

CBV INSTITUTE CANADIAN TAX PRIMER



2024 EDITION



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CBV Institute Canadian Tax Primer 2024 Edition

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141 Adelaide Street West, Suite 1007,

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Glossary of Acronyms

Acronym	Full Term
ABI	Active Business Income
ABIL	Allowable Business Investment Loss
ACB	Adjusted Cost Base
AccII	Accelerated Investment Incentive
AI	Aggregate Investment Income
AOC	Acquisition of Control
AR	Accounts Receivable
ART	Additional Refundable Tax on Investment Income
BIL	Business Investment Loss
CCA	Capital Cost Allowance
CCPC	Canadian Controlled Private Corporation
CDA	Capital Dividend Account
CRA	Canada Revenue Agency
EBIT	Earnings Before Interest and Tax
EBITDA	Earnings Before Interest, Tax, Depreciation and Amortization
ERDTOH	Eligible RDTOH
FMV	Fair Market Value
GAAP	Generally Accepted Accounting Principles
GRE	Graduated Rate Estate
GRIP	General Rate Income Pool
IFRS	International Financial Reporting Standards
ITA / Act	Income Tax Act
ITC	Investment Tax Credits
LCGE	Lifetime Capital Gains Exemption
LRIP	Low Rate Income Pool
M&P	Manufacturing and Processing
NERDTOH	Non-Eligible RDTOH
NRV	Net Realizable Value
POD	Proceeds of Disposition
PPA	Purchase Price Allocation
QSBC	Qualified Small Business Corporation

RDTOH	Refundable Dividend Tax on Hand
S22 election	Section 22 Election
SBC	Small Business Corporation
SBD	Small Business Deduction
SIB	Specified Investment Business
SR&ED	Scientific Research and Development
T1	Personal Income Tax Return
T2	Corporate Income Tax Return
T3	Trust Income Tax Return
TAB	Tax Amortization Benefit
UCC	Undepreciated Capital Cost
WACC	Weighted Average Cost of Capital

Introduction

The implications of taxes are crucial for a business valuator to understand, as they can significantly influence the valuation of a business. In this guide, you will learn how to evaluate various tax scenarios and accurately quantify their impact in determining a business's Fair Market Value (FMV). While this guide aims to enhance your understanding, it is not exhaustive. For complex tax matters or those beyond the expertise of a business valuator, it is advisable to consult with a qualified tax professional.

The Canadian Tax System

The primary purpose of taxation in Canada is to generate revenue for funding government programs and services such as healthcare, education, infrastructure, and social welfare initiatives. Taxes provide the necessary funds for public goods and services that benefit society. Personal income tax is the largest source of revenue for the federal government accounting for approximately 50% of total revenues collected, while corporate tax contributes approximately 15%.

Taxation also plays an important role in redistributing wealth, aiming to promote fairness and equity by transferring resources from higher income earners to lower ones. Furthermore, the tax system can play a key role in stabilizing the economy by influencing spending and investment behavior. For instance, during economic downturns, tax cuts or credits may be implemented to boost consumer spending and encourage business investment. Additionally, tax policies can be leveraged to achieve specific social objectives by promoting investment in renewable energy and discouraging the participation in certain activities like pollution or the consumption of tobacco or alcohol. Tax incentives, credits, and deductions are commonly employed for these purposes, reflecting the multifaceted nature of the tax system.

In Canada, both the federal and provincial governments have the authority to levy taxes within their respective jurisdictions. The division of taxation power is outlined in the Canadian Constitution. The federal government has the authority to levy taxes on income earned throughout the entire year for all individuals residing in Canada. Provinces, on the other hand, possess the ability to impose taxes on income earned within their borders and on individuals who reside there. This results in combined federal and provincial tax rates that vary across different provinces.

In Canada there are three taxable entities: individuals, corporations, and trusts. Various structures, such as partnerships or joint ventures, can be utilized depending on the tax objectives of the stakeholders; however, they are ultimately taxed as one of these three taxable entities. For instance, taxable income earned by an unincorporated business, such as a proprietorship, will be included in an individual's personal income tax return (T1) and subject to taxation at their marginal tax rate. In the case of a partnership, the taxable income is allocated to the partners, based on their respective interests. In this instance, partners can potentially refer to individuals, corporations, or trusts.

The Importance of Tax in a Business Valuation

A business valuator must consider taxes, as they directly impact cash flows, profitability, transaction structuring, and overall business value. Understanding and accurately evaluating taxes is essential for conducting thorough and reliable business valuations. From a Canadian tax perspective, there are various classifications and bases for taxes. Some of the more common ones include:

- Income tax (corporate and personal)
- Property tax
- Consumption tax
- Value added tax
- Capital tax

While each of these categories are used in Canada, the type of tax primarily considered in a business valuation is income tax. The following examples illustrate how taxes can impact business valuations:

- **Income-Based Approach:** When preparing a valuation using an income-based approach, which is based on prospective future earnings or cash flows, one of the key mechanics includes deducting income taxes to determine the discretionary earnings or cash flows of the business.
- **Asset-Based Approach:** When using the asset-based approach to value the shares of a business, any increase in FMV of assets, beyond their acquisition or development costs, can result in trapped-in capital gains. The resulting tax liability must be considered. Additionally, tax balances such as the Capital Dividend Account (CDA) and Refundable Dividend Tax on Hand (RDTOH) may have implications for tax planning among the shareholders of a business.
- **Tax Assets and Liabilities:** Tax assets, such as non-capital loss, carry forwards, or Investment Tax Credits (ITC), can increase the value of a corporation and must be considered in valuation assignments. Conversely, tax liabilities can reduce the corporation's equity value and should also be considered during the valuation process.

Determining the appropriate analysis, application, and tax effects varies for each valuation assignment and requires the professional judgment of the valuator. These topics will be explored in detail throughout this primer to provide the necessary knowledge of Canadian taxation required to successfully complete a valuation assignment.

Valuations for Tax Purposes

Valuations are often required for various situations, including matrimonial matters, mergers and acquisitions, assessing damages, and income tax purposes. Within the context of tax law, valuations are necessary to establish FMV, as referenced in numerous provisions of the Income Tax Act (ITA or Act).

A common scenario requiring a valuation is the transfer of assets to non-arm's length parties, where FMV cannot be established through arm's length bargaining. The Act also covers tax-deferred rollovers of assets between non-arm's length corporations and the exchange of shares between different classes. Additionally, the Act addresses situations involving the deemed disposition of assets, such as upon a taxpayer's death or departure from Canada, necessitating valuations for tax reporting purposes.

It is important to consider the purpose and circumstances surrounding a valuation; however, the income tax implications apply, regardless of the specific purpose. Understanding the impact of taxes is crucial for ensuring accurate and compliant reporting in accordance with tax regulations.

Income Tax on Taxable Entities in Canada

As previously mentioned, there are three distinct taxable entities in Canada: individuals, corporations, and trusts. Each of these entities is subject to its own specific type of income tax—personal income tax, corporate income tax, and trust income tax, respectively.

Personal income tax

In Canada, an individual is subject to tax if they are considered a resident. Residency is determined by whether or not an individual has employment, housing, family members, and/or personal property located in Canada. These factors are known as primary ties to Canada. Extended periods spent outside Canada do not affect this residency status. For individuals without primary ties to Canada, specific rules determine their Canadian residency status for tax purposes. Residents of Canada are taxed on their worldwide income, which includes employment income, business income (if self-employed), property income, and other sources of income. Individuals report their income and deductions on a T1 for each calendar year.

In Canada, individuals are taxed under a progressive taxation system, meaning that higher incomes are subject to higher tax rates as people move into higher income brackets. Provinces also use increasing tax rates across higher income brackets, although these provincial brackets may differ from the federal ones. As an illustration, for the tax year 2024, the federal tax brackets and corresponding tax rates are as follows:

Exhibit 1: Canada 2024 Personal Income – Federal Tax Rates

2024 Taxable Income	Federal Tax Rate
First \$55,867	15.0%
Over \$55,867 up to \$111,733	20.5%
Over \$111,733 up to \$173,205	26.0%
Over \$173,205 up to \$246,752	29.0%
Over \$246,752	33.0%

As an individual's income increases from one bracket to another, the tax rate applies only to the additional income in that bracket. For example, for taxable income of \$107,000, the individual will pay federal taxes of 15.0% on the first \$55,867 and 20.5% on the amount over \$55,867 to \$107,000, resulting in an effective tax rate of 17.9%. It is important to consider provincial tax rates in addition to federal tax rates, as they are applied in a similarly graduated manner. The combined federal and provincial tax rates can vary each year and can be found easily through available resources.

In addition to tax rates, deductions are applied to income to determine the taxable income for individuals. Tax credits can then be applied against the tax payable, based on this taxable income, which thereby lowers the overall tax liability. These deductions and credits play a key role in determining the final amount of tax owed by individuals after accounting for various allowances and offsets.

Personal taxes are seldom considered in valuation mandates because they are specific to the individual and vary based on the buyer's own tax situation, which is not directly relevant to the valuation of the business itself. Instead, personal income taxes are more commonly addressed when advising shareholders about the net proceeds they will receive upon the sale or liquidation of a business. These calculations may also be relevant in specific cases, such as matrimonial disputes or damages assessments, where understanding the personal tax implications is crucial for determining the financial impact on the individual involved. This distinction helps ensure that business valuations remain objective and focused on the business's value, while personal tax considerations are addressed separately, tailored to the specific circumstances of the individual shareholder. These valuation considerations will be discussed in further detail throughout the primer.

Corporate Income Tax

Corporations are subject to taxation based on their business earnings, with corporate income tax rates varying depending on the type of corporation and amount of taxable income earned. To fulfill their tax obligations, corporations are required to file a corporate income tax return (T2) each fiscal year that reports their income, deductions, and credits. Unlike a calendar year, a fiscal year can start and end on a date chosen by the corporation. Similar to individual taxation, corporate taxes are payable at both the federal and provincial levels.

The basic corporate tax rate starts at 38.0% for all corporations. To maintain the integrity of the basic corporate rate, adjustments are applied to it instead of altering the rate directly. These adjustments are designed to adjust the tax rate based on whether the corporation fulfills certain criteria, including:

1. **Federal Tax Abatement:** This longstanding measure allows a 10.0% abatement to accommodate provincial tax rates, effectively reducing the federal corporate tax rate to 28% after abatement.

2. **General Rate Reduction:** Introduced in 2011, the General Rate Reduction is set at 13.0% and applies to full rate taxable income.¹
3. **Small Business Deduction (SBD):** This is a tax incentive whereby eligible small businesses receive a deduction to their federal tax rate of 19%. This incentive is only available on the first \$500,000 of Active Business Income (ABI) earned in a year.² In order to qualify for the SBD, the following criteria must be met:
 - i) **Eligibility:** To qualify for the small business deduction, a corporation must be a Canadian Controlled Private Corporation (CCPC), meaning it is Canadian-owned and not controlled by non-residents or public corporations. A personal service business or a Specified Investment Business (SIB) is not eligible for the small business deduction. Personal service business and specified investment business will be discussed later in the primer.
 - ii) **Threshold:** The small business deduction applies to the first \$500,000 of ABI earned in a year by an eligible CCPC. The previously mentioned general rate reduction cannot be applied to income eligible for the SBD.³
 - iii) **Associated Corporations:** When corporations are associated (i.e., they share control or ownership), they must share the \$500,000 small business deduction limit. This rule prevents businesses from splitting their income among multiple associated corporations to benefit from multiple small business deductions.
 - iv) **Business Activities:** The small business deduction is intended for income generated from active business activities, such as providing goods or services. It does not apply to passive investment income such as interest, dividends, or capital gains.
4. **Manufacturing and Processing (M&P) profits deduction:** The M&P profits deduction continues to exist; however, it cannot be applied to the same income as the general rate reduction. Since these deductions offer the same amount of tax relief, the M&P deduction does not provide any additional benefit to corporations from a federal tax perspective. However, some provinces impose a lower tax rate on manufacturers.

Trust Income Tax

Trusts are subject to taxation on the income they generate, which may include interest, dividends, rental income, capital gains, and other sources of income. Trusts are required to file an income tax return (T3) to report their income and deductions.

Trusts are taxed differently from individuals or corporations. They hold assets for the benefit of one or more beneficiaries and are managed by a trustee. Income generated from the trust's assets can be taxed either within the trust itself or in the hands of the beneficiaries.

If income generated within the trust is distributed to the beneficiaries by the end of the year, these payments are deductible by the trust, and the trust will not pay tax on this income. However, if the income remains within the trust at year-end, it will be subject to tax within the trust at the maximum personal tax rate.⁴ When income is taxed within the trust, it can later be distributed to the beneficiaries tax-free. This ensures that the income is taxed only once.

When income is distributed to the beneficiaries at year-end, the trust deducts these disbursements and does not pay tax on them. Instead, the beneficiaries receive the disbursement and are subject to tax on it. The type of income distributed to the beneficiaries is retained for tax purposes. For example, if the trust triggers a capital gain and distributes this gain to the beneficiaries, the beneficiaries will report a capital gain on their tax return. This flow-through mechanism is why trusts are often referred to as flow-through entities.

1 Full rate taxable income refers to income not eligible for other rate reductions such as the small business deduction or manufacturing and processing profits deduction.

2 The business limit is \$500,000 for every province and territory except Saskatchewan, which is \$600,000.

3 The SBD is phased out for CCPCs (including associated corporations) with taxable capital employed in Canada in excess of \$10 million. This results in the SBD being completely eliminated when taxable capital is \$50 million or more.

4 This applies to all trusts except for graduated rate estates, which is beyond the scope of this primer.

Integration - Tax Neutrality

The concept of integration in the Canadian tax system aims to ensure that individuals pay an equal amount of tax on their income, irrespective of whether the income is earned personally, through a corporation, or from a trust. Integration seeks to eliminate disparities in tax treatment based on the form of income or business structure, thereby promoting fairness and neutrality within the tax system.

