the corporation, a lesser leasing property to the corporation, or as an employee of the corporation. Such relationships are common in a CCPC because the number of shareholders is usually small and the affairs of the corporation and the shareholders are closely associated. In a public corporation, there are a large number of shareholders who do not participate in the management of the corporation and, therefore, secondary relationships are rare.

R13-3. The statement is not true. Active business income is defined as any business carried on by the corporation other than a specified investment business or a personal service business. While the definition excludes a personal service business it does not mean income from selling services is excluded. The term personal service business has a special and narrow definition and relates to providing services in a particular manner (i.e., where there is an employer/employee relationship between the entity receiving the service and the individual shareholder of the corporation that is providing the service). As this type of relationship is not common, it can be said that corporate income derived from selling services (e.g., consulting services) is normally considered to be active business income eligible for the small business deduction [ITA 125(7)].

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R13-4. The corporation that earns $100,000 in year 1 and $500,000 in year 2 has all of its income ($100,000 + $500,000 = $600,000) eligible for the small business deduction because in both years the income does not exceed the annual $500,000 limit. The corporation will pay less tax than the other corporation which also earns $600,000, but in year 2 has income in excess of $500,000. This corporation will receive the small business deduction on $50,000 in year 1 and $500,000 in year 2 (total $550,000) leaving $50,000 to be taxed at a higher corporate rate. This major difference in tax cost results from the imposition of an annual limit, which means that not only is the amount of income earned important but also when that income is earned.

R13-5. In question 4 above, the second corporation could take steps to increase the income in the first year and reduce the income of the second year. This would qualify more of the total income for the small business deduction. These steps do not change the real income of the entity but change the time period in which they are recognized. For example, the corporation could choose not to claim a reserve for doubtful accounts in year 1 but recognize the deduction in year 2. Similarly, owners' salaries could be reduced in year 1 and increased in year 2.

While such actions reduce the rate of tax payable, it also speeds up the timing of tax. In other words, the total tax for the two years is less but more tax is payable in the first year than would otherwise be payable. Therefore, the impact on cash flow must also be considered before this decision is made.

R13-6. The use of the small business deduction results in a corporate tax rate of approximately 13%. This rate is substantially lower than the top marginal rate of tax that an individual would pay if the business income was earned by a proprietorship (or partnership) rather than a corporation. However, when the corporate structure is used, the after-tax income of the corporation is subject to a second level of tax when it is paid to the shareholder as a dividend or, if not paid as a dividend, when the shares are sold and a capital gain occurs. This second level of tax, although deferred, normally will eliminate most, if not all, of the tax saving achieved from the use of the small business deduction. Consequently, the small business deduction is useful if the corporate earnings are retained in the corporation; its benefit is a deferral and not permanent savings.

R13-7. A CCPC has specified business investment income if it earns income from property (interest, rents, royalties) other than dividends from Canadian corporations. Property income is achieved from these sources when the return on investment is earned with little attention or labour of the owner; otherwise it is business income. For a CCPC, such income is arbitrarily classified as active business income if the corporation employs more than five full-time employees who work to generate that income. Therefore, based on this arbitrary factor one CCPC may have active business income and another CCPC may have specified business investment income [ITA 125(7)].

When classified as active business income, the income is eligible for the small business deduction resulting in a tax rate of 13% provided that it is within the $500,000 business limit. Active business income in excess of the $500,000 business limit is subject to the higher corporate rate (27%). If the income is classified as specified business investment income, it is subject to the highest rate of corporate tax (50 ⅔%) but is eligible for a partial refund when that income is distributed to the shareholders as dividends [ITA 129(3)].

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R13-8. Specified business investment income is taxed in a CCPC at the highest corporate rate (50 ⅔%). In spite of this high rate, the element of double taxation is reduced by a refund mechanism [ITA 129(3)]. The potential refund is 30⅔% of specified business investment income earned and the refund is paid to the corporation when a dividend distribution is made to the shareholder. Although the corporate tax rate may be as high as 50 ⅔% when the income is earned, this amount is reduced by 30 ⅔% to 20% when distributed. The combination of the refund plus the dividend tax credit for the shareholder eliminates most of the double taxation.

R13-9. Double taxation generally does not occur when a CCPC earns a capital gain. One-half of the capital gain is taxable at the high corporate rate of 50 ⅔%. However, of this tax, an amount equal to 30 ⅔% of the taxable gain is refunded to the corporation when the gain is distributed as a taxable dividend to the shareholder [ITA 129(3)]. This reduction of corporate tax plus the dividend tax credit reduces double taxation. One-half of the capital gain is not taxable. This tax-free portion of the gain can be distributed as a tax-free capital dividend [ITA 83(2), 89(1)]. The refund mechanism plus the tax-free dividend are designed specifically to avoid double taxation for a CCPC on this type of income.

R13-10. Dividends received by a CCPC are not subject to normal corporate rates of tax because the dividends are excluded from taxable income. However, portfolio dividends (from public corporations) and certain dividends from Canadian private companies are subject to a special Part IV tax of 38 ⅓% [ITA 186(1)]. This tax is fully refundable to the corporation when the dividend income is distributed to the shareholder. Once distributed to an individual shareholder, the dividend will be taxed in the ordinary manner.

