***Canadian Tax Principles, 2022-2023* (Byrd/Chen)**

**Chapter 15 Corporate Taxation and Management Decisions**

15.1 Online Exercises

1) Frank Labelle carries on a business as a sole proprietor that produces just enough income to meet his personal consumption needs. He anticipates that the business income will exceed his consumption needs in the foreseeable future. Will he save income tax by incorporating? Will he defer income tax by incorporating? Explain your conclusions.

Answer: The use of a corporation only provides significant income tax deferral in those cases where income can be left in the corporation and not paid out to the shareholders. As Frank requires all of the income of the business in order to provide for his personal consumption needs, the use of a corporation will not provide any deferral. However, as he anticipates that the business's income will exceed his personal consumption needs in the foreseeable future, there will be deferral on amounts of income that are left in the corporation in future years.

It appears that Frank's business would be incorporated in a CCPC earning active business income (ABI). Provided this income does not exceed the amount eligible for the SBD, there may be a small reduction in some provinces or territories. However, this income tax savings is usually not large enough to justify the costs of establishing and maintaining a corporation.

Type: ES

Topic: Income tax savings & deferral - the decision to incorporate a business

2) Briefly describe the two basic types of tax benefits that can arise through the incorporation of a business.

Answer: As described in the text, the two basic types of benefits are as follows:

**Tax Reduction -** In some situations, the total income taxes that would be paid at the combined corporate and individual level will be less when the business is incorporated than would be the case if the individual had carried on the business as a sole proprietor. The likelihood of tax reduction is increased where the business activity is M&P particularly in those provinces and territories which offer enhanced M&P incentives.

**Tax Deferral -** When a business is carried on by a corporation the corporation will pay income tax on profits and any after tax profits can then be distributed as taxable dividends to individual shareholders who are then subject to personal income tax. The combination of the corporate and personal income tax are meant to equate to the income taxes that would have been payable by an individual were the business to be carried on by that individual as a sole proprietor. This means that when a corporation is involved there are two levels of income tax - a general low income tax rate by the corporation and then an additional level of income tax once taxable dividend distributions of corporate after-tax earnings are made to individuals. If the an individual shareholder does not require all of the after-tax corporate income then funds can be left in the corporation, resulting in a postponement of the second level of personal income tax. If the rate at which the corporation is taxed is lower than the rate at which the individual would be taxed then there is tax deferral.

Type: ES

Topic: Income tax concepts - tax reduction & tax deferral

3) One of the advantages that is cited for the use of a corporation is limited liability. Explain this concept and indicate whether you believe that it is an advantage for a small private corporation with a single shareholder.

Answer: Because a corporation is a separate legal entity, the shareholders' liabilities to creditors are limited to the amount invested in the corporation and any corporate property. That is, creditors of the corporation can look only to the assets of the corporation for satisfaction of their claims. However, for owner-managed corporations, obtaining significant amounts of financing will almost always require the owners to provide personal guarantees, making this advantage somewhat illusory for this type of company. Note, however, limited liability may still be important for a business that is exposed to significant product or environmental claims.

Type: ES

Topic: Corporate concepts - limited liability

4) Varying provincial income tax rates on corporations and varying provincial/territorial dividends tax credits for individuals can result in imperfections in the integration system. Briefly explain how these imperfections can influence the decision to incorporate a business.

Answer: The goal of integration is to ensure that, when a corporation is used, the combined corporate and individual income will be the same as those paid by an individual receiving the same income directly. For eligible dividends, the enhanced gross up and dividend tax credit mechanism is based on the assumption of a combined federal/provincial/territorial corporate income tax rate of 27.54% and for non-eligible dividends, the gross up and tax credit mechanism is based on the assumption of a combined federal/provincial/territorial corporate income tax rate of 13.04%. If the actual combined income tax rate exceeds these rates, it will discourage the use of a corporation whereas if the actual combined rate is less than these rates, use of a corporation becomes more attractive.

The other assumption that is inherent in integration is that the combined federal/provincial/territorial dividend tax credit will be equal to the gross up. For eligible dividends, the federal credit is equal to 6/11 of the gross up. For the combined credit to equal the gross up, the provincial/territorial credit must be equal to 5/11 of the gross up. For non-eligible dividends, the federal credit is equal to 9/13 of the gross up. For the combined credit here to equal the gross up, the provincial/territorial credit must be equal to 4/13 of the gross up. If the provincial/territorial credit exceeds these amounts, the combined credit exceeds the notional corporate income tax and makes the use of a corporation more attractive. Alternatively, if the provincial/territorial credit is less than these amounts, the credit does not compensate for corporate income tax and this discourages the use of a corporation.

Type: ES

Topic: Integration - general concepts

5) Under what circumstances would income splitting become an effective tax planning strategy? Explain your conclusion.

Answer: For income splitting to be an effective tax planning strategy, there must be significant differences in the income levels of individuals in a closely related group such as immediate family members. Income splitting is based on the idea that some amount of income will be shifted from individuals in a high income tax bracket to individuals in a low income tax bracket. This will create a savings based on the difference between the income tax rates applicable to the two individuals. A typical situation would be a parent in the 29% or 33% federal income tax bracket, with adult children with little or no income. Note, however, that income splitting does not work if the income transferred to the individual in the low income tax bracket is subject to the Tax On Split Income (TOSI) since the TOSI applies a 33% federal income tax rate effectively negating and income tax splitting advantages.

Type: ES

Topic: Income splitting (TOSI) - general concepts

6) An individual has started a new business. While the individual is confident that, in the long run, that the business will be very profitable, it is expected that the business will incur losses in the first 3 to 5 years. Would you advise this individual to carry on the business as a sole proprietorship or, alternatively, to incorporate the business?

Answer: Until the business becomes profitable, it would be best to continue the business as a sole proprietorship. The major reason for this advice is that, if the individual carries on the business that the business losses can be applied against other income of the individual (e.g., investment income) to reduce personal income tax. In contrast, if the business is incorporated the losses will be locked within the corporation and only available to be used when the corporate business becomes profitable. This is why the general rule is to carry on a business as a sole proprietor during years in which losses are anticipated and to only incorporate when the business becomes profitable to take advantage of income tax rates that are lower for corporations than they are for individuals.

Type: ES

Topic: Income tax savings & deferral - the decision to incorporate a business

7) Provinces and territories have sometimes declared a tax holiday (i.e., a period in which no provincial or territorial income tax will be payable) for new CCPCs that commence a business within the province or territory. The objective in granting this tax free period is to encourage economic growth and employment. Describe the impact of such tax holidays on the type of compensation that will be used for the owner-manager of the business. Explain your conclusion.

Answer: The effect of a provincial/territorial income tax holiday for a CCPC is to reduce the overall corporate income tax rate on the first $500,000 of active business income to 9% (38% - 10% - 19% + 0%). This is 4.04% below the 13.04% rate that is assumed in perfecting integration and, as a consequence, the tax deduction associated with salary payments would be less significant. Without considering other factors, the presence of a provincial/territorial income tax holiday would favour the use of dividend payments to the owner-manager over the use of salary compensation.

Type: ES

Topic: Corporate concepts - provincial tax holidays

8) Indicate the conditions that are necessary for integration to work for income earned by a public company.

Answer: For integration to work for a public company, the combined federal/provincial/territorial income tax rate on corporations must be 27.54%. In addition, the provincial/territorial dividend tax credit for eligible dividends must be equal to 5/11 of the dividend gross up.

Type: ES

Topic: Integration - general concepts

9) What is "bonusing down"? What is the advantage that results from the use of this tax planning technique?

Answer: Bonusing down is a tax planning technique that involves paying deductible salary to owner-managers in order to reduce a CCPC's active business income to the amount that is eligible for the SBD. The advantage of bonusing down is that the personal income taxes paid on the salary will sometimes be less than the corporate income tax on income in excess of the SBD, combined with the income taxes paid by the owner-manager when the after tax income is distributed as taxable dividends.

Type: ES

Topic: Trusts - income tax planning

10) Ms. Copeland has invested in the common shares of a number of large Canadian public companies, all of which pay eligible dividends. She has no intention of selling the shares in the foreseeable future. She has asked your advice as to whether there would be either tax deferral or tax savings if she incorporated these investments to a private company. She would be the only shareholder of this new company. Ms. Copeland has sufficient other income that she is in the 29% federal income tax bracket. She lives in a province where her marginal income tax rate is 12% and the provincial dividend tax credit on both eligible and non-eligible dividends is equal to 25% of the dividend gross up.

Answer: If Ms. Copeland receives the taxable dividends directly, the effective income tax rate will be 26.4% {[(Dividends)(138%)(29% + 12%)] - [(Dividends)(38%)(6/11 + 25%)]}. Given that her investments are in large public companies, if she incorporates, the dividends would be subject to Part IV tax at a rate of 38-1/3%. This means that there is no tax deferral through the use of a corporation in this situation.

With respect to income tax savings, the 38-1/3% Part IV tax is refunded and the full amount of taxable dividends received by the corporation could be paid out to Ms. Copeland. The income tax that she would pay would be exactly the same as if she had received the taxable dividends directly. This means that there would be no income tax savings through the use of a corporation in this situation.

Type: ES

Topic: Income tax savings & deferral - the decision to incorporate investments

11) For an individual in the maximum income tax bracket, incorporating sources of income such as a business or investments can result in tax deferral. Depending on corporate income tax rates, this may or may not be beneficial to the individual. Explain this statement.

Answer: When a source of income is incorporated, there are two levels of income tax. Income taxes are imposed on the corporation on the income and again by the individual shareholder when after tax corporate income is distributed as taxable dividends. If the individual does not require all of the income for personal needs and can leave some part of the income in the corporation, the second level of personal income tax can be delayed/deferred. However, whether or not this will be beneficial depends on the combined federal/provincial/territorial income tax rate of the corporation. If this combined corporate income tax rate is less than the rate that would have applied to the individual had the source of income not been incorporated, the deferral will be beneficial. If the combined rate is higher, there will be no deferral.

