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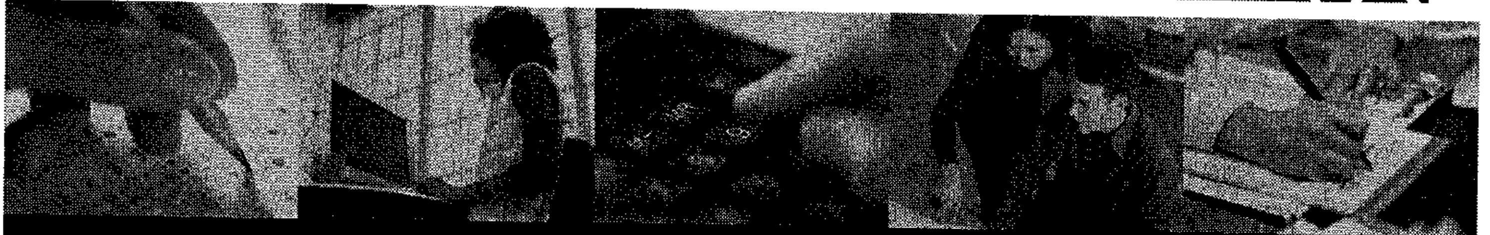

Readings Book

Advanced Personal & Corporate Taxation

Authored by
Johanne Leduc
Francine St-Onge

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CGD = capital gain dividend — over $750,000 no tax (small business share)

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The Certified General Accountants Association of Canada Association sets standards, develops education programs, publishes professional materials, advocates on public policy issues, and represents CGAs nationally and internationally. The Association represents 71,000 CGAs and students in Canada, Bermuda, the Caribbean, Hong Kong and China.

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CGA-Canada advances the interests of its members and the public through national and international representation and the establishment of professional standards, practices, and services.

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The Certified General Accountants Association of Canada — CGA-Canada — was founded in Montréal in 1908 under the leadership of John Leslie, vice-president of the Canadian Pacific Railway. From the beginning, its objective was to encourage improvement in skills and job performance — a goal the Association holds to this day.

On April 14, 1913, Canada's Parliament passed the Act that incorporated CGA-Canada as a self-regulating professional Association. Over the decades that followed, branches became associations in their own right, affiliated with the national body.

A revised Act of Incorporation, passed in 1999, updated CGA-Canada's powers and reflected the Association's objectives and initiatives for the next millennium. The Act also established a French name for CGA-Canada — *Association des comptables généraux accrédités du Canada.*

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The Association:

- ensures national recognition for the profession and advocates on policy issues of concern to the profession
- raises the profile of the CGA designation and represents members internationally
- sets national educational standards, and develops and maintains an internationally competitive program of professional studies and examinations to certify CGAs in Canada and overseas
- provides a range of services to Affiliates and members

- contributes to the profession's body of knowledge through research and participation in international accounting organizations, particularly the International Federation of Accountants (IFAC)

Nationally and internationally, CGA-Canada contributes to accounting standard-setting by sharing its research findings and views. The Association also represents its members in debates of public policy.

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Mandatory continuing professional education ensures that CGAs maintain their professional competence. CGA-Canada provides professional development opportunities in public practice, ethics, accounting and auditing standards, business valuation, taxation, and other topics. The Professional Development Network — PD Network — developed collaboratively with CGA Affiliates, is an extensive and powerful online information resource for members.

For more information

More information about CGA-Canada is available on its Web site at www.cga.org/canada.

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Benefits conferred on a shareholder

LEVEL 1

The Canadian tax system provides for a two-level system for taxing corporate income: first in the corporation, and then in the hands of the shareholder when dividends are received from the corporation. Dividends received from a corporation resident in Canada by an individual are subject to a specific tax treatment based on the principle of integrating the income of the corporation and that of the shareholder. These concepts have been covered in your previous study of taxation and will not be repeated here.

A shareholder may also be an employee or executive of the corporation and, in this capacity, receive remuneration in the form of salary. A shareholder-manager of a private corporation may therefore remove funds from the corporation in the form of salary or dividends. The method of distribution chosen will generally be that which maximizes net after-tax cash in the hands of the shareholder, after taking into consideration the income tax payable by both the shareholder and the corporation. However, this does not mean that the shareholder may avoid personal income taxes on the income received from the corporation. This approach merely minimizes income taxes.

To prevent shareholders from withdrawing or benefiting from the corporation's property or capital other than in the form of salary or dividends, thereby avoiding tax at the personal level, the Income Tax Act (ITA) contains a number of special rules.

General rule under subsection 15(1)

Subsection 15(1) was introduced to prevent shareholders of a corporation from directly or indirectly appropriating corporate funds or property free of tax.

Subsection 15(1) applies each time a corporation confers a benefit of any kind on a shareholder. As defined by subsection 248(1), a shareholder includes a person entitled to receive payment of a dividend. Subsection 15(1) also applies to a benefit that is conferred on a person in contemplation of that person becoming a shareholder. It is recognized in case law that there is a benefit conferred if there is economic enrichment on the part of the shareholder.

The rules contained in subsection 15(1) are very broad and cover a multitude of situations. They apply where

- a payment has been made to a shareholder otherwise than pursuant to a bona fide business transaction. For example, a shareholder sells property to the corporation for a consideration greater than the fair market value (FMV) of the property transferred.
- funds or property of the corporation have been appropriated in any manner whatever to, or for the benefit of, a shareholder. For example, the corporation pays personal expenses of the shareholder, or the shareholder personally receives the income of the corporation without recording the transaction in the books of the corporation as income and as an advance to the shareholder.
- a benefit or advantage has been conferred on a shareholder by a corporation. For example, a cottage owned by the corporation is used by a shareholder for personal use, free of charge.

Under the rules in subsection 15(1), the value of any benefit conferred on a shareholder is included in the shareholder's income as "ordinary" income and not as a dividend, thus denying the dividend tax credit to individual shareholders. Also, corporate shareholders are

denied the section 112 deduction, which would otherwise be available on the receipt of a dividend from a taxable Canadian corporation.

Very often, the application of the rules relating to benefits conferred on a shareholder results in double taxation. For example, if a corporation pays for a shareholder's trip to Hawaii, which is solely for pleasure, under paragraph 18(1)(a), the corporation may not deduct the amount expended, since this is not an expense incurred in order to obtain business or property income. In turn, under subsection 15(1), the shareholder is taxed on the amount of the benefit conferred.

Where the shareholder is also an employee of the corporation, it is important to determine whether the property is appropriated or whether the benefit is conferred on the shareholder in the capacity of an employee or a shareholder. Where the benefit is conferred on the shareholder in the capacity of an employee, the corporation may generally deduct the cost of the benefit from income. The facts determine whether the benefit is conferred on the shareholder in the capacity of an employee or a shareholder. As a general rule, if employees of the enterprise or similar enterprises who are not shareholders receive benefits similar to those conferred on employee-shareholders, the taxable benefit conferred on employee-shareholders will be considered a benefit conferred by virtue of employment under paragraph 6(1)(a) rather than a taxable benefit under subsection 15(1).

Under subsection 15(7), the rules in subsection 15(1) apply whether the corporation conferring the benefit is resident in Canada or not. For example, where an American corporation confers a benefit on a Canadian shareholder, the shareholder must include the value of the benefit in income taxable in Canada.

Note that if, under section 84, a portion of the benefit conferred on a shareholder is considered to be a deemed dividend, this portion of the benefit will not be included in computing the shareholder's income under subsection 15(1).

A benefit conferred on a person related to the shareholder may constitute a taxable benefit for the shareholder, either because he indirectly derives a benefit from it or because, under subsection 56(2), any payment or transfer of property made to a person with the concurrence of the taxpayer as a benefit that the taxpayer desires to have conferred on the other person, must be included in computing the taxpayer's income to the extent that it would be if the payment had been made to the taxpayer. For example, a taxable benefit will be added to the shareholder's income if the corporation pays the travel expenses of the shareholder's spouse accompanying the shareholder when the shareholder attends a convention, or if the corporation gives property to a child of the shareholder or sells it to him at a preferential price.

Under subsection 246(1), where the benefit is conferred by a subsidiary of the corporation of which the taxpayer is a shareholder, the taxpayer is liable for tax on the value of the benefit as if he were a shareholder of the subsidiary.

Value of benefit

The taxable "value" of a benefit is generally based on the FMV of the property appropriated by, or the benefit conferred on, a shareholder. Determining this value is often difficult and complex. Recent court cases on the method of valuing a taxable benefit arising from the personal use of corporate property (cottage, airplane, Florida condominium) demonstrate that the valuation method may vary depending on the applicable facts in each case. As a general rule, if the property is used principally for business purposes, only the rental value or the costs of maintaining the property for the period of personal use will be used to determine the value of the taxable benefit for the shareholder. Where the property is used mainly by the shareholder, Canada Revenue Agency (CRA), as supported by recent court decisions, values the benefit on the basis of costs assumed by the corporation with respect to the property, plus

the foregone yield on the capital invested for the acquisition of the property where the amount thus calculated exceeds the rental value or where no rental value can be established. On this subject read paragraph 11 of IT-432R2.

Under subsection 15(1.2), where a shareholder's debt is settled or extinguished for an amount that is less than the amount of the obligation outstanding at that time, there is a taxable benefit for the shareholder equal to the amount of the "forgiven amount," as defined in subsection 15(1.21). In brief, the forgiven amount is the principal of the debt less repayments made and amounts already included in the shareholder's income. Thus, when a loan is made by a corporation to a shareholder and the amount of this loan is included in the shareholder's income under the provisions of subsection 15(2), there will be no "forgiven amount" to be included in the shareholder's income if the corporation subsequently foregoes collection of the amount owing to it. On the other hand, if the loan is exempted from the application of subsection 15(2) because of one of the exceptions contained in that subsection, then subsections 15(1), 15(1.2), and 15(1.21) will apply, requiring inclusion in the shareholder's income a taxable benefit corresponding to the amount that remained unpaid on the loan when the debt was forgiven.

Where a corporation makes an automobile available to a shareholder or related person, the shareholder must include in income the value of the benefit obtained. Under subsection 15(5), the computation of the taxable benefit for the use of an automobile by a shareholder is identical to the computation of the benefit where the automobile is made available to an employee.

Example 1-1 illustrates the rules that apply when benefits are conferred on shareholders.

EXAMPLE 1-1

Frances Baron is the president and sole shareholder of Active Ltd. She devotes more than 55 hours per week to the management of the business operated by Active Ltd.

In 2008, Frances had a swimming pool installed at her residence, at a cost of $15,000. Active Ltd. paid the bill and claimed the $15,000 in its expenses.

In 2007, Active Ltd. purchased a $225,000 condominium in an American city where Frances' son is studying. The condo was inhabited by Frances' son for the entire year of 2008. The rental value of the condo is estimated by Frances at $950 per month. However, since such condos are not usually rented out, this value cannot be determined with certainty. The expenses relating to the condo were paid entirely by Active Ltd. in 2008, and they are as follows:

Property taxes	$ 1,800
Insurance	$ 700
Electricity/heating	$ 1,500
Condo fees	$ 3,000

Active Ltd. currently obtains a return of 4% on its investments.

In 2008, Active Ltd. realized exceptional profits. As a token of appreciation for the efforts of five key employees, including Frances, Active Ltd. bought them a trip to Las Vegas. The cost of the trip was $1,500 per employee.

All figures are in Canadian dollars.