In essence, if you operate an unincorporated business or hold personal investments, you will be subject to taxation at personal tax rates. Alternatively, you can opt to incorporate your business or transfer your investments to a corporation. Upon incorporation, income will be taxed within the corporation at corporate tax rates.

Subsequently, any distributions (i.e., dividends) of after-tax earnings to shareholders will be taxed again at your personal tax rate. Integration addresses potential double taxation that can arise when income is earned within a corporation and distributed to shareholders as dividends. The goal of integration is to ensure that whether income is derived through personal ownership or corporate ownership, the total tax burden on this income should be approximately equal. Therefore, both structures should ideally result in similar tax amounts being paid on the income earned.

To achieve integration and avoid double taxation, individual shareholders (as opposed to corporate shareholders) receiving dividends from Canadian corporations are entitled to a gross-up which reflects the taxes paid at the corporate level. The total grossed-up amount represents the corporate income before taxes. The grossed-up amount is then included in the individual shareholder's income for tax purposes and their taxes payable is calculated on the grossed-up amount. To offset the impact of this gross-up, shareholders also receive a dividend tax credit which is applied against their taxes payable. The dividend tax credit represents a credit for the taxes that was already paid by the corporation. The concept of dividend income, including eligible and non-eligible dividends, and how they are taxed will be covered in greater detail later in the primer.

Types of Income for Tax Purposes

In Canada, income for tax purposes can be classified into several types, each with specific tax treatment:

1. **Employment Income:** Income earned from employment, including salaries, wages, bonuses, tips, and certain benefits provided by employers.
2. **Business Income:** Income earned from operating a business, including self-employment income, partnership income, and income from professional practices.
3. **Property Income^{5,6}:** Includes income earned from investments where minimal effort has been used to generate the return. Property income includes the following:
 - **Interest Income:** Income earned from investments such as savings accounts, GICs, bonds, loans, and other fixed-income securities.
 - **Dividend Income:** Income received from owning shares in Canadian corporations, categorized as eligible or non-eligible dividends.
 - **Rental Income:** Income earned from renting real property.
 - **Royalty Income:** Income from intellectual property rights or mineral rights.
4. **Capital Gains⁵:** Gains arising from the disposition of capital property, such as stocks, bonds, real estate, or other investment assets.

5 It is important to note that the amount of time and effort used to generate returns from a particular asset generally dictates the type of income it generates. For example, if a company's core business model involves owning and renting various restaurants, the income generated from renting the restaurants would be treated as business income and not rental income.

6 Investment income includes property income and net taxable capital gains income. This concept is discussed in further detail throughout this primer.

5. Other Income:

- **Foreign Income:** Income earned from foreign sources, subject to Canadian taxation rules and potential foreign tax credits.
- **Retirement Income:** Income received from pensions, annuities, RRSPs (Registered Retirement Savings Plans), and RRIFs (Registered Retirement Income Funds).
- **Social Assistance:** Benefits received from social assistance programs.
- **Scholarships and Fellowships:** Certain scholarships and fellowships may be taxable depending on the circumstances.

For tax purposes, it's important to know how each type of income may have specific rules and exemptions under the Canadian tax system.

This section will focus on income earned from corporations such as business income, property income, and capital gains. The source of income affects the applicable tax rate. The source generally refers to the activity that generated the income or what gave rise to it. All income must be attributed to a particular source, and only deductions applicable to a specific source of income may be claimed against it. This emphasizes the importance of matching expenses directly to the income that was generated by the expenditure.

Active Business Income

ABI refers to income or revenue generated by a corporation's operations, such as selling products or providing services. It excludes income from a SIB, personal service business, and passive sources of income such as investments or rental properties. This distinction is significant for tax purposes as ABI may be eligible for certain deductions or favorable tax treatments which passive income is not. For example, the SBD is only applicable to ABI.

Income from Property

While there are various forms of property income, this section of the primer will focus on rental income and the concept of a SIB, each of which will be examined in further detail below.

Property income generated passively within a corporation is taxed at the highest corporate rate. This higher tax rate aims to discourage individuals from forming corporations with the sole intention of benefiting from a lower tax rate, which would be higher if the income was generated personally. Therefore, it is essential to distinguish between property income and business income. As previously mentioned, property income includes various income sources such as interest, dividends, and rental income.

Generally, if the income requires minimal operational effort by the taxpayer or the company's employees, it is considered passive and classified as property income. A business which was created with the sole intention to derive income from property is classified as a SIB. However, if a corporation meets one of the SIB exceptions, the income is classified as ABI due to the significant operational effort, such as active management and day-to-day involvement required to generate it.

When property is held as an investment, two types of income may result:

1. **Income or Losses from Disposition:** This includes capital gains, recapture, and terminal losses, all of which are discussed later in this primer.
2. **Income or Losses During Ownership:** This refers to the income or losses generated while the investment is held, such as rental income or interest.

Taxation of Property Income in a Corporation

When property income is earned in a corporation, it is not eligible for any tax rate reductions, such as the SBD or the general rate reduction. Consequently, property income earned within a corporation is taxed at the highest corporate rate. When this income is subsequently paid out to a shareholder, it is taxed again at the personal level, resulting in a higher overall tax rate compared to a situation in which the property income was earned personally. If the corporate tax rate were lowered to approximate the combined personal tax rates, there would be an incentive to earn and retain property income within the corporation. Retaining the income within the corporation would allow for the deferral of additional personal tax indefinitely. Although imperfect, the fully integrated tax system attempts to avoid this disparity by maintaining higher corporate tax rates on property income, with a portion of this tax being refundable to the corporation when a taxable distribution is made to shareholders.

There are three components of the total tax paid by a corporation that can be refunded upon making a taxable distribution to shareholders: Refundable Part I Tax, Additional Refundable Tax on Investment Income, and Refundable Part IV Tax.

Refer to Example 1 and Example 2 below.

Rental Income

Rental income reflects revenues earned from leasing tangible property to tenants, such as residential units, commercial buildings, or land. Certain expenses can be deducted against rental revenues, including Capital Cost Allowance (CCA), property tax, and repairs. Claiming CCA on rental properties is allowed if the two following rules are adhered to:

1. Each piece of rental property purchased for more than \$50,000, and after 1971, must be placed in a separate CCA class.
2. Net rental losses cannot be created or increased by claiming CCA.

Specified Investment Business

A SIB is a corporation whose principal purpose is to earn income from property (such as interest, rent, dividends, or royalties). These businesses do not typically engage in active business activities. Certain businesses are excluded from being classified as a SIB if it satisfies one of the following two exceptions:

- A corporation employs more than five full-time employees throughout the year
- An associated corporation, while carrying on an active business, provides managerial, administrative, financial, maintenance or other similar services to the corporation during the year. In this case, it would be reasonable to assume that the corporation would have required more than five full time employees in its business, if those services had not been provided.

The SIB concept was introduced as a mechanism to exclude property income from benefiting from the SBD and to eliminate the incentive for individuals to incorporate solely to take advantage of the lower tax rate applicable to private corporations. This is because corporations are subject to a flat tax rate, while individuals are taxed based on a marginal rate. A business deemed to be a SIB is not eligible for the SBD and is taxed at the corporate investment tax rate. For 2024 in Ontario, corporate investment income is subject to a 38.7% federal tax rate, plus an 11.5% provincial tax rate resulting in an effective investment income tax rate of 50.2%.^{7,8}

⁷ Exhibit 2 demonstrates how the investment income tax rate is calculated.

⁸ The investment income tax rate of 50.2% includes a refundable tax component of 30.67% that results in a net corporate tax rate of approximately 19.5%, once sufficient taxable dividends are paid to shareholders.

However, the Act excludes income from property that is “incidental to or pertains to an active business carried on by the corporation, or that is used/held principally for the purpose of gaining or producing income from an active business.” Examples of active business income are interest charged on accounts receivable, interest on money held in short-term investments, and rents received from renting an otherwise unused portion of premises.

Capital Gains and Losses

Capital gains and losses are viewed separately and treated differently when compared to employment, business, and property income. This distinction primarily arises because only a portion of a capital gain is subject to taxation, which is referred to as the inclusion rate. The inclusion rate must also be applied to the applicable capital loss to determine the allowable capital loss.

While business income is fully taxable, the appropriate inclusion rate must be applied to a capital gain to determine the taxable amount. As at the issuance of this primer, the inclusion rate currently ranges from 50.0% to 66.67%. Up to June 25, 2024, the inclusion rate, or taxable portion of capital gains, for all taxpayers was 50.0%. As of June 25, 2024, the inclusion rate increased to 66.67% for all corporations, and individuals whose capital gains exceed \$250,000 per calendar year. Individuals with capital gains of less than \$250,000 per calendar year continue to have an inclusion rate of 50.0%. For individuals, the tax rate on the taxable capital gain is based on their marginal personal tax rate, while the taxable capital gain in a corporation is taxed at the corporate investment rate.

Capital gains and losses generally occur when capital property is disposed of. Capital property refers to an asset that provides the owner with long-term and enduring benefits and is typically acquired for investment or income generating purposes. A way to distinguish between capital and business income is by understanding how the capital property is used to generate returns. As an analogy, a capital asset is likened to a fruit-bearing tree. The proceeds from selling fruit generated from the tree represent business income, while the tree itself is considered capital property.

Capital gains and losses are calculated from the disposition of capital property based on the determination of the Proceeds of Disposition (POD) less the Adjusted Cost Base (ACB) and disposal costs. Typical disposal costs include legal fees, finder's fee, broker's fees, and advertising costs. These expenses are only considered for calculating the capital gain or loss on the disposal of capital property. If the POD exceeds the ACB, the disposition results in a capital gain. Conversely, if the POD is less than the ACB, the disposition results in a capital loss.

As previously mentioned, the taxable portion of the capital gain or the allowable capital loss is determined by the inclusion rate. It is important to note that capital losses cannot arise from the disposition of depreciable property; instead, any shortfall results in a terminal loss. However, capital gains can arise from the disposition of both depreciable and non-depreciable property. The concepts of depreciable property, non-depreciable property, and terminal losses will be discussed in greater detail later in the primer.

Proceeds of Disposition

The POD generally represents the value of consideration received, or receivable upon disposition. According to the Canada Revenue Agency (CRA), the disposition of property includes all forms of disposals, even those without actual proceeds, such as when a property is lost, stolen, destroyed, confiscated, or expropriated without compensation. A deemed disposition occurs when the disposition of property is considered to have happened, even though the disposition did not actually occur. In the case of a deemed disposition, the deemed proceeds will reflect the FMV of the property at the time of disposition. Deemed dispositions include change in use of the property, death of a taxpayer, gifting, and ceasing to be a resident of Canada. If an asset is transferred by way of gift, it will be deemed to have been disposed of by the transferor at FMV, and the transferee is deemed to have acquired it at the same FMV. If an asset is transferred from a corporation to its shareholder, the corporation is deemed to have disposed of the asset at FMV, and the shareholder is deemed to have acquired it at the same FMV. When a taxpayer ceases to be a resident of Canada, their capital property is deemed to be disposed of at its FMV. This ensures that any gains accrued during the period of Canadian residency are subject to taxation.

Adjusted Cost Base

ACB is defined in the ITA as the capital cost to the taxpayer where the property is depreciable, and in any other case, the adjusted cost to the taxpayer.⁹ The ACB generally reflects the purchase price of an asset, including any expenses incurred to prepare the asset for its intended use, such as delivery and installation costs. For tax purposes, the ACB may be subject to modifications for specific legislated adjustments. For example, if government assistance was received for acquiring capital property, the ACB is reduced by the total amount of assistance. Additionally, expenses initially denied as deductions can be added to the ACB of the property, such as interest and property taxes on land.

Accurately determining the ACB is an integral component in calculating capital gains and losses. In the event of a partial disposition of capital property, such as selling a parcel of land, the capital gain is calculated by allocating a reasonable portion of the ACB to the proceeds of partial disposition. The allocated ACB should reflect the ratio of the value of the portion sold to the total value of the capital property.

Capital Gain Reserves

When a taxpayer does not receive the full proceeds upon the disposal of a capital asset (i.e., the proceeds are received over time rather than in a lump sum), the ITA allows the taxpayer to claim a reasonable reserve to defer a portion of the gain until all proceeds are received. A reasonable reserve is determined by prorating the uncollected proceeds against the total capital gain. This capital gain reserve applies only to deferring capital gains; there are no reserves available to defer recapture.

The general principle is that the capital gain reserve can be used to offset the total gain when not all of the proceeds are expected to be received in the year of the sale.

The capital gain reserve cannot be claimed:

- i. by a non-resident, or
- ii. if the seller disposes the capital property to a corporation it controls, or
- iii. if the purchaser is a partnership where the vendor is a majority interest partner; or,
- iv. in the year of death.

The reserve formula is calculated as the lesser of (i) and (ii):

- i. $\frac{\text{[Proceeds not yet due]}}{\text{[Total proceeds]}} \times \text{[Total Gain]} = \text{Reasonable reserve}$
- ii. $20.0\% \text{ of total gain} \times [4 - \text{[the number of preceding years after disposition]}]$

The formula calculates a reserve based on the fraction of the gain represented by the portion of total proceeds not due until a later date, while also requiring the taxpayer to include a minimum of 20.0% of the gain in income each year. This limits the maximum deferral period for the gain to five years, starting with the year of disposition. The reserve formula noted above accounts for amounts not yet due and restricts the payment terms to prevent indefinite tax deferral while also limiting the length of payment. Without these limits, transactions could be structured to defer the taxation of gains over an extended period, if not, indefinitely. If the transaction is structured so that a larger amount of proceeds is received in the earlier years, a larger portion of the capital gain may need to be included in income, since part (i) of the formula above addresses the actual proceeds not yet due. Conversely, if the collection period is less than five years, part (ii) of the reserve formula spreads the capital gain over the collection period. As is typical for the treatment of reserves, a reserve must be included in income in the following year, and then a new reasonable reserve may be claimed, if eligible.

⁹ An in-depth list of adjustments can be found in Section 53 of the ITA.