Type: ES

Topic: Income tax savings & deferral - the decision to incorporate investments

12) For a CCPC paying eligible dividends, perfect integration occurs which the combined federal/provincial/territorial corporate income tax rate is 27.54% and the combined federal/provincial/territorial dividend tax credit is equal to the dividend gross up. Briefly explain how rates that differ from these affect the outcome of incorporating sources of income.

Answer: With respect to combined federal/provincial/territorial corporate income tax rates, rates that are higher than 27.54% make the use of a corporation less desirable, while rates that are less than 27.54% make incorporation more desirable.

With respect to the combined federal/provincial/territorial dividend tax credit, a credit that is larger than the dividend gross up will make incorporation more desirable, while a credit that is smaller than the dividend gross up will make the use of a corporation less desirable.

Type: ES

Topic: Integration - eligible dividends

13) In 2022 a single individual with no income can receive $31,450 in non-eligible dividends without incurring any income tax liability. In contrast, such an individual would start paying income tax in 2022 after receiving only $14,398 in interest income. Explain this difference in treatment of the two types of income.

Answer: For each dollar of non-eligible dividends received, the individual must add a gross up of $0.15 to net income and taxable income. For individuals in the lowest federal income income tax bracket, the federal income tax on this amount will be $0.1725 [($1.15)(15%)]. However, there will be a federal credit against this tax payable equal to 9/13 of the gross up, or $0.1038 [(9/13)($0.15)]. This means that, as long as an individual is in the lowest federal income tax bracket, the increase in income tax associated with one dollar of non-eligible dividends received can be calculated as follows:

Federal Income Tax on Grossed up Dividend $.1725

Federal Dividend Tax Credit ( .1038)

Increase in Federal Income Tax $.0687

As compared to an increase in federal income tax of $0.15 for each one dollar increase in interest income, there is only a $0.0687 increase in federal income tax for each one dollar increase in taxable dividends received. This means that dividend income uses up an individual's available tax credits at a much slower rate than other types of income. For example, while one dollar of interest income will use up one dollar [($1.00)($.15 ÷ $.15)] of an individual's personal tax credit base of $14,398, one dollar of non-eligible dividends received will use up only $0.458 of this base [($1.00)($.0687 ÷ $.15)]. This means that, in comparison with other types of income, a much larger amount of dividends can be received before an individual's tax credits are absorbed and income tax will have to be paid.

Conceptually the reasoning is that when an individual earns interest income it is only that individual that is paying the income tax. However when an individual receives eligible or non-eligible dividends the underlying corporate income tax on the income that funds the dividends has already been charged therefore it is only the next level or personal income tax that is required to be paid by the individual which justifies a lower amount of income tax.

Type: ES

Topic: Integration - general concepts

14) Jessica Simsung has 2 children over the age of 20. While Ms. Simsung has several million dollars invested in shares of public companies that earn a substantial rate of return through taxable dividends, her children have no income of their own. Ms. Simsung has employment income which places her in the maximum income tax bracket. Describe briefly how Ms. Simsung could use a corporation to split income with her children.

Answer: Ms. Simsung could incorporate a new corporation and incorporate her investments which essentially means she would sell the investments to her own corporation. The corporation would pay for the investments with a combination of interest bearing debt at the prescribed interest rate, along with preferred voting shares. Her children could then purchase non-voting shares with the right to receive the income from the investments. Depending on the amount of such income, the income could be received on a tax free basis. Alternatively, if Ms. Simsung continues to own the investments personally, this income would be taxed at her maximum income tax rate. Note, however, that this strategy does not work if her children will be subject to the Tax on Split Income (TOSI).

Type: ES

Topic: Income splitting (TOSI) - general concepts

15) In making management compensation decisions, how does the owner-manager environment differ from that of a publicly traded company?

Answer: Unlike the situation with publicly traded companies, the owner-manager is subject to few constraints on the use of corporate property. In effect, the individual would be in a position to personally benefit from the use of the corporation and to personally benefit others such as family members without review by internal and external auditors or concern about the financial effects on unrelated shareholders. This allows the owner-manager much more flexibility in designing a compensation package.

Type: ES

Topic: Corporate concepts - owner-manager corporations vs public corporations

16) One of your friends, who is the sole shareholder of a private corporation, has decided that it would be a good idea to have the company pay for a swimming pool at his personal residence. He has concluded that this would be better than paying himself sufficient salary to construct the pool with his own funds. Do you agree? Explain your conclusion.

Answer: This would not be a good idea. To begin, the FMV of the pool would be included in your friend's income as a shareholder benefit under ITA 15(1). The amount included in the shareholder's income would not be deductible to the company. The friend would be better off either paying sufficient salary to finance the pool (while he would pay income tax on the additional salary, the amount paid would be deductible to the company) or, alternatively, paying sufficient dividends to finance the pool (while the dividends could not be deducted by the corporation, they would be taxed more favourably than the taxable benefit resulting from the construction of the pool). A better option would be for the friend to borrow the necessary funds on an interest-free basis from the corporation resulting in little income tax consequences.

Type: ES

Topic: Shareholder benefits - ITA 15(1)

17) The general rule for shareholder loans is that they must be included in the shareholder's income when received. Indicate two exceptions to this general rule that are available to all shareholders, without regard to whether they are employees as well as shareholders.

Answer: The two required exceptions can be selected from the following:

• The general rule does not apply when the loan is in the ordinary course of the corporation's business.

• The general rule does not apply when the loan is repaid within one year after the end of the taxation year of the lender or creditor in which the loan was made or the indebtedness arose.

Type: ES

Topic: Shareholder loans - ITA 15(2)

18) If the owner-manager of a private corporation borrows funds from the corporation to assist in purchasing a home, one of the conditions to avoid having to include the loan principal in income requires that the loan be received in an employment capacity, rather than in a shareholder capacity. Explain why this may be difficult to justify.

Answer: In order to make a convincing case that the loan was received by the owner-manager in an employment capacity, the same type of loan must be extended to all employees with similar duties and responsibilities. If the loan is particularly large, or on particularly favourable terms, the owner-manager may not be able to justify a loan in an employment capacity. In addition, in some cases the business may not have other senior employees or any other employees at all. This could make it difficult to argue an employee capacity based loan. The CRA, in cases where a private corporation has few employees with which to make a comparison, looks to what is standard or accepted practice within a given industry in deciding whether a loan is received in an employment capacity.

Type: ES

Topic: Shareholder loans - ITA 15(2)

19) John Brothers is a shareholder and employee of Brothers Ltd. Brothers Ltd. provides John with an interest free loan to assist him in purchasing a home after being moved to a new work location. Explain why John would prefer to have any loan benefit taxed as as an employee benefit, rather than as a shareholder benefit.

Answer: There are two advantages to having an employee benefit, rather than a shareholder benefit:

• The principal amount does not have to be included in John's income when the loan is made as long as all of the conditions for the exception apply. Such loans received in a shareholder capacity would not qualify for the housing loan exception.

• If the loan is an employee loan, for the first five years of the loan, the benefit calculation rate will go no higher than the prescribed interest rate that was in effect when the loan was made. In other words employment capacity loans have a five year locked in rate to determine the annual interest benefit.

Type: ES

Topic: Shareholder loans - ITA 15(2)

20) Provide two examples of forms of employee compensation that can either reduce or defer income tax to a corporation and its shareholders. For each example, explain how the reduction or deferral occurs.

Answer: • **Registered Pension Plans (RPP) -** Within prescribed limits, a corporation can deduct contributions to an RPP in the year of the contribution. These contributions are not included in the income of the employee as compensation until received as a pension benefit which typically occurs when the individual reaches retirement age, resulting in an effective tax deferral arrangement.

• **Deferred Profit Sharing Plans (DPSP) -** In a fashion similar to an RPP, amounts that are contributed to a DPSP are deductible to the corporation but are deferred until benefits are received from the plans by employees years later.

• **Private Health Services Plans (PHSP) -** The premiums paid by the corporation for such benefits as dental plans can be deducted in full by the corporation and are not considered taxable employee benefits. This can generate a significant income tax savings.

• **Stock Options -** Stock options provide employees with an incentive to improve the performance. In addition, taxation of any benefits resulting from the options is deferred until the option are exercised or sold. (For a full discussion of the deferral of stock option benefits, see Chapter 3.) Further, the amount of the employment benefit is, in general, only 50% of the actual benefit.

Type: ES

Topic: Employee compensation - tax reduction & tax deferral

21) List and describe three factors, other than tax reduction and tax deferral, that should be considered by an owner-manager when choosing between salary and taxable dividends.

Answer: The required three factors could be chosen from the following:

• Corporate Income Tax - Salary is deductible and taxable dividends are not.

• The added costs of CPP, EI, and payroll taxes discourage the use of salary.

• Taxable dividends do not provide an addition to earned income for RRSP purposes.

• Taxable dividends do not provide an addition to earned Income for child care expense purposes.

• Taxable dividends reduce a CNIL balance and increase the amount of available capital gains deduction.

• Salary can provide CPP and Canada Employment tax credits.

Type: ES

Topic: Employee compensation - salary vs dividends

22) Even in situations where provincial/territorial tax and dividend tax credit rates favour the use of taxable dividends, owner-managers may retain more after tax income if they receive some part of their compensation in the form of salary. Explain this statement.

Answer: As taxable dividends use up available tax credits at a much slower rate than is the case with salary, the payment of all compensation in the form of taxable dividends may result in unused personal tax credits for the current taxation year. As most of these credits are non-refundable, if they are not used during the current year they will be lost. Given this, it may be beneficial to pay a combination of salary and taxable dividends that is sufficient to use up all of the individual's non-refundable personal tax credits.

Type: ES

Topic: Employee compensation - salary vs dividends

23) An advantage of incorporating a business is the ability to use business losses to reduce income tax on an individual's other income.

Answer: FALSE

Explanation: Corporate losses belong to the corporation and cannot be used against any of an individual shareholder's other income.