If the portfolio dividend was a non-eligible dividend and was received directly by an individual in the top tax bracket, the rate of tax would be approximately 43%. Therefore, earning portfolio dividends in a CCPC can result in a tax deferral. (Depending on the province, actual rates in 2022 on non-eligible dividends vary– see Appendix A at the back of the text book or on Connect).

R13-11. The tax deferral from the small business deduction results in two basic advantages.

- The increased cash flow from the lower tax rate (compared to the personal tax rate) can be reinvested in business expansion or passive investments resulting in greater long-term return on investments.

- The increased cash flow, especially at the early stages of a new business, reduces the risk of business failure by providing greater liquidity for responding to changing business needs.

R13-12 The tax advantage from incorporating a proprietorship business results from the reduced tax rate on active business income that is subject to the small business deduction. This tax reduction is only a deferral as ultimately the shareholder must realize their investment through dividend distribution and/or a disposal of the shares. The increased cash flow in the corporation, when reinvested, will provide returns to the corporation that are subject to tax. If those additional returns are also subject to the small business deduction or are specified investment business income (subject to the high corporate tax rate combined with a refund when distributed), minimal double taxation, if any, on those returns will occur. However, when the returns from investing the tax deferrals from the small business deduction earn active business income subject to the high corporate tax rate, some double

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taxation on those returns may occur at some future time.

It is important to recognize that the additional cash flow provided from the small business deduction may be critical to the success of the business and the expansion opportunities that it can participate in.

R13-13. The incorporation of investment income (other than certain dividends) does not provide a substantial advantage. In a CCPC investment income such as interest and rents, as well as taxable capital gains, are subject to the highest corporate tax rate (50 ⅔%) which, in some provinces, is higher than the top individual tax rate. Therefore, incorporation does not provide a tax deferral.

Investment income in the form of dividends from Canadian public corporations and non-connected private corporations are subject to a special refundable tax of 38 ⅓% (Part IV tax) when received by a Private corporation. The rate is higher than the top marginal personal tax rate on eligible dividends. Therefore, incorporating this income provides no tax deferral. Dividends received by a CCPC from a connected corporation are normally not subject to Part IV tax and a substantial tax deferral will occur [ITA 186(1)].

One disadvantage to incorporating investments should be noted. If an investment in shares of a qualified small business corporation is made through another corporation, any gain on the subsequent sale of those shares will not be available for the capital gains deduction since only individuals can claim a capital gains deduction [ITA 110.6].

R13-14 It may be advantageous for a corporation to pay an additional salary or bonus to the manager/shareholder in situations where the corporation has earned active business income that is not subject to the small business deduction. Such income is subject to the high corporate tax rate (27% in some provinces on income over $500,000) and is subject to further taxation when distributed as dividends to the shareholder at some future time. The result is some double taxation. The payment of an additional salary reduces the amount of corporate income by shifting it directly to the shareholder. Although the shareholder's tax rate is higher than the corporate rate, the double tax is avoided.

When the shareholder does not need the funds, the additional salary or bonus can be loaned back to the corporation (the bonus amount minus personal tax). However, in this case the decision is difficult. The corporate rate of 27% is lower than the top personal tax rate but still results in some double taxation at some future time. The combined corporate and personal tax on the dividend distribution is approximately 53% [See Chapter 11, Part IV, The Integration of Corporate and individual Taxation]. Therefore, if the shareholder does not need the funds immediately, a decision to leave the funds in the corporation to gain a 23% tax deferral (50% personal rate v 27% corporate rate) must be weighed against the impact of the small amount of double taxation at some future time. It should be recognized that the payment of an additional salary or bonus must pass the test of reasonableness before it can be deducted from corporate income [ITA 67].

R13-15. Under certain circumstances, a shareholder may be able to secure temporary use of corporate funds without the corporation declaring taxable dividends or paying salaries. If the shareholder is also an employee or officer of the corporation, the corporation may loan funds to the shareholder for acquiring a personal residence, for acquiring treasury shares of the corporation, or for acquiring an automobile to be used in performing employment duties. The loan will have no tax consequences to the shareholder provided that reasonable repayment terms are made and the loan is received because of employment and not

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because of someone's shareholding [ITA 15(2.4)]. However, there will be an imputed interest benefit included in the employee's employment income if the loan is interest-free or at a low interest rate [ITA 80.4(1) & (3)].

Loans made to shareholders for any other purpose must be repaid within one year from the end of the taxation year of the corporation in which the loan was made. Otherwise, the amount of the loan will be considered as income to the shareholder in the year received [ITA 15(2.6)]. If this occurs, a subsequent repayment of the loan is permitted as a deduction from the shareholder's income in the year of repayment [ITA 20(1)(j)].

R13-16. Because 70% of the new corporation's shares are owned by X Corporation, the two corporations are associated [ITA 256(1)(a)]. X Corporation controls the new corporation. Consequently, the $500,000 small business deduction limit must be shared between the two corporations [ITA 125(3)]. As X Corporation also carries on an active business, it would be to X Corporation's advantage to use the full $500,000 limit and not share any of it with the new corporation that is owned 33% by individual A. As a minority shareholder of the new corporation, individual A should be concerned about not having the use of the small business deduction in the new corporation. This issue could be resolved by a shareholders' agreement that establishes the allocation of the $500,000 business limit for future years [256(1), 125(3)].