Lifetime Capital Gain Exemption

The Lifetime Capital Gain Exemption (LCGE) is a valuable deduction available to Canadian residents. It allows individuals to shelter capital gains on the disposition of qualified farm and fishing property or Qualified Small Business Corporation shares (QSBC), ultimately providing significant tax savings over an individual's lifetime. The LCGE is available only to individuals (not corporations or trusts) and is indexed to inflation. As at the beginning of 2024, the LCGE amount is \$1,016,836, which permits a taxable capital gains deduction of \$508,418 based on a 50.0% inclusion rate. In addition to the change in legislation related to the inclusion rate, the LCGE limit increased to \$1,250,000 for dispositions occurring on or after June 25, 2024. With the adjusted inclusion rate, the effective taxable capital gains deduction increased from \$508,418 ($\$1,016,836 \times 50.0\%$) to \$833,333 ($\$1,250,000 \times 2/3$).¹⁰

To satisfy the definition of a QSBC share, the following three tests must be met:

- 1 **Small Business Corporation (SBC) Test¹¹:** Must be shares of a SBC, owned by the individual, or the individual's spouse.
- 2 **Holding Period Test:** Shares were not owned by anyone other than the individual, or someone related to the individual throughout the 24-month period prior to the date of disposal.
- 3 **Basic Asset Test (also referred to as the 50.0% test):** In the 24 months prior to disposal:
 - i. Shares are of a CCPC; and,
 - ii. More than 50.0% of the FMV of the corporation's assets were used principally in an active business carried on primarily in Canada by the corporation, or a related corporation.

It is important to note that not all SBCs qualify as QSBCs. If a corporation holds assets that are not used to generate ABI (i.e., redundant assets), these assets can be removed to meet the 90.0% test for SBC status. This process is commonly referred to as "purifying" the corporation and involves either selling the redundant assets and using the proceeds to pay off liabilities or reinvesting them into assets that are used in the active business. Simply disposing of the redundant assets is not sufficient if the proceeds are not reinvested in the active business carried on by the corporation.

Refundable Part I Tax / Additional Refundable Tax on Investment Income

Canadian tax legislation provides CCPCs with the ability to recover a portion of the Part I tax paid on investment income in the form of a refund. The term Aggregate Investment Income (AII) is defined in section 129(4) of the ITA and includes net taxable capital gains, interest income, rent income, royalty income, as well as the consideration of net capital losses deducted during the year. It is important to note that AII is used to determine the refundable portion of Part I tax available.¹² Notably, AII typically excludes dividends from Canadian corporations, as they are usually not subject to Part I taxes.

The general idea is that high corporate tax rates are applied to investment income as a deterrent for accumulating this income in corporations. This ultimately discourages indefinite tax deferral. The use of refundable tax ensures that the overall rate of tax is reasonable and comparable to that of an individual. The Additional Refundable Tax on investment income (ART) increases the tax rate on income from investments by an additional 10 2/3%. Refer to the example below for an illustration as to how ART is applied.

10 Based on the changes in legislation previously discussed, if a first-time LCGE user has total capital gains of \$1,250,000, the individual would include \$791,667 ($\$250,000 \times 50.0\% + \$1,000,000 \times 66.67\%$) in their income calculation and be permitted to include a LCGE deduction of \$791,667. It is important to note that this deduction would reduce their total LCGE limit by the full \$833,333 to prevent them from exceeding their lifetime limit.

11 SBC is defined as a CCPC of which all, or substantially all (i.e., at least 90.0%), of the assets on a FMV basis are used in an active business that is carried on primarily (i.e., more than 50%) in Canada by the corporation, or a related corporation. This means that assets leased or loaned to a related corporation also qualify.

12 The refundable portion of Part I taxes considers AII and foreign investment income. The consideration of foreign investment income is outside the scope of this primer.

Exhibit 2: 2024 Ontario Corporation Income Tax Rates (ABI vs Investment Income)

Active Business Income*		Investment Income	
Basic Corporate Rate	38.00%	Basic Corporate Rate	38.00%
Less: Federal Tax Abatement	-10.00%	Less: Federal Tax Abatement	-10.00%
Net Rate	28.00%	Net Rate	28.00%
Less: General Rate Reduction	-13.00%	Add: ART Rate	10.67%
General Federal Corporate Rate	15.00%	Investment Income Federal Corporate Rate	38.67%
Ontario General Rate	11.50%	Ontario General Rate	11.50%
Combined Federal and Provincial Rate	26.50%	Combined Federal and Provincial Rate	50.17%

*Small business deduction has not been considered

Investment income includes both property income (rent, royalty, interest, dividends) as well as net taxable capital gains. As previously mentioned, dividends from Canadian corporations are generally excluded as they are not subject to Part I tax.¹³

To maintain integration, as income from a corporation is issued as a dividend to investors, a portion of the taxes paid on the investment income is refunded back to the corporation. To keep track of the refundable amount, a notional balance referred to as the RDTOH is utilized. 30 2/3% of the investment income is added to the RDTOH account and upon paying a taxable dividend to the shareholders, the corporation is entitled to a refund equal to 38 1/3% of the taxable dividend, limited to balance in the RDTOH account.

Example 1: Refundable Part I Tax

Biz Inc. is a CCPC operating in Ontario that has earned business income of \$400,000, capital gains of \$450,000, and interest income of \$75,000 in the year. Biz Inc. paid dividends this year of \$200,000. The tax rate on business income is 12.2% (9.0% federal and 3.2% Ontario for a CCPC on the first \$500,000) and the tax rate on investment income is 50.2% (38.7% federal + 11.5% Ontario for CCPC). The calculation of total taxes payable would be as follows:

Taxes payable:

Taxes on business income	48,800	[A] = 400,000 x 12.2%
Taxes on capital gains	150,608	[B] = (450,000 x 66.67%) x 50.2%
Taxes on investment income	37,650	[C] = 75,000 x 50.2%
Less: Refundable Part I tax	76,660	[D] = 200,000 x 38.33%
Total tax payable	160,398	[E] = [A] + [B] + [C] - [D]

Note 1: Calculation of Refundable Part I Tax

Opening balance	-	[F] = Prior year's closing balance
30.67% of taxable capital gain	92,015	[G] = (450,000 x 66.67%) x 30.67%
30.67% of interest income	23,003	[H] = 75,000 x 30.67%
Less: 38.33% of dividends paid	76,660	[D] = 200,000 x 38.33%
Closing balance	38,357	[I] = [F] + [G] + [H] - [D]

¹³ Throughout the course of studies, examples are often included which illustrate business income and investment income having a tax rate of 30% and 40%, respectively. Although these rates are not in line with the ITA, they are used to simplify the tax rates across the provinces and territories.

After 2018, a corporation will have two separate RDTOH accounts: Non-Eligible RDTOH (NERDTOH) and Eligible RDTOH (ERDTOH). The NERDTOH account includes the refundable portion of Part I tax on investment income and Part IV tax on non-eligible portfolio dividends. The ERDTOH account includes Part IV taxes on eligible portfolio dividends and dividends from connected corporations that have received dividend refunds. The mechanics of these accounts is outside the scope of this primer.

Refundable Part IV tax on Dividends Received

Part IV tax was implemented to prevent a flaw in integration whereby dividends issued between private or other closely held corporations could result in a significant deferral of taxes on investment income. For instance, if a subsidiary corporation earns investment income and pays a dividend from this income, it receives a dividend refund which can be distributed to the parent company. Since intercorporate dividends are not taxable, the parent company can effectively receive the investment income at a very low tax rate.

As a result, there exists a Part IV tax on dividends received. If the corporations are connected (one owns greater than 10.0% of the shares of the other), and the payor corporation receives a dividend refund, a Part IV tax is levied on the dividend received, to the extent that it was paid out of investment income. This Part IV tax amounts to 38 1/3% of the dividend received. Similar to the refundable Part I tax, the Part IV tax is added to the RDTOH account and is subsequently refunded based on 38 1/3% of the dividend paid. If the dividend is paid out of a mixture of investment income and business income, the RDTOH balance indicates the portion of investment income subject to the Part IV tax. Similarly, if a portfolio dividend is received (a dividend from a corporation in which you own less than 10.0% of the shares), a Part IV tax of 38 1/3% is payable on the dividend and is refundable based on 38 1/3% of the dividend paid.

Example 2: Refundable Part IV Tax

Assume Parentco, a parent company, owns 100% of its subsidiary, Subco. Subco earns \$100,000 of investment income which is subject to taxation at a rate of 50 2/3%. After paying the tax, Subco could distribute the after-tax income to Parentco and receive a dividend refund, which could also be distributed to Parentco. The effect of these transactions would be as follows:

Investment income earned by Subco	\$	100,000	[A]
Corporate tax (includes ART)		50,667	[B] = [A] * 50 2/3%
Income available for distribution	\$	49,333	[C] = [A] - [B]
Dividend refund		30,667	[D] = \$80,000 * 38 1/3%
Total dividend	\$	80,000	[E] = [C] + [D]
Dividend received from Subco	\$	80,000	[F] = [E]
Part IV tax payable		30,667	[G] = [F] * 38 1/3%
Income retained by Parentco	\$	49,333	[H] = [F] - [G]

Without the application of Part IV tax, Parentco would receive an after-tax payment of \$80,000, reflecting a very low effective tax rate. However, after the Part IV tax is applied, the total tax paid on the income by Parentco aligns with what would have been paid by Subco, ensuring consistent tax treatment across corporate structures. It is important to note that Parentco would be eligible for a refund of its Part IV tax upon payment of an \$80,000 taxable dividend to its shareholders.

Corporate Tax Losses and Tax Credits

Non-Capital Losses

Non-capital losses generally represent any loss a taxpayer incurs from its employment, business, and property activities. A non-capital loss is often referred to as any loss other than those incurred on the disposition of capital assets and reflect the amount by which the total losses for the year exceed the income generated from those sources. These losses can only be carried over after the income for the current year is reduced to zero. If losses remain, they are available for carry over (i.e., carry forward or carry back), and can be applied, at the taxpayer's discretion, to any of the eligible carry over years.

Non-capital losses may be carried back three taxation years and applied against any type of taxable income. If there is insufficient taxable income in those years to absorb the full amount, any remaining balance can be carried forward for a period of 20 taxation years. The ability to apply non-capital losses against taxable income in different years allows business/corporations to manage their tax liabilities effectively. The underlying rationale for the 20-year carry forward period is that it provides sufficient recovery time for a business to generate taxable income.

Net Capital Losses

A net capital loss represents the excess of allowable capital losses over taxable capital gains. It is important to note that the net capital loss balance already reflects the applicable inclusion rate. Net capital losses can be carried back three taxation years or carried forward indefinitely to reduce taxable capital gains in subsequent years. When a balance is carried forward, it is referred to as a "net capital loss balance." Irrespective of the carry over rules, capital losses can only be applied against capital gains.

Special Considerations for Non-Capital Losses and Net Capital Losses

Typically, the earliest incurred losses are applied first to minimize the risk of expiration. Effective tax planning strategies can be performed to utilize the appropriate losses in the correct taxation year and often include deferring optional or permissive deductions such as CCA, Scientific Research and Experimental Development (SR&ED), and reserves. These deductions can be utilized in future years when there is sufficient income to offset them.

Business Investment Loss

A Business Investment Loss (BIL)¹⁴ is a unique subset of capital losses that occurs on the disposition of shares or debt of a SBC.¹⁵ Given that a BIL is a type of capital loss, it is deductible based on the applicable inclusion rate. The deductible portion of the BIL is referred to as an Allowable Business Investment Loss (ABIL).

Typically, a loss on the disposal of capital property is only eligible to offset capital gains. However, the special treatment for a BIL under the Act permits any portion of the ABIL, not used in the current year, to be treated as a non-capital loss. This non-capital loss can be carried back three years and carried forward 10 years. This special treatment is provided to incentivize investment in SBCs.

Any ABIL amount not utilized within the 10-year carry forward period will revert to its original nature as a net capital loss and subject to the standard net capital loss rules. This means it will only be deductible against capital gains and can be carried forward indefinitely. In other words, if the ABIL which is initially treated as a non-capital loss is not used by the end of the 10th carry forward year, it becomes a net capital loss, added to the net capital loss balance, and restricted by the net capital loss carry over rules.

14 BIL must arise from disposition of shares or debt of an SBC where:

- i) Disposition of shares or debt is to an arm's length person,
- ii) Debt has become a bad debt in the year; or,
- iii) For shares not actually disposed of, the company has become bankrupt during the year, is in process of winding up or is insolvent, has no value, and has ceased to carry on business.

15 For purposes of the BIL, an SBC which ceases to meet the conditions of the definition of a SBC, will still be considered as a SBC if it met the conditions at any time in the 12 months preceding the disposition.

Scientific Research and Experimental Development Tax Credit

SR&ED is defined in the ITA as “systematic investigation or research carried out in a field of science or technology by means of experiment or analysis, including basic research, applied research, and experimental development.” Entities that perform SR&ED work in Canada are offered two forms of incentives:

- Tax deductions; and,
- ITCs.

Qualified SR&ED expenditures include current expenditures for basic or applied research and the development of new products and processes. It is important to note that capital expenditures do not qualify for SR&ED credits. This primer provides only a brief overview of SR&ED, as the rules surrounding SR&ED are complex and beyond its scope.

ITCs are tax incentives that are available to Canadian taxpayers undertaking SR&ED. These credits allow for the deduction of a specified percentage of the cost of eligible current and capital expenditures from their federal tax payable. However, when capital expenditures are involved, the amount of the ITC must be removed from the capital cost of the asset, so that only the net capital cost is deductible through CCA.

As of 2024, the investment tax credits available on SR&ED expenditures are:

- 15.0% for expenditures incurred by any taxpayer
- 35.0% for expenditures incurred by a CCPC. This includes an additional 20.0% for certain expenditures made by a corporation that is a CCPC throughout the taxation year.