Type: TF

Topic: Income tax savings & deferral - the decision to incorporate a business

24) The use of a corporation can facilitate splitting income with other members of an individual's family.

Answer: TRUE

Type: TF

Topic: Income splitting (TOSI) - general concepts

25) For eligible dividends, perfect integration requires that the provincial/territorial dividend tax credit be equal to 5/11 of the dividend gross. If the provincial/territorial credit is larger than this, the use of a corporation will be less attractive.

Answer: FALSE

Explanation: The higher credit makes using a corporation more attractive because an excessive credit over-compensates for corporate income tax paid.

Type: TF

Topic: Integration - eligible dividends

26) "Bonusing Down" is a procedure that owner-managers use to defer income tax on the salary amounts that they receive from their corporation.

Answer: FALSE

Explanation: It is a procedure that is used to avoid having amounts of active business income in excess of amounts eligible for the SBD taxed at high corporate income tax rates.

Type: TF

Topic: Trusts - income tax planning

27) Individuals with no income can receive a substantial amount of taxable dividends on a tax free basis. This is because taxable dividend income uses up an individual's tax credits at a lower rate than is the case with other income.

Answer: TRUE

Type: TF

Topic: Integration - general concepts

28) An owner-manager of a construction company would like to have a swimming pool installed at the individual's home. It doesn't really matter whether the individual has the corporation install the pool or, alternatively pay sufficient salary so that the individual can pay for the pool on their own.

Answer: FALSE

Explanation: If the corporation pays for the pool, there will be a taxable benefit equal to the FMV of the pool. While the income tax on the shareholder benefit are likely to be similar to those that would have been paid on an equivalent amount of salary, the main difference is that the corporation would be able to deduct the salary but cannot deduct any amount that relates to the shareholder benefit.

Type: TF

Topic: Shareholder benefits - ITA 15(1)

29) Jo Beth Williams is employed by the Royal Bank and also owns a few shares of the bank. The bank has extended her a $25,000 interest free loan that she can use for any purpose she chooses. Because she is a shareholder, she will have to include the $25,000 principal of the loan in her net income.

Answer: FALSE

Explanation: Shareholder loans do not have to be included in net income if the corporation (the Bank) makes loans in the ordinary course of its business as the Royal Bank does.

Type: TF

Topic: Shareholder loans - ITA 15(2)

30) A shareholder loan with repayment terms that is for the purposes of purchasing a home does not have to be included in the shareholder's net income, provided the loan was received in an employment capacity.

Answer: TRUE

Type: TF

Topic: Shareholder loans - ITA 15(2)

31) Any form of compensation that is deductible to a corporation in a taxation year prior to the year in which it is required to be included in the income of a shareholder/employee results in tax deferral.

Answer: TRUE

Type: TF

Topic: Income tax concepts - tax reduction & tax deferral

32) If an owner-manager wishes to make contributions to an RRSP, the individual will prefer taxable dividends over salary compensation.

Answer: FALSE

Explanation: Salary increases earned income base for purposes of making RRSP contributions. Taxable dividends do not increase earned income.

Type: TF

Topic: Employee compensation - salary vs dividends

33) All other things being equal, higher provincial/territorial income tax rates on corporations favour the use of a corporation to earn business income.

Answer: FALSE

Explanation: Higher provincial/territorial corporate income tax rates discourage the incorporation of sources of income.

Type: TF

Topic: Income tax savings & deferral - general concepts

34) In cases where a corporation is subject to a low income tax rate (e.g., a combined federal/provincial/territorial rate of 11%), charitable donations have less value to a corporation than they do to an individual.

Answer: TRUE

Explanation: As charitable donations are a taxable income deduction to a corporation, they would have a value of $0.11 on the dollar to a corporation that is subject to a small business income tax rate of 11%. In contrast, donations made by individuals create a federal credit against income tax payable of $0.15, $0.29 or $0.33 on the dollar, all of which are higher than the combined rate of $0.11. There would be additional credits at the provincial/territorial level for individuals.

Type: TF

Topic: Charitable donations - corporate vs individual contributions

35) Income splitting refers to tax planning designed to spread an individual's income over several taxation years.

Answer: FALSE

Explanation: Income splitting refers to planning designed to shift income between family members with the objective of reducing the effective income tax rate for the family as a whole.

Type: TF

Topic: Income tax planning - income splitting

36) All other things being equal, a low provincial/territorial dividend tax credit favours the use of taxable dividends to compensate the owner/manager of a CCPC.

Answer: FALSE

Explanation: A low provincial/territorial dividend tax credit means that the individual shareholder is being ender-compensated for the underlying corporate income tax which favours the use of salary.

Type: TF

Topic: Integration - general concepts

37) If the owner/manager of a CCPC has a large Cumulative Net Investment Loss (CNIL) balance, taxable dividends should be paid rather than salary.

Answer: TRUE

Explanation: Taxable dividends reduce the CNIL balance and, as a result, increase the available capital gains deduction.

Type: TF

Topic: Employee compensation - salary vs dividends

38) Any resident Canadian individual over the age of 17 can, in 2022, receive $31,450 in non-eligible dividends from a CCPC without paying any federal income tax regardless of other income.

Answer: FALSE

Explanation: Only individuals with no income can receive this amount of dividends tax free.

Type: TF

Topic: Integration - non-eligible dividends

39) Which of the following statements about the use of a corporation is **NOT** correct?

A) The use of a corporation is more desirable in a province or territory with a high dividend tax credit.

B) The use of a corporation will always result in deferral of income tax on income retained by a corporation.

C) The use of a corporation is less desirable in a province or territory with a low dividend tax credit.

D) The use of a corporation is more desirable in a province or territory that has high income tax rates on individuals.

Answer: B

Explanation: B) The use of a corporation will always result in deferral of tax on income that is retained by a corporation. For some types of corporate income, the corporate income tax rate may be higher than the income tax that would have applied to an individual.

Type: MC

Topic: Corporate concepts - the decision to incorporate

40) Which of the following is **NOT** a possible advantage of incorporating a business?

A) The ability to defer income tax on income retained by the corporation.

B) The ability to use corporate business losses to reduce income tax on the employment income of the individual.

C) Limiting personal liability to the amount paid to the corporation for its' shares.

D) The ability to use the capital gains deduction.

Answer: B

Explanation: B) The ability to use corporate business losses to reduce income tax on the employment income of the individual.

Type: MC

Topic: Corporate concepts - the decision to incorporate

41) Individual taxpayers decide to incorporate for many reasons. In which of the following situations would there be an advantage to the incorporation of a business?

A) The individual has significant personal losses and is looking for a way to utilize them.

B) The individual has significant personal property and investment income, and does not need all of the cash from the business in order to pay day to day living expenses.

C) The individual has significant personal property and investment income, and needs all of the cash from the business in order to pay day to day living expenses.

D) The individual makes significant charitable donations each year and wants to use a corporation to maximize the tax savings from these donations.

Answer: B

Explanation: B) The individual has significant personal property and investment income, and does not need all of the cash from the business in order to pay day to day living expenses.

Type: MC

Topic: Corporate concepts - the decision to incorporate

42) The use of a corporation is most likely to result in an overall reduction in total income tax by an individual and a corporation if:

A) the corporation is a public company earning manufacturing income.

B) the corporation is a CCPC earning taxable dividends.

C) the corporation is a CCPC earning other investment income.

D) the corporation is a CCPC earning active business income.

Answer: D

Explanation: D) The corporation is a CCPC earning active business income.

Type: MC

Topic: Corporate concepts - the decision to incorporate

43) There are several benefits to incorporating a business. Which of the following statements about such benefits is correct?

A) Investment income under $500,000 is eligible for a lower income tax rate; taxable dividend payments may be deferred until after a shareholder has retired; and the capital gains deduction may be available if conditions are met.

B) Active business income under $500,000 is eligible for a lower income tax rate; taxable benefits may be provided to the shareholder if they are an employee; and taxable dividend payments may be deferred until after a shareholder has retired.

C) The capital gains deduction may be available if conditions are met; a tax deferral is available if the shareholder requires the corporation's profits for personal use in the year; and taxable dividend payments may be deferred until after a shareholder has retired.

D) Taxable dividend payments may be deferred until after a shareholder has retired; The capital gains deduction may be available if conditions are met; and active business income under $500,000 is eligible for a lower income tax rate.

Answer: D

Explanation: D) Taxable dividend payments may be deferred until after a shareholder has retired; The capital gains deduction may be available if conditions are met; and active business income under $500,000 is eligible for a lower income tax rate.

Type: MC

Topic: Corporate concepts - the decision to incorporate

44) Joan Barskey purchased 4,500 shares in Barskey Inc., a corporation that is controlled by her family. The cost of these shares was $900,000. In addition, she has personally guaranteed a bank loan for Barskey Inc. in the amount of $250,000. If Barskey Inc. goes bankrupt, which of the following statements is correct?

A) Joan's financial risk is limited to $1,150,000.

B) Joan's financial risk is limited to $900,000.

C) Joan's financial risk is limited to $250,000.

D) Joan's financial risk is unlimited.

Answer: A

Explanation: A) Joan's financial risk is limited to $1,150,000 which is the amount she would potentially lose.

Type: MC

Topic: Corporate concepts - limited liability

45) Mr. Dawson is considering incorporating a company and incorporating some of his income earning property to take advantage of the possibility of some income tax savings and deferral possibilities. Which of the following situations would provide the largest income tax savings for Mr. Dawson?

A) Incorporating a CCPC earning only Active Business Income (ABI) eligible for the SBD.

B) Incorporating a CCPC earning a 50/50 combination of ABI eligible for the SBD and investment income.

C) Incorporating a CCPC earning only investment income.

D) Incorporating a CCPC earning only taxable dividend income.

Answer: A

Explanation: A) Incorporating a CCPC earning only Active Business Income (ABI) eligible for the SBD.