Tax consequences

Active Ltd. confers several benefits on Frances:

- payment of a personal expense: construction of a pool at her residence
- use of the corporation's property for personal purposes without consideration: the condo
- purchase of a pleasure trip

Frances is a shareholder and employee of Active Ltd. Therefore, before it is concluded that these benefits are taxable under subsection 15(1), it is necessary to look at the facts and determine whether one or more of these benefits may be considered to be a benefit to an employee. The trip to Las Vegas was not limited to Frances, and its purpose was to reward certain key employees. Accordingly, this benefit is an employment benefit taxable under paragraph 6(1)(a).

Therefore, the tax consequences for Frances and Active Ltd. are as follows:

1. For Frances:

   She must include the following in her income:

   Benefit by virtue of her employment [6(1)(a)]

Value of the trip to Las Vegas		$ 1,500
Benefit to shareholder [15(1)]		
• Cost of the swimming pool		$ 15,000
• Benefit from personal use of the condo by her son		
The greater of:		
i) rental value of the condo (12 × $950)	$ 11,400	
ii) cost of operation plus foregone return on the capital invested		
Property taxes	$ 1,800	
Insurance	700	
Electricity/heating	1,500	
Condo fees	3,000	
Foregone return (4% × $225,000)	9,000	
	$ 16,000	$ 16,000
Total benefits to shareholder		$ 31,000

2. For Active Ltd.:

   Under paragraph 18(1)(a), Active Ltd. cannot deduct the cost of the swimming pool or the costs related to the condo since these are not expenses incurred in order to gain income.

Subsection 15(1.3) spells out the effect of sales taxes (GST, HST, PST) on the taxable value of the benefit. Under subsection 15(1.3), the value of the benefit is to be calculated taking into account the sales taxes that were payable by the corporation with respect to the property or that would have been payable had the corporation not been exempted from payment of the GST because of its nature or the use to which the property or service was to be put. Since the GST and other sales taxes are not studied in this course and were not covered in a previous course, their effects should be ignored for purposes of this course and, unless otherwise indicated, they are **not examinable**.

Exceptions

The following transactions are specifically excluded from the application of the rules in subsection 15(1):

- reducing the corporation's paid-up capital
- redeeming, cancelling, or acquiring shares by the corporation
- winding-up, discontinuing, or reorganizing the corporation's business
- winding-up a Canadian corporation
- paying a dividend or a stock dividend
- conferring on all holders of common shares a right, identical for each common share, to buy additional shares of the corporation
- converting contributed surplus into paid-up capital by an insurance corporation or a bank
- converting any contributed surplus created on the issue of shares of a class after March 31, 1977, to paid-up capital of such class of shares, pursuant to paragraph 84(1)(c.3)

Transfer of property between corporations and their shareholders

The purchase and sale of property between corporations and their shareholders are situations that most often invoke the rules relating to benefits to shareholders contained in subsection 15(1). The provisions of subsections 69(1) and 69(4) may also affect such transactions.

Thus, when a shareholder sells property to the corporation of which he or she is a shareholder at a price that exceeds its FMV, the shareholder must include in his or her income, as a benefit conferred on a shareholder under subsection 15(1), the difference between the price paid by the corporation and the FMV of the property. This could result in double taxation, when the capital gain on the disposition of the property based on the excess of proceeds of disposition (POD) over adjusted cost base (ACB) is calculated. However, paragraph 39(1)(a) provides that the portion of the capital gain otherwise included in income is excluded from the amount considered to be capital gain. From the corporation's perspective, the cost of the property will be limited to its FMV under paragraph 69(1)(a) if the shareholder and the corporation do not deal at arm's length.

On the other hand, subsection 69(4) applies whenever a corporation confers property on a shareholder for an amount below its FMV; it provides that the corporation is deemed to have disposed of the property at its FMV. The shareholder, in turn, must pay tax under subsection 15(1) on the value of the benefit conferred by the corporation, namely, the difference between the FMV of the property and the price paid. If the property acquired by the shareholder is a capital property, the amount of the benefit taxed under subsection 15(1) is added to the adjusted cost base of the property under subsection 52(1).

Examples 1-2 and 1-3 illustrate these situations.

EXAMPLE 1-2

shareholder selling

Disposition of a non-depreciable capital property by a shareholder to a corporation at a value in excess of FMV, where the shareholder does not deal with the corporation at arm's length.

POD (in cash)	$ 150,000
FMV of the property	$ 100,000
ACB of property for shareholder	$ 40,000

Tax consequences

1. For the shareholder:

Taxable benefit [15(1)]

Cash received from the corporation	$ 150,000
FMV of the property transferred	(100,000)
Taxable benefit [15(1)]	$ 50,000

Capital gain

Cash received from the corporation (POD)	$ 150,000
ACB	(40,000)
Gain	110,000
Less:	
Portion of gain already included in income under 15(1) [39(1)(a)]*	(50,000)
Capital gain	$ 60,000
Taxable capital gain (1/2)	$ 30,000

* Under paragraph 39(1)(a), the portion of a capital gain that is otherwise included in income under paragraph 3(a) is excluded from the capital gain.

2. For the corporation:

The cost of the property will be deemed to be equal to the FMV [69(1)(a)]	$ 100,000

EXAMPLE 1-3

corporation selling

Acquisition of non-depreciable property by a shareholder from the corporation for an amount less than FMV. The property would not have been subject to any sales tax if acquired on the open market.

Purchase price to the shareholder	$ 50,000
FMV of the property	$ 75,000
ACB of the property for the corporation	$ 10,000

Tax consequences

1. For the shareholder:

Taxable benefit [15(1)]

FMV of the property	$ 75,000
Purchase price	(50,000)
Taxable benefit [15(1)]	$ 25,000

ACB of the property acquired

Purchase price	$ 50,000
Taxable benefit [52(1)]	25,000
ACB of the property for the shareholder	$ 75,000

2. For the corporation:

Capital gain

Deemed POD under 69(4) — FMV of the property	$ 75,000
ACB of the property	(10,000)
Capital gain	$ 65,000
Taxable capital gain (1/2)	$ 32,500

Penalty under subsection 163(2)

The penalty provided for in subsection 163(2) is often imposed when CRA makes an assessment under subsection 15(1). This penalty, which can amount to 50% of the income tax payable on the amount of the taxable benefit, may be imposed when a person, knowingly or in circumstances amounting to gross negligence, has made or participated in, assented to, or acquiesced in a false statement or omission in a return.

Where a majority shareholder appropriates the income of the corporation that he controls, he will, under subsection 15(1), be liable for tax on the income that he has appropriated, and the income appropriated by the shareholder will also be added to the income of the corporation. Also, a penalty under subsection 163(2) will generally be imposed on both the shareholder and the corporation.

First time, no penalty.

Where the corporation claims personal expenses of a shareholder in its expenses and CRA makes an assessment under subsection 15(1) for the shareholder and an assessment denying the deduction of expenses for the corporation, the penalty under subsection 163(2) will automatically be applied if an assessment for the same reason was made in the past. If this is the first assessment for this reason, the facts will be examined to determine whether the taxpayer acted knowingly or was grossly negligent.

Where there is a transfer of property to or from a corporation for an amount that triggers the application of subsection 15(1), the penalty under subsection 163(2) may also be imposed if the facts of the case indicate that the taxpayer acted knowingly or in circumstances amounting to gross negligence.

Planning

Since there is the possibility of double taxation and heavy penalties in the application of subsection 15(1), transactions between a corporation and its shareholders should be adequately structured in order to avoid the application of this subsection.

Price adjustment clause

Where the shareholder and the corporation transact at FMV, subsection 15(1) may not be invoked because a benefit is not conferred on the shareholder. However, given that it may be difficult to arrive at FMV and that it may be challenged by CRA, a price adjustment clause should be included in contracts for transfers of property between a corporation and its shareholders. Read Interpretation Bulletin IT-169 dealing with this topic.

Control and records

A procedure for controlling shareholders' expenses should be put in place to ensure that their personal expenses are not claimed by the corporation.

When the corporation pays a shareholder's personal expenses, the amount paid should be recorded as a shareholder advance or loan that may be subject to inclusion in income under subsection 15(2) if it is not repaid within the time period provided for in that subsection.

READING 1-2

Loans to shareholders

LEVEL 1

Interest-free or low-interest loans are another way for shareholders to benefit from the corporation's funds. There are rules governing shareholder loans which deal with this issue. These rules apply when a corporation advances funds to a shareholder or members of his family, in the form of a loan or otherwise, or carries out any other transaction that makes the shareholder a debtor of the corporation, such as the sale of property on credit by the corporation to a shareholder. As used below, the term "loan" applies to any form of debt of the shareholder toward the corporation.

Inclusion of loan in income under subsection 15(2)

Under subsection 15(2), where a corporation has made a loan (or advanced funds in any other manner) to a person or partnership that was a shareholder of the particular corporation, the amount of the loan must be included in the income of the person or partnership to whom the loan was made for the taxation year during which it was made.

This rule does not apply when the loan is made to a corporation resident in Canada or a partnership all of whose members are corporations resident in Canada.

Under subsection 15(7), subsection 15(2) applies even if the lending corporation is not resident in Canada and does not carry on business there. However, the shareholder must reside in Canada in such a case, because under subsection 15(2.2), if a corporation not resident in Canada makes a loan to a non-resident, the ITA does not allow for the non-resident to be taxed on this loan.

Subsection 15(2) applies where the corporation that makes the loan to the shareholder is the one whose shares he holds, a corporation related to that corporation, or a partnership of which the corporation or the related corporation is a member. Example 1-4 illustrates this principle.

EXAMPLE 1-4

Jean Merso is a shareholder of Merso Holdco Ltd., which holds 51% of the shares of Bosol Inc. If Bosol Inc. makes a loan to Jean Merso, the provisions of subsection 15(2) may apply with respect to the loan. If subsection 15(2) applies, Jean Merso must include the total amount of the loan in his income for the year in which the loan was made.

The provisions of subsection 15(2) also apply when the loan is made, not to the shareholder himself but to a person who is connected with him or to a person who is indirectly a shareholder through a partnership or trust of which he is a member or beneficiary. In such a case, the person to whom the loan was made must include it in his income.

Persons connected with a shareholder are described in subsection 15(2.1) as any person not dealing at arm's length with the shareholder, with the exception of certain foreign affiliates.

EXAMPLE 1-5

Return to Example 1-4. Subsection 15(2) could apply to a loan made by Bosol Inc. or Merso Holdco Ltd. to the daughter of Jean Merso. If subsection 15(2) applies, it is the daughter of Jean Merso who must include the total amount of the loan in her income for the year in which the loan was made to her.

Exceptions

Subsection 15(2) does not apply unless the person to whom the loan is made is a shareholder or is connected with the shareholder. Consequently, a loan made by a corporation to an employee who is neither a shareholder nor connected with a shareholder does not fall under this rule.

Exceptions for shareholders include:

1. Repayment in the year following the taxation year in which the loan is made or the indebtedness incurred [subsection 15(2.6)]:

   The loan is not required to be included in the shareholder's income if it is repaid within the year following the end of the taxation year of the lending corporation in which the loan was made. Example 1-6 illustrates this exception.

EXAMPLE 1-6

The lender corporation's taxation year ends on June 30. On July 2, 2007, the corporation made a loan to one of its shareholders.