For CCPCs, SR&ED expenditures eligible for the 35.0% ITC are also eligible for a 100% refund. However, this 100% refund applies only to the first \$3.0 million of qualifying expenditures, keeping in mind that capital expenditures do not qualify for SR&ED credits. SR&ED expenditures must relate to a business carried on by the taxpayer incurring the expenditure. The SR&ED expenditures are added to a pool and are eligible for a 100% deduction in the year they are incurred. Any remaining balance in the SR&ED pool can be carried forward indefinitely. SR&ED deductions are permissive, therefore companies can determine how much, if any, of the SR&ED pool is deducted for tax purposes. Unused ITCs can be carried back for three years and carried forward for 20 years.

The following exhibit summarizes the rules surrounding the application of the losses, expenditures and credits discussed in the section above:

Exhibit 3: Summary of Losses, Deductions, and Credits

Type of Loss / Deduction / Credit	Carry Back	Carry Forward	Notes
Non-capital loss	3 years	20 years	Applied to taxable income
Net capital loss	3 years	Indefinite	Application is limited to net taxable capital gains
ABIL	3 years (taxable income)	10 years (non-capital loss), then 10 year net capital loss	Same provisions as a non-capital loss, except if unutilized within the 10 year carry forward period becomes a net capital loss
SR&ED Deduction	n/a	Indefinite	Current SR&ED expenditures can be carried forward indefinitely
SR&ED ITC	3 year	20 years	

Losses on Acquisition of Control

The value of losses lies in their ability to reduce taxable income, thereby lowering the amount of tax owed. There are situations when a business has accumulated significant losses over time and is unlikely to generate enough income to utilize these losses. In such cases, a company with substantial non-capital or net capital losses may become an attractive acquisition target for a profitable company.

For example, if Company A has accumulated \$1,000,000 in non-capital loss carry forwards, but has been unable to generate sufficient income to use these losses, Company B might consider acquiring Company A for \$150,000. This acquisition would provide Company A with \$150,000, while Company B could potentially realize tax savings of \$300,000 (assuming a 30.0% tax rate on \$1,000,000 of income).

However, if losses could be traded without restriction as outlined above, it would result in a tremendous cost to the government. While the government allows businesses to apply losses against their income, it does not want to finance loss-generating enterprises with no prospects of future income. Consequently, Acquisition of Control (AOC) rules exist to limit the use of losses and prevent loss trading.

An AOC occurs when the majority voting power changes for a business. This often occurs when a majority shareholder sells their shares to an arm's length person. An AOC is not limited to an outright purchase of shares, but also includes scenarios where a shareholder gains control through the redemption of shares. For instance, if a company has two shareholders, one holding 25.0% and the other 75.0%, and the shares of the 75.0% shareholder are redeemed, the 25.0% shareholder would gain control by holding all outstanding shares.

Several rules, primarily enforced to restrict the use of loss carry forwards, come into effect upon AOC. A deemed year-end is triggered immediately preceding an AOC which can potentially result in a shortened fiscal year. Regardless of the duration of this short year, it represents a full year of loss carry forwards. Additionally, on AOC, any unutilized net capital losses and ABILs are deemed to expire. These losses cannot be carried forward or carried back to periods before the AOC. Hence, unutilized net capital losses and ABILs cease to confer any benefits to an acquiring entity post-acquisition. However, non-capital losses can be carried forward but are subject to the "same or similar business rules" (also referred to as loss streaming rule) which stipulate that:

- The corporation must continue the business from which the losses were incurred.
- There must be a reasonable expectation of profit in that business.
- The losses can only offset future income derived from the same or similar business.

SR&ED losses are treated akin to non-capital losses. While they expire upon an acquisition of control, they can be reinstated if the same or similar business rules are satisfied.

Accrued losses also warrant consideration upon an AOC. Any decline in the value of assets owned by the corporation before the acquisition (unrealized loss) must also be recognized and will be subject to the loss application rules.

For non-depreciable property such as land or shares that have depreciated in value, a write-down is necessary, resulting in a realized capital loss. Depreciable property, such as buildings or equipment, must also be written down. If this write-down pushes the asset's value below the Undepreciated Capital Cost (UCC), the difference is treated as a CCA and added to the non-capital loss balance. Given that net capital losses expire upon an AOC, an election is permitted to recognize inherent gains on depreciable or non-depreciable assets, thereby allowing the utilization of net capital losses prior to expiration. Estimating the FMV associated with losses involves calculating the tax savings generated by applying the losses and assessing the timing of these tax savings. Present valuing these future tax savings requires considering the risk of not generating prospective income or not being able to apply all losses as promptly as anticipated.

Example 3: Calculating the FMV of Losses

The CEO and majority shareholder of Pizzalo Inc. believes that the company can become profitable in the next two years. The company has invested significantly in research and development to produce a more health-conscious product while still maintaining an exceptional taste. The company has now accumulated the following losses:

Non-capital losses	\$ 1,523,000
Net capital losses	\$ 110,000
SR&ED losses	\$ 843,000

The following projections have been prepared by the company to support the restructuring arrangements.

Pizzalo Inc.

Income Statement Projections (CA\$)

For the Years Ended December 31

	2022	2023	2024	2025	2026	2027
Revenues	2,500,000	2,625,000	3,752,000	4,314,800	5,177,760	6,731,088
Cost of sales	1,500,000	1,575,000	2,251,200	2,588,880	3,106,656	4,038,653
Gross Profit	1,000,000	1,050,000	1,500,800	1,725,920	2,071,104	2,692,435
Operating expenses						
Selling	350,000	350,000	350,000	350,000	400,000	400,000
General and admin	550,000	590,000	619,500	650,475	682,999	717,149
Depreciation (same as CCA)	73,000	70,000	67,500	75,000	72,500	70,000
Interest	50,000	52,000	53,000	54,000	56,000	60,000
Total operating expenses	1,023,000	1,062,000	1,090,000	1,129,475	1,211,499	1,247,149
Net income (loss) before taxes	(23,000)	(12,000)	410,800	596,445	859,605	1,445,286

The CEO requires the value of the accumulated losses for Pizzalo Inc., based on the above projections.

Required:

Calculate the FMV of the losses to Pizzalo Inc.

Solution:

The following calculation determines the FMV of the losses incurred by Pizzalo Inc. Both the SR&ED deduction and non-capital losses have been used to reduce the taxable income of the corporation. The tax savings resulting from their application are discounted to the present date. To account for the higher level of risk associated with achieving the projections, a discount rate higher than the corporation's cost of capital was applied.

Accumulated losses and deductions as at the valuation date:

Non-capital losses	1,523,000
Net capital losses	110,000
SR&ED deduction	843,000

Net income (loss) before taxes	(23,000)	(12,000)	410,800	596,445	859,605	1,445,286
Add: depreciation (same as CCA)	73,000	70,000	67,500	75,000	72,500	70,000
Taxable income	50,000	58,000	478,300	671,445	932,105	1,515,286
SR&ED					666,850	176,150
Non-capital losses	50,000	58,000	478,300	671,445	265,255	
Total losses applied	50,000	58,000	478,300	671,445	932,105	176,150
Tax rate (30%)	15,000	17,400	143,490	201,434	279,632	52,845
Discounted at 30% (end-year convention)*	11,538	10,296	65,312	70,527	75,313	10,948
FMV of tax savings	243,935					

*End-year convention has been used as this is when the tax benefit is expected to be realized.

In the above example, CCA is added back to the projected net income of the company. This adjustment aims to optimize the utilization of losses and deductions before they potentially expire. Unlike other losses and deductions which can expire, the CCA is a permissive deduction which can be deferred indefinitely. While there are no rules dictating the order in which losses and deductions should be utilized, it is important to consider their expiration dates when deciding which to use first. Note that net capital losses are not factored into the tax savings calculations, since there are no capital gains contained in the projections against which such losses could be applied.

Accounting Income vs Taxable Income

Accounting income refers to the net income or profit calculated according to Generally Accepted Accounting Principles (GAAP) or relevant accounting standards, such as the International Financial Reporting Standards (IFRS). It represents the income earned by a business over a specific period and is reported on the financial statements. On the other hand, taxable income is the income amount used to calculate how much tax a taxable entity owes to the government. It is based on the rules and regulations upheld and enforced by the tax authorities, such as the CRA in Canada. Taxable income can differ from accounting income due to various adjustments, deductions, and exemptions allowed or disallowed by tax laws.

Accounting income is focused on reporting financial performance for internal and external stakeholders, while taxable income is used to determine the amount of tax liability owed to the government. Therefore, taxable entities must reconcile these differences when preparing financial statements and tax returns to ensure compliance with both accounting standards and tax regulations. Therefore, to begin calculating taxable income, pre-tax accounting income (i.e., net income before taxes) serves as the initial basis, which is subsequently adjusted according to specific provisions outlined in the ITA. Here are the fundamental components involved in adjusting accounting income to taxable income:

- i. Subtracting or adding income that was included for accounting purposes, but is not taxable:
 - Intercompany dividends
 - Accounting gains or losses on the disposition of capital
- ii. Adding income that was taxable, but not included in accounting income:
 - Unpaid remuneration that remains unpaid 180 days after the taxation year in which the expense was deducted
 - Unpaid amounts in a non-arm's length transaction that remain unpaid two years after the taxation year in which the amounts were declared payable
 - Taxable capital gains on disposal of capital property
 - Recapture on disposal of depreciable capital property
 - Amounts received for services to be rendered or goods to be delivered in the future; a reasonable reserve for unearned amounts included in income can be taken
 - Amounts receivable in respect of services rendered or property sold during the year in the course of business; amounts receivable must be legally receivable as a result of the taxpayer having completed the performance of the service contracted for. Holdbacks (common in the construction industry) are not legally receivable until the year in which the final certificate accepting/approving the work completed is issued
- iii. Adding back expenses that are deductible for accounting purposes, but not for tax purposes:
 - Accounting derived amortization and depreciation on capital assets (ITA requires use of CCA)
 - Political contribution: Corporations are prohibited from making federal political contributions by the federal elections act

- Meals and entertainment expenses are restricted to 50.0% deductible
 - Provisions, reserves and contingent liabilities
 - Personal or living expenses
 - Payments made under the ITA or Excise Tax Act such as taxes, interest, and penalties
 - Expenses related to use of recreational facilities and club dues
 - Losses on disposal of capital property
 - Personal service business expenses
 - Any unreasonable amount
- iv. Subtracting expenses that are deductible for tax purposes, but not for accounting:
- CCA (i.e., tax amortization)
 - Realized bad debts
 - Terminal loss on disposal of depreciable capital property
- v. Barter transactions:
- Occurs when one taxpayer accepts property (goods or a right to a service) in exchange for goods and/or services. In these cases, the taxpayer must recognize sales revenue equivalent to the fair market value of the goods or services provided as income for tax purposes. Barter transactions are considered reciprocal exchanges and are fully taxable, allowing deductions for the cost of goods or services provided in the exchange.

Non-Deductible or Partially Deductible Business Expenses

In this section of the primer, we will explore non-deductible and partially deductible business expenses, focusing on their treatment for tax purposes. While certain expenses such as meals and entertainment, and club fees are considered entirely for accounting purposes, they receive special treatment under the applicable ITA regulations. In some situations, the ITA partially limits the deductibility of a certain expenditures to reflect a balance between the personal and business benefits conferred. On the other hand, some expenses are entirely non-deductible due to their significant personal enjoyment components and the difficulty in justifying direct business benefits. Ultimately, these restrictions are put in place to ensure tax fairness and to prevent abuse of the tax system. By examining these specific tax rules, we aim to provide clarity on how to appropriately account for these expenses.

Accounting Provisions and Reserves

GAAP requires businesses to make certain estimates, such as an allowance for doubtful accounts, to match potential bad debt expenses with current revenues and accurately reflect accounts receivable. However, the ITA does not recognize these accounting reserves. Instead, any reserve must be added back to income and can only be deducted for tax purposes when it is realized. On the other hand, the ITA allows for a reasonable bad debt reserve, if supported by specific invoices.

In tax terms, a “reserve” modifies amounts received or receivable, such as those for undelivered goods or doubtful debts, and is treated as a deduction in determining net business income. While provisions and reserves are deductible in accounting income calculations, they are not deductible for taxable income. Deductions for reserves, contingent liabilities, or sinking funds are generally not allowed, except as specified by tax regulations.

A contingent liability is a potential obligation dependent on uncertain future events and is not deductible until it becomes measurable. Furthermore, anti-avoidance rules may apply if a liability is bona fide and unconditional but may be reduced or eliminated in the future. These rules would consider it reasonable to expect the taxpayer to exercise their right to reduce the liability, such as with accrued interest expenses that might be reducible in the future.

Meals and entertainment expenses

The ITA limits the deductibility of meals and entertainment expenses to 50.0% of the amount paid or payable, or a reasonable amount, whichever is less. This restriction also applies to expenses such as tickets for entertainment or sporting events, gratuities, cover charges, room rentals for entertainment purposes, and the cost of private boxes at sports facilities.

The following items are excluded from the 50.0% limitation noted above:

- Costs incurred by a restaurant, airline, or a hotel providing meals to customers in their ordinary course of business.
- Meals and entertainment expenses relating to an event intended primarily for benefiting a registered charity.
- Cost of meals and entertainment that are included as a taxable benefit to the employee.
- Costs of meals and recreation provided by an employer for the general benefit of all employees at a specific location, limited to occasional events not exceeding six per year.

Recreational facilities and club dues

The deduction of expenses related to recreational facilities and club dues is strictly prohibited under the Act, regardless of their importance to revenue generation. Similarly, expenses for maintaining a yacht, camping, lodging, or golfing are generally not deductible unless these facilities are available to the public as part of the taxpayer's business operations. However, costs incurred for meals and beverages at a golf club are subject to a 50.0% restriction, as mentioned above.

Payments mandated by the Act

Payments required under the Act, such as federal income taxes, interest, and penalties imposed, are not deductible for tax purposes. However, interest paid on a tax refund that must be repaid due to an excessive refund is an allowable deduction.

Prepaid expenses

The Act allows for the deduction of prepaid expenses only in the fiscal year to which they pertain. Prepaid expenses include payments for services scheduled to be provided after the corporate fiscal year end and may include interest and tax payments, rent, royalties and insurance payments for future periods.