Type: MC

Topic: Corporate concepts - the decision to incorporate

46) GMR Inc is a CCPC owned 100% by Ms. Rothstein. For the current year, the company accountant is predicting that taxable income will exceed $500,000. The accountant has suggested that Ms. Rothstein should consider having the company pay her additional salary to ensure the taxable income of the CCPC will be less than $500,000. Why?

A) Because only income eligible for the SBD benefits from a modest tax deferral and significant tax savings.

B) Because the CRA will never challenge the reasonableness of remuneration to a shareholder, and the accountant must feel that Ms. Rothstein deserves a bonus this year.

C) Because if the income over $500,000 remains in the company it will not benefit from the SBD, and therefore after tax retention on this excess income in the company will be lower than it would be on paying a salary to Ms. Rothstein.

D) Because the case for "bonusing down" has gotten stronger in the past few years, and it is therefore more important than ever to take advantage of this possibility to save income tax.

Answer: C

Explanation: C) Because if the income over $500,000 remains in the company it will not benefit from the SBD, and therefore after tax retention on this excess income in the company will be lower than it would be on paying a salary to Ms. Rothstein.

Type: MC

Topic: Trusts - income tax planning

47) John is thinking about incorporating his charter boat business. Which of the following describes an advantage that could be associated with incorporating the business as compared to carrying it on as a sole proprietor?

A) John could use any future business losses to offset his employment income and reduce his personal income tax.

B) John could protect himself from being held personally liable if a client sustained injuries by falling overboard.

C) John could hire his brother to pilot the boat on days when he is not available. His brother's salary would be deductible in calculating the corporation's income.

D) John will not pay CPP on any salary paid to him by the corporation if he owns more than 40% of the voting shares.

Answer: B

Explanation: B) John could protect himself from being held personally liable if a client sustained injuries by falling overboard.

D) The 40% exception applies to EI premiums and not to CPP.

Type: MC

Topic: Corporate concepts - the decision to incorporate

48) An individual's only income is from taxable dividends from shares of public companies. The individual is considering incorporating the public company shares. If the individual was to do so, which of the following statements is correct?

A) There would be a reduction in the individual's total income tax.

B) There would always be deferral of income tax as long as the taxable dividend income was retained in the corporation.

C) All of the federal corporate income tax paid on the taxable dividends would be refunded when all of the dividends received by the corporation are paid out to the individual shareholder.

D) The individual taxes on the taxable dividends would be lower after they have passed through the corporation.

Answer: C

Explanation: C) All of the federal corporate income tax paid on the taxable dividends would be refunded when all of the dividends received by the corporation are paid out to the individual shareholder.

Type: MC

Topic: Income tax savings & deferral - the decision to incorporate investments

49) With respect to the incorporation of a business earning less than $500,000 of ABI, which of the following statements is correct?

A) Incorporation will always result in an overall reduction in income tax because it combines the SBD with the dividend tax credit.

B) Incorporation will result in an overall reduction in income tax because corporations are able to deduct many items that cannot be deducted by an unincorporated business.

C) Incorporation will result in a deferral of income tax to the extent profits are retained in the corporation.

D) Incorporation will be beneficial because it will always limit the shareholders' obligations to creditors.

Answer: C

Explanation: C) Incorporation will result in a deferral of income tax to the extent profits are retained in the corporation.

Type: MC

Topic: Income tax savings & deferral - the decision to incorporate a business

50) An individual carries on a retail business as a sole proprietor. The business earns $150,000 annually, all of which is needed by the individual for personal living expenses. The individual is considering incorporating the business. Which of the following statements is correct?

A) There may be a small income tax advantage associated with incorporation.

B) The application of the SBD will result in a significant reduction in overall income tax.

C) The application of the SBD will result in a significant deferral of income tax payments.

D) The application of the gross up and tax credit procedures for taxable dividends will result in a significant reduction in overall income tax.

Answer: A

Explanation: A) There may be a small income tax advantage associated with incorporation. C is incorrect as the individual needs all of the earnings so there is no deferral.

Type: MC

Topic: Income tax savings & deferral - the decision to incorporate a business

51) Joan Farnun has annual employment income of $100,000. This employment income is sufficient to cover her personal living expenses. In addition, she carries on a consulting business as a sole proprietor which earns $50,000 annually. She is considering incorporating the consulting business. With respect to the incorporation, which of the following statements is correct?

A) There will be an overall income tax savings because of the SBD.

B) There will be an overall income tax savings because of the dividend tax credit.

C) There will be tax deferral because of the SBD.

D) There will be no tax deferral because of the integration provisions in the *Income Tax Act*.

Answer: C

Explanation: C) There will be income tax deferral because of the SBD.

Type: MC

Topic: Income tax savings & deferral - the decision to incorporate a business

52) Which of the following factors is **NOT** significant in contributing to imperfections in the integration system for corporate income tax?

A) Varying provincial/territorial rates for the dividend tax credit.

B) Varying provincial/territorial rates for corporate income tax on CCPCs.

C) Differing federal dividend tax credit rates for eligible and non-eligible dividends.

D) Varying provincial/territorial rates for corporate income tax on public companies.

Answer: C

Explanation: C) Differing federal dividend tax credit rates for eligible and non-eligible dividends.

Type: MC

Topic: Integration - general concepts

53) The use of a corporation to provide tax deferral is most successful when:

A) the combined federal/provincial/territorial income tax rate on corporations is greater than the combined federal/provincial/territorial income tax rate on individuals.

B) the combined federal/provincial/territorial income tax rate on corporations is less than the combined federal/provincial/territorial income tax rate on individuals.

C) the combined federal/provincial/territorial income tax rate on corporations is equal to the combined federal/provincial/territorial income tax rate on individuals.

D) the combined federal/provincial/territorial dividend tax credit rates add up to 100% of the dividend gross up.

Answer: B

Explanation: B) The combined federal/provincial/territorial income tax rate on corporations is less than the combined federal/provincial/territorial income tax rate on individuals.

Type: MC

Topic: Integration - general concepts

54) Which of the following factors is **NOT** relevant in determining whether a corporation can be used to reduce income tax?

A) The combined federal/provincial/territorial income tax rate on corporations.

B) The combined federal/provincial/territorial dividend tax credit.

C) The combined federal/provincial/territorial income tax rate on individuals.

D) All of the above factors are relevant in determining whether a corporation can be used to reduce overall income tax.

Answer: C

Explanation: C) The combined federal/provincial/territorial income tax rate on individuals.

Type: MC

Topic: Integration - general concepts

55) Which of the following statements with respect to the ability of an individual to receive a large amount of taxable dividends without paying any income tax is correct?

A) Any individual can receive a significant amount of eligible dividends without the payment of income tax on the amounts received.

B) For an individual in the lowest income tax bracket, the dividend tax credit will be larger than the income tax on the grossed up dividends.

C) To be received on a tax free basis, taxable dividends must be designated as eligible.

D) For individuals in the lowest income tax bracket, taxable dividends always use up tax credits at a slower rate than other types of income.

Answer: D

Explanation: D) For individuals in the lowest income tax bracket, dividends always use up tax credits at a slower rate than other types of income.

Type: MC

Topic: Integration - general concepts

56) While of the following statement about income splitting is **NOT** correct?

A) For income splitting to be a useful tax planning tool, the related individuals must be in different income tax brackets.

B) Income splitting can only be accomplished by using a corporation.

C) Income splitting may be accomplished by giving shares in an owner-managed corporation to adult children who are in a low income tax bracket.

D) Income splitting can be accomplished by selling shares in an owner-managed corporation to the owner-manager's spouse.

Answer: B

Explanation: B) Income splitting can only be accomplished by using a corporation.

Type: MC

Topic: Income tax planning - income splitting

57) The general rule is that loans made to shareholders must be included in the shareholder's income in the calendar year that the loan is received. There are, however, a number of exceptions to this rule. Which of the following is **NOT** an exception to the general rule?

A) A loan to an owner-manager to assist in the purchase of a principal residence. The loan does not have a specific repayment date.

B) An interest free loan to an employee/shareholder of a bank.

C) A loan to an owner-manager to acquire an automobile that will be used in the individual's employment duties. The company has no other employees.

D) A loan extended to an owner manager that must be repaid within two years. The company has a December 31 taxation year end and the loan is made on January 1 of the current year.

Answer: A

Explanation: A) A loan to an owner-manager to assist in the purchase of a principal residence. The loan does not have a specific repayment date.

Type: MC

Topic: Shareholder loans - ITA 15(2)

Use the following information to answer the questions below.

A corporation loans a shareholder $30,000 on April 1, 2022, interest free. The shareholder is not an employee of the corporation. The taxation year end of the corporation is October 31. Assume the prescribed rate is 2% for all years under consideration.

58) The shareholder purchases investments with the $30,000. The loan is to be repaid on December 31, 2025. The increase in 2022 net income of the shareholder due to the loan and the investment of the proceeds is:

A) $450.

B) $600.

C) $30,000.

D) $30,450.

E) $30,600.

F) Nil.

Answer: C

Explanation: C) The amount of the loan of $30,000 must be added to the shareholder's income as the loan is not going to be paid by October 31, 2023. No imputed interest benefit will be added to income since the loan is included in income.

Type: MC

Topic: Shareholder loans - ITA 15(2)

59) The shareholder purchases investments with the $30,000. The loan is to be repaid on April 1, 2023. The increase in 2022 net income of the shareholder as a result of the loan and the use to purchase investments is:

A) $450.

B) $600.

C) $30,000.

D) $30,450.

E) $30,600.

F) Nil.

Answer: F

Explanation: F) The imputed interest of $450 [(9/12)(2%)($30,000)] will be added to income. However, as the proceeds of the loan were used to earn income, the imputed interest is deductible under ITA 20(1)(c) through ITA 80.5. The net effect on net income is nil.

Type: MC

Topic: Shareholder loans - ITA 15(2)

60) A shareholder sells their home and purchases another, larger house, in the same neighbourhood, using the $30,000. The loan is to be repaid in full on December 31, 2025. The increase in 2022 net income of the shareholder as a result of the loan and its use is:

A) $450.

B) $600.

C) $30,000.