R13-17. Corporation A should be concerned that the increased income from B would cause all of the income from B to be classified as specified corporate income and therefore not eligible for the small business deduction [ITA 125(1)(a)(i)(B)]. If A owns any interest in B and the income from B (together with income from other non-arm's length customers) is more than 10% of A's total active business income, that income will be specified corporate income [*specified corporate income* ITA125(7)]. So, if A's income from B increases from 8% to over 10% of its total active business income the small business deduction on that income will be denied unless B assigns a portion of its annual small business limit to A [ITA 125 (3.2)].

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Key Concept Questions

QUESTION ONE

Determine the type of business income being earned by each of the following Canadian-controlled private corporations.

a) Corporation A earns interest and dividends from numerous Canadian corporations. Corporation A employs three full-time employees.
b) Corporation B earns rental income from leasing automobiles.
c) Corporation C carries on a wholesaling business. In the current year, Corporation C earned interest income on overdue accounts receivable in addition to income from the wholesaling business.
d) Corporation D earns interest income from numerous sources. Corporation D employs 10 full-time employees.
e) Corporation E earns consulting income from services provided to X Ltd. Eddy Vasquez is the sole shareholder and the only employee of Corporation E. Eddy was previously employed by X Ltd. as VP operations.
f) Corporation F provides consulting services to several clients. Franny Jenkins is the sole shareholder and only employee of Corporation F.
g) Corporation G earns interest income on a loan to an associated corporation. The interest was deducted in computing the active business income of the associated corporation that carries on an active business.
h) Corporation H earns 30% of its management fees from Y Ltd. and 70% of its management fees from various other parties. Y Ltd. is controlled by a non-arm's length person.

CPA Competency 6.2.2 Taxes payable for a corporation – sources and types of income. Income tax reference: ITA 125(7), 129(6).

QUESTION TWO

Can Corp., a Canadian-controlled private corporation, has net income and taxable income of $100,000 for the current year. The income is specified investment business (SIB) income.

Determine the federal Part I tax payable.

CPA Competency 6.2.2 Taxes payable for a corporation – elements of taxes payable. Income tax reference: ITA 123(1), 124(1), 123.3.

QUESTION THREE

A Canadian private corporation incurred the following transactions in previous years:

- In 2004, a capital asset was sold that resulted in a capital gain of $12,000
- In 2005, a capital asset was sold that resulted in a capital loss of $4,000
- In 2006, a capital dividend of $1,000 was paid
- In 2011, life insurance proceeds of $50,000 were received; the policy had an adjusted cost base of $10,000.

In the current year, a capital dividend of $15,000 was received.

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Determine the current balance in the capital dividend account based on the above information.

CPA Competency 6.2.2 Taxes payable for a corporation – tax implications of dividends. Income tax reference: ITA 89(1).

QUESTION FOUR

Black Ltd., a Canadian private corporation, owns 40% of the voting shares of White Ltd. In the current year, White paid a dividend of $60,000, which triggered a dividend refund of $20,000 to White. Black also received dividends of $40,000 from its wholly-owned subsidiary, Red Ltd., and dividends of $30,000 from sundry Canadian public corporations in which Black owns less than 1% of the issued shares. Red carries on an active business and, thus, did not receive a dividend refund.

Determine the refundable Part IV tax payable by Black Ltd. for the current year.

CPA Competency 6.2.2 Taxes payable for a corporation – elements of taxes payable. Income tax reference: ITA 186(1), (2), (4).

QUESTION FIVE

On March 1, 2022, Martin Torres received an interest-free loan from his employer, X Ltd., a private corporation, owned by his spouse. Martin used the loan to purchase the condominium in which he lives. A loan agreement was signed by Martin agreeing to repay the loan in full after three years. Such a loan is not available to other employees. X Ltd. has a June 30 year end.

Determine the tax implications of the loan for Martin.

CPA Competency 6.6.2 income tax implications of compensation planning between a shareholder and a closely held corporation. Income tax reference: ITA 15(2), (2.1), (2.4), (2.6), 20(1)(j), 80.4(3).

QUESTION SIX

Hallie Wolf owns 2% of the shares of Y Ltd. She is also employed by Y in a middle management position. On August 1, 2022, Hallie received a loan from Y that she used to repay personal debts. Hallie signed a loan agreement, agreeing to pay interest on the loan at the bank prime rate in effect on August 1, 2022 and to repay the loan over three years by monthly payroll deductions. Similar loans have been made in the past to mid-level management employees. Y has a December 31 year end.

Determine the tax implications of the loan for Hallie.

CPA Competency 6.6.2 income tax implications of compensation planning between a shareholder and a closely held corporation. Income tax reference: ITA 15(2), (2.4), (2.6), 80.4(3).

QUESTION SEVEN

Consider each of the following unrelated situations.