The shareholder will be able to take a maximum of just under two years to repay the loan. The corporation made a loan in its taxation year from July 1, 2007, to June 30, 2008. To avoid including this amount as income for 2007, the shareholder must repay the loan in the year following the end of the corporation's taxation year in which the loan was made, that is, it must be repaid no later than June 30, 2009.

If only a portion of the loan is repaid before July 1, 2009, only the portion unpaid on June 30, 2009 must be added to the income for the year in which the loan was made, which in this example is 2007.

In order for this exception to apply, the repayment must not be part of a series of loans and repayments. In Example 1-6, if the shareholder repaid the loan on June 28, 2009, and the corporation reloaned him the amount on July 3, 2009, the loan would not be considered as repaid, and the amount of the loan would be included in the shareholder's income for 2007 under subsection 15(2).

When a shareholder has a current loan account in which payments made by the corporation to third parties on behalf of the shareholder, advances, or other transactions are recorded, the specific facts of each case must be examined to determine if the transactions in this account are part of a series of loans and repayments. When the year-end balance of a current loan account is repaid in the form of declared dividends and wages credited to the loan account, CRA agrees that these payments should not be considered as being part of a series of loans or repayments.

Example 1-7 illustrates the treatment of a series of current loan accounts according to the current policy of CRA when the annual balance of the loan account is repaid by means of an annual dividend declaration.

EXAMPLE 1-7

Sergei Romanov is the sole shareholder of Juxtapose Inc. The corporation's taxation year ends August 31. Throughout the year, Juxtapose Inc. advances amounts to Sergei in the form of cheques made out to him or payments to third parties on his behalf. Two months after the end of the taxation year, a dividend equal to the year-end balance of Sergei's running account is declared and paid, reducing the running account.

Following is a breakdown of Sergei's running account as shown in the books of Juxtapose Inc. for 2005 to 2008.

Balance as at August 31, 2005	$ —
September to December: various payments	15,000
Balance as at December 31, 2005	15,000
January to August: various payments	18,000
Balance as at August 31, 2006	**33,000**
September to December: various payments	22,000
October: repayment in the form of a declared dividend	**(33,000)**
Balance as at December 31, 2006	22,000
January to August: various payments	17,000
Balance as at August 31, 2007	**39,000**
September to December: various payments	12,000
October: repayment in the form of a declared dividend	**(39,000)**
Balance as at December 31, 2007	12,000
January to August: various payments	9,000
Balance as at August 31, 2008	$ 21,000

Tax consequences

According to the administrative position adopted by CRA, the repayments of the balance at the end of the taxation year of Juxtapose Inc. (August 31) two months after the year end by means of a declared dividend to Sergei are not part of a series of loans and repayments. Since the money advanced or loaned by Juxtapose Inc. in a given taxation year was repaid within twelve months after the year end no amount is taxable under subsection 15(2).

Consult paragraph 36 of IT-119R4 for an illustration of how subsection 15(2) applies when there are a series of loans and repayments.

2. Loans made or indebtedness arising in the ordinary course of the lender's business [subsection 15(2.3)]:

   A corporation whose ordinary activity is the lending of money may make a loan to a shareholder or connected person in the ordinary course of business without the loan being included in their income. This also applies to indebtedness arising in the normal course of the lender's business. However, for this exception to apply, bona fide arrangements must be made, and adhered to, for the loan to be repaid within a reasonable time.

3. Loans received as employees [subsection 15(2.4)]:

   There are exceptions to the application of subsection 15(2) that depend on the use for which the money is borrowed; however, these apply only to shareholders or connected persons who are also executives or employees of the lender corporation. The executive or employee must use the loan to:

- purchase or construct a dwelling for personal use [paragraph 15(2.4)(b)];
- purchase treasury shares (previously unissued shares) of the corporation or a related corporation [paragraph 15(2.4)(c)]; or
- purchase an automobile to be used in the performance of the duties of his office or employment [paragraph 15(2.4)(d)].

In addition, in all cases:

- the loan must be obtained because of the employment and not because of the number of shares held [paragraph 15(2.4)(e)], and
- bona fide arrangements must be made and adhered to for repayment of the loan within a reasonable time [paragraph 15(2.4)(f)].

The exemption applicable to an employee purchasing a dwelling for personal use also applies to a loan made to the employee's spouse. Note also that it extends to the purchase of shares of the capital stock of a cooperative housing corporation where the sole purpose of the purchase is to acquire the right to personally inhabit a dwelling owned by the cooperative corporation.

The exception relating to loans for the purchase of shares also applies where the loan is made by a corporation related to the corporation that employs the shareholder or the person connected with the shareholder.

Where the employee-shareholder to whom the loan was made has, alone or together with persons with whom the employee-shareholder does not deal at arm's length, less than 10% of the issued shares of a given class of the capital stock of the corporation or a related corporation, the use made of the money is irrelevant [paragraph 15(2.4)(a)]. It is sufficient that the loan is made to him in his capacity as an employee and arrangements have been made in good faith to repay the loan within a reasonable time.

It is not always easy to determine whether a person obtained a loan as an employee or as a shareholder. The following criteria may be considered in making this determination:

- Are similar benefits granted to other employees of the corporation?
- Is the loan in proportion to the importance of the services rendered to the corporation, considering the salary and other remuneration paid?
- Would an employee of a similar-sized business who was not a shareholder have received a similar loan?
- What is the extent of the employee-shareholder's control over the corporation?

If the loan is made to the employee-shareholder in his capacity as a shareholder, the above-mentioned exceptions do not apply, and the amount loaned must be included in the shareholder's income for the year in which the loan was made, even if the loan is interest-bearing and reasonable arrangements have been made for repayment.

Deduction on repayment

When a person repays, in whole or in part, a loan included in his income for a previous year under subsection 15(2), he may, under paragraph 20(1)(j), deduct the amount of the repayment from his income for the year in which the repayment is made.

Example 1-8 illustrates how subsection 15(2) and paragraph 20(1)(j) apply.

EXAMPLE 1-8

Jambore Inc., whose fiscal period ends March 31, made an interest-free loan of $20,000 to Myriam Dusseault on February 5, 2007. Myriam, who owns 25% of the shares of Jambore Inc., uses the borrowed money to purchase a painting by a recognized artist. She repays the loan on October 31, 2009. Jambore Inc. is in the business of importing and distributing oriental carpets.

Tax consequences

Myriam will have to include an amount of $20,000 in her income for 2007, since the loan was not repaid within the one-year period following the end of the taxation year of Jambore Inc. during which the loan was made, that is, before April 1, 2008, and it is not a loan that is otherwise exempt.

Under paragraph 20(1)(j), Myriam will be able to deduct $20,000 from her income for 2009, that being the amount repaid during the year.

Deemed interest

Under subsections 80.4(2) and 15(9), where a shareholder or person with whom the shareholder does not deal at arm's length has received an interest-free or low-interest loan, the shareholder or that person may be required to include an amount in income equal to the benefit of paying little or no interest. However, **a taxable benefit for insufficient interest is not required to be included in the shareholder's income where the amount of the loan must otherwise be included in computing his income under subsection 15(2)** [paragraph 80.4(3)(b)].

More particularly, this rule applies where:

- a particular corporation,
- a corporation related to the particular corporation,

or

- a partnership of which either or both corporations is a member;

has made a loan to a person or partnership that was:

- a shareholder of the particular corporation,
- a person connected with the shareholder of the particular corporation,

or

- a person who is a shareholder indirectly through a partnership or trust;

and the loan has not been included in income under subsection 15(2).

Subsection 80.4(2) does not apply where the loan is granted to a corporation resident in Canada or to a partnership whose members are all corporations resident in Canada.

Where subsection 80.4(2) applies, the value of the benefit calculated for a taxation year, and hence the calendar year for an individual, is determined as follows:

1. Determine the amount of deemed interest computed at the prescribed rate for the period in the year during which the loan was outstanding.
2. From the amount obtained in step 1, deduct the interest for the year paid to the corporation on the loan during the year and within 30 days after the end of the year.

The prescribed interest rate is contained in REG 4301 and is set every quarter.

Where a taxable benefit in the form of deemed interest has been included in a shareholder's income for an interest-free loan or low-interest loan, and subsequently this loan is taxed under subsection 15(2), the taxable benefit must be cancelled and the return will be amended, as illustrated in Example 1-9.

EXAMPLE 1-9

Interest-free loan made on July 1, 2006	$ 50,000
Corporation's year end: December 31	
Amount of the interest included in the shareholder's income in 2006 as a taxable benefit (assume the prescribed rate is 3% for the entire year)	$ 750

Loan repaid in December 2008

July 07 deadline

Because the shareholder did not repay the loan before the end of the corporation's taxation year following the taxation year in which the loan was made, the amount of the loan must be included in the shareholder's income for 2006. Furthermore, since the loan is included in the shareholder's income, no taxable benefit for unpaid interest need be imputed to him for 2006, 2007, or 2008.

Amendment to the shareholder's income — 2006

Inclusion of the loan [15(2)]	$ 50,000
Cancellation of the deemed interest [80.4(3)(b)]	(750)
Increase in 2006 income	$ 49,250

As the loan was repaid in 2008, the shareholder may deduct $50,000 from his 2008 income under paragraph 20(1)(j).

Employee-shareholder

Where an employee-shareholder received a loan in his *capacity as an employee* (such as a loan for the purchase of an automobile to be used in his employment), the interest benefit is computed under subsections 80.4(1) and 6(9) rather than subsections 80.4(2) and 15(9). The computation is essentially the same, but the amount of the benefit is included in computing employment income. Where subsection 80.4(1) applies, the employee is still taxed on the amount of the benefit, even if the loan is made to a person related to that employee.

Where the loan is made to the employee-shareholder, by virtue of employment, *for the purchase of a dwelling*, the benefit may be calculated by using the lesser of

a. the prescribed rate in effect when the loan was made,

or

b. the prescribed rate in effect each quarter during which the loan remains unpaid.

Where the loan has a term exceeding five years, it will be deemed to be a new loan on each fifth anniversary. The prescribed rate in effect on that date will replace the original prescribed rate. These rules are contained in subsections 80.4(4) and 80.4(6), and apply to both home purchase loans and home relocation loans. Read paragraphs 17 to 22 of IT-421R2, which cover these rules.

Deduction under section 80.5

Under section 80.5, if the loan is used to earn income or acquire income-producing property, the amount of the benefit may be deducted as interest paid on a loan in computing the shareholder's income. This matter is explained in paragraph 24 of IT-421R2.

For example, where a corporation makes an interest-free loan to an employee-shareholder to enable the person to purchase an automobile to be used in the performance of the duties of his office or employment, the amount of the taxable benefit corresponding to the unpaid interest on the loan will be considered to be interest paid on a loan for the purchase of an automobile. Consequently, it will be included in computing the automobile expenses deductible by the employee-shareholder under paragraph 8(1)(j).

Examples 1-10 and 1-11 illustrate the joint application of subsections 15(2) and 80.4(2), and paragraph 20(1)(j).

EXAMPLE 1-10

Mary Yasita is the sole shareholder of Mataploc Inc., whose fiscal period ends November 30 of each year. On January 15, 2007, Mataploc Inc. made a $300,000 loan to Mary for the purchase of a residence. Mataploc Inc. does not make loans to its employees. The loan bears interest at 5%, and the principal is repayable at the rate of $30,000 per year for a period of 10 years. Mary makes her payments of principal and interest annually on the date stipulated, that is, on January 15 of each year.