D) $30,450.

E) $30,600.

F) Nil.

Answer: C

Explanation: C) The amount of the loan of $30,000 must be added to the shareholder's income as the loan is not going to be paid by October 31, 2023 and there are no other exceptions that would exclude the loan from being included in income. No imputed interest will be added to income since the loan principal is included in income. Since the shareholder is not an employee, there is no exception for a housing loan.

Type: MC

Topic: Shareholder loans - ITA 15(2)

61) Albert Jay is an employee and 15% shareholder of Rick's Welding Shop Ltd. (Rick's). During the 2022 calendar year, Albert Jay was having cash flow problems. Rick's made a loan to Albert Jay of $5,000 on May 1, 2022 to help him out. Rick's also gave Albert Jay's son, Jake, a loan of $2,000 on September 30, 2022 to help him meet expenses while at college. Rick's has said that Albert Jay and Jake can repay the loans whenever they can afford it. The loans remain outstanding as at January 31, 2024. Rick's year end for accounting and taxation purposes is December 31.

How much, and in which taxation year, is Albert Jay required to include in his net income as a result of the above transactions?

A) $5,000 - 2022.

B) $5,000 - 2023.

C) $7,000 - 2022.

D) $7,000 - 2023.

E) None of the above.

Answer: A

Explanation: A) $5,000 in 2022. ITA 15(2) requires the principal amount of the loan to be included in the income of the recipient of the loan. In this case, Albert Jay will add $5,000 in 2022 and his son would include $2,000 in income for 2022, as the loans were still outstanding on January 31, 2024. Had the loans been repaid by December 31, 2023 they would not have been included in net income although an interest benefit would have been required to be included in income for each year in which the loan was outstanding.

Type: MC

Topic: Shareholder loans - ITA 15(2)

62) Jacquie is the sole shareholder of Holdings Ltd., which has a January 31 taxation year end. On January 1, 2022, Jacquie borrowed $10,000 interest-free from Holdings Ltd. She used $8,000 of this amount to acquire shares of Arrow Inc. and the remaining $2,000 for personal purposes. Arrow Inc. is a small CCPC that manufactures cross-bows. In March 2022, Arrow Inc. paid a non-eligible dividend of $1,100 to Jacquie. Jacquie repaid the $10,000 loan to Holdings Ltd. in full on June 30, 2022.

Assume that these were her only transactions with Holdings Ltd. and the prescribed interest rate was 4% for the first quarter of 2022 and 3% for the second quarter of 2022. Which one of the following represents the effect on Jacquie's 2022 net income as a result of these transactions?

A) $1,100.00.

B) $1,265.00.

C) $1,299.68.

D) $1,438.42.

Answer: C

Explanation: C) Jacquie's 2022 net income effect is:

Grossed up Non-Eligible Dividend [($1,100)(115%)] $1,265.00

ITA 80.4 Interest Benefit

[($10,000)(4%)(90/365)] $98.63

[($10,000)(3%)(91/365)] 74.79 173.42

ITA 20(1)(c) Interest Deduction

[($10,000 - $2,000)(4%)(90/365)] ($78.90)

[($10,000 - $2,000)(3%)(91/365)] ( 59.84) ( 138.74)

Total $1,299.68

Type: MC

Topic: Shareholder loans - ITA 15(2)

63) Paul is one of six shareholders, but not an employee, of a CCPC that manufactures doors. The corporation has a large amount of cash on hand and the other shareholders have agreed that the corporation can lend Paul the $200,000 for a few years. To avoid having the principal included in his income, the loan must meet which of the following conditions?

A) Interest must be charged using the prescribed interest rate*.*

B) It must be used for the purchase of the company's shares.

C) It must be repaid within one year from the end of the taxation year of the corporation in which it was made.

D) It must have a specific repayment date.

Answer: C

Explanation: C) It must be repaid within one year from the end of the taxation year of the corporation in which it was made.

Type: MC

Topic: Shareholder loans - ITA 15(2)

64) Martin Locks owns 100% of the shares of Locks Inc., a corporation with a December 31 taxation year end. Martin is also an employee of the corporation. In January 2022, the corporation loans Martin $350,000 in order to assist him in acquiring a new home. The loan is interest free and will be paid in full on January 1, 2024. While small loans are made to other employees of the Company, a loan of this size is only available to Martin. Assume that the prescribed interest rate is 4% throughout 2022 and 5% throughout 2023. Which of the following statements is correct?

A) Martin will have to include $350,000 in his income for 2022.

B) Martin will have to include $14,000 in his income in both 2022 and 2023.

C) Martin will have to include $14,000 in his income for 2022 and $17,500 in his income for 2023.

D) Martin will have to include $350,000 in income for 2022 only if the loan is not repaid by December 30, 2023.

Answer: A

Explanation: A) Martin will have to include $350,000 in his income for 2022.

Type: MC

Topic: Shareholder loans - ITA 15(2)

65) ITA 15(1) deals with situations where a corporation has provided a benefit to a shareholder. Which of the following transactions/events would **NOT** result in a ITA 15(1) shareholder benefit?

A) The corporation provides an interest free loan to the shareholder to assist in the purchase of a home suitable for entertaining business clients. An interest benefit is calculated.

B) The shareholder purchases a corporate owned vehicle for 50% of its FMV.

C) The shareholder takes a two week, $12,000 vacation paid for by the corporation. During the vacation, the shareholder attends a 1 day session on tax issues related to the corporation's business.

D) The corporation purchases life insurance on the life of the shareholder in order to ensure that the company has the necessary funds to deal with a sudden, unexpected death of the shareholder. The company is the beneficiary of the policy.

Answer: D

Explanation: D) The corporation purchases life insurance on the life of the shareholder in order to ensure that the company has the necessary funds to deal with a sudden, unexpected death of the shareholder. The company is the beneficiary of the policy.

Type: MC

Topic: Shareholder benefits - ITA 15(1)

66) Which of the following types of owner-manager compensation is the least likely to provide either tax deferral or tax savings?

A) Contributions to an RPP.

B) Contributions to a group disability plan

C) Granting options to acquire shares in the company.

D) Salary.

Answer: D

Explanation: D) Salary.

Type: MC

Topic: Employee compensation - tax reduction & tax deferral

67) An owner-manager can generally choose whether to receive compensation in the form of taxable dividends or, salary. All other things being equal which of the following would encourage the use of taxable dividends?

A) A desire to make contributions to an RRSP.

B) A low provincial/territorial dividend tax credit.

C) A desire to eliminate a large CNIL balance.

D) A high provincial/territorial corporate income tax rate.

Answer: C

Explanation: C) A desire to eliminate a large CNIL balance.

Type: MC

Topic: Employee compensation - salary vs dividends

68) Joan Barts owns all of the outstanding shares of Barts Ltd., a CCPC that is carrying on an active business. She would prefer to receive salary instead of taxable dividends if:

A) the corporation has a large RDTOH balance.

B) the corporation is located in a province or territory with a low corporate income tax rate.

C) the corporation has taxable income in excess of $500,000.

D) the corporation is located in a province or territory with a high dividend tax credit.

Answer: C

Explanation: C) The corporation has taxable income in excess of $500,000.

Type: MC

Topic: Employee compensation - salary vs dividends

69) Larry Watts, a Canadian resident, owns 49% of the shares of Zatch Ltd., a Canadian corporation. Laura Marsh, who is a resident of England, owns the remaining 51%. For the current year, the corporation has $150,000 in income, all of which will be paid out as either salary or eligible dividends. Because of other income, Larry is in the 29% federal income tax bracket and an 18% provincial income tax bracket. On both eligible and non-eligible dividends, the provincial dividend tax credit is equal to 30% of the gross up. Zatch Ltd. pays income tax at a combined federal/provincial rate of 31%. With respect to Larry's choice between receiving his share of the after tax corporate income in the form of salary or taxable dividends, which of the following statements is correct?

A) It does not matter whether he receives salary or dividends as he would retain the same after tax amount with either alternative.

B) He should take the salary because he will have more left after tax.

C) He should take taxable dividends because he will have more left after tax.

D) In order to fully use his personal tax credits, he should receive a combination of salary and taxable dividends.

Answer: B

Explanation: B) He should take the salary because he will have more left after tax. Since the Company is not a CCPC because it is controlled by a non-resident, it is not eligible for the SBD. The fact that the company will pay taxable dividends that are eligible for the enhanced gross up and tax credit procedures will not compensate Larry for corporate income taxes paid at a 31% rate (the rate assumed for the enhanced credit is 27.54%). Note that only non-eligible dividends should be paid to the non-resident since they are only subject to Part XIII tax on Canadian dividends.

Type: MC

Topic: Employee compensation - salary vs dividends

70) Sharon Hartly is the owner-manager of a CCPC from which she receives an annual salary of $70,000. In 2022, after deducting her salary, the CCPC will have additional income of $150,000. Sharon would like to take additional funds of $40,000 out of the corporation. Which of the following statements is correct?

A) The best solution is to take the funds out as salary as this will increase her pensionable earnings for CPP purposes.

B) The best solution is to take the funds out as a taxable dividend as this will have the lowest income tax cost.

C) The best solution is to take the funds out as salary because this will reduce her CNIL balance for purposes of the capital gains deduction.

D) The best solution is to take the funds out as salary so that she can maximize her contribution to her RRSP.

Answer: D

Explanation: D) The best solution is to take the funds out as salary so that she can maximize her contribution to her RRSP.

Type: MC

Topic: Employee compensation - salary vs dividends

71) Stephen Lee carries on a business as a sole proprietor and anticipates active business income (ABI) of $98,000 for the taxation year ending December 31, 2022. Mr. Lee also has employment income in excess of $800,000 with additional amounts subject to a provincial income tax rate of 16%. The provincial dividend tax credit is equal to 4/13 of the dividend gross up for non-eligible dividends. The provincial corporate income tax rate is 3% on income eligible for the SBD and 15% on other income.