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1) Sally Mullins owns 80% of the issued shares of Salt Ltd. and 20% of the issued shares of Pepper Ltd. Her friend owns the remaining 20% of Salt Ltd. and 80% of Pepper Ltd.
2) Bob Weaver owns 70% of the issued shares of B Ltd., which in turn owns 40% of the shares of X Ltd. Bob's father owns the remaining 60% of the shares of X Ltd.
3) Glen Yang and his brother each own 50% of the shares of A Ltd. Glen's child owns 50% of the shares of B Ltd. The remaining shares of B Ltd. are owned equally by Glen and his father.
4) Wanda Snyder owns 100% of the shares of W Ltd. Her child owns 100% of the common shares of S Ltd. Wanda owns 100% of the preferred shares of S Ltd. The preferred shares are non-voting, have a fixed dividend rate (4%), have an issue price of $1,000 per share and are redeemable at $1,000 per share. The prescribed rate was 5% when the shares were issued.

For each situation, determine whether the two corporations are associated and if so, state the paragraph in ITA 256(1) that makes them associated.

CPA Competency 6.2.1 General tax issues for a corporate entity – basic stakeholder relationships. Income tax reference: ITA 256(1),(1.1),(1.2).

QUESTION EIGHT

TV Ltd. is a Canadian-controlled private corporation. The taxable income for its current year has been correctly calculated below:

Business income profits	$640,000
Taxable capital gains from passive investments	100,000
Eligible dividends from Canadian public corporations	24,000
Interest on five-year bonds	10,000
Net income for tax purposes	774,000
Dividends	(24,000)
Net capital losses	(30,000)
Non-capital losses	(20,000)
Taxable income	$700,000

TV Ltd and Nano Ltd. are associated corporations. For the current year, Nano Ltd. claimed the small-business deduction on $120,000 of its active business income. In the previous year, TV Ltd.'s adjusted aggregate investment income was below $50,000 and the taxable capital of the two corporations, combined, was below $10,000,000.

Determine the following:

a) The small-business deduction for TV Ltd. for the current year.
b) The business limit reduction for TV Ltd. for next year.

CPA Competency 6.2.2 Taxes payable for a corporation – elements of taxes payable. Income tax reference: ITA 125(1), (2), (3) (5.1).

QUESTION NINE

Using the information provided in Question Eight, determine TV Ltd.'s refundable tax on investment income. *Income tax reference: ITA 123.3, 129(4).*

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QUESTION TEN

Using the information provided in Question Eight, determine TV Ltd.'s general rate reduction. *Income tax reference: ITA 123.4(1).*

QUESTION ELEVEN

TV Ltd. has Part I tax payable for the current year of $101,133. TV Ltd. had a balance in its non-eligible refundable dividend tax on hand at the end of the previous year of $27,000. TV Ltd. calculated a dividend refund of $6,000 in respect of non-eligible dividends paid in the previous year.

Using the information provided in Question Eight, determine TV Ltd.'s RDTOH balances (eligible and non-eligible) at the end of the current year.

Income tax reference: ITA 129(4), 186(1).

QUESTION TWELVE

TV Ltd. paid non-eligible dividends of $90,000 and capital dividends of $30,000 in the current year.

Determine the dividend refund for the current year using the RDTOH balances calculated in Question Eleven.

Income tax reference: ITA 129(1).

QUESTION THIRTEEN

EX Ltd. is a Canadian-controlled private corporation operating a retail business in Canada. For the current year, EX Ltd. has net income of $662,000 and taxable income of $600,000. Included in net income are taxable capital gains of $46,000 and interest from Canadian sources of $30,000 as well as $42,000 of eligible dividends from Canadian companies. Net capital losses of $20,000 were deducted in computing taxable income. EX Ltd. is claiming a small-business deduction of $95,000 ($500,000 x 19%), which reduces the Part I tax payable to $73,255. The eligible RDTOH at the end of the previous year was $0 and the non-eligible RDTOH was $12,000. During the current year, $50,000 of dividends were paid ($42,000 eligible and $8,000 non-eligible). Dividends were not paid in the previous year.

Determine the dividend refund for EX Ltd. for the current year.

QUESTION FOURTEEN

Ready Ltd is a Canadian-controlled private corporation operating a business. Ready Ltd is not associated with any other corporation and last year its taxable capital was under $10,000,000 and its adjusted aggregate investment income was under $50,000. For its current year ended, its records showed the following amounts:

Income from retail business	$600,000
Interest income	10,000
Eligible dividend received from a Canadian company	40,000
Net income	650,000

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Dividend	(40,000)
Taxable income	$610,000

Ready Ltd. has not paid dividends in the last few years and had a general rate income pool (GRIP) account balance of $50,000 at the end of the previous year.

Determine the GRIP account balance at the end of the current year.

CPA Competency 6.2.2 Taxes payable for a corporation – elements of taxes payable. Income tax reference: ITA 89(1) – definition of GRIP.

QUESTION FIFTEEN

Hitech Ltd., a Canadian-controlled private corporation, spent $1,000,000 in current expenditures for scientific research and experimental development (SR&ED), as well as $500,000 in capital expenditures for SR&ED in the current year. Hitech Ltd. is not associated with any other corporation. Its taxable income for the previous year was $120,000, which resulted in federal tax payable of $10,800. There was no tax payable for the two years before that. The taxable capital is below $10,000,000. Taxable income for the current year is $100,000 (all active business income).

Determine the following:

a) The investment tax credit earned by Hitech Ltd.
b) The cash refund available due to the investment tax credit
c) The investment tax credit available for carry over

How would your answers change if Hitech was a Canadian public corporation?