Assume that the prescribed rate is constant at 3% and the commercial rate prevailing at the time the loan was made was 6%.

Tax consequences

The loan made to Mary is not an exempt loan, for although it was used to purchase a residence and arrangements were made in good faith to repay it within a reasonable period, it was not made to Mary by reason of her employment.

In her income for 2007, Mary will have to include an amount of $270,000 ($300,000 less the January 2008 repayment). Under paragraph 20(1)(j), for 2009 and following years, she will be able to deduct from her income $30,000 per year, the amount repaid during the year.

The amount of $30,000 repaid in January 2008 does not have to be included in income under subsection 15(2) because it was repaid within the one-year period following the end of the taxation year of the corporation during which the loan was made. This amount is subject to the provisions of subsection 80.4(2). However, since the loan bears interest at a rate higher than the prescribed rate and the interest was actually paid within thirty days following the end of the year, there will be no amount to be included in income for 2007 or 2008 under 80.4(2).

EXAMPLE 1-11

Return to the facts of Example 1-10, but assume that Mary makes the first payment of capital and interest on March 15, 2008 instead of January 15, 2008 and that the subsequent annual payments are made on time. What are the tax consequences of the late payment in 2008?

The amount of $30,000 repaid in March 2008 does not have to be included in income under subsection 15(2) because it was repaid within the one-year period following the end of the taxation year of the corporation during which the loan was made. However, a taxable benefit with respect to the interest will have to be included in Mary's income for 2007 because the interest, while higher than the prescribed rate, was not paid within the 30 days after the end of the year as required by subsection 80.4(2).

2007

80.4(2) applicable on $30,000 from January 15 to December 31, 2007

3% × $30,000 × 350 ÷ 365	$	863
Less: Interest paid in 2007 or at the latest on January 30, 2008	(	0)
Benefit	$	863

There is no taxable benefit for 2008 since the interest on the $30,000 for the period unpaid in 2008 (January 1, 2008 to March 15, 2008) will have been paid before January 30, 2009. Specifically, the payment on March 15, 2008 covers the interest from January 1, 2008 to January 15, 2008 and the payment on January 15, 2009 includes the interest from January 16, 2008 to March 15, 2008.

2008

80.4(2) applicable on $30,000 from January 1 to March 15, 2008

3% × $30,000 × 74 ÷ 365	$	182
Less: Interest paid on March 15, 2008 and January 15, 2009 with respect to this period (had to be paid no later than January 30, 2009) 5% × $30,000 × 74 ÷ 365	(	304)
Benefit (cannot be negative)	$	—

This example illustrates an important point. When a loan to a shareholder is not included in income under subsection 15(2) and it bears interest, the terms with respect to the payment of interest must be such as to ensure that the payment of the interest for a calendar year will be made at the latest by January 30 of the following year. Sometimes this means that the date for the annual repayment of principal may be different from the date for the payment of interest.

For example, assume a loan exempted from subsection 15(2) is granted to a shareholder on April 1 and that the terms of the loan specify that the annual payments of principal and interest are to be made on April 1 of each year. In such a case, even though the interest is paid on the due date under the terms of the loan and is at a rate higher than the prescribed rate, the interest paid on April 1 of a year with respect to interest accrued from April 2 to December 31 of the previous year will not be taken into account when computing a taxable benefit under subsection 80.4(2) for that previous year because it was not paid within the required time period.

The terms of the loan must insure that the payment of interest for a given calendar year are paid at the latest by January 30 of the following year while the repayment of principal may be at the anniversary date of the loan or any other date.

Under paragraph 80.4(3), the interest benefit rules under 80.4 (1) and (2) do not apply on a loan on which the interest rate is equal or higher than the commercial rate available from a financial institution on the open market at the time the loan was received for loans having similar terms and conditions. In Example 1-11, if the interest rate on the loan had been 6%, that is, the commercial rate, no interest benefit would have to be included in the 2007 income, since subsection 80.4(2) would not have applied by virtue of the exception in paragraph 80.4(3).

Control and records

Loans and advances to shareholders and members of their families must be recognized separately from other debts. The terms and conditions of each loan must be known and must be checked annually for compliance. This serves to determine whether a shareholder or a member of his family must include an amount in his income under subsection 15(2) or 80.4(2).

READING 1-4

Paid-up capital

LEVEL 1

Before being able to compute the amount of a deemed dividend under section 84, you must understand the concept of paid-up capital (PUC).

According to the definition of PUC in subsection 89(1), **paid-up capital** is generally equal to the amount recorded as issued and outstanding share capital as determined under the legislation under which the corporation was formed (legal PUC). It therefore represents the contribution of capital to the corporation on the issue of shares, as recorded in the corporation's legal records. An amount recorded in contributed surplus is not included in PUC. For example, if a share is issued for $100 but only $25 is entered as the amount paid for the share while $75 is entered as part of a contributed or other surplus, then $25 will be taken into account when calculating the PUC. It should not be assumed that the capital entered on the financial statements in accordance with GAAP is always equal to the legal capital. Under some accounting rules, such as those on transactions between related persons provided for in Chapter 3840 of the CICA Handbook, accounting capital is sometimes shown as different from legal capital.

When shares are issued as consideration for a non-cash contribution and in some exceptional cases, adjustments to PUC are required under specific provisions of the ITA. Sections 84.1, 84.2, and 212.1 as well as subsections 51(3), 66.3(2), 66.3(4), 85(2.1), 85.1(2.1), 86(2.1), 87(3), 87(9), 128.1(2), 128.1(3), 138(11.7), 139.1(6) and (7), 192(4.1), and 194(4.1) contain such provisions.

Note that most of these adjustments are intended to prevent the conversion of other income into a capital gain in transactions involving the issue of shares, so as to prevent undue use of the capital gains deduction (CGD — also called the capital gains exemption or CGE) or avoidance of non-resident tax on dividends, or merely to take advantage of the more favourable tax rate for capital gains.

PUC is determined by class of shares and the PUC of a share of a particular class is equal to the PUC of the class divided by the number of shares issued in the class.

Example 1-12 illustrates the computation of PUC in a case where no adjustment applies.

EXAMPLE 1-12

Joe Perkins acquires 100 Class A treasury shares from Opco Ltd. for $10,000.

Class A shares previously issued: 500 shares with a PUC of $2,000.

Tax consequences

1. PUC of each Class A share after the issue of 100 shares:

Total PUC ($10,000 + $2,000)	$ 12,000
Divided by the number of issued shares	÷ 600
PUC per share	$ 20

2. For Joe Perkins:

Total PUC of the 100 Class A shares held by Joe (100 × $20)	$ 2,000
ACB of the 100 Class A shares held by Joe	$ 10,000

In this example, note that Joe Perkins paid $10,000 for 100 Class A shares but their PUC is $2,000. This is due to the fact that PUC is not a concept connected with the shareholder, as is ACB. The PUC is connected with the class of shares. It is computed at a given point in time, taking into account all the capital paid to the corporation for the shares issued in a given class on the date in question, regardless of who actually paid these amounts.

The PUC represents the return of capital that may be received by a shareholder without the amount being subject to tax as a dividend, as you will see below. The PUC of a share is not affected by the subsequent purchase or sale of this share. In Example 1-12, if Joe Perkins were to sell his 100 shares to Sally Chong for $15,000, the PUC of the shares in Sally's hands would remain at $2,000, even though for Sally the ACB of the shares would be $15,000. *This distinction between the PUC of shares and their ACB is very important.* The PUC serves to determine whether there is a deemed dividend in the case of certain transactions provided for in section 84 that involve the issuing corporation, whereas the ACB is one of the elements entering into the calculation of the capital gain or loss where there is a disposition of shares.

Exhibit 1-1 compares and contrasts PUC and ACB.

EXHIBIT 1-1

Comparative table

PUC of a share	ACB of a share
• Same for all shareholders holding shares of the same class	• May be different for each shareholder holding shares in the class
• Equal to the average of the PUC of all shares issued in the class	• Equal to the price paid by the shareholder to acquire the share
• Serves to determine the deemed dividend in some transactions carried out by the issuing corporation	• Serves to determine the capital gain or loss on disposition of the share

Legal considerations

The corporation's Act of incorporation determines the amount that can be recorded as the amount paid for the shares in the legal books of the corporation.

In general,

1. If the shares have a nominal value, the amount paid is the nominal value. Any excess amount paid is included in a contributed surplus.
2. If the shares have no nominal value, what is generally recorded is the FMV of the consideration received when they are issued, unless the Act of incorporation provides for exceptions. Normally, when the shares are issued as consideration for a cash payment, the amount paid is equal to the amount received. Exceptions may apply only when the

consideration consists of property other than cash or services, or when the shares are issued as part of a reorganization.

For the purposes of this course, unless otherwise indicated, the shares mentioned in examples or exercises have no nominal value and are issued for cash.

Practical aspect

Determining the ACB of a share is usually easy. Ask the client how he acquired the shares and check the documents relating to this acquisition, such as the agreement of sale, the term sheet or, if the shares were acquired on the death of a person, the final return of the person from whom the shares were inherited. In exceptional cases, there will be an adjustment under paragraph 53(1)(b) or 53(2)(b).

However, it is sometimes difficult to determine the PUC of a share. The legal books of the corporation should be consulted to find information on the original issue of the shares of the class. Sometimes, these books are not up-to-date or are unavailable. In this case, the corporation's legal advisor should be consulted.

Also, other documents must be examined if the shares were issued in circumstances other than an issue in exchange for cash, in order to determine whether adjustments must be made under various provisions of the ITA, including sections 84.1, 84.2, and 212.1, as well as subsections 51(3), 66.3(2), 66.3(4), 85(2.1), 85.1(2.1), 86(2.1), 87(3), 87(9), 128.1(2), 128.1(3), 138(11.7), 139.1(6) and (7), 192(4.1), and 194(4.1).

The financial statements should not serve as a basis for determining the PUC. Nor should you rely on the amount supplied by the client or the accountant of the corporation without checking the method that was used to determine it.

Once checked, the information on the PUC of the different classes of shares should be kept in the permanent file on the client.

READING 1-5

Deemed dividends

(not a real dividend payment)

LEVEL 1

The purpose of section 84 is to prevent the withdrawal of funds of a corporation resident in Canada as a return of capital. Certain transactions, which are not dividend payments from a legal point of view, will be treated as such for purposes of the ITA. Such dividends are **deemed dividends**. These deemed dividends, like all dividends from corporations resident in Canada, must be grossed up under subsection 82(1)(b) and will entitle the shareholder to a dividend tax credit if the shareholder is an individual. If the shareholder is a corporation, a dividend from a taxable Canadian corporation will be deductible from income under subsection 112(1) and may be subject to Part IV tax.

Before dealing with deemed dividends under section 84, it is useful to review the rules on the taxation of dividends received from corporations resident in Canada by individuals resident in Canada. After 2005, the taxation of dividends depends on whether or not the dividend is designated as an **eligible dividend**. Designation is done by notifying the beneficiary in writing that the dividend paid to him is an eligible dividend. The table below shows the gross-up and dividend tax credit rates on an eligible dividend and a non-eligible taxable dividend.

Type of dividend	Gross-up	Federal credit % of grossed-up dividend
Non-eligible dividend	25%	13.33% (2/3 of gross-up)
Eligible dividend	45%	18.97% (11/18 of gross-up)

The gross-up rate and the tax credit rate on eligible dividends will change effective 2010 to take account of the reduction in the corporate tax rate.