Mr. Lee has asked your advice as to whether he should incorporate the business. Advise him with respect to any tax deferral that will be available on income retained by the corporation and on any income tax savings that will be available if all of the after-tax income is distributed as taxable dividends.

Answer: Mr. Lee's combined income tax rate on income earned by his business is 49% (33% + 16%). If he does incorporate, all of the $98,000 will be eligible for the SBD. This means that it will be subject to an income tax rate of 12% (38% - 10% - 19% + 3%).

Mr. Lee's personal income tax rate on non-eligible dividend income is 41.4% [(115%)(49%) - (9/13 + 4/13)(15%)]. Using these rates, the relevant calculations are as follows:

**With a Without a**

**Corporation Corporation**

Business Income $98,000 $98,000

Income Tax Rate 12% 49%

Income Tax $11,760 $48,020

Business Income $98,000 $98,000

Income Tax ( 11,760) ( 48,020)

Maximum Non-Eligible Dividend $86,240 N/A

Personal Income Tax on Dividends [(41.4%)($86,240)] ( 35,703) N/A

Income Retained by Mr. Lee $50,537 $49,980

There is clearly a significant amount of tax deferral with respect to income retained by the corporation. Income tax on the business income without incorporating the business is $48,020, far higher than the $11,760 that would be paid by the corporation were the business incorporated.

After tax retention with the use of a corporation would be $50,537. This is $557 more than the $49,980 that would be retained without a corporation. You should advise your client that, in addition to providing the possibility of tax deferral, using a corporation will also have a modest overall income tax savings.

Type: ES

Topic: Income tax savings & deferral - the decision to incorporate a business

72) Wanda Ho has annual employment income in excess of $300,000. Because of this, any additional income that she receives will be subject to a combined federal/provincial income tax rate of 51%. Several years ago, she began to carry on a business as a sole proprietor. She anticipates business income of $142,000 for the 2022 taxation year.

In her province of residence:

• the corporate income tax rate is 2.5% on income eligible for the SBD and 13% on other corporate income

• the dividend tax credit is 20% of the dividend gross up for non-eligible dividends and 30% for eligible dividends

Ms. Ho has asked your advice as to whether she should incorporate the business. Advise her with respect to any tax deferral that will be available on income retained by the corporation and on any tax savings that will be available if all of the after-tax income is distributed as taxable dividends.

Answer: Ms. Ho's personal income tax rate on income earned by her business is 51%. If she chooses to incorporate, all of the income earned by the corporation will be eligible for the SBD and will be subject to an income tax rate of 11.5% (38% - 10% - 19% +2.5%). Ms. Ho's income tax rate on non-eligible dividend is 45.3% [(115%)(51%) - (9/13 + 20%)(15%)].

Using these income tax rates, the relevant calculations are as follows:

**With a Without a**

**Corporation Corporation**

Business Income $142,000 $142,000

Income Tax Rate 11.5% 51%

Income Tax $ 16,330 $ 72,420

Business Income $142,000 $142,000

Income Tax ( 16,330) ( 72,420)

Maximum Non-Eligible Dividend $125,670 N/A

Personal Income Tax on Dividends [(45.3%)($125,670)] ( 56,929) N/A

Income Retained by Ms. Ho $ 68,741 $ 69,580

If Ms. Ho's continues to carry on the business as a sole proprietor, income tax on the business profits of $142,000 will be $72,420, which is more than four times the amount of income tax that would be paid by the corporation were the business incorporated. Therefore the income tax deferral is significant. However, there is an ultimate tax cost if the after-tax income is distributed by the corporation as taxable dividends. The tax cost is $839, $69,580 without the corporation, compared to $68,741 with the corporation.

Type: ES

Topic: Income tax savings & deferral - the decision to incorporate a business

73) Ms. Shauna MacDonald has investments that she anticipates will earn interest income of $143,000 for the 2022 taxation year. She has annual employment income in excess of $300,000 with additional amounts subject to a provincial income tax rate of 18%.

In her province of residence:

• the corporate income tax rate is 3% on income eligible for the SBD and 14% on other corporate income

• the dividend tax credit is 25% of the dividend gross up for non-eligible dividends

Ms. MacDonald has asked your advice as to whether she should incorporate her investments to a corporation in which she would own all of the shares. Advise her with respect to any tax deferral that could be available on after-tax income retained by the corporation and on any income tax savings that could be available if all of the after-tax income were distributed as taxable dividends.

Answer: Ms. MacDonald's combined personal income tax rate on the interest income is 51% (33% + 18%). If she incorporates, the interest income she will not be eligible for the SBD or the GRR and it will be subject to the ART. This means that, if the investments are incorporated, the interest will be subject to a corporate income tax rate of 52-2/3% (38% - 10% + 10-2/3% + 14%).

Ms. MacDonald's personal income tax rate on non-eligible dividends is 44.5% [(115%)(51%) - (9/13 + 25%)(15%)].

Using these income tax rates, a comparison of the income retained with and without the use of a corporation is as follows:

**With a Without a**

**Corporation Corporation**

Interest Income $143,000 $143,000

Income Tax Rate 52-2/3% 51%

Income Tax $ 75,313 $ 72,930

Interest Income $143,000 $143,000

Income Tax ( 75,313) ( 72,930)

Corporate Income before Dividend Refund $ 67,687 N/A

Maximum Dividend Refund (See Note) 42,075

Maximum Taxable Dividend Payable $109,762

Personal Income Tax on Dividends [(44.5%)($109,762)] ( 48,844)

Income Retained by Ms. MacDonald $ 60,918 $ 70,070

Non-Eligible RDTOH Balance [(30-2/3%)($143,000)] $43,853

**Note** - The refund is the lesser of 38-1/3% of taxable dividends paid and the balance in the Non-Eligible RDTOH account. The after tax funds would support a dividend of $109,762 ($67,687 ÷ .61667), including a potential dividend refund o f $42,075 [(38-1/3%)($109,762)]. The refund would be the lesser amount of $42,075.

As the corporate income tax rate is higher than the personal income tax rate of 51%, the corporation does not provide any tax deferral. In this case, incorporation requires prepayment of additional tax.

Using a corporation, she would be left with $60,918 in after tax funds as compared to $70,070 without the use of a corporation. The tax cost of incorporation is $9,152 ($70,070 - $60,918).

Type: ES

Topic: Income tax savings & deferral - the decision to incorporate investments

74) Victor Vice is a very conservative investor who only invests in fixed income securities. He anticipates that he will have interest income of $210,000 for the 2022 taxation year. As he has annual employment income in excess of $400,000, any additional income is subject to a combined federal/territorial income tax rate of 51%.

In his territory of residence:

• the corporate income tax rate is 3% on income eligible for the SBD and 13% on other corporate income

• the dividend tax credit is 30% of the dividend gross up for non-eligible dividends

Mr. Vice has asked your advice as to whether he should incorporate the interest bearing investments in which he would own all of the shares. Advise him with respect to any income tax deferral that could be available on income retained by the corporation and on any income tax savings that could be available if all of the after-tax income of the corporation is distributed as taxable dividends.

Answer: Victor's personal income tax rates are 51% on interest income and 43.8% [(115%)(51%) - (9/13 + 30%)(15%)] on non-eligible dividends. The corporate income tax rate on investment income will be 51-2/3% (38% - 10% + 10-2/3% + 13%).

Using these income tax rates, a comparison of the income retained with and without the use of a corporation is as follows:

**With a Without a**

**Corporation Corporation**

Interest Income $210,000 $210,000

Income Tax Rate 51-2/3% 51%

Income Tax $108,500 $107,100

Interest Income $210,000 $210,000

Income Tax ( 108,500) ( 107,100)

Corporate Income before Dividend Refund $101,500 N/A

Maximum Dividend Refund (See Note) 63,095

Maximum Taxable Dividend Payable $164,595

Personal Income Tax on Dividends [(43.8%)($164,595)] ( 72,093)

Income Retained by Mr. Vice $ 92,502 $102,900

Non-Eligible RDTOH Balance [(30-2/3%)($210,000)] $64,400

**Note -** The dividend refund is the lesser of 38-1/3% of dividends paid and the balance in the Non-Eligible RDTOH account ($64,400). The available cash would support a taxable dividend of $164,595 ($101,500 ÷ .61667), resulting in a potential dividend refund of $63,095 [(38-1/3%)($164,595)]. The lesser of the two amounts is $63,095.

As the corporate rate of 51-2/3% is higher than Victor's personal income tax rate of 51%, the use of a corporation provides no tax deferral.

There is also no tax savings once the corporation distributes all after-tax cash as taxable dividends given that the use of a corporation has a tax cost of $10,398 ($102,900 - $92,502). Clearly, incorporating the investments would not be cost effective.

Type: ES

Topic: Income tax savings & deferral - the decision to incorporate investments

75) One of your clients has asked your advice on whether she should incorporate her investments. The corporation will be a CCPC and she anticipates that the investments will generate the following amounts of income for the 2022 taxation year:

Non-Eligible Dividends on Portfolio Investments $39,000

Non-Eligible Dividends from 100% Owned Subsidiary

(A Dividend Refund of $20,000 will be received) 75,000

Interest Income 36,500

Your client has annual business income in excess of $250,000. She needs all of the investment income to purchase art for her cherished collection. Your client is subject to a provincial income tax rate of 18% on any additional income.

In her province of residence:

• the corporate income tax rate is 2.5% on income eligible for the SBD and 12% on other corporate income

• the dividend tax credit is 25% of the dividend gross up for non-eligible dividends

Provide the requested advice, including an explanation of your conclusions.