CPA Competency 6.2.2 Taxes payable for a corporation – elements of taxes payable. Income tax reference: ITA 127(5),(9),(10.1), (10.2), 127.1, 12(1)(t).

QUESTION SIXTEEN

Smallco Ltd, a Canadian-controlled private corporation, has taxable income and active business income equal to $300,000 in 2022. $35,000 of this amount was from providing services to Bigco Ltd. Smallco is owned 60% by Alysha and 40% by Boris. Bigco is owned 96% by Xiao Xiao and 4% by Yolanda. Alysha and Yolanda are siblings.

Determine Smallco's small business deduction for 2022. What steps, if any can be taken to improve Smallco's tax liability in 2022?

CPA Competency 6.2.2 Taxes payable for a corporation – elements of taxes payable. Income tax reference: ITA 125(1)(a)(i)(B), "specified corporate income" ITA 125(7), 125 (3.2), 251(2).

QUESTION SEVENTEEN

In addition to its active business income of $300,000, P Ltd., a CCPC, received dividends of $30,000 from a public corporation and had a taxable capital gain of $90,000 on sale of passive investments in 2021. A net capital loss carry-over from a previous year of $20,000 was

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deducted in arriving at the corporation's taxable income. Management anticipates that in 2022, P Ltd will earn active business income of $450,000 and receive dividends from public corporations of $32,000. P Ltd is not associated with any other corporation and has under $10 million in taxable capital.

Determine P Ltd.'s anticipated small business deduction for the 2022 taxation year.

CPA Competency 6.2.2 Taxes payable for a corporation – elements of taxes payable. Income tax reference: ITA 125(1),(5.1),(7)

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Solutions to Key Concept Questions

KC 13-1

[ITA: 125(7), 129(6) – Types of Business income]

There are three types of business income:

1) Active business income (ABI) – any business carried on by the corporation other than a specified investment business (SIB) or a personal services business (PSB).

2) SIB – a business whose principal purpose is to earn income from property, unless more than 5 full-time employees are employed in the business throughout the year.

3) PSB – a business that provides services, when the person providing the services is a specified shareholder of the corporation, and the relationship between the person providing the services and the entity receiving the services is of an employment nature. Two exceptions are made to the definition of PSB:

   - More than 5 full-time employees are employed in the business throughout the year, or
   - The services are provided to an associated corporation.

Specified shareholder means someone who alone, or together with related persons, owns at least 10% of the issued shares of any class of the corporation or a related corporation [ITA 248(1)].

a) Corporation A earns SIB.
b) Corporation B earns ABI.
c) Corporation C earns ABI. The interest on the overdue accounts receivable is income from an active business because it is pertaining to or incidental to the wholesaling business.
d) Corporation D earns ABI. It is not SIB because more than 5 full-time employees are employed in the business throughout the year.
e) Corporation E earns PSB if an employer/employee relationship exists between Eddy and X Ltd.
f) Corporation F earns ABI. It is not PSB as the employer/employee relationship (between Franny and the several clients) is absent.
g) Corporation G earns ABI. The interest is deemed to be ABI because it is deductible in computing the ABI of an associated corporation [ITA 129(6)].
h) Corporation H earns ABI, but the management fees earned from Y Ltd. are not eligible for the small business deduction since a non-arm's length person has a direct interest in Y Ltd and less than 90% of Corporation H's ABI is earned from arm's length parties. The amount could qualify for the small business deduction to the extent that it is specified corporate income, but this would require Y Ltd. to assign some of its own business limit to Corporation H. [ITA 125(7)]

KC 13-2

[ITA: 123(1), 124(1), 123.3 – Federal tax calculation - SIB]

ITA 123(1) Basic federal tax - $100,000 x 38%	$38,000
ITA 124(1) Federal abatement - $100,000 x 10%	(10,000)
	28,000

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ITA 123.3 Refundable tax on CCPC investment income ($100,000 x 10 ⅔%)	10,667
Federal tax	$38,667

KC 13-3

[ITA: 89(1) – Capital dividend account]

ITA 89(1)(a)	Non-taxable portion of capital gains ($12,000 x ½)	$ 6,000
	Non-allowable portion of capital losses ($4,000 x ½)	(2,000)
		4,000
ITA 89(1)(b)	Capital dividends received	15,000
ITA 89(1)(d)	Life insurance proceeds $50,000 – ACB $10,000	40,000
ITA 89(1)	Less – Capital dividends paid	(1,000)
	Capital dividend account balance	$58,000

KC 13-4

[ITA: 186(1),(2),(4) – Part IV tax]

Dividends received from Non-connected corporations $30,000 x 38 ⅓%	$11,500
Dividends received from connected corporations:	
• White Ltd. - 40% of White Ltd.'s dividend refund $20,000	8,000
• Red Ltd. - 100% of Red Ltd.'s dividend refund $0	0
Part IV tax	$19,500

KC 13-5

[ITA: 15(2),(2.1),(2.4),(2.6), 20(1)(j), 80.4(3) – Shareholder loan]

Since a similar loan is not available to other employees, Martin is considered to receive the loan because of his spouse's shareholding. If the loan is not repaid by June 30, 2023, the loan will be included in Martin's income for tax purposes for 2022, the year he received the loan [ITA 15(2), (2.6)]. Even though the loan is used to buy a condominium to live in, it is not an exempt loan, since the loan was received because of his wife's shareholding and not because of employment [ITA 15(2.4)(e)]. Since the loan is included in income, there is no imputed interest benefit [ITA 80.4(3)(b)]. If the loan is included in Martin's income in 2022, then Martin can deduct the loan repayment in the year the loan is repaid [ITA 20(1)(j)].