Whether or not an eligible dividend can be paid depends on the type of corporation. For a Canadian-controlled private corporation (CCPC), a dividend can be designated as eligible up to the balance in the corporation's general rate income pool (GRIP) at the end of the taxation year. In brief, the GRIP is a cumulative account consisting primarily of 68% of the income taxed at the general rate, that is, the corporation's taxable income that does not qualify for the small business deduction (SBD), excluding investment income. GRIP is supplemented by eligible dividends received from other corporations.

For corporations other than a CCPC, it is possible to designate all dividends as eligible dividends, provided that the low rate income pool (LRIP) of the corporation is nil at the time the dividend is paid. If the corporation has an LRIP, it must first pay enough taxable dividends to bring the LRIP down to zero before it can pay eligible dividends. In brief, the LRIP consists of taxable dividends, other than eligible dividends, received by the corporation that are deductible under section 112. Any excessive designation by a corporation makes it liable for a 20% tax on the amount of the excessive designation under Part III.1 tax. This tax may be avoided if the corporation and all the shareholders agree to the excess being taxed as a non-eligible dividend.

When a transaction involving a corporation resident in Canada results in a deemed dividend under section 84, this dividend can be designated as an eligible dividend, taking the above-mentioned limitations into account.

The rules set out below regarding deemed dividends apply to private corporations. They may also apply to public corporations in some cases. The study of rules for public corporations is highly specialized and will not be covered here.

Artificial increase in paid-up capital

Since the PUC may be returned to shareholders without being treated as a taxable dividend, it may be advantageous to artificially increase the PUC of a class of shares of the corporation.

Under subsection 84(1), where there is an artificial increase in the PUC of a class of shares, the amount of the increase is deemed to be a dividend paid immediately after the transaction by the corporation to the shareholders of the class. The deemed dividend is distributed among the shareholders of the class of shares proportionately to the number of shares held after the increase that gave rise to the deemed dividend.

An artificial increase in PUC arises where the PUC of the issued shares of a class of shares is increased *without*:

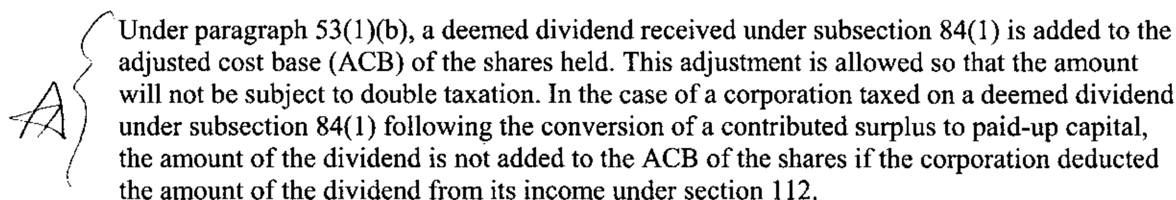
- a corresponding increase in the value of the corporation's assets
- a corresponding reduction in the value of its net liabilities
- a corresponding reduction in the PUC of another class of shares

The conversion of contributed surplus to PUC of a class of shares may also give rise to a deemed dividend under subsection 84(1). Such conversion does not give rise to a deemed dividend provided that the two following conditions are met:

- the contributed surplus arises from the issue of shares of such class after March 31, 1977, and
- neither the rollover provisions nor sections 84.1 or 212.1 are applied on the issuance.

Under this provision, the PUC of a class of shares may be increased without tax consequences to reflect the amount received from shareholders on the issue. For example, shares having a nominal value of $20 were issued for $25. At the time of the issue, $20 was added to the legal PUC and $5 to contributed surplus. If the corporation wishes to amend its share capital structure to convert the contributed surplus created on the issue to PUC of shares, this conversion may be undertaken without any deemed dividend consequences provided the conditions mentioned above are met.

Also excluded from the purview of subsection 84(1) is the conversion of a contributed surplus created after March 31, 1977, through the transfer of property to the corporation by a shareholder of that class, even if no shares were issued at the time, as, for example, in the case of a gift of property to the corporation.



Under paragraph 53(1)(b), a deemed dividend received under subsection 84(1) is added to the adjusted cost base (ACB) of the shares held. This adjustment is allowed so that the amount will not be subject to double taxation. In the case of a corporation taxed on a deemed dividend under subsection 84(1) following the conversion of a contributed surplus to paid-up capital, the amount of the dividend is not added to the ACB of the shares if the corporation deducted the amount of the dividend from its income under section 112.

Example 1-13 provides an example of how subsection 84(1) applies when the PUC of a corporation increases without there being a corresponding increase in the value of the net assets of the corporation.

EXAMPLE 1-13

Liz Kelly and her spouse, Rafael Gomez, each own 50 Class A shares of the corporation Phoenix Ltd., for which each paid $5,000. Phoenix Ltd. is a CCPC that has a nil GRIP.

Liz transfers land valued at $20,000 to Phoenix Ltd. in exchange for 50 Class A shares having a PUC and FMV of $30,000. The ACB of the land for Liz is $15,000.

Tax consequences

The provisions of subsection 84(1) apply because Phoenix Ltd. issues shares having a PUC of $30,000 in exchange for property that is worth only $20,000. The PUC of the Class A shares has increased by $30,000, whereas the value of the net assets has increased by only $20,000. Therefore, there is an artificial increase of $10,000 in the PUC. Furthermore, since Liz receives $30,000 from the corporation for property that is worth only $20,000, she receives a benefit that must also be taken into account when the land is disposed of.

The tax consequences of the transaction for Liz, Rafael, and Phoenix Ltd. are as follows:

For Liz:

Deemed dividend [84(1)]

Increase in the PUC of the Class A shares	$ 30,000
Increase in net assets: FMV of the land	(20,000)
Deemed dividend	$ 10,000
Liz's share (100 ÷ 150)	$ 6,667

Under paragraph 82(1)(b), this amount must be grossed up by 25% when it is included in Liz's income as this is not an eligible dividend. Since the corporation has no GRIP, it cannot make a designation to this effect. The dividend tax credit granted is 13.33% of the grossed-up dividend at the federal level, and the provincial tax credit varies depending on Liz's province of residence.

Taxable benefit [15(1)]

FMV of the Class A shares received	$ 30,000
FMV of the land	(20,000)
	10,000
Deemed dividend [84(1)]	(10,000)
Benefit conferred [15(1)]	$ —

Under subsection 15(1), a benefit conferred on a shareholder is not taxed under that subsection to the extent of the amount deemed to be a dividend by section 84.

ACB of the Class A shares

Acquisition cost of the 50 new shares	$ 20,000
Deemed dividend [84(1), 53(1)(b)]	6,667
	26,667
ACB of the 50 shares held before the transfer of the land	5,000
ACB of the 100 shares held by Liz	$ 31,667

Capital gain — on land

POD — FMV of shares received	$ 30,000
ACB	(15,000)
Gain	15,000
Less: Amount already included in income [84(1), 39(1)(a)]*	(6,667)
Capital gain	$ 8,333
Taxable capital gain (1/2)	$ 4,167

* An adjustment under paragraph 39(1)(a) is made because the portion of the POD of the land that exceeds its FMV constitutes a taxable benefit to the shareholder that is taxed as a deemed dividend.

For Rafael:

Deemed dividend [84(1)]

Increase in the PUC of the Class A shares	$ 30,000
Increase in net assets: FMV of the land	(20,000)
Deemed dividend	$ 10,000
Rafael's share (50 ÷ 150)	$ 3,333

Under paragraph 82(1)(b), this amount must be grossed up by 25% when it is included in Rafael's income as this is not an eligible dividend. Since the corporation has no GRIP, it cannot make a designation to this effect. The dividend tax credit granted is 13.33% of the grossed-up dividend at the federal level, and the provincial tax credit rate varies depending on Rafael's province of residence.

ACB of the Class A shares

ACB of the 50 shares held before the deemed dividend	$ 5,000
Deemed dividend [84(1), 53(1)(b)]	3,333
ACB of the 50 shares held by Rafael	$ 8,333

For Phoenix Ltd.:

Cost of land [69(1)(a)]	$ 20,000

You should recall that when a shareholder transfers property to a corporation and receives consideration greater than the FMV of the property transferred, the shareholder obtains a taxable benefit that must normally be included in the shareholder's income under subsection 15(1). However, it is mentioned at the beginning of subsection 15(1) that only that portion of the benefit that is not considered a dividend under section 84 is included in income under subsection 15(1). In Example 1-13, since the amount of the taxable benefit ($10,000) is equal to the amount of the deemed dividend under subsection 84(1), there is no taxable benefit under subsection 15(1). See paragraph 7 of IT-432R2 for an illustration of where subsections 15(1) and 84(1) apply.

Distribution on the reorganization or winding-up of a business

Where property or funds of a corporation have been distributed or appropriated to its shareholders on a winding-up, discontinuance, or reorganization of its business, the corporation is deemed to have paid a dividend to the shareholders to the extent that the value of the assets distributed exceeds the reduction in PUC at that time.

The dividend is computed by class of shares, and each shareholder of a class of shares is deemed to have received a dividend proportionate to the number of shares held before the transaction.

Under subsections 69(4) and 69(5), if the corporation distributes property other than cash, there is a deemed disposition of such property at its FMV. This may result in tax consequences.

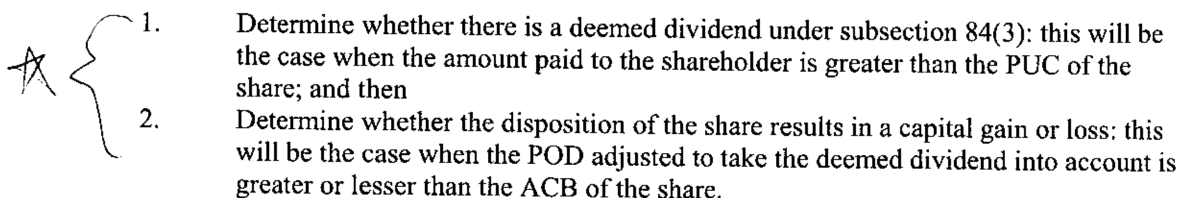
The deemed dividend under subsection 84(2) is not considered to be POD if there is a disposition of shares in the process [section 54: proceeds of disposition, paragraph (j)].

Purchase or redemption of shares by the issuing corporation

In corporate law, a corporation may issue redeemable or retractable shares. Other shares may be issued without a right of redemption being attached to them, as is usually the case with common shares. In the latter case, there is nothing to prevent the issuing corporation from purchasing by mutual consent the shares held by a shareholder and cancelling them. Regardless of whether the shares are redeemed under a right of redemption or purchased by the issuing corporation by mutual consent, under subsection 84(3) there is a deemed dividend for the shareholder equal to the difference between the amount paid by the corporation and the PUC of the shares.

According to the definition of a **disposition** in subsection 248(1), when a share is redeemed, acquired, or cancelled, there is a disposition of that share, and the capital gain or loss realized on the disposition must therefore be determined. In order to avoid double taxation, the amount of the deemed dividend under subsection 84(3) is excluded from the POD of the share under paragraph (j) of the definition of **proceeds of disposition** in section 54.