Answer: If the income is earned personally (without the use of a corporation), the total income tax payable will be:

Non-Eligible Dividends Received ($39,000 + $75,000) $114,000

Gross Up at 15% 17,100

Taxable Dividends $131,100

Interest Income 36,500

Taxable Income $167,600

Personal Income Tax Rate (33% + 18%) 51%

Income Tax before Dividend Tax Credit $ 85,476

Dividend Tax Credit [(9/13 + 25%)($17,100)] ( 16,113)

Personal Income Tax $ 69,363

The after tax retention can be calculated as follows:

Cash Received ($39,000 + $75,000 + $36,500) $150,500

Income Tax Payable (See Calculation) ( 69,363)

After Tax Retention - Without a corporation $ 81,137

**Incorporating the Investments**

The corporate income tax rate on investment income will be 50-2/3% (38% - 10% + 10-2/3% + 12%). If the investments are incorporated, corporate income taxes will be as follows:

Part IV Tax on Non-Eligible Dividends Received

[(38-1/3%)($39,000) + $20,000] $34,950

Tax on Interest Income [($36,500)(50-2/3%)] 18,493

Corporate Income Tax Payable before Dividend Refund $53,443

As this corporate income tax payable is less than the $69,363 that would be paid personally without the use of a corporation, the use of a corporation would provide tax deferral. However, as the client needs all of the income produced by these investments, the use of a corporation to defer taxes is not relevant.

As this would be a new corporation, it would have no RDTOH balances at the beginning of the year. The Non-Eligible RDTOH balance prior to the dividend refund would be calculated as follows:

Part IV Tax on Non-Eligible Dividends Received $34,950

Part I Addition [(30-2/3%)($36,500)] 11,193

Non-Eligible RDTOH Balance $46,143

The dividend refund would be the lesser of 38-1/3% of taxable dividends paid and the balance in the Non-Eligible RDTOH account ($46,143). The cash available after corporate income taxes is $97,057 ($150,500 - $53,443). This would support a taxable dividend of $157,390 ($97,057 ÷ .61667), with a potential dividend refund of $60,333 [(38-1/3%)($157,390)]. However, as the Non-Eligible RDTOH balance is less than this, the refund would be $46,143.

After Tax Corporate Cash $ 97,057

Dividend Refund (Non-Eligible RDTOH Balance) 46,143

Non-Eligible Dividends Received $143,200

Gross Up at 15% 21,480

Taxable Dividends $164,680

Personal Income Tax Rate 51%

Income Tax before Dividend Tax Credit $ 83,987

Dividend Tax Credit [(9/13 + 25%)($21,480)] ( 20,241)

Personal Income Tax $ 63,746

After tax retention with the use of a corporation would be $79,454 ($143,200 - $63,746). This is $1,683 less than the $81,137 that would be retained if the investments were not incorporated.

You should advise your client that using a corporation would result in an overall tax cost, making it inadvisable to incorporate the investments.

Type: ES

Topic: Income tax savings & deferral - the decision to incorporate investments

76) Maximilian Maximus has annual employment income in excess of $300,000. This means that any additional income will be taxed at a combined federal/provincial income tax rate of 51%.

For the 2022 taxation year, in addition to his employment income, Max has the following amounts of investment income:

Interest Income $ 71,000

Non-Eligible Dividends - Portfolio Investments 102,000

Non-Eligible Dividends from a 100% owned CCPC

(The CCPC receives a Dividend Refund of $23,000) 96,000

Max requires all of the income that is produced by these investments.

In his province of residence:

• the corporate income tax rate is 2.5% on income eligible for the SBD and 12% on other corporate income

• the dividend tax credit is 4/13 of the dividend gross up for non-eligible dividends

Max has asked your advice as to whether there would be any tax savings or tax deferral were he to incorporate the investment. Provide the requested advice, including an explanation of your conclusions.

Answer:

**Personally retaining the investments**

If the investments are not incorporated, the total personal income tax will be:

Non-Eligible Dividends Received

($102,000 + $96,000) $198,000

Gross Up at 15% 29,700

Taxable Dividends $227,700

Interest Income 71,000

Taxable Income $298,700

Personal Income Tax Rate 51%

Income Tax before Dividend Tax Credit $152,337

Dividend Tax Credit [(9/13 + 4/13)($29,700)] ( 29,700)

Personal Income Tax $122,637

The after tax retention can be calculated as follows:

Cash Received ($71,000 + $102,000 + $96,000) $269,000

Income Tax ( 122,637)

After Tax Retention - Without the use of a corporation $146,363

**Incorporating the Investments**

The corporate income tax rate on investment income is 50-2/3% (38% - 10% + 10-2/3% + 12%). If the investments are incorporated, corporate income taxes will be as follows:

Part IV Tax on Non-Eligible Dividends Received

[(38-1/3%)($102,000) + $23,000] $62,100

Tax on Interest Income [($71,000)(50-2/3%)] 35,973

Corporate Income Tax before Dividend Refund $98,073

As this income tax is smaller than the $122,637 that would be paid personally on the investment income, the use of a corporation provides for tax deferral. However, as the individual needs all of the investment income, the use of a corporation to defer income tax is not relevant.

As this would be a new corporation, it would have no RDTOH balances at the beginning of the year. The Non-Eligible RDTOH balance prior to the dividend refund would be calculated as follows:

Part IV Tax on Non-Eligible Dividends Received $62,100

Part I Addition [(30-2/3%)($71,000)] 21,773

Non-Eligible RDTOH Balance $83,873

The dividend refund is the lesser of the balance in the Non-Eligible RDTOH account ($83,873) and 38-1/3% of taxable dividends paid. The available cash of $170,927 ($269,000 - $98,073) would support a taxable dividend of $277,177 ($170,927 ÷ .61667), including a potential dividend refund of $106,251 [(38-1/3%)($277,177)]. However, this amount is larger than the Non-Eligible RDTOH balance and, given this, the refund is limited to $83,873.

Personal income tax on the taxable dividend would be calculated as follows:

After Tax Corporate Cash $170,927

Dividend Refund (Non-Eligible RDTOH Balance) 83,873

Non-Eligible Dividends Received $254,800

Gross Up at 15% 38,220

Taxable Dividends $293,020

Personal Income Tax Rate 51%

Income Tax before Dividend Tax Credit $149,440

Dividend Tax Credit [(9/13 + 4/13)($38,220)] ( 38,220)

Personal Income Tax $111,220

After tax retention with the use of a corporation would be $143,580 ($254,800 - $111,220). This is $2,783 ($146,363 - $143,580) less than the amount that Max would have been retained without the use of a corporation. You should advise Max that incorporating his investments has a tax cost.

Type: ES

Topic: Income tax savings & deferral - the decision to incorporate investments

77) Sandra Peterson has asked your advice on whether she should incorporate her investments to a new CCPC in which she will be the sole shareholder. She anticipates that the FMV of the investments are likely to increase by the end of 2022 by $142,000 resulting in capital gains of that same amount. No other investment income will be earned with respect to the investments. Sandra plans to will sell the investments at the end of the year to provide needed funds to purchase a condo. Capital gains on the investments would not qualify for the capital gains deduction.

The corporation will be subject to a provincial income tax rate of 3% on income eligible for the SBD and 16% on all other corporate income including capital gains. Sandra has annual employment income in excess of $250,000 and, as a result, any additional income will be subject to a provincial income tax rate of 18%. The provincial dividend tax credit is equal to 4/13 of the dividend gross up for non-eligible dividends. Provide the requested advice, including an explanation of your conclusions.

Answer:

**Personally retaining the Investments -** Ms. Peterson's personal income tax rate is 51% (33% + 18%). Based on this, the after tax amount retained with respect to the investments can be calculated as follows:

Capital Gain $142,000

Inclusion Rate 1/2

Taxable Capital Gain $ 71,000

Rate 51%

Personal Income Tax $ 36,210

Cash from Capital Gain $142,000

Personal Income Tax ( 36,210)

After Tax Retention - Without the use of a corporation $105,790

**Incorporating the investments -** The corporation's income tax rate on investment income would be 54-2/3% (38% - 10% + 10-2/3% + 16%). Based on this, the maximum after-tax corporate distribution that can be made to Ms. Peterson would be calculated as follows:

Capital Gain $142,000

Inclusion Rate 1/2

Taxable Capital Gain $ 71,000

Corporate Income Tax at 54-2/3% ( 38,813)

Available for Non-Eligible Dividend $ 32,187

Dividend Refund (See Note) 20,008

Non-Eligible Dividend Received $ 52,195

Non-Eligible RDTOH Balance [(30-2/3%)($71,000)] $ 21,774

**Note -** The dividend refund is the lesser of the balance in the Non-Eligible RDTOH account of $21,774 and 38-1/3% of taxable dividends paid. The available cash of $32,187 would support a taxable dividend of $52,195 ($32,187 ÷ .61667), which includes a dividend refund of $20,008 [(38-1/3%)($52,195)]. The lesser of the two amounts is $20,008.

Ms. Peterson's income tax rate on non-eligible dividend income is 43.7% [(115%)(51%) - (9/13 + 4/13)(15%)]. Based on this, the after tax retention when a corporation is used would be as follows:

Tax Free Capital Dividend Received [(1/2)($142,000)] $ 71,000

Non-Eligible Dividend Received 52,195

Income Tax on Non-Eligible Dividend

[(43.7%)($52,195)] ( 22,809)

After Tax Retention - With the use of a Corporation $100,386

As this is less than the after tax cash retained of $105,790 without the use of a corporation, the use of a corporation is not advisable. Note that, as the client needs all of the income produced by these investments, the use of a corporation to defer taxes is not relevant.

Type: ES

Topic: Income tax savings & deferral - the decision to incorporate investments (with capital gains)

78) On January 1, 2022, Saul Barkin owns shares with an ACB of $420,000. While these shares do not pay taxable dividends, he expects that, by the end of 2022, their FMV will increase to $640,000. At that point he expects to sell the shares in order to purchase a sailboat. None of these investments are eligible for the capital gains deduction.

Saul has annual employment income in excess of $250,000 and, as a result, any additional income will be taxed at a combined federal/territorial income tax rate of 52%.

He would like your advice on whether there would be any income tax advantages to incorporating the investment in these shares.

In his territory of residence:

• the corporate income tax rate is 2.5% on income eligible for the SBD and 14% on other corporate income including capital gains

• the dividend tax credit is 25% of the dividend gross up for non-eligible dividends

Provide the requested advice, including an explanation of your conclusions.