KC 13-6

[ITA: 15(2),(2.4), 80.4(3) – Shareholder loans]

Since Hallie is a shareholder of Y Ltd., the shareholder loan rules must be considered. The loan is an excluded loan and will not be included in Hallie's income even if it is not repaid by December 31, 2023. Hallie is not a specified employee of Y Ltd., she received the loan because of her employment, and *bone fide* arrangements were made for repayment of the loan within a reasonable time [ITA 15(2.4)]. A specified employee is someone, who alone or together with related persons, owns 10% or more of any class of shares of the corporation [ITA 248(1)]. Hallie owns only 2%. Since the loan is not a low-interest loan or an interest-free loan, there is no imputed interest benefit [ITA 80.4(3)(a)].

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KC 13-7

[ITA: 256(1), (1.1), (1.2) - Associated corporations]

1) Salt Ltd. and Pepper Ltd. are associated corporations [ITA 256(1)(b)]. They are controlled by the same group, Sally and her friend. ITA 256(1.2) clarifies that a shareholder need own only one share to be included in the group; and that a corporation may be controlled by a person or group of persons notwithstanding that the corporation is also controlled by another person or group of persons.

2) B Ltd. and X Ltd. are associated corporations [ITA 256(1)(c)]. Bob controls B Ltd. and he is related to his father, who controls X Ltd. Although Bob does not own any shares of X Ltd. directly, he is deemed to own 28% of X Ltd. (70% x 40%) by the look-through rules in 256(1.2)(d). Thus, the 25% cross ownership requirement is met.

3) Since neither corporation is controlled by one person, the only possible provision under which A Ltd. and B Ltd. could be associated is 256(1)(e). Both corporations are owned by a related group and Glen owns 25% of the issued shares of a class of both corporations. But the two corporations are not associated. To be associated each of the members of each related group must be related to all of the members of the other related group. Since Glen's son and his brother (nephew and uncle) are not related, the two corporations are not associated.

4) W Ltd. and S Ltd. are not associated. For the corporations to be associated, Wanda would have to own at least 25% of the issued shares of any class of S Ltd. (other than a specified class) or her child would have to own 25% of the issued shares of any class (other than a specified class) of W Ltd. The preferred shares of S Ltd. are shares of a specified class [ITA 256(1.1)], therefore, the 25% cross ownership test is not met.

   In general terms, *shares of a specified class* are non-voting, preferred shares that have a fixed dividend rate and redemption amount. The dividend rate cannot exceed the prescribed interest rate at the issue date of the shares and the redemption amount cannot exceed the issue amount.

KC 13-8

[ITA: 125(1),(2),(3), (5.1) – Small business deduction; Business Limit Reduction]

a) Before the small business deduction can be calculated, the active business income and the annual business limit must be determined.

Net income for tax purposes	$774,000
Less: Interest income	(10,000)
Eligible dividends from Canadian corporations	(24,000)
Taxable capital gains from passive investments	(100,000)
Active business income	$640,000

Business limit [ITA 125(2)]	$500,000
Less amount claimed by associated corporation [ITA 125(3)]	(120,000)
Business limit available to TV Ltd.	$380,000

The small business deduction is calculated as follows:

Least of:	
Active business income	$640,000
Taxable income	$700,000
Business limit	$380,000
Least amount $380,000 x 19%	$72,200

b) To determine the business limit reduction for next year, the adjusted aggregate investment income for the current year must be calculated.

Taxable capital gains from passive investments	$100,000
Interest on five-year bonds	10,000
Net capital losses	(30,000)
Aggregate investment income [129(4)]	80,000
Net capital losses	30,000
Dividends from non-connected corporations	24,000
Adjusted aggregate investment income [125(7)]	$ 134,000

The business limit is reduced on a straight-line basis for CCPC's with excessive income from passive investments (having between $50,000 and $150,000 in investment income) [125(5.1)]. The business limit reduction is $420,000 ($134,000 - $50,000 threshold = $84,000 x $5).

This means there will be $80,000 of business limit available next year ($500,000 – $420,000). This amount must be shared between TV Ltd. and Nano Ltd. since they are associated and the business limit reduction caused by the adjusted aggregate investment income impacts the entire associated group. The two companies may choose to allocate the $80,000 limit amongst themselves in any manner they agree to.