In summary, each time a corporation carries out a redemption or retraction of one of its shares, there are two possible tax consequences for the shareholder from whom the share is redeemed or retracted. These tax consequences are not mutually exclusive but are instead cumulative. Thus, it is necessary to proceed in two steps:



1. Determine whether there is a deemed dividend under subsection 84(3): this will be the case when the amount paid to the shareholder is greater than the PUC of the share; and then
2. Determine whether the disposition of the share results in a capital gain or loss: this will be the case when the POD adjusted to take the deemed dividend into account is greater or lesser than the ACB of the share.

Example 1-14 illustrates the tax consequences of a redemption of shares.

EXAMPLE 1-14

Jean Noël owns 1,000 Class B shares of Delta Ltd. These shares have a PUC of $10,000 and a redemption value of $15,000. The ACB of the shares for Jean is $9,000.

On December 31, 2007, Delta Ltd. redeems the 1,000 Class B shares held by Jean.

Delta Ltd. is a CCPC with a large GRIP.

Tax consequences

Deemed dividend [84(3)]

Amount paid on redemption	$ 15,000
PUC	(10,000)
Deemed dividend	$ 5,000

Under paragraph 82(1)(b), this amount must be grossed up by 25% or 45% when it is included in Jean's income, depending on whether the dividend is non-eligible or eligible. The dividend tax credit granted is equal to 13.33% or 18.97% of the grossed-up dividend at the federal level, and the provincial tax credit rate varies depending on Jean's

province of residence. In order for the dividend to be an eligible dividend, Delta must inform Jean of this in writing.

Capital gain

POD [54]		
Amount received	$ 15,000	
Deemed dividend [84(3)]	(5,000)	$ 10,000
ACB		(9,000)
Capital gain		$ 1,000
Taxable capital gain (1/2)		$ 500

Example 1-14 shows the distinction to be made between PUC, which is used for calculating the deemed dividend, and the ACB, which enters into the calculation of capital gain. Also note that a single transaction, in this case a share redemption, gives rise to both a deemed dividend and a capital gain. This is because a share redemption, subject to the provisions of subsection 84(3), constitutes a disposition of shares according to the definition of a disposition in subsection 248(1).

When a shareholder suffers a loss on the redemption, acquisition, or cancellation of a share and immediately after the redemption, acquisition or cancellation of the share, the shareholder or his spouse controls the corporation, the loss is deemed to be nil under subsection 40(3.6). Subsection 40(3.6) applies because subsection 84(9) presumes that the redeemed, acquired, or cancelled shares have been disposed of to the corporation. Under paragraph 40(3.6)(b), the capital loss denied under subsection 40(3.6) is added to the ACB of the shares that the shareholder still holds in the corporation. If he does not hold any, the loss can no longer be used.

Example 1-15 illustrates a situation in which subsection 40(3.6) applies.

EXAMPLE 1-15

Josie owns 75% of the common shares of Coats Ltd. as well as 500,000 non-voting, non-participating preferred shares redeemable or retractable for $1 each. The details of her shareholdings are as follows:

	PUC	**ACB**	**FMV**
750 common shares	$ 750	$ 750	$ 100,000
500,000 preferred shares	$ 10,000	$ 500,000	$ 500,000

Josie needs cash, and 200,000 preferred shares are redeemed by Coats Ltd. for $200,000.

Coats Ltd. is a CCPC with a large GRIP.

Tax consequences

For Josie:

Deemed dividend [84(3)]

Amount paid on redemption	$ 200,000
PUC [(200,000 ÷ 500,000) × $10,000]	(4,000)
Deemed dividend	$ 196,000

Under paragraph 82(1)(b), this amount must be grossed up by 25% or 45% when it is included in Josie's income, depending on whether the dividend is non-eligible or eligible. The dividend tax credit granted is equal to 13.33% or 18.97% of the grossed-up dividend at the federal level, and the provincial tax credit rate varies depending on Josie's province of residence. In order for the dividend to be an eligible dividend, Coats must inform Josie of this in writing.

Capital loss

POD [54]		
Amount received	$ 200,000	
Deemed dividend [84(3)]	(196,000)	$ 4,000
ACB [(200,000 ÷ 500,000) × $500,000]		(200,000)
Capital loss		$(196,000)

Since Josie controls Coats Ltd. after the redemption, she is affiliated with it and the loss of $196,000 is deemed nil under paragraph 40(3.6)(a). Under paragraph 40(3.6)(b), the amount of the loss is added to the ACB of the shares that Josie still owns in proportion to their FMV.

Increase in the ACB of the common shares

$196,000 × ($100,000 ÷ $400,000) — $ 49,000

Increase in the ACB of the preferred shares

$196,000 × ($300,000 ÷ $400,000) — $ 147,000

Therefore, following the redemption, the shares held by Josie have the following characteristics:

	PUC	ACB	FMV
750 common shares	$ 750	$ 49,750	$ 100,000
300,000 preferred shares	$ 6,000	$ 447,000	$ 300,000

As a final point on the redemption or purchase of shares by the issuing corporation, it should be kept in mind that the PUC of the class will be reduced by the amount of the PUC of the shares redeemed or purchased, with the result that the PUC of the share will not be changed. In Example 1-15, assuming that Josie held all the preferred shares issued, the PUC of the class, which was $10,000 before the redemption, will be reduced by the PUC of the redeemed shares ($4,000) and therefore the PUC of the class after the redemption will be $6,000 for 300,000 shares, or $0.02 per share. 6000/300000 = 0.02 or 10,000/500,000 = 0.02

Reduction in paid-up capital

Subsection 84(4) covers situations where there is a reduction in the PUC of a class of shares without a reduction in the number of shares through the redemption, acquisition, or cancellation of shares. Where there is such a reduction in PUC, a deemed dividend may result if the amount paid to the shareholder exceeds the amount of the reduction in the PUC of the class.

A PUC reduction does not give rise to a disposition by the shareholder of shares whose PUC has been reduced. However, the amount paid in the capital reduction, except insofar as it has

been included in income as a deemed dividend under subsection 84(4), reduces the ACB of the shares [subparagraph 53(2)(a)(ii)].

Example 1-16 shows the tax consequences of a reduction in the PUC of a class of shares.

EXAMPLE 1-16

Maria Garcia holds 500 Class Z common shares of Dennon Ltd., a CCPC with a nil GRIP. The PUC of the shares is $100,000 and their FMV is $500,000. Dennon Ltd. no longer requires as much capital as it did on incorporation. It decides to reduce the PUC of the 500 Class Z shares to $10,000 and pays Maria $90,000. The ACB of the 500 Class Z shares for Maria is equal to their PUC of $100,000.

Tax consequences

For Maria:

Deemed dividend [84(4)]

Amount paid	$ 90,000
Reduction in PUC ($100,000 – $10,000)	(90,000)
Deemed dividend	$ —

ACB of the 500 Class Z shares

ACB before the reduction in PUC	$100,000
Amount paid less dividend under 84(4) [53(2)(a)(ii)]	(90,000)
ACB after the reduction in PUC	$ 10,000

Subsection 84(4) may be very useful where a shareholder has invested significant amounts in a corporation in the form of participating shares and wishes to withdraw the capital without any immediate tax consequences. For example, if Dennon Ltd. had purchased or redeemed the Class Z shares for $90,000 rather than reducing the PUC, it would have had to redeem 90 shares at a FMV of $1,000 each. This would have resulted in a deemed dividend under subsection 84(3).

Deemed dividend [84(3)]

Amount paid	$ 90,000
PUC of the shares (90 ÷ 500 × $100,000)	(18,000)
Deemed dividend [84(3)]	$ 72,000

Under paragraph 82(1)(b), this amount must be grossed up by 25% when it is included in Maria's income, as this is not an eligible dividend. Since Dennon Ltd. has no GRIP, it cannot make a designation to this effect. The dividend tax credit granted is 13.33% of the grossed-up dividend at the federal level, and the provincial tax credit rate varies depending on Maria's province of residence.

Capital gain

POD [54]		
Amount received	$ 90,000	
Deemed dividend [84(3)]	(72,000)	$ 18,000
ACB		(18,000)
Capital gain		$ —

In comparison, by reducing the PUC, there were no immediate tax consequences.

Note that when a corporation reduces its PUC without making a payment to the shareholders, subsection 84(4) does not apply and there is no tax consequence for the shareholders.

Deemed dividend payable from the capital dividend account

A deemed dividend under section 84 constitutes a taxable dividend under the usual rules. As you know from previous tax courses, these rules vary depending on whether the dividend is received by a corporation or an individual.

If the corporation has a capital dividend account (CDA), a deemed dividend under one of subsections 84(1) to (4) may be deemed to be paid from the CDA if the election provided in subsection 83(2) is made. Subsection 84(7) allows a CDA election to be made for a deemed dividend under section 84 by deeming the dividend to have become payable, which is one of the conditions set out in subsection 83(2).

You will recall that a dividend paid from the CDA is not taxable and it does not affect the ACB of the shares.

If the shares on which the dividend is deemed to be paid are disposed of and the result is a loss, this loss may be reduced by the dividend paid out of the CDA.

Shares distributed in transactions covered by subsections 84(2) to 84(4)

For purposes of subsections 84(2) to 84(4), where property distributed to shareholders includes shares of the capital stock of the corporation, the shares should be valued at their PUC rather than at FMV. This rule is contained in subsection 84(5). It is illustrated in Example 1-17.

EXAMPLE 1-17

Annie Duncan owns 200 Class D shares of Zeolite Mines Ltd., having a PUC and ACB of $2,000 and a FMV of $10,000.

Zeolite Mines Ltd. redeems 100 Class D shares owned by Annie in exchange for 10 Class E shares and $3,000 cash. The Class E shares have a PUC of $800 and a FMV of $2,000.

Zeolite Mines is a CCPC with a large GRIP.

Tax consequences

Deemed dividend [84(3)]

Cash	$ 3,000	
PUC of Class E shares [84(5)]	800	$ 3,800
PUC of the 100 Class D shares		(1,000)
Deemed dividend		$ 2,800

Under paragraph 82(1)(b), this amount must be grossed up by 25% or 45% when it is included in Annie's income, depending on whether the dividend is non-eligible or eligible. The dividend tax credit granted is equal to 13.33% or 18.97% of the grossed-up dividend at the federal level, and the provincial tax credit varies depending on Annie's province of residence. In order for the dividend to be an eligible dividend, Zeolite Mines must inform Annie of this in writing.

Capital gain

POD [54]		
FMV of the Class E shares + cash	$ 5,000	
Dividend [84(3)]	(2,800)	$ 2,200
ACB		(1,000)
Capital gain		$ 1,200
Taxable capital gain (1/2)		$ 600
ACB of the 10 Class E shares		$ 2,000

Planning

As you can see, the concept of PUC is very important in transactions affecting the capital stock of a corporation.

On a new issue of shares of a given class, it is always necessary to assess the impact on the PUC of the class as well as the future impact for shareholders in the case of, say, the purchase or redemption of shares by the corporation. This assessment will show whether the new issue should instead be done in a different class of shares.

Example 1-18 illustrates a situation in which a new shareholder of the corporation subscribes for common shares of the corporation at a different price than the founding shareholder.

EXAMPLE 1-18

In 2000, Amira Bissada incorporated Communication Inc. On the incorporation, Amira acquired 100 common shares of the capital stock of Communication Inc. for $10,000.

Communication Inc. has grown, and Amira's shares are currently worth $200,000. In order to continue growing, Communication Inc. needs new capital. John Cheng, a Canadian resident, is willing to invest $200,000 in the corporation for a 50% interest. It is therefore agreed to issue him 100 common shares of the capital stock of Communication Inc. in consideration of his investment of $200,000.