Unpaid amounts

An unpaid amount related to a non-arm's length transaction or circumstance must be paid within two years of the taxation year-end in which it was declared payable or accrued. If the amount remains unpaid after two years, it must be included in income on the first day of the third taxation year following the year in which it was declared payable.

Unpaid remuneration such as salaries, or wages, must be paid within 179 days of the taxation year-end in which the expense was incurred (payment on the 180th day is deemed acceptable). Failure to settle the amount by this deadline results in it being ineligible for deduction. Therefore, the expense will only be deductible in the year it is actually paid.

Accounting Depreciation vs Tax Depreciation

In this section, we will explore the differences between accounting depreciation and tax depreciation, focusing on their objectives and calculation methods. Depreciation is a fundamental concept in both accounting and taxation, but it serves different purposes in each context.¹⁶ Accounting depreciation aims to allocate the cost of depreciable assets over their useful lives for financial reporting purposes, ultimately matching the expense of the asset to the revenue generated by that asset. In contrast, tax depreciation is designed to determine the allowable portion of depreciable assets that can be expensed for income tax purposes each year, often following specific rules and rates established within the ITA.

The ITA includes rules for deducting tax depreciation referred to as CCA. The CCA system commonly employs a declining balance method and groups assets of the same class into a single pool.¹⁷ Deductible amounts for tax purposes are determined by the specific asset class of the depreciable property. The objective of this approach is to minimize variability in calculations, ultimately providing a more consistent and neutral application compared to GAAP, which often uses professional judgement to estimate the useful lives and salvage value of assets. While the financial reporting rules within GAAP require the annual recognition of amortization, claiming CCA is optional under tax law. When the amount of CCA claimed for tax purposes and depreciation recorded for accounting purposes differ, it results in a deferred tax asset or liability.

There are two types of capital property: depreciable and non-depreciable. Non-depreciable capital property consists of assets such as land and investments that are not used up or worn out during the course of business. As a result, they are neither subject to depreciation for accounting purposes nor eligible for CCA deductions for tax purposes. In contrast, depreciable property is used up or worn out during the course of business, is subject to depreciation, and is eligible for CCA deductions. Examples of depreciable assets include buildings, machinery and equipment, as well as intangible assets such as software, brand names, trademarks, and licenses.

UCC and CCA

The grouping of similar assets into a UCC pool is a method used for tax purposes to simplify the administration of CCA. This pooling approach allows taxpayers to aggregate assets of the same class into a single pool of asset balances, rather than calculating CCA for each individual asset separately.¹⁸

As mentioned earlier, in contrast to accounting depreciation which is taken every year, claiming CCA is optional/discretionary and can vary depending on the prescribed rate of the applicable class. An asset becomes eligible for CCA in the year it is available for use. The maximum allowable CCA is calculated by multiplying the UCC of the tax pool balance by the prescribed CCA rate for the asset class. To calculate the ending tax balance of asset pools, the CCA claimed is subtracted from the beginning UCC in the asset class to determine the remaining UCC available for future CCA claims.

For most classes, half of any excess additions (for acquisitions) over deductions (for dispositions) to a class within the year must be subtracted prior to applying the appropriate CCA rate. In other words, in the year of acquisition, 50.0% of the net additions to the class are eligible for CCA. This is known as and commonly referred to as the “Half-Year” or “First Year” Rule. This prevents an asset purchased towards the end of the tax year from being eligible for the full CCA deduction. Instead, the rule uses a 50.0% adjustment as a practical alternative to calculating the exact period of ownership within the year. The half-year rule does not apply to depreciable property acquired in a non-arm’s length transaction if the property was owned continuously by the transferor for at least 364 days before the end of the acquiring corporation’s taxation year.

¹⁶ For financial reporting purposes, the terms depreciation and amortization are typically used in different contexts. Depreciation refers to the allocation of the cost of tangible assets over their useful lives, while amortization refers to the allocation of the cost of intangible assets over their useful lives. However, for the purposes of this primer, these terms may be used interchangeably without distinction.

¹⁷ While declining balance method is more commonly used, the Act permits the use of straight-line depreciation for certain asset classes. This method spreads the cost of the asset evenly over its useful life.

¹⁸ There are several exceptions to this grouping rule which are outside of the scope of this primer.

When a taxation year is less than 12 months (such as due to an acquisition of control event), CCA must be pro-rated based on the number of days in the shortened taxation year. A short tax year can also occur in the first or last year of business operations, or during a fiscal year change. Pro-rating CCA for a short taxation year is independent of the half-year rule adjustment. Therefore, in a short tax year, a newly acquired asset may be subject to both the half-year rule and the pro-rating for the number of days in the taxation year.

For acquisitions after November 20, 2018, special provisions were enacted to significantly increase the amount of CCA that can be deducted in an asset's first year of use. This is referred to as the Accelerated Investment Incentive (AcclI) and was introduced to stimulate and encourage capital investment by allowing purchasers to claim a higher amount of CCA in the earlier years of an asset's life. It is important to note that this a temporary measure which will begin phasing out in 2024.¹⁹

Under specific circumstances, taxpayers may find it advantageous to claim less than the maximum allowable CCA amount. This optional deduction is particularly beneficial when a taxpayer has a significant amount of unused non-capital losses that may expire before they can be utilized. Typically, taxpayers prefer to first utilize non-capital tax loss carry forwards that are subject to expiration before applying CCA deductions, which do not expire. As long as an asset remains in the UCC pool, the pool balance remains available for future years, ensuring that the opportunity to claim CCA is preserved. However, if a taxpayer opts not to claim CCA in a specific year, they cannot carry forward this deduction to the subsequent year (i.e., they are not permitted to claim double the amount the following year).

Finally, to claim CCA on depreciable property, the taxpayer must have legal ownership of the asset (with an exception for class 13 leasehold improvements), and the property must be "available for use." Property is considered available for use when it is delivered and capable of performing the intended function for which it was acquired.

A building is available or use at the earlier of (i) and (ii):

- i. When all or substantially all of the building is first used for its intended purposes; and
- ii. The second taxation year after the year of acquisition.

Example 4: CCA Calculation

Case Facts:

Class 8 has a beginning UCC balance of \$10,000 in Year 1

Year 1 - Corporation acquired a piece of machinery (Class 8, CCA Rate: 20.0%) for \$50,000

Year 3 - Corporation disposed of the machinery for a proceeds of disposition of \$20,000

	Year 1	Year 2	Year 3	
UCC, Beginning Balance	10,000	53,000	42,400	[A]
Acquisitions	50,000	-	-	[B]
Lesser of Cost or POD	-	-	20,000	[C]
UCC	60,000	53,000	22,400	[D] = A + B - C
Net Additions (Half-Year Rule)	25,000	-	-	[E] = (B - C) * 50%
UCC, Adjusted	35,000	53,000	22,400	[F] = D - E
CCA Rate	20%	20%	20%	[G]
CCA	7,000	10,600	4,480	[H] = F * G
UCC, Ending Balance	53,000	42,400	17,920	[I] = D - H

Notes:

A = UCC beginning balance is equal to the previous years UCC ending balance

B = Cost of acquisitions; new property must be available for use

E = Amount cannot be negative

F = Represents UCC balance eligible for CCA

¹⁹ Given that AcclI is a temporary measure which adds significant complexities to the CCA process, it will not be included in examples throughout this primer.

Terminal Loss and Recapture

When there is a disposition of depreciable property, an amount is deducted from the UCC balance of the relevant CCA class. The amount of the deduction will be equal to the lesser of:

- (1) The POD.
- (2) The capital cost of the individual asset.

In many cases, the POD for a depreciable asset will be less than its capital cost and the POD will be subtracted from the balance in the relevant CCA class. If the business has additional assets remaining in the UCC class subsequent to the disposition, the balance in the class will be reduced, resulting in lower CCA deductions in the future. If there are no other assets remaining in the UCC class after the disposition, and the UCC balance is subtracted from the lesser of the (1) POD and (2) capital cost, and if the resulting UCC balance is positive, the ITA recognizes this amount as a terminal loss. Unlike a capital loss, a terminal loss is fully deductible against business or property income.^{20,21} The ITA does not allow for CCA to be taken for the year in which the terminal loss occurs. If the deduction from the UCC class results in a negative balance, and this negative balance is not offset by new acquisitions made prior to the end of the taxation year, the ITA recognizes the negative balance as recapture. Recapture is included into income and represents previous CCA deductions made in excess of the UCC pool available to the taxpayer. Unlike terminal losses which can only occur when no assets remain in the UCC class at the end of the taxation year, recapture will occur if the UCC balance is negative, regardless of the assets it comprises.

The example below provides the calculation of recapture and terminal loss under the same scenario as presented above, with varying POD.

Example 5: Capital Gain, Recapture, and Terminal Losses

	Scenario A	Scenario B	Scenario C	
Calculation of Capital Gain				
Proceeds of Disposition	20,000	40,000	60,000	[A]
Less: Capital Cost	50,000	50,000	50,000	[B]
Capital Gain	-	-	10,000	If A - B > 0, Capital Gain
Calculation of Terminal Loss (Recapture)				
UCC, Beginning of Year	36,000	36,000	36,000	[C]
Minus the lesser of:				
Capital Cost	50,000	50,000	50,000	[D]
Proceeds of Disposition	20,000	40,000	60,000	[A]
Terminal Loss (Recapture)	16,000	(4,000)	(14,000)	[E] = [C] - Lessor of [D] and [A]
	[1]	[2]	[2]	

Notes:

[1] Terminal loss to be deducted from business or property income as this is the last asset in the class.

[2] Recapture to be added to income and taxed at the same rate as business income.

²⁰ While a capital gain can result from the disposition of a depreciable asset, a capital loss cannot.

²¹ If the terminal loss exceeds income, it can be carried back or carried forward as a non-capital loss.

CCA Classes not Allowed to be Pooled – Rental Properties (Class 1) and Luxury Cars (Class 10.1)

Rental Properties – Included in Class 1

Each rental building purchased for over \$50,000 must be classified separately for CCA purposes and cannot be pooled into a single class. This restriction ensures that a recapture of CCA is triggered whenever each rental property is sold for proceeds that exceed the UCC balance of that property. This rule was established to prevent taxpayers from avoiding recapture on the sale of a rental property by simply purchasing another rental property of the same class. Without this provision, a taxpayer could buy a new rental property at the end of the taxation year to offset the negative balance. The separate class rule intends to force recognition of recapture each time the pool has a negative balance as a result of a disposition. Lastly, losses from rental properties can be used to reduce/offset other sources of income, but the Act restricts the ability to create or increase a loss from rental properties using CCA.

Luxury Motor Vehicles – Included in Class 10.1

Motor vehicles categorized under class 10 adhere to standard rules for recapture, terminal loss, and CCA. However, if an automobile's capital cost exceeds the pre-tax prescribed limit (set at \$37,000 for 2024), it falls into class 10.1 and cannot be pooled. Additionally, the asset is subject to a maximum capital cost of \$37,000. In the year of disposition, half of the CCA that would have been allowed for that automobile if it had not been sold can be deducted. For example, given the CCA rate of 30.0% for class 10.1, a 15.0% CCA claim is eligible in the year of disposition.

A comparison of the rules applicable to class 10 vs. Class 10.1 vehicles is summarized below:

Exhibit 4: Comparison of Class 10 and Class 10.1 Vehicles Based on Criteria

Item	Class 10	Class 10.1
Applicable CCA rate	30%	30.0%
Group all vehicles in one class	Yes	No
List each vehicle separately	No	Yes
Maximum capital cost	No	Yes
Half-year rule on acquisitions	Yes	Yes
Half-year rule on sale	No	Yes
Recapture on sale or trade-in	Yes	No
Terminal loss on sale or trade-in	No	No

Taxable Income Example

In this section, we will provide a detailed example to illustrate the process of reconciling accounting income to taxable income. Accounting income, reported under GAAP, reflects the financial performance of a business, incorporating various estimates, judgments, and principles aimed at providing a true and fair view of the company's financial health. However, for tax purposes, certain adjustments must be made to align accounting income with the tax regulations outlined in the ITA. These adjustments may include adding back non-deductible expenses, deducting allowable tax deductions not considered in accounting income, and applying specific tax provisions such as CCA.

Through this example, we will illustrate the process of reconciling accounting income to taxable income, highlighting common adjustments and their implications. This exercise will help clarify the differences between accounting principles and tax regulations, ensuring a comprehensive understanding of how taxable income is derived from accounting income.

Example 6: Accounting Income to Taxable Income

ABC Corporation provides professional services across Ontario. Net income reported for accounting purposes for the current fiscal year is \$150,000. The following accounting items have been recorded in the financial statements below:

Accounting Item	Notes	Amount
Charitable donations	[1]	\$ 5,000
Political donations	[2]	\$ 1,400
Life insurance premiums	[3]	\$ 6,000
Bad debt expense	[4]	\$ 4,000
Meals and entertainment	[5]	\$ 4,000
Membership fees	[6]	\$ 11,000
Penalties and interest	[7]	\$ 2,400
Amortization / Depreciation	[8]	\$ 2,000
Dividends received	[9]	\$ 10,000
Net gain on disposal of assets	[10]	\$ 32,000

Notes:

- [1] Reflects donations to a registered charitable organization.
- [2] Reflects donations to a federal political party.
- [3] Life insurance premiums for the shareholder, not acquired for obtaining financing.
- [4] The company was unable to collect monies owed for an invoice issued earlier in the year which is not included in net income.
- [5] Reflects 100% of meals and entertainment expenses.
- [6] Reflects membership fees for a recreational club (golf club) often used to entertain clients.
- [7] Reflects penalties and interest related to the late filing of the prior years corporate taxes.
- [8] Amortization and depreciation on assets.
- [9] ABC Corporation received dividends of \$10,000 during the year from a taxable Canadian corporation.
- [10] Reflects the disposal of equipment and a tenanted building.