KC 13-9

[ITA: 123.3, 129(4) – Refundable tax on CCPCs Investment income]

The 10 ⅔% refundable tax applies to the CCPC's *aggregate investment income* which is calculated as follows [ITA 129(4)]:

Net taxable capital gains	$100,000
Income from property (interest)	10,000
Investment income	110,000
Net capital losses	(30,000)
Aggregate investment income	$ 80,000

The refundable tax is $8,533, as follows [ITA 123.3]:

The lesser of:	
a) Aggregate Investment income	$80,000
b) Taxable income ($700,000) minus income subject to the small business deduction ($380,000) [KC 13-8]	$320,000
Lesser amount $80,000 x 10⅔%	$8,533

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KC 13-10

[ITA: 123.4 – General rate reduction]

The general rate reduction (13%) applies to the corporation's taxable income other than income eligible for the M&P and SBD deductions, resource income, investment income earned by CCPCs, and personal services business income. TV Ltd. claimed the SBD deduction on income of $380,000 (See solution to KC 13-8); and has aggregate investment income of $80,000 (See solution to KC 13-9). Taxable income eligible for the general rate reduction is calculated as follows [ITA 123.4 - part (b) of the definition of "full-rate taxable income]:

Taxable income	$700,000
Less: Income eligible for the M&P deduction	(0)
Income eligible for the SBD deduction	(380,000)
Aggregate Investment income (calculated in KC 13-9)	(80,000)
Income eligible for the general rate reduction	$240,000

The General rate reduction is $31,200, calculated as $240,000 X 13%.

KC 13-11

[ITA: 129(4), 186(1) – RDTOH]

In general terms, eligible RDTOH tracks refundable taxes paid under Part IV while non-eligible RDTOH tracks refundable taxes paid under Part I and Part IV (on non-eligible dividends).

Non-eligible RDTOH		
Balance at end of previous year		27,000
Less: Dividend refund for preceding year		(6,000)
Add: Part IV tax on non-eligible dividends		-
Add: refundable Part I tax - least of:		
(i) 30 2/3% x AII ($80,000)	24,536	
(ii) 30 2/3% (TI - income subject to SBD)	98,144	
(iii) Part I tax	101,133	24,536
		45,536
Eligible RDTOH		
Balance at end of previous year		-
Less: Dividend refund for preceding year		-
Add: Part IV tax on eligible dividends of $24,000		9,199
		9,199

(See solutions for KC 13-8 and KC 13-9 for the calculation of income subject to the small business deduction and aggregate investment income.)

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KC 13-12

[ITA: 129(1) – Dividend Refund]

The dividend refund for the current year is $34,500 calculated as follows [ITA 129(1)(a)]:

The lesser of:

(i)	38 ⅓% x non-eligible dividends paid in the year ($90,000)	$34,500
(ii)	Non-eligible RDTOH at end of current year	$45,536

KC 13-13

[ITA: 129(1),(4), 186(1) - RDTOH and Dividend Refund]

The dividend refund for EX Ltd. for the current year is $19,166, calculated as follows [ITA 129(1)(a)]:

Aggregate investment income				
	Taxable capital gains			46,000
	Net capital losses			(20,000)
	Interest			30,000
				56,000

Part IV Tax				
38 1/3% x Dividends from non-connected corporations				
	38 1/3% x $42,000			16,100
Non-eligible RDTOH				
Balance at end of previous year				12,000
Less: Dividend refund for preceding year				-
Add: Part IV tax on non-eligible dividends				-
Add: refundable Part I tax - least of:				
(i) 30 2/3% x AII			17,175	
(ii) 30 2/3% (TI - income subject to SBD)			30,670	
(iii) Part I tax			73,255	17,175
				29,175
Eligible RDTOH				
Balance at end of previous year				-
Less: Dividend refund for preceding year				-
Add: Part IV tax on eligible dividends				16,100
				16,100

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Dividend Refund (A) + (B) + (C)		
(A) Lessor of:		
(i) 38 1/3% x eligible dividends paid	16,100	
(ii) Eligible RDTOH balance	16,100	16,100
Plus		
(B) Lessor of:		
(i) 38 1/3% x non-eligible dividends paid	3,066	
(ii) Non-eligible RDTOH balance	29,175	3,066
Plus		
(C) nil since (B)(i) is less than (B)(ii)		-
		19,166

KC 13-14

[ITA: 89(1) – GRIP]

GRIP end of previous year		$ 50,000
Add:		
• 72% of full-rate taxable income:		
Taxable income	$610,000	
Less:		
Income subject to the small business deduction	(500,000)	
Aggregate investment income	(10,000)	
	$100,000	
72% x $100,000		72,000
• Eligible dividends received		40,000
Deduct: Eligible dividends paid in the preceding year		0
GRIP end of current year		$162,000

Notes:

A CCPC may designate a dividend as an eligible dividend as long as it has sufficient GRIP at the end of the year. If the eligible dividend exceeds the GRIP balance, the excess will be subject to a 20% Part III.1 tax.

KC 13-15

[ITA: 127(5),(9),(10.1), (10.2), 127.1, 12(1)(t)]

a) The investment tax credit enhanced rate of 35% applies to the first $3 million of annual SR&ED expenditures incurred by a CCPC [ITA 127(10.1)]. The 35% rate is gradually reduced to the standard 15% rate when the corporation's taxable capital is between $10 million and $50 million [ITA 127(10.2)]. Since Hitech's taxable capital is less than $10 million, the 35% investment tax credit rate applies to all of Hitech's SR&ED current expenditures. Therefore, the investment tax credit earned by Hitech Ltd. in the current year is $350,000 ($1,000,000 x 35%).