Communication Inc. is a CCPC with a large GRIP.

Tax consequences

1. PUC of each of the 200 common shares issued:

PUC of the 200 common shares $10,000 + $200,000	$ 210,000
PUC per share $210,000 ÷ 200	$ 1,050

2. For John, if his 100 shares were purchased by Communication Inc. for $200,000:

Deemed dividend [84(3)]

Amount paid	$ 200,000
PUC of the 100 common shares (100 × $1,050)	(105,000)
Deemed dividend	$ 95,000

Under paragraph 82(1)(b), this amount must be grossed up by 25% or 45% when it is included in John's income, depending on whether the dividend is non-eligible or eligible. The dividend tax credit granted is 13.33% or 18.97% of the grossed-up dividend at the federal level, and the provincial tax credit varies depending on John's province of residence. In order for the dividend to be an eligible dividend, Communication Inc. must inform John of this in writing.

Capital gain

POD [54]		
Amount paid	$ 200,000	
Deemed dividend [84(3)]	(95,000)	$ 105,000
ACB of the 100 common shares		(200,000)
Capital loss		$ (95,000)
Allowable capital loss (1/2)		$ (47,500)

3. For Amira, if her 100 common shares were purchased by Communication Inc. for $200,000:

Deemed dividend [84(3)]

Amount paid	$ 200,000
PUC of the 100 common shares (100 × $1,050)	(105,000)
Deemed dividend	$ 95,000

Under paragraph 82(1)(b), this amount must be grossed up by 25% or 45% when it is included in Amira's income, depending on whether the dividend is non-eligible or eligible. The dividend tax credit granted is equal to 13.33% or 18.97% of the grossed-up dividend at the federal level, the provincial tax credit rate varies depending on Amira's province of residence. In order for the dividend to be an eligible dividend, Communication Inc. must inform Amira of this in writing.

Capital gain

POD [54]		
Amount paid	$ 200,000	
Deemed dividend [84(3)]	(95,000)	$ 105,000
ACB of the 100 common shares		(10,000)
Capital gain		$ 95,000
Taxable capital gain (1/2)		$ 47,500

In Example 1-18, you can see that John may incur immediate tax consequences, even though he merely recovers his investment. He would be taxed on a dividend, and he would be recognized as having a capital loss of an amount equal to that dividend. Since a capital loss can only be used against capital gains, it will probably be some years before John can use this loss. The deemed dividend results from the fact that the PUC of John's shares is not equal to the amount that he contributed because of the calculation of the PUC that is done for all the shares in the class. This also explains the result obtained in the case of Amira, who, instead of realizing a deemed dividend of $190,000 [$200,000 – $10,000], realizes a deemed dividend of $95,000 and a capital gain of $95,000 (of which $47,500 is taxable).

On a new share issue, in order to ensure that the PUC of the shares corresponds to the amount paid to the corporation for their issuance, it is necessary to issue shares of a class separate from that of the shares currently issued. Note that if common shares A and common shares B have identical rights, they cannot constitute separate classes. It is therefore necessary to provide for a difference, however minimal it may be, such as the preference granted to common shares B to receive $100 in the event of liquidation before equally dividing the residual among common shares A and common shares B.

Exhibit 1-2 gives a summary of how a deemed dividend is calculated, and the other tax consequences of some specific situations.

EXHIBIT 1-2

Section 84 and private corporations

Situation considered	Computation of deemed dividend	Effect on ACB	Effect on POD
Subsection 84(1) — Artificial increase in PUC Example 1-13	Amount of increase in the PUC of the shares of a class less: • amount of increase in net assets • amount of decrease in net liabilities • amount of decrease in the PUC of the shares of any other class The deemed dividend is distributed among the shareholders of the class after the increase in the PUC according to the number of shares that they obtain.	Under paragraph 53(1)(b), the amount of the deemed dividend is added to the ACB of the shares.	None. There is no disposition of the shares.
Subsection 84(2) — Windups, reorganizations, or discontinuance of a business Ex 1-14	Amount or value of the property distributed to the shareholders of a class less: • reduction of the PUC of the shares of the class The deemed dividend is distributed among the shareholders of the class according to the number of shares that they held immediately before the distribution.	None	Deemed dividend excluded from the POD under paragraph (j) of the definition of POD in section 54.
Subsection 84(3) — Purchase or redemption of shares of a class by the issuing corporation Ex 1-14	Amount paid less: • PUC of the purchased or redeemed shares The deemed dividend is distributed among the shareholders whose shares have been purchased or redeemed according to the number of purchased or redeemed shares that they held as a proportion of the total number of purchased or redeemed shares.	None	Deemed dividend excluded from the POD under paragraph (j) of the definition of POD in section 54.
Subsection 84(4) — Reduction of PUC Ex 1-16	Amount paid to shareholders for the reduction of PUC of the class of shares less: • amount subtracted from the PUC of the class of shares The deemed dividend is distributed among the shareholders of the class on the basis of the number of shares that they held immediately before the reduction.	Reduction of the ACB of the shares according to subparagraph 53(2)(a)(ii) for that amount received in the reduction of the PUC which is not considered a deemed dividend.	None. There is no disposition of the shares.

READING 1-6

Ethics and tax planning

LEVEL 1

Advanced Personal & Corporate Taxation examines different issues arising in tax planning, particularly for corporations but also for individuals, trusts, and partnerships. Ethical issues arise when there is a choice between right and wrong. Unit A5 of the *Ethics Readings Handbook* deals with moral principles. It states that wrongful actions include: harming others, interfering with their freedom of choice, denying them benefits to which they are entitled, and treating them unfairly. Hence, wrongful actions are often those that have serious adverse effects on third parties.

In tax planning, there are three principal parties:

- the government representing the public
- the client as the taxpayer
- the CGA acting as a tax advisor

Tax policy and tax payers

Earlier, you learned that the Canadian tax system provides for the taxation of corporate income at two levels, first within the corporation itself and second as dividends in the hands of shareholders. This two-level system of taxation is based on the principle of income integration that underlies the Canadian tax system. Our tax system also distinguishes between different sources of income, namely employment income, business income, income from property, and other sources of income, and it grants them different tax treatments for reasons based on fiscal policies. Fiscal policies also underlie the deductions and tax credits that are granted to corporations and individuals in computing their taxable income and their income tax payable. The choice of fiscal policies is in the hands of the government of the day, and it is open to criticism. However, when these policies are incorporated into the ITA, they must be respected by taxpayers and tax advisors.

Taxpayers are entitled to plan their financial affairs in such a way as to minimize their income tax payable, provided that they act within the framework of the ITA and hence the social choices made by the government. Some taxpayers who do not approve of these social choices will be tempted to circumvent the rules or avoid them. For example, some taxpayers may want to use, for personal purposes, assets of a corporation that they control without being taxed on the benefit that they are receiving. Others will be tempted to act as free riders — getting the benefits of taxation in the form of public services without paying their fair share of the costs. This was illustrated in Example 1-1, where Frances Baron had a swimming pool built at her personal residence at the expense of her corporation, Active Ltd., which claimed the construction costs as an expense.

The ethical problems facing CGAs in taxation matters are not limited to illegal actions that their clients may take. Indeed, owing to the complexity of the ITA, many Canadian taxpayers may violate the ITA without intending to. The CGA, as a tax advisor, then faces two challenges:

1. to inform the client about the ITA provisions that the client is violating;
2. to deal with situations in which the client wants to structure financial affairs in ways that are contrary to the ITA.

The CGA as a tax advisor

The CGA acting as a tax advisor therefore has the following obligations:

1. to possess the knowledge required in taxation matters in order to convey appropriate information to clients; and
2. to act professionally when advising clients.

The first obligation is in accord with the *Code of Ethical Principles and Rules of Conduct* (Code), found in *ERH*, Unit C3, in particular the principle of due care and professional judgment:

> Members shall strive to continually upgrade and develop their technical knowledge and skills in the areas in which they practice as professionals. This technical expertise shall be employed with due professional care and judgment.

As noted above, the ITA is complex, and it is continually changing. As a tax advisor, the CGA has a duty to stay up to date on tax matters. CGAs should not offer tax advice if they lack the requisite knowledge. This means being honest with clients about the limits of one's expertise. If the CGA cannot provide an off-the-cuff answer to a given question, the CGA must take the time to study the question and if necessary obtain the required assistance from a person specializing in the subject in order to give the client an informed answer. You should also make the client aware of any risk or uncertainties surrounding the opinion being given. This is especially important in tax matters, since the ITA and its interpretation are constantly changing as a result of both legislative amendments and case law. Efforts on the part of governments to close loopholes often result in new loopholes being created. Furthermore, in tax planning, there are sometimes alternative ways of achieving a client's objectives, where each alternative has its own pluses and minuses. In these situations the CGA should discuss the different alternatives with the client so that the client can make an informed decision.

The Code also offers important guidance on the CGA's second duty, that is to act professionally. The Preamble to the Code specifies that:

> Certified General Accountants are committed to the public interest. Normally, acting in the public interest is achieved by acting in the interest of one's client or employer. However, whenever there is a conflict between these interests, the professional's first obligation is to the public at large. Acting appropriately in such situations may require the courage of one's convictions.

Two types of situations may arise: those in which CGAs are expected to act in the interests of clients or employers, and those where there is a conflict between the interests of the client or the employer and the public. Knowing the difference between these two situations requires moral judgment or discernment; acting appropriately in the two cases requires moral integrity and, as stated in the Preamble, the courage of one's convictions.

The usual situation: The interest of the client or employer prevails

Normally the CGA, acting in the interests of the client, also serves the public interest. In this situation, the primary responsibility of the CGA acting as a tax advisor is to serve the interests of clients or employers. The CGA can leave it to the government to be concerned with the fairness and adequacy of tax policies.

From a legal perspective, the CGA is not an agent of CRA. For example, when CRA makes an error in assessing a tax return, the CGA has no legal obligation to report the error to CRA. From an ethical perspective, it would be right for the CGA to inform the client of the error and obtain the client's approval for disclosing it to CRA.

However, this claim that tax advisors are not expected to act as agents of CRA is subject to the following important qualification. The CGA as a tax advisor must always act within the law. A CGA must never advise a client to break the law. For example, counselling a client to transfer assets to a tax haven in order to avoid Canadian taxes would be a violation of ethical principles and illegal as well. Indeed, subsection 239(1) of the ITA provides for criminal penalties of up to 200% of the tax amount the guilty party sought to evade, as well as a maximum of two years of imprisonment when a person who either participates in, consents to, acquiesces in, or conspires in evasion of the payment of tax. Furthermore, under section 163.2, civil penalties are provided for in the case of advising or participating in a false statement or omission or, in the case of a person who knowingly plans, promotes, or sells an arrangement that includes a false statement or omission that may be used for tax purposes. The administrative penalty is generally the greater of $1,000 or the tax that the taxpayer attempted to evade or the refund that he attempted to obtain.

Acting in the interest of the client or employer does not mean following all the orders of the client or employer. CGAs must play an active role in helping clients or employers understand their best interest. For example, in the case of complex tax planning, they should suggest alternatives that the client or employer has not considered or point out difficulties that the client or employer may have ignored.

Furthermore, showing respect for the interests of the client or employer requires the avoidance of conflict of interest. As the Code notes in the principle of trust and duties:

> Members shall honour the trust bestowed on them by others, and shall not use their privileged position without their principal's knowledge and consent. Members shall avoid conflicts of interest and situations in which the potential for conflict of interest is high.