	Equipment	Building - Tenanted	Total
Proceeds of disposition	\$ 8,000	\$ 100,000	\$ 108,000
Less: Cost	\$ 13,000	\$ 63,000	\$ 76,000
Gain (loss) on disposal	\$ (5,000)	\$ 37,000	\$ 32,000

[11] In the last quarter of the current year, the Company purchased a new passenger vehicle for \$30,000 + 13.0% HST

[12] The ending UCC balance from the prior year shows the following depreciable assets:

Class 1: Building-Tenanted, UCC \$50,000

Class 1: Building-Vacant, UCC \$40,000

Class 8: Equipment, UCC \$9,000; reflects the last item in the class

Required:

Determine the amount of taxable income for ABC Corporation for the current fiscal year.

Solution:

Reconciliation of Accounting Income to Taxable Income Notes

Items deducted from accounting income for the purpose of determining taxable income

Income (loss) for accounting purposes

Add: Charitable donations	[1]	\$	-	\$	150,000
Add: Political donations	[2]	\$	1,400		
Add: Life insurance premiums	[3]	\$	6,000		
Add: Bad debt expense	[4]	\$	4,000		
Add: Meals and entertainment (50%)	[5]	\$	2,000		
Add: Membership fees - recreational club	[6]	\$	11,000		
Add: Penalties and interest	[7]	\$	2,400		
Add: Amortization and depreciation	[8]	\$	2,000		
Add: Recapture on disposal of building	[9]	\$	13,000		
Total additions				\$	41,800

Items deducted from accounting income for the purpose of determining taxable income

Deduct: Terminal loss on disposal of equipment	[9]	\$	(1,000)		
Deduct: Dividends received	[10]	\$	(10,000)		
Deduct: Gain on disposal of asset	[11]	\$	(32,000)		
Deduct: CCA	[12]	\$	(6,685)		
Total deductions				\$	(49,685)
Net income for tax purposes				\$	142,115

Notes:

- [1] Corporations can deduct charitable donations limited to 75% of net income.
- [2] Political contributions are not considered an allowable business expense under the ITA.
- [3] Policy was not required to obtain financing such as a bank loan, and therefore, not deductible. If the policy was required for the purpose of obtaining financing, the Act limits the deduction of the lesser of the premiums paid or the net cost of pure insurance, which is a specific calculation related to the pure insurance component of the policy.
- [4] Bad debt expenses are deductible as long as the amount was previously included in income. As this relates to an amount that was not yet included in income, it is not deductible.
- [5] Restricted/limited to 50% by the Act.
- [6] Deduction for use of recreational facilities and club dues are specifically denied by the Act.
- [7] Amounts payable under the Act are not deductible.
- [8] The Act specifically prohibits amortization of an amount that is capital in nature; CCA deduction must be calculated for tax purposes.
- [9] Refer to the capital gain, recapture, and terminal loss schedule below.
- [10] Dividends received from a taxable Canadian corporation are deductible under section 112(1) of the Act.
- [11] Gain calculated for financial reporting purposes is deducted. Recapture and terminal loss included. Capital gain should be considered after applying the appropriate inclusion rate when calculating taxable income.
- [12] CCA reflects use of a depreciable asset which is deducted for tax purposes. Refer to the CCA Schedule below.

Accompanying CCA Schedule and Calculations:

Item	Building - Tenanted 1	Building - Vacant 1	Equipment 8	Passenger Vehicle 10.1	
CCA Class					
UCC, Beginning Balance		40,000		-	[A]
Acquisitions		-		33,900	[B]
Lesser of Cost or POD		-		-	[C]
UCC		40,000		33,900	[D] = A + B - C
Net Additions (Half-Year Rule)		-		16,950	[E] = (B - C) * 50%
UCC, Adjusted		40,000		16,950	[F] = D - E
CCA Rate		4%		30%	[G]
CCA		1,600		5,085	[H] = F * G
UCC, Ending Balance		38,400		28,815	[I] = D - H

	Building - Tenanted	Building - Vacant	Equipment	Passenger Vehicle
Calculation of Capital Gain				
POD	100,000		8,000	[A]
Less: Capital Cost	63,000		13,000	[B]
Capital Gain	37,000		-	If A - B > 0, Capital Gain
Calculation of Terminal Loss (Recapture)				
UCC, Beginning of Year	50,000		9,000	[C]
Minus the lesser of:				
Capital Cost	63,000		13,000	[D]
POD	100,000		8,000	[A]
Terminal Loss (Recapture)	(13,000)		1,000	[E] = [C] - Lesser of [D] and [A]

Notional Valuation Tax Considerations

This section discusses the specific tax considerations a valuator should take into account when conducting a notional valuation. Unlike in an open market transaction where corporate and personal taxes are immediately realized from the sale of a business, a notional valuation does not result in immediate tax considerations. Consequently, in certain scenarios, assumptions regarding the eventual realization and timing of these tax liabilities are required by the valuator.

Understanding the various valuation methodologies is crucial for identifying the specific areas where taxes must be considered. The detailed mechanics of valuation approaches are beyond the scope of this primer, including the valuation of a business as a going concern (using asset-based, income-based, or market-based methods) or on a liquidation basis. However, we will introduce the methodologies included in the income approach and the common areas where taxation is considered.

Three primary methods of the income approach exist for valuing a business based on its ability to generate prospective cash flows:

- 1) Capitalized Earnings Methodology
- 2) Capitalized Cash Flow Methodology
- 3) Discounted Cash Flow Methodology

Selecting the appropriate methodology depends on the specific circumstances surrounding the operations of the business and the financial information available. The table below summarizes the common areas where taxes are considered in all three approaches.

Exhibit 5: Common Areas of Taxation in the Income Approach

Capitalized Earnings Method*	Capitalized Cash Flow Method*	Discounted Cash Flow Method*
- Cash taxes are considered on earnings before interest and tax (EBIT) - Redundant assets are considered at their net realizable value (i.e., gross proceeds less notional taxes and disposition costs)	- Cash taxes are considered on earnings before interest, tax, depreciation, and amortization (EBITDA) - Tax shield is considered on sustaining capital reinvestment - Future tax savings on UCC balance as at the valuation date is considered - Redundant assets are considered at their net realizable value (i.e., gross proceeds less notional taxes and disposition costs)	- Cash taxes are considered on EBITDA - Tax shield is considered on sustaining capital reinvestment - Future tax savings on UCC balance as at the valuation date is considered - Redundant assets are considered at their net realizable value (i.e., gross proceeds less notional taxes and disposition costs)

*Assumes unlevered approach has been considered.

All three primary methods can be conducted based on an unlevered approach or levered approach. The main difference between the two methods is that the unlevered approach considers the after-tax cash flows available to both equity and debt investors, which are discounted using the Weighted Average Cost of Capital (WACC), while the levered approach considers only the after-tax cash flows available to equity investors, which is discounted by the firms' cost of equity. Conceptually, both approaches should arrive at the same value conclusion. These common taxation areas will be discussed in-depth throughout the subsequent sections of this primer.

Calculating Income Taxes for Valuation Purposes

In the preceding section, we extensively explored the adjustments applied to accounting income used to arrive at taxable income. However, in practice, when conducting a notional valuation on a going concern basis, valuers use a proxy for taxable income to calculate income taxes. Typically, GAAP financial statements are used as a starting point to determine taxable income for a valuation, rather than the taxable income used in the preparation of the business's tax return.

As outlined in **Exhibit 5**, income taxes are typically calculated based on a standardized metric of profitability. For example, when performing a capitalized earnings methodology using an unlevered approach, maintainable earnings in the form of EBIT is used to determine the applicable income taxes. Alternatively, when performing a capitalized cash flow methodology using an unlevered approach, maintainable EBITDA is selected to determine income taxes. Once the valuator has determined the appropriate maintainable earnings, they must then determine the appropriate tax rate. Given that one of the fundamental principles of valuations is that value is prospective, the tax rate should be based on the future rates expected as well as what a prospective purchaser would likely incur.

Redundant Assets and Liabilities

Redundant assets and liabilities, which are not required for business operations, are valued separately from the core operations of a business. Some examples of redundant assets include excess land purchased but not used, and marketable securities. When these assets have increased in value from their adjusted cost base, an inherent unrealized tax liability exists.

Redundant assets are valued at their Net Realizable Value (NRV), which is the estimated amount expected upon sale, minus selling expenses and taxes. As these assets are not required for the company's operations, it is assumed any prospective purchaser would sell them immediately, realizing the associated tax gains or losses. Alternatively, a vendor could withdraw these assets prior to selling the company's shares, leading to immediate tax consequences. Therefore, when performing a valuation, redundant assets are assumed to be disposed of immediately on the valuation date, considering all corporate tax consequences.²²

Tax Shields on Undepreciated Cost of Capital

A tax shield is a reduction in taxable income achieved through claiming allowable deductions, such as tax depreciation. The present value of a tax shield on tax depreciation such as CCA represents the tax savings from depreciating a capital asset over time assuming they can be fully utilized.²³ The formula for calculating the present value of CCA tax shields are:

Tax Shield Formula – Full CCA Available – Existing Asset:

$$\text{Tax shield} = \frac{\text{Remaining UCC} \times \text{Tax rate} \times \text{CCA Rate}}{\text{Rate of return} + \text{CCA Rate}}$$

²² In some cases, the notional tax liability on redundant assets is discounted to reflect the fact that they may not be immediately incurred (e.g., a notional buyer may have use for excess land).

²³ Given that the CCA deductions can be fully utilized, it assumes there are no impediments, such as non-capital loss carry forwards, which would prevent the deductions from being applied to taxable income.

Tax Shield Formula – CCA Half-Year Rule Applies – First Year of Acquisition

$$\text{Tax shield} = \frac{\text{Investment cost (UCC)} \times \text{Tax rate} \times \text{CCA Rate}}{\text{Rate of return} + \text{CCA Rate}} \times \frac{[1 + (0.5 \times \text{Rate of return})]}{(1 + \text{Rate of return})}$$

Tax Shield Formula – Accelerated Investment Incentive:

$$\text{Tax shield} = \frac{\text{Investment cost (UCC)} \times \text{Tax rate} \times \text{CCA rate}}{\text{Rate of return} + \text{CCA rate}} \times \frac{[1 + (1.5 \times \text{Rate of return})]}{(1 + \text{Rate of return})}$$

Tax Shield Formula – Straight-Line Depreciation²⁴:

$$\text{Tax shield} = \frac{\text{Investment cost (UCC)} \times \text{Tax rate}}{\text{Remaining years}} \times \frac{1 - 1 / (1 + \text{Rate of return})^{\text{Remaining years}}}{\text{Rate of return}}$$

While tax shields can be calculated on a class-by-class basis, common practice is to total the UCC balance and calculate the applicable weighted average CCA rate. As illustrated in **Exhibit 5**, there are two main areas where CCA tax shields are calculated when preparing a valuation using the capitalized cash flow methodology or the DCF methodology.

The first consideration takes place when estimating the appropriate level of capital expenditures. Capital reinvestment is often required by a business to maintain operations (sustaining capital expenditures) and to grow operations (expansionary/growth capital expenditures). Given that these capital expenditures are depreciable for tax purposes, a tax shield must be considered to quantify the income tax savings. Given that these depreciable assets are newly acquired, they are subject to the half-year rule and the corresponding tax shield formula would apply. Lastly, if a business has an existing UCC balance of depreciable assets as at the valuation date, the tax shield associated with that balance should be included to ensure the business enterprise value is not understated. Given that these depreciable assets already exist and have not been newly acquired, the corresponding tax shield formula would apply.

The valuation of intangible assets is important for financial reporting purposes. Financial reporting standards, such as IFRS and GAAP, require the fair value recognition and valuation of intangible assets through the preparation of Purchase Price Allocations (PPAs) and impairment testing. Similar to tax shields determined on tangible depreciable capital assets, a Tax Amortization Benefit (TAB) is calculated when valuing an intangible asset and represents the present value of the tax savings from amortizing an intangible asset over its useful life. The amortization expense reduces taxable income, resulting in lower tax payments and increased after-tax cash flow, which is the essence of the tax benefit. TAB is calculated using the tax shield formula provided earlier.

Latent Tax Liabilities

Latent tax liability refers to potential future tax obligations that have been accrued but are not yet due or recognized. When a business is sold, the transaction is either consummated as a share sale or an asset sale. If the assets within a corporation are sold at FMV, the sale price will become the new cost base for the buyer. If the asset has appreciated in value, the tax liability associated with the disposition of the assets will be recognized within the corporation immediately upon disposition. In contrast, if the shares of the corporation are sold, the cost base of the assets within the corporation remains the same and only until their subsequent disposition will a tax liability arise. This is often relevant for holding companies but can apply in any situation where the value of a company's common shares is based on the assets the company owns. Consider the following example below:

Example 7: Calculating Latent Taxes

You are purchasing the shares of a corporation which holds a building and no other assets. The FMV of the building is \$5.0 million; however, the original purchase price was \$4.0 million, resulting in an unrealized capital gain of \$1.0 million. Furthermore, the corporation has historically claimed \$2.0 million of CCA, resulting in a UCC of \$2.0 million. If the corporation were to sell the building, it would incur taxes on the capital gain of \$1.0 million, and recapture of \$2.0 million. Therefore, by purchasing the shares of the corporation, you're acquiring both the building and a latent tax liability which requires consideration when determining the value of the company's shares. The following calculation of the unrealized tax liability is as follows:

²⁴ The formula is specific to leasehold improvements that are subject to straight-line depreciation for tax purposes.