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Note:

1) *Expenditures for SR&ED capital property are excluded for federal investment tax credit purposes.*

2) *A corporation's $3 million maximum expenditure limit is shared by associated corporations. It is phased out where taxable capital of the associated group exceeds $10 million in the prior year. The expenditure limit is eliminated at taxable capital of $50 million.*

b) Hitech's federal tax payable before applying the investment tax credit is $9,000 being taxable income of $100,000 x 9% (38% - 10% - 19% = 9%). $9,000 of the $350,000 will be used to reduce the federal tax payable to Nil; the remaining $341,000 can be carried back three years and forward 20 years to reduce taxes in those years [ITA 127(9) - definition of *Investment tax credit*]. $10,800 will be carried back to the previous year to recover $10,800 in federal tax paid. Hitech can claim and receive a cash refund for the excess [ITA127.1].

Current Expenditure	Investment Tax Credit (ITC)	Applied in current year	Carried Back	100% Refund Available
$1,000,000	$350,000	$(9,000)	$(10,800)	$330,200

c) If Hitech claims a refund of $330,200, there will be no investment tax credit left to carry forward.

d) If Hitech was a Canadian public corporation:

- The federal corporate tax rate would be 15% (38% - 10% - 13% = 15%).
- The investment tax credit rate would be 15%. The investment tax credit would be $1,000,000 x 15% = $150,000.
- There is no investment tax credit refund available to public companies.
- The investment tax credit available for carry forward would be $117,000.

Investment tax credit earned	$150,000
Applied in the current year to reduce federal tax $100,000 x 15%	(15,000)
Carried back to prior year to reduce federal tax $120,000 x 15%	(18,000)
Investment tax credit available for carryforward	$117,000

Note: The provinces provide SR&ED tax incentives as well.

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KC 13-16

[ITA: 125(1)(a)(i)(B), “specified corporate income” ITA 125(7), ITA 125(3.2), ITA 21(2)]

Smallco’s active business income consists of $35,000 from Bigco and $265,000 from other customers ($300,000 - $35,000 = $265,000). Due to the amount of Smallco’s income from Bigco and its relationship to a Bigco shareholder, the $35,000 of income must be carved out from the active business income that would otherwise be eligible for the small business deduction [ITA 125(1)(a)(i)(B)]. This $35,00 will be referred to as “the carved out amount"[1] for this purpose of this analysis.

Two factors cause this carve out to occur. First, Yolanda does not deal at arm’s length with Smallco and also has a direct interest in Bigco (the amount of that interest is not relevant). Yolanda (owns 4% of Bigco) is related to Alysha (siblings) who controls Smallco (60% of shares). Therefore, Smallco and Yolanda do not deal at arm’s length [ITA 251(2)]. Second, more than 10% of Smallco’s active business income is earned from Bigco.

It must be determined if any of this carved out amount meets the definition of specified corporate income [ITA 125(7)], and if so, it can remain eligible for the small business deduction [ITA 125(1)(a)(ii.1)].

The specified corporate income of Smallco is determined as the least of:

1. The carved out amount, $35,000
2. Any business limit assigned to Smallco by Bigco.
3. An amount that the Canada Revenue Agency (CRA) determines to be reasonable. It will be assumed that this is not smaller than the other two amounts.

Smallco could request Bigco to assign some of its business limit to Smallco for the year [ITA 125(3.2)]. Bigco may only comply if it has not used its entire business limit and, even then, would only do so to please Yolanda who holds a mere 4% share interest in Bigco. It will be assumed that Bigco did not assign any of its limit over to Smallco since the assignment does not happen automatically and there was no indication in the given information that an assignment occurred. This will result in the least of the three amounts above to be zero, resulting in no specified corporate income.

Therefore, Smallco’s small business deduction for 2022 is $50,350, determined as 19% of the least of:

1. Active business income ($300,000) less the carved out amount ($35,000) plus specified corporate income ($0) = $265,000
2. Taxable income ($300,000)
3. Smallco’s business limit ($500,000).

It should be noted that if Bigco did assign $35,000 of its business limit to Smallco, it would not increase Smallco’s business limit from $500,000 to $535,000. The assignment results in Bigco’s business limit decreasing by $35,000, but from Smallco’s perspective, the assignment is only used to determine Smallco’s specified corporate income.

[1] Not defined in the ITA. This phrase is being used as a stand in for the amount described in subparagraph (a)(i) of the definition specified corporate income in subsection 125(7).

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KC 13-17

[ITA: 125(1), (5.1), (7)]

Because P Ltd. has “excess income from passive investments” in 2021, the 2022 business limit will be reduced.

In 2021, P Ltd. has *aggregate investment income* of $70,000 (taxable capital gain $90,000 – net capital loss $20,000 = $70,000) and *adjusted aggregate investment income* of $120,000 ($70,000 + net capital loss $20,000 + dividends from non-connected corporations $30,000 = $120,000). Since 2021 adjusted aggregate investment income exceeds the $50,000 threshold, the $500,000 business limit for 2022 will be reduced by $350,000 ($120,000 - $50,000 = $70,000 x $5 = $350,000) to $150,000.

Therefore, the maximum small business deduction for 2022 is $28,500, being 19% (in 2021) x the least of (a) active business income carried on in Canada $450,000, (b) taxable income $450,000, and (c) the business limit for the year $150,000.

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