This has particular relevance for tax planning, since the CGA has access to important financial information and also has the client's confidence.

Thus, if a tax advisor who advises a client to invest in an advantageous tax shelter in which the tax advisor or a member of his or her family is directly or indirectly involved, it is necessary to disclose to the client one's interest in the project and also inform the client of the risk inherent in this type of investment. Not to do so is to break the rules on conflict of interest.

Similarly, if a tax advisor of a public corporation learns in the course of the engagement that the corporation is planning to make a major acquisition, he or she may see an opportunity to realize a sizable gain and purchase shares of the corporation on the strength of this information. Not only does this go against R205 of the CGA-Canada Code, but it may also violate the rules on insider trading that are provided for in securities legislation.

Tax advisors not only have a duty to avoid conflicts of interest, but they must also respect the confidentiality of information relating to a given client, even if that information could be useful to another client. Normally, confidential information cannot be disclosed to others without the consent of the client or unless required by law. This subject is dealt with in rule R201 of the Code.

Acting as a tax advisor for their clients or employer, CGAs not only have negative obligations (things they must not do), but also positive obligations (things they must do). For example, a CGA who regularly gives a client tax advice must inform the client about relevant changes to the ITA.

For instance, say a CGA has advised a client regarding the method of valuing the taxable benefit relating to the use of a condo belonging to the corporation of which the client is a shareholder. The CGA must inform the client of any possible change in the valuation method

as a result of amendments to the ITA or court decisions if the CGA is still working for that client or had given the original opinion not long before the change.

Another duty of CGAs in tax matters is to file returns or forms in a timely manner. Not to do so is to expose the client to the risk of penalties. The CGA is then liable to be sued by the client for negligence and may be required to pay damages. The client may also submit the case to the provincial association, which may result in disciplinary action.

The exceptional situation: Acting to protect the public

In exceptional cases, the CGA acting as a tax advisor will be faced with a choice between serving the interests of the client or the employer and the public interest. This generally occurs when the client or employer chooses to plan their financial affairs in a way that is contrary to the ITA. In such a case, the CGA must inform the client or employer that what they propose to do goes against the ITA. The CGA must not participate or help the client carry out his or her plan and must even, in some circumstances, sever relations with the client or employer (see R102 of the Code). Carrying on a relationship with a client who is acting unlawfully is not only a breach of ethics but may also cause the CGA to have to answer difficult questions in court or before the discipline committee of the provincial association.

If a CGA decides to resign from the engagement, he will probably have to inform his replacement of the reasons for resigning (see R504 of the Code).

Competence and competition

Like other areas in financial planning, tax planning is a highly competitive area including competition from those with no professional, let alone accounting, training. There is no legal restriction on who may claim to offer tax-planning services.

Even though this is a competitive area, it is important for accounting professionals not to make exaggerated or unrealistic claims to clients (see R509 on advertising and other forms of solicitation). Ultimately, such claims damage both the individual's and the profession's credibility.

CGAs may encounter a situation in which they believe another tax planner has given a client inadequate or even poor advice. In such a situation, it is essential to provide the client with correct tax advice. However, before moving to the conclusion that the previous tax planner was possibly negligent, the CGA should make reasonable efforts to find out the facts from the client (for example, did the client provide sufficient information to the previous tax planner, have relevant provisions of the ITA changed since the advice was provided).

It should be noted that any criticism of a professional colleague (another CGA) is subject to R105. But it is important to understand that this provision must be interpreted in light of R104, Breach of Rules. R104 requires reporting the competence, lack of integrity, and other matters to the Association where the member has "sufficient knowledge."
Clearly it is the responsibility of each CGA engaged in tax planning to provide accurate and timely advice to clients. In cases where mistaken advice has been given or an error has occurred, it is important to inform the client as soon as possible and provide the correct information. The failure to be candid with clients and accept responsibility for mistakes not only damages the trust relationship, but it may also place the client at financial risk and perhaps even result in a penalty from tax authorities.

Who is the client?

A final ethical complication for CGAs concerning corporate clients is discussed in reading C1 of *ERH,* Corporate clients. The text deals with the case of a lawyer, but CGAs face the same question when dealing with clients who are corporations, namely, who is the client — the corporation, or one or more shareholders? This question becomes especially thorny when a shareholder seems to have been aggrieved by other shareholders. The same problem arises if the client is a trust or partnership. Who is the client — the trust or the beneficiaries, the partnership or particular partners?

READING 1-7

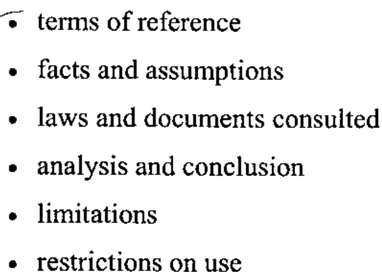
Writing a tax opinion

LEVEL 1

You have seen that tax planning raises a number of ethical issues. In tax matters, another concern of the CGA is how to communicate clearly and effectively with the client and, at the same time, to limit the potential for a professional liability lawsuit. The point here is not to get around the rules of ethics but rather to state your opinions or conclusions on a tax matter in such a way that their limitations and scope will be clearly understood by the client so as to avoid legal disputes.

Taxation is a complex matter in which the rules are continually changing. An opinion given today might not be valid when the client decides to implement the planning proposed, either because of a change in the law or because the client's own situation has changed since the opinion was given. And what if the client were to show the opinion to a third party who then used it himself in a similar case? These are examples of situations that may give rise to possible lawsuits. To avoid these situations, it is therefore important to follow certain rules when a client consults you on tax matters.

Tax opinions should be set out in writing and should contain the following elements:



- terms of reference
- facts and assumptions
- laws and documents consulted
- analysis and conclusion
- limitations
- restrictions on use

The tax opinion provided to the client, whether in the form of a memorandum or a letter, should always contain all these elements. The order may sometimes vary; however, the terms of reference and the facts should be presented at the beginning.

If all the above elements are included in the opinion, the client will be able to determine whether the opinion corresponds to what he requested and whether it is based on all the facts or on reliable facts, and he will be able to understand the limitations of the opinion. If he does not agree with one of the elements or wants more details, he can react immediately and ask the CGA to revise his opinion accordingly. For his part, the CGA is protected in the event of a possible professional liability lawsuit, since he is able to demonstrate that he acted with the skill and care required at the time the opinion was requested, using the information provided to him.

Very often in practice, the opinion is not given to the client but rather to a partner. The opinion, which in that case will generally be in the form of a memorandum, should still contain the same elements as those listed above for the opinion given to the client. This is especially true when it there is a possibility that a copy of the memorandum will be given to the client. The memorandum to a partner will normally be written in more technical terms and will include more detailed calculations, since it will be given to someone who is more informed on the subject.

Example 1-19 presents a sample tax opinion to a client concerning the transfer of property from a corporation to its shareholder.

EXAMPLE 1-19

Sydney is the sole shareholder of Water Lily Inc., a private Canadian corporation. Recently, he has noticed that the taxable benefit for an automobile supplied by the corporation is very high. He wants to transfer the automobile to his name. He therefore calls a CGA recommended by a friend to ask whether it is possible for the company to sell him the automobile for $1. According to Sydney, the automobile, purchased for $65,000, is currently worth $22,000, and the undepreciated capital cost (UCC) is $13,000. After some discussion, it is agreed that the CGA will give him a written opinion on the income tax consequences if the automobile is sold for $1. If appropriate, the CGA will also make recommendations on how to reduce the tax consequences. In no event does Sydney want to pay more than $1 to the company for the transfer of the automobile.

The CGA sends Sydney the following opinion.:

Sample opinion

(date)

Mr. Sydney __________
(Address)

Re: Acquisition of the automobile owned by Water Lily Inc.

Dear Sir:

[**Terms of reference**]
You requested our opinion regarding acquisition for $1 of the automobile that is currently supplied to you by Water Lily Inc. More specifically, you want to know the income tax consequences of such a sale, both for you and for the corporation. You also want to know whether there is a way to reduce these tax consequences without your having to pay more than $1 to Water Lily Inc.

[**Facts and assumptions**]
Our opinion is based on the following facts that you gave us by telephone:

1. You are the sole shareholder of Water Lily Inc.
2. Water Lily Inc. provides you with an automobile that originally cost $65,000.
3. The current market value of the automobile is $22,000.
4. You want to acquire the automobile currently owned by Water Lily Inc. for $1.
5. The automobile is a Class 10.1 depreciable property of Water Lily Inc. with a UCC of $13,000.

We wish to make it clear that we have not verified any of these factual data and we take it for granted that they are accurate.

Furthermore, for the purposes of this opinion, we assume that you are currently taxed at the maximum rate applicable in the province, that is, at a combined federal-provincial rate of 32% on dividends and 45% on other types of income.

[**Analysis and conclusions**]
The sale of the automobile for $1 will have no major tax consequence for Water Lily Inc. Under section 69(4) of the *Income Tax Act* (hereinafter ITA), the company will be deemed to have disposed of the automobile at its fair market value. However, since the automobile is a Class 10.1 property on which the corporation cannot recapture depreciation under section 13(2) of the ITA, the only impact is that in the year of the sale, Water Lily Inc. can

claim only half the CCA that it could have claimed if it had not sold the automobile, pursuant to REG 1100(2.5).

On the other hand, if Water Lily Inc. sells you the automobile for $1, you will be taxable on a shareholder benefit of $21,999 under subsection 15(1) of the ITA, which will represent taxes in the order of $9,900. The cost of the automobile for you will be $22,000.

A way to reduce the tax payable on the transfer of the automobile would be for Water Lily Inc. to declare a dividend of $22,000, which it would pay you in kind, that is, by the transfer of the automobile. The tax consequences for Water Lily Inc. would be identical to the consequences of selling the automobile for $1. On the other hand, for you, the amount of $22,000 will be taxed as a dividend rather than as ordinary income, which means that the tax payable would be $7,040 instead of $9,900.

[Limitations of the opinion]
In this opinion, we have assumed that the market value of the auto, which you set at $22,000, was accurate. However, if the value were different, it would be necessary to change the value of the taxable benefit or dividend accordingly, which would change the amount of tax payable. An appraisal by an independent expert is desirable in order to avoid problems with the tax authorities.

Also, we have not considered the impacts of the goods and services tax (GST), motor vehicle transfer fees, or other fees or taxes that might be applicable on the transfer of the automobile.

[Laws and documents consulted]
This opinion is based on the *Income Tax Act* and its regulations in force on the date of this opinion. It also takes into account any proposed amendment to the Act and administrative practices published as of that date. We have consulted no other provincial or federal law. Note that the law and administrative practices are subject to amendment. Therefore, if the transaction being considered is not carried out for some time, it will be necessary to verify whether the conclusions in this opinion are still valid.

[Restrictions on use of opinion]
Also, this opinion is intended exclusively for your use and is limited to the facts described above.

If you have any comments or questions, we are at your disposal to discuss any aspect of the opinion at your convenience.

Your truly,

CGA

Note

You will notice that in the sample the opinion given to Sydney, specific references were made to the ITA. Such references are often omitted when writing an opinion to a client who is not familiar with the ITA, since such a client is interested in the conclusions and not in all the technical analysis underlying the opinion. However, the CGA's file should contain the references that support the conclusions

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