Calculation of Capital Gain		Building	
Proceeds of Disposition		5,000,000	[A]
Less: Capital Cost		4,000,000	[B]
Capital Gain		1,000,000	[C] = [A] - [B]
Taxable portion of capital gain (assume 66.67% inclusion)		666,700	[D] = [C] * 66.67%
Capital gain taxes (assume tax rate of 40%)	\$	266,680	[E] = [D] * 40%

Calculation of Terminal Loss (Recapture)			
UCC, Beginning of Year	\$	2,000,000	[F]
Minus the lesser of:			
Capital Cost		4,000,000	[B]
Proceeds of Disposition		5,000,000	[A]
Terminal Loss (Recapture)		(2,000,000)	[G] = [F] - [B]
Corporate income taxes (assume 30.0%)		600,000	[H] = [G] * 30.0%
Total latent taxes	\$	\$866,680	[I] = [E] + [H]

Simply put, the calculation above ignores disposition costs, therefore FMV is equal to POD. In this situation, if you planned to purchase the shares of the corporation and immediately sell the building, you would be willing to pay no more than \$4,133,320 for the shares (\$5,000,000 - \$866,680). However, it is rare for a purchaser to acquire a corporation with the immediate intention of selling the assets. If the assets are not going to be sold immediately, the time value of money influences the quantum of the tax liability at the time of purchase. In the example provided above, the total latent taxes equate to \$866,680 at the time of acquisition. However, if the building is not intended to be sold for five years, the tax liability should be discounted back at the date of purchase using an appropriate discount rate to determine the tax liability for the prospective purchaser. In practice, predicting the timing of asset disposition is often uncertain.

To estimate the tax liability at an unknown time in the future, valuers calculate the lower and upper bounds of the tax liability. The greatest tax liability arises when an immediate disposition is assumed, resulting in full income tax on the capital gain, and recaptured depreciation. Conversely, the lower bound of tax liability assumes that the asset will be held indefinitely, resulting in no realized capital gains.

In the given example, if you purchased the building directly through an asset purchase, the ACB and UCC of the building would be the purchase price (i.e., \$5.0 million ACB and UCC) and the purchaser would be eligible to claim CCA on this entire amount. In contrast, if the building is purchased through shares of the corporation, the purchaser assumes the existing tax basis from the vendor (i.e., \$4.0 million ACB and \$2.0 million UCC). The difference in the present value of tax benefits between these two scenarios is referred to as the foregone tax shield.

To calculate the lost tax shield, first determine the present value of the tax shield based on the current FMV of the asset, applying the half-year rule or accelerated formula, if necessary. This represents the tax benefit you would receive claiming tax depreciation based on the FMV of the asset. Next, subtract the tax shield based on the existing UCC balance of the asset, without applying the half-year rule or accelerated formula, representing the tax shield benefit of the asset received when purchasing the shares of the corporation. This calculation is performed to understand the difference in tax benefits and to quantify the foregone tax shield. Using the same example, the foregone tax shield calculation is illustrated below:

Example 8: Calculating the Foregone Tax Shield

Assumptions:

CCA rate: 4.0%

Rate of return: 10.0%

Tax rate: 30.0%

UCC of building: \$2,000,000

FMV of building: \$5,000,000

Forgone tax shield calculations:

Tax shield on building at fair market value

$$\frac{(5,000,000 \times 30.0\% \times 4.0\%)}{(10.0\% + 4.0\%)} \times \frac{[1 + (0.5 \times 10.0\%)]}{(1 + 10.0\%)} = \$409,091 \text{ [A]}$$

Tax shield on existing UCC balance of building:

$$\frac{(2,000,000 \times 30.0\% \times 4.0\%)}{(10.0\% + 4.0\%)} = \$171,429 \text{ [B]}$$

Forgone tax shield

$$\$237,662 \text{ [C] = [A] - [B]}$$

From the above analysis, the foregone tax shield and the latent taxes associated with purchasing the shares of a corporation ranges from \$237,662 to \$866,680 and assumes that the building will either be held by the purchaser indefinitely or disposed of immediately, respectively. If the timing of the disposition of the asset is unknown/uncertain, the midpoint within this range is considered appropriate.

The calculations above ensure that the appropriate tax implications are considered when situations arise when the value of a company is dependent on the value of its individual assets, specifically, depreciable assets. For non-depreciable assets, such as land and shares of other corporations, additional considerations must be made. As with depreciable assets, it is important to consider the timing of the disposition and any accrued gains on the non-depreciable assets. However, there is no tax shield associated with non-depreciable assets because the Act does not permit tax depreciation for these assets. Therefore, other factors need to be considered with dealing with non-depreciable assets.

The windup provisions of the ITA provide a mechanism for a parent company to wind up a subsidiary and transfer the ACB of the subsidiary's shares to its non-depreciable assets, up to their FMV. For example, if a parent company acquires shares of another corporation, and this newly acquired corporation holds a single piece of land with an ACB of \$200,000 and a FMV of \$1.2 million, the land will have an accrued gain of \$1.0 million, a taxable capital gain of \$666,667 (\$1.0 million x 2/3 inclusion rate) and an inherent tax liability of \$266,667 (\$666,666 x 40.0%). An individual purchaser would be willing to pay \$933,333 at the minimum to account for the tax liability. However, if a parent corporation purchased the shares, they could wind-up the shares into their corporation and section 88 of the Act would allow the transfer of the cost base of the shares to the land. This parent corporation would no longer have the inherent tax liability associated with the land and the purchaser would be willing to pay \$1.2 million for the shares.

These wind-up provisions are outlined in section 88 of the Income Tax Act, and the "bump up" of the ACB of non-depreciable assets is permitted under subsection 88(1)(d). To utilize the wind-up provisions, the shareholder must own more than 90.0% of the subsidiary's shares. This requirement exists to ensure the parent has significant control over the subsidiary and will minimize complications arising from minority shareholders who may have differing interests and rights.

Utilizing the applicable section 88 wind-up provisions and increasing the ACB of non-depreciable assets will result in the elimination of the unrealized tax liability. The ability to "bump up" the ACB to FMV increases the value of the holding company shares, since the purchaser can effectively eliminate the latent tax liability associated with the non-depreciable assets. As highlighted above, assuming the prospective purchaser is eligible to utilize the subsection 88(1)(d) bump, a tax liability on the land would not be considered and the resulting FMV of the shares would be \$1.2 million. It is prudent for a valuator to always consider the range of possible discounts, as determining the "highest price available" is fundamental when determining the appropriate FMV.

Finally, when calculating the corporate tax liabilities and the foregone tax shield, it is necessary to consider the appropriate tax rates to apply. For example, the investment tax rate should be used for investment income, such as taxable capital gains, and the appropriate business tax rate should be used for business income, such as recaptured tax depreciation. Similarly, the appropriate business income tax rate will apply for tax shield calculations since CCA is a business expense and deducted from business income. The example below demonstrates the appropriate tax rates to use for different types of income.

Example 9: Considering Taxes When Valuing the Shares of a Business

Brown's Holdings Inc. (Brown's) is a corporation holding various investments owned by the Brown family. Mr. Brown has approached you to determine the FMV of the company's common shares to facilitate some tax planning.

Brown's has 100 common shares outstanding and is 100% owned by Mr. Brown. The company has accumulated various investments, including real estate and investments in both private and public companies, as shown on the attached financial statements. Brown's pays tax at a rate of 30.0% on business income and 40.0% on investment income. Additionally, the company requires a 10.0% rate of return on assets.

One of Brown's investments is in Allterain, a small manufacturer of all-terrain vehicles. Despite showing initial promise due to innovative technology designed to improve speed and traction, Allterain has performed poorly for the past five years. Industry competition and consolidation have posed significant challenges, and Brown's expects to continue incurring losses under its current operations. Considering these accumulated losses, the FMV of Allterain has been determined to be \$2.9 million.

Required:

Determine the fair market value of the shares of Brown's Holdings Inc as at Oct 31, 2023.

Financial Information:

Brown's Holdings Inc.

Balance sheet

As at Oct 31, 2023

(000's)

Assets

Cash	5,000	
Short-term investments	23,000	[1]
Investments in public companies	1,40,250	[2]
Investment in Allterain	3,500	
Buildings	2,000	[3]
Total assets	1,73,750	

Liabilities

Shareholder loan	1,20,000
Total liabilities	1,20,000

Shareholders' equity

Common shares	100
Retained earnings	53,650
Total shareholders' equity	53,750
Total shareholders' equity and liabilities	1,73,750

Notes:

- [1] The fair market value of the short-term investments is \$21.5 million.
 [2] The fair market value of the investments in public companies is \$156 million.
 [3] The UCC of the building is \$2.5 million and the fair market value is \$6.5 million. The original capital cost was \$4 million. The CCA rate used for the building is 4.0% and the appropriate rate of return is 10.0%

Solution:**Brown's Holdings Inc.****Adjusted Net Book Value****As at Oct 31, 2023****(000's)**

	Net Book Value	-----Fair Market Value-----			
	Oct 31, 2023	Low	Midpoint	High	
Cash	5,000	5,000	5,000	5,000	
Short-term investments	23,000	21,500	21,500	21,500	[1]
Investments in public companies	140,250	156,000	156,000	156,000	
Investment in Allterain	3,500	2,900	2,900	2,900	[2]
Buildings	2,000	6,500	6,500	6,500	[3]
Latent taxes (low) and forgone tax shield (high)	-	(557)	(462)	(368)	[4], [5]
Total assets	173,750	191,343	191,438	191,532	
Liabilities					
Shareholder loan	120,000	120,000	120,000	120,000	
Total liabilities	120,000	120,000	120,000	120,000	
Net assets	53,750				
FMV of en bloc equity		71,343	71,438	71,532	
[1] Short-term investments					
Proceeds of disposition		21,500			
Less: ACB		23,000			
Capital loss		(1,500)	[A]		
[2] Investment in Allterain					
Proceeds of disposition		2,900			
Less: ACB		3,500			
Capital loss		(600)	[B]		
[3] Building					
Proceeds of disposition		6,500			
Less: ACB		4,000			
Capital gain		2,500	[C]		
UCC		2,500			
Less: Lesser of Cost and Proceeds of disposition		4,000			
Recapture		(1,500)	[D]		
[4] Calculation of latent taxes					
Net capital gain		400	[E] = [A] + [B] + [C]		
Taxable portion of capital gain		66.7%	[F]		
Taxable capital gain		267	[G] = [E] * [F]		
Tax rate on capital gain		40.0%	[H]		
Taxes payable on taxable capital gain		107	[I] = [G] * [H]		

Recapture	1,500	[D]
Tax rate on recapture	30.0%	[J]
Taxes payable on recapture	450	[K] = [D] * [J]
Total taxes payable on capital gain and recapture	557	[L] = [I] + [K]

[5] Forgone tax shield on building

Forgone tax shield on building at FMV

$$((6,500 \times 30.0\% \times 4.0\%) / (10.0\% + 4.0\%)) * [1 + (0.5 \times 10.0\%)] / (1 + 10.0\%) \quad 582 \quad [M]$$

Forgone tax shield on building at existing UCC

$$((2,500 \times 30.0\% \times 4.0\%) / (10.0\% + 4.0\%)) \quad 214 \quad [N]$$

$$\text{Forgone tax shield} \quad \mathbf{368} \quad [O] = [M] - [N]$$

In the above example, the capital loss on short-term investments and the investment in Allterain is calculated and included in the latent tax liability. However, the capital gain on investments in public companies is excluded since Section 88 could be used to avoid this potential tax liability. Next, the capital gain on the building (depreciable property) is calculated, along with the associated recapture, and the total latent taxes assuming immediate disposition is determined. In the calculation of the foregone tax shield, the half-year tax shield formula is used to calculate the tax shield on the FMV of the building, followed by the standard tax shield formula on the existing UCC balance of the building in order to determine the applicable foregone tax shield. The amounts have been included when determining the FMV of the en bloc equity of Brown's which is \$71.3 million at the low and \$71.53 million at the high.

Open Market Transaction Tax Consideration

An open market transaction represents the sale and purchase of business interests exposed to real-world market conditions. The price and terms of the transaction are negotiated between the buyer and the seller at arm's length, which includes deciding the structure of the transaction, such as a share or asset, and the various forms of consideration. Each structure presents different business and tax considerations for both the vendor and the purchaser.

For the vendor, the primary focus is maximizing the net proceeds they will realize after accounting for both corporate and personal taxes. On the other hand, the purchaser is typically concerned with minimizing the purchase price and latent tax liabilities associated with the acquisition. This difference in focus highlights the importance of understanding the tax implications of each transaction structure, as they can significantly impact the final outcomes for both parties.

Sale of Shares

When a vendor is deciding whether to sell the shares of their corporation or the assets within it, they will typically prefer to sell the shares. This preference is primarily due to the favorable tax treatment of capital gains, the potential to utilize LCGE if the shares are of a CCPC, and the ability to avoid recapture that would otherwise apply in an asset sale. Upon the sale of shares, the purchaser assumes the vendor's position, inheriting the existing ACB and UCC balances. However, the acquisition of control rules will result in the expiry of any unutilized net capital loss carry-forward balances, while any non-capital loss carry-forward balances will be subject to the loss streaming rules.

Sale of Assets

If the vendor opts to sell the assets of the corporation, this will trigger taxes on any capital gains and recapture. This results in two levels of taxes: taxes payable at the corporate level on business income and investment income, and taxes payable at the personal level when the proceeds are distributed from the corporation to the shareholder. However, the purchaser in an asset sale benefits from an increased cost base, as the UCC of the assets will now reflect their purchase price rather than remaining unchanged as they would in a share sale. In addition, any "goodwill" that is acquired pursuant to an asset purchase can be depreciated for tax purposes, which is not the

case in a share purchase. This increased cost base provides a significant advantage to the purchaser, allowing them to claim CCA based on the FMV of the assets.

Example 2.12 in the Level II Course Notes provides a detailed example demonstrating the after-tax proceeds to the vendor under both scenarios – the sale of shares and the sale of assets.

Liquidation Approach - Adjusting Assets and Liabilities to FMV

While the liquidation approach is considered notional in context, it carries the same tax consequences as an open market transaction. This is because assets and liabilities are valued at NRV, which assumes an immediate disposition or settlement. Therefore, considerations for the liquidation approach have been included in this section of the primer for clarity.

In an open market transaction, the purchase price of the assets has been negotiated, and the resulting values are used as a basis for calculating taxes payable. However, in a liquidation approach, the assets have not been exposed to the open market. Therefore, the first step in calculating the amount realizable to shareholders is to adjust the assets and liabilities to FMV. Below are some common assets and an explanation for how their dispositions are treated for tax purposes.

Sale of accounts receivable

When a business sells its Accounts Receivable (AR) as part of an asset sale, the ITA provides certain mechanisms to ensure that the tax implications are handled correctly for both the seller and the buyer. Although the revenue associated with the receivables has already been included in the vendor's income, these mechanisms will ensure the vendor can transfer the receivables at their FMV without triggering double taxation. For the buyer, these mechanisms provide them with the ability to recognize bad debts as they arise after the sale. Without the use of these mechanisms, the sale of AR would be on account of capital. For the vendor, this means any reserve for doubtful accounts previously taken must be added back into income, and if the AR is sold below face value, the loss would be treated as a capital loss. Additionally, the purchaser would not be able to claim an allowance for doubtful accounts, as they were not carrying on the business that generated the AR.

To address this, it is advantageous for the vendor and purchaser to file a joint election, specifically a S22 election. A S22 election allows the vendor to avoid including the allowance for doubtful account in income and permits the purchaser to deduct the allowance for doubtful accounts in income, if and when they occur. In effect, this election will convert a capital transaction into an income transaction.

For example, an AR balance with face value of \$14,000 and an existing reserve for doubtful accounts of \$3,000 is sold for \$10,000. Utilizing the S22 election will allow the purchaser to recognize a business loss of \$4,000. Without this election, the \$4,000 loss would be treated as a capital loss, deductible at 66.67% and only eligible to be applied against taxable capital gains.

Sale of inventory

A sale of inventory is treated as if it were made in the ordinary course of business. The sale proceeds are treated as income to the seller and the cost of inventory to the buyer. When selling all inventory as part of a business sale, it is treated the same for tax purposes as the usual sale of inventory during normal business operations. In other words, the sale of inventory is considered business income.

Sale of Depreciable Property

When selling depreciable property, all assets within the CCA classes must be disposed of. Consequently, any recapture, terminal loss, or capital gain related to these asset classes must be determined and the appropriate tax assessed accordingly. This also applies to intangible assets, including any goodwill that is included in the negotiated price for the business. As previously mentioned, capital losses cannot arise from the disposition of depreciable property; instead, any shortfall will result in a terminal loss.

Distributions to Shareholders

After all assets and liabilities are disposed of and the associated taxes on these dispositions are accounted for, the proceeds of the sale need to be distributed to the shareholders. These distributions can be classified into two types: taxable and non-taxable. Shareholders will typically first receive non-taxable distributions, such as capital dividends and paid-up capital.

Capital Dividend and Paid-Up Capital

A capital dividend is a distribution to shareholders that is paid out of a corporation's capital dividend account. The CDA is a notional account that accumulates the non-taxable portion of capital gains, among other specific items. Since this portion of the capital gain is not taxable, the balance in the CDA can be distributed to the shareholders on a tax-free basis as a capital dividend. Capital dividends provide relief to shareholders as they ensure that certain types of income that are non-taxable when received by a corporation are also non-taxable when distributed to shareholders. The common components of the CDA have been outlined below:

Exhibit 6: Common Components of the Capital Dividend Account

Item	Description
Capital Dividends Received	Capital dividends received from other corporations are included in the notional CDA. This is done to preserve the integrity of the capital dividends between corporations.
Capital Gains	Represents the non-taxable portion of realized net capital gains which is reduced by the non-deductible portion of realized capital losses.
Life Insurance Proceeds	When a corporation holds an insurance policy on one or more of its shareholders, the proceeds from the policy are included in the CDA.
Capital Dividends Paid	The CDA balance is reduced by any capital dividends paid by the corporation.

A shareholder's share capital investment into the business can also be returned to the shareholder tax free. This represents the paid-up capital of their shares. Once all non-taxable distributions have been utilized by a shareholder, any subsequent dividend distributions will be considered taxable. This taxable dividend can trigger a refundable dividend tax for the corporation, as previously discussed, reducing their overall corporate tax liability. The shareholder will then pay personal tax on the received dividend.

Dividend Distributions

A shareholder can receive a return on their investment through dividend distributions, which are paid by the corporation from its after-tax earnings. After the corporation pays corporate tax on its earnings, the remaining amount can be distributed to shareholders as dividends. When shareholders receive these dividends, they are required to pay additional personal taxes. However, because dividends are paid from after-tax corporate earnings, a gross-up and tax credit calculation is applied to avoid double taxation and ensure tax integration.

The goal of tax integration is to ensure that the total tax paid on income earned through a corporation (corporate tax plus personal tax on dividends) is approximately the same as if the income were earned directly by an individual and taxed at personal rates.

Here's how personal tax on dividends is calculated:

1. **Gross-Up Calculation:** The dividend amount is first grossed up to reflect the pre-tax income that was earned by the corporation before corporate taxes were applied (i.e., the gross-up is approximately equivalent to the tax paid at the corporate level).
2. **Application of Personal Tax Rate:** The shareholder's personal tax rate is then applied to this grossed-up amount.
3. **Tax Credit:** A tax credit is applied to the calculated personal tax, reflecting the corporate tax that has already been paid, to prevent double taxation.

This gross-up and tax credit calculation is designed to ensure that the total tax paid is roughly equivalent, whether the income is earned directly by an individual or through a corporation. Although the various corporate tax rates make this calculation less precise, the procedure's aim to achieve similar total taxation.

Lastly, a CCPC typically pays a significantly lower tax rate than a public corporation on income eligible for the SBD. Therefore, the ITA applies different rates for the dividend gross-up and tax credit calculations, depending on the corporate tax rate paid. While it is impractical to have varying rates for every corporate tax rate, two broad categories of dividends have been established:

- Eligible dividends: generally paid by public companies which are taxed at the general corporate income tax rate.
- Non-eligible dividends: generally paid by CCPC's which are generally taxed at the small business rate.

These distinctions ensure that the tax integration mechanism remains effective across different types of corporations and dividend distributions.

Eligible and Non-eligible Dividends

Eligible dividends receive a gross-up rate of 38.0% and a dividend tax credit equal to 6/11 of the gross-up amount. Generally, public companies and private companies that are not Canadian controlled pay eligible dividends. However, a notional account called the Low Rate Income Pool (LRIP) has been established to track income taxed at a lower rate. Income tracked in the LRIP may be paid out as non-eligible dividends.

Conversely, non-eligible dividends receive a gross-up rate of 17.0% and a dividend tax credit equal to 21/29 of the gross-up amount. These dividends are generally paid by CCPC's; however, a notional account called the General Rate Income Pool (GRIP) has been established to track any income taxed at higher rates. Eligible dividends can be paid from this account.

Lastly, each province has its own rate for the dividend tax credit, often expressed as a percentage of the grossed-up dividend. For instance, for a \$100 dividend in Ontario, the calculation of tax would be either an eligible or non-eligible dividend. The example below illustrates the calculation.

Example 10: Eligible and Non-Eligible Dividend Calculation

	Rate	Eligible	Rate	Non-Eligible	
Dividend		\$ 100.00		\$ 100.00	[A]
Gross-up rate	38.00%	38.00	15.00%	15.00	[B] = [A] * gross-up rate
Grossed-up dividend		138.00		115.00	[C] = [A] - [B]
Tax at personal rate	53.00%	73.14	53.00%	60.95	[D] = [C] * personal tax rate
Dividend tax credit*	25.02%	34.53	12.02%	13.82	[E] = [C] * dividend tax credit rate
Total individual tax payable		\$ 38.61		\$ 47.13	[F] = [D] - [E]

*Applicable Federal and Ontario rates.

Other Tax Considerations

This section of the primer addresses additional considerations a valuator should be aware of, including the tax implications of asset disposition upon the death of a taxpayer and the operation and taxation of trusts. These considerations are critical for a comprehensive understanding of the tax implications associated with various financial scenarios.

Understanding how assets are handled for tax purposes upon the death of a taxpayer is essential for accurate estate planning and valuation. The tax code has specific provisions, such as the deemed disposition rules, which impact the valuation and transfer of capital property. These rules ensure that capital gains are appropriately recognized and taxed at the time of death, with special considerations for transfers to a spouse, common-law partner, or spousal trust.

Similarly, trusts play a significant role in estate planning and asset management. Trusts are unique legal entities with distinct tax rules and benefits. Key considerations include the trust's income distribution, tax residency, and the 21-year deemed disposition rule, all of which have significant implications for how trusts are valued and taxed. Understanding these elements is crucial for providing accurate and comprehensive valuation services.

Deemed disposition on Death

Subsection 70(5) of the Act deems a taxpayer to have disposed of all capital property immediately before death, with the proceeds considered equal to the property's FMV. However, there are special rules for capital property transferred to a spouse, common-law partner, or spousal trust.

For non-depreciable capital assets transferred upon death, the property is deemed to have been disposed of at the deceased's ACB. This ACB then becomes the cost base of the property for the surviving spouse or partner. As a result, the capital gain or loss can be deferred until the surviving spouse or partner disposes of the assets, or the estate elects not to apply the interspousal rollover at the time of death.

For depreciable capital assets transferred upon death to a spouse or partner, the assets are deemed to have been disposed of at their UCC. This UCC then becomes the cost base of the property for the surviving spouse or partner, effectively deferring any capital gains, recapture, and/or terminal losses until the assets are disposed of by the surviving spouse or partner.

In contrast, when depreciable and non-depreciable capital property is transferred to a beneficiary other than a spouse or partner, the property is deemed to have been disposed of at FMV upon death. In this case, the beneficiary is deemed to have acquired the property at FMV, and any resulting capital gains, recapture, and/or terminal losses are captured on the deceased's final tax return.

Understanding Trust and Their Tax Implications

A trust is a legal relationship whereby a person, known as the trustee, is obliged to manage property which they have control over. This is referred to as the trust property. For the benefit of another person or persons, known as the beneficiaries, who have the right to enforce this obligation. A trust is created when a person, also called the settlor, transfers ownership of property to the trustee, who then holds and manages it for the beneficiaries.

A fundamental characteristic of a trust is the separation between title-holding and the management of property. For a trust to exist, the following three certainties must be present:

1. **Certainty of intention:** The settlor must have intended to establish a trust.
2. **Certainty of subject matter:** Specific property must be given to the trustee.
3. **Certainty of objects:** The beneficiaries must be clearly defined.

A trust is considered a separate and distinct taxpayer from its settlors, trustees, and beneficiaries. For tax purposes, the trust is deemed to be an individual, meaning its income is generally computed in the same way as an individual's income.

For the purposes of the Act, a trust's residency is determined by where its central management and control are located. If a trust is resident in Canada, it will be taxed on its worldwide income. If not, it will be taxed in Canada as a non-resident. However, a non-resident trust can be deemed a Canadian resident for specific purposes if it has a resident contributor or resident beneficiary. When a trust ceases to be a resident in Canada, it is deemed to have disposed of all its capital property.

Most trusts are subject to what's known as the 21-year rule, which requires that every 21 years, a trust is deemed to have disposed of all its capital property at FMV. This rule applies 21-years after the day the trust was created and is known as the deemed disposition day. Upon a deemed disposition, the trust is considered to have disposed of its capital property for proceeds equal to FMV and then reacquired the property at the same value immediately afterwards. For depreciable capital property, the trust must report any capital gains and/or recapture of CCA.

Generally, the income earned by a trust is distributed to the beneficiaries according to the terms of a will or a trust document, a process referred to as allocating income. The type of income retains its original character, allowing the beneficiaries to take advantage of deductions and credits specific to that income type, such as the capital gains deduction or dividend tax credits. As a result, the trust itself does not pay tax on the allocated income; instead, the beneficiaries must report it on their tax returns. Expenses incurred to earn income for the trust, such as legal, accounting, and management fees are deductible. However, certain expenses, including those of a capital nature, personal expenses of the beneficiaries or trustee (such as funeral expenses or probate fees), and any amounts paid to the beneficiaries, are not deductible. Trusts are entitled to claim certain credits, such as the dividend tax credit, and foreign tax credit, when calculating taxes payable. However, trusts cannot deduct personal credits.

Similar to the carry back and carry forward rules outlined earlier, non-capital losses for the trust can be carried back three years and carried forward 20 years. Net capital losses can be carried back three years and carried forward indefinitely. The two main types of trusts are testamentary trusts and inter-vivos trusts. A testamentary trust is created as a result of an individual's death, whereas an inter-vivos trust is defined in the Act "as a trust other than testamentary trust." An inter-vivos trust is typically created while the settlor is still alive.

A testamentary trust arises from an individual's death, including a trust created under the terms of an individual's will or by court order in relation to the deceased's estate under provincial or territorial law. A testamentary trust can be tainted and lose its status if property is contributed to the trust other than as a result of the individual's death, for example, if someone else contributes property to the trust or if the assets are not distributed to the beneficiaries according to the terms of the will. Additionally, if a testamentary trust borrows money from a non-arm's length party, such as a beneficiary, it may be reclassified as an inter-vivos trust, which is taxed at the highest marginal rate on all income earned.

When an individual dies, properties that are not jointly owned or transferred directly to a beneficiary become part of the individual's estate until all of the deceased's liabilities are paid and a clearance certificate is issued by the CRA. The estate is treated as a testamentary trust for tax purposes.

A testamentary trust can be designated as a Graduated Rate Estate (GRE) for up to 36 months following the individual's death. After this period, the estate will cease to be classified as a GRE, if it is still in existence. The primary benefit of a GRE is that it is subject to graduated tax rates on any income earned, similar to an individual. Therefore, it is important to maintain the trust's status without tainting it.

A GRE can have a non-calendar tax year and is deemed to have a year-end for tax purposes. This occurs 36 months after the individual's death, marking the end of its GRE status. All other trusts are generally required to use a calendar year-end, December 31st, for tax purposes.

Subsection 164(6) of the ITA allows a GRE to elect to treat certain capital losses and terminal losses that arise in the first tax year after the individual's death as losses of the deceased individual for that individual's final tax year. This election only applies to the first tax year of the deceased person's estate and does not affect their returns for any year prior to the year of death.