Answer:

**Personally retaining the Investments -** Based on his personal income tax rate of 52%, the amount of after-tax income would be as follows:

Capital Gain (POD $640,000 - ACB $420,000) $220,000

Inclusion Rate 1/2

Taxable Capital Gain $110,000

Income Tax Rate 52%

Personal Income Tax $ 57,200

Cash from Capital Gain $220,000

Personal Income Tax ( 57,200)

After Tax Retention - Without the use of a Corporation $162,800

**Incorporating the Investments -** The corporation's income tax rate on investment income would be 52-2/3% (38% - 10% + 10-2/3% + 14%). Based on this, the maximum after-tax distribution that can be made to Mr. Barkin would be calculated as follows:

Capital Gain (POD $640,000 - ACB $420,000) $220,000

Inclusion Rate 1/2

Taxable Capital Gain $110,000

Corporate Income Tax at 52-2/3% ( 57,933)

Available for Non-Eligible Dividend $ 52,067

Dividend Refund (See Note) 32,366

Non-Eligible Dividend $ 84,433

Non-Eligible RDTOH Balance [(30-2/3%)($110,000)] $ 33,733

**Note -** The dividend refund is the lesser of the balance in the Non-Eligible RDTOH account of $33,733 and 38-1/3% of the taxable dividends paid. The available cash of $52,067 would support a taxable dividend of $84,433 ($52,067 ÷ .61667), including a dividend refund of $32,366 [(38-1/3%)($84,433)]. The lesser of the two amounts is $32,366.

Mr. Barkin's income tax rate on non-eligible dividend income is 45.7% [(115%)(52%) - (9/13 + 25%) (15%)]. Based on this, the after tax retention when a corporation is used would be as follows:

Tax Free Capital Dividend

[(1/2)($220,000)] $110,000

Non-Eligible Dividend 84,433

Income Tax on Non-Eligible Dividend

[(45.7%)($84,433)] ( 38,586)

After Tax Retention - With a Corporation $155,847

As the corporate income taxes of $57,933 are higher than the $57,200 that would be paid without the use of a corporation, the use of a corporation does not provide any tax deferral.

With respect to tax savings, the $155,847 of after tax cash retained with the use of a corporation is less than the $162,800 that was retained when the capital gain was realized personally. There is, in fact, a tax cost of $6,953 ($162,800 - $155,847) associated with incorporating the share investments.

Type: ES

Topic: Income tax savings & deferral - the decision to incorporate investments (with capital gains)

79) Ms. Janice Thiessen is an employee of Thiessen Ltd., a large company in which her spouse owns 60% of the outstanding shares. Ms. Thiessen owns the remaining 40% of the shares. Thiessen Ltd. has a December 31 taxation year end. It is the policy of the Company to provide an interest free loan of up to $25,000 to any employee who wishes to purchase a new home. They do not provide loans for home furnishings to employees.

On April 1 of the current year, Ms. Thiessen receives a $25,000 interest free loan from the Company to purchase a new home. On the same day, she receives an additional $15,000 interest free loan to purchase furnishings for the home. Both loans are to be repaid in four annual instalments to be made on March 31 of each year. Assume the prescribed interest rate for the current year is 2%. What are the current year income tax implications to Ms. Thiessen of receiving these loans?

Answer: The $25,000 loan is the same as any other employee loan and is exempt from inclusion in income under ITA 15(2). However, it is an interest free loan and will result in a current year taxable benefit for Ms. Thiessen of $375 [($25,000)(2% - Nil)(9/12)]. Because Ms. Thiessen received the loan in her capacity as an employee, the benefit can be calculated under ITA 80.4(1). This means that for the first five years of the loan, the benefit calculation will use a rate no higher than the prescribed interest rate of 2% that was in effect when the loan was received.

The $15,000 loan is unavailable to other employees and will be subject to the general rule under ITA 15(2) as Ms. Thiessen is a specified employee. However, there is an exception for the one-quarter of the loan that will be repaid prior to the end of the following taxation year of the corporation. This means that, while three-quarters of the loan, or $11,250, will have to be included in income in the current year, the remaining one-quarter, or $3,750 is not required to be included in income. However, this latter amount will attract a current year taxable benefit of $56.25 [($3,750)(2% - Nil)(9/12)].

This means the total income for the current year is $11,681.25 ($375 + $11,250 + $56.25).

Type: ES

Topic: Shareholder loans - ITA 15(2)

80) Jonathan Baxter owns all of the shares of Baxter Ltd. The Company has a December 31 taxation year end. He also works full time as an employee in the company business. It is the policy of the Company to provide every employee an interest free loan of up to $30,000 to acquire an automobile that will be used in their employment duties. The loan must be repaid in full 3 years from the day the loan was received.

On January 1, 2022, Jonathan borrows $30,000 on an interest free basis. The funds are used to purchase an automobile to be used in his employment duties. In addition, on July 1, 2022, he borrows $250,000 on an interest free basis in order to assist in the purchase of a new and larger residence. The Company does not provide home purchase loans to its other employees. The loan will be repaid in full on July 1, 2025. Assume that the prescribed interest rate for all of 2022 is 2%. What are the income tax implications of these loans to Mr. Baxter for the 2022 taxation year?

Answer: As the $30,000 vehicle loan is available to all employees, it will not be included in Mr. Baxter's 2022 income. However, as the loan is interest free, there will be a taxable benefit of $600 [($30,000)(2% - Nil)(12/12)]. Some portion of this taxable benefit may be deductible to the extent of the percentage use of the automobile in the year towards employment use.

With respect to the housing loan, such loans are not available to all employees and, because none of the loan will be repaid prior to the Company's second taxation year end, all of the$250,000 will be included in Mr. Baxter's income for 2022. Because all of the loan has been included in Mr. Baxter's income there will be no taxable interest benefit related to the housing loan.

Type: ES

Topic: Shareholder loans - ITA 15(2)

81) Cloister Inc. is a CCPC with a December 31 taxation year end. For the 2022 taxation year, Cloister Inc. has taxable income, before consideration of taxable dividends or salary paid to its sole shareholder, of $197,000. All of its income has always been from an active business. The cash balance of the Company, prior to any payments on the current year's income tax, is also equal to this same amount.

Its only shareholder, Ms. Sally Cloister, has no income other than the taxable dividends or salary paid by the corporation and has combined personal tax credits of $3,375 for 2022.

In her province of residence, assume:

• The corporate income tax rate is 3% on income eligible for the SBD.and 14% on other corporate income.

• Personal provincial income tax on the first $155,625 is $16,000 with a 12% rate on additional amounts.

• The dividend tax credit is 4/13 of the dividend gross up for non-eligible dividends.

Determine the amount of after tax cash that Ms. Cloister will retain if the maximum salary is paid by the corporation out of the available cash of $197,000. Ignore CPP contributions and the Canada employment tax credit.

Answer: If the full $197,000 is paid out as salary, it will be deductible and will reduce the Company's taxable income to nil. This means that there would be no corporate income tax. This salary payment will result in Ms. Cloister having taxable income of $197,000. Given this, her 2022 income tax will be calculated as follows:

Combined Tax on first $155,625 ($32,181 + $16,000) $ 48,181

Combined Tax on remaining $41,375 ($197,000 - $155,625)

at 41% (29% + 12%) 16,964

Combined Income Tax before Credits $65,145

Personal Tax Credits (Given) ( 3,375)

2022 Personal Income Tax $61,770

Ms. Cloister's after tax retention would be $135,230 ($197,000 - $61,770), ignoring CPP contributions and the Canada employment credit.

Type: ES

Topic: Employee compensation - salary

82) Lisgar Ltd. is a CCPC with a December 31 taxation year end. For the 2022 taxation year, it has taxable income, before consideration of taxable dividends or salary paid to its sole shareholder, of $325,000. All of this income is from an active business. Its available cash balance is also $325,000.

Harry Lisgar is the only shareholder of Lisgar Ltd. His only income is either salary or taxable dividends from Lisgar Ltd and he has 2022 personal tax credits of $4,550.

In his province of residence, assume:

• The corporate income tax rate is 3% on income eligible for the SBD and 13% on other corporate income.

• Personal provincial income tax on the first $221,708 is $27,000. The rate on additional amounts is 18%.

• The dividend tax credit is 25% of the dividend gross up for non-eligible dividends.

Determine the amount of after tax cash that Mr. Lisgar will retain if the maximum salary is paid by the corporation out of the available cash of $325,000. Ignore CPP contributions and the Canada employment tax credit.

Answer: If all of the income is paid out as deductible salary, the Company will pay no income tax as its taxable income would be nil. The salary payment will result in Mr. Lisgar having net income and taxable Income of $325,000. The income tax on this amount is as follows:

Combined Tax on first $221,708 ($51,345 + $27,000) $ 78,345

Combined Tax on remaining $103,292 ($325,000 - $221,708)

at 51% (33% + 18%) 52,679

Combined Income Tax before Credits $131,024

Personal Tax Credits (Given) ( 4,550)

2022 Personal Income Tax $126,474

Based on these calculations, Mr. Lisgar will have after tax retention of $198,526 ($325,000 - $126,474). This result ignores CPP contributions, as well as the Canada employment tax credit.

Type: ES

Topic: Employee compensation - salary

83) Cloister Inc. is a CCPC with a December 31 taxation year end. For the 2022 taxation year, Cloister Inc. has taxable income, before consideration of taxable dividends or salary paid to its sole shareholder, of $197,000. All of its income has always been from an active business. The cash balance of the Company, prior to any payments on the current year's taxes, is also $197,000.

Its only shareholder, Ms. Sally Cloister, has no income other than the taxable dividends or salary paid by the corporation and has combined 2022 personal income tax credits of $3,375.

In her province of residence, assume:

• The corporate income tax rate is 3% on income eligible for the SBD and 14% on other corporate income.

• Personal provincial income tax on the first $155,625 is $16,000. The rate on additional amounts is 12%.

• The dividend tax credit is 4/13 of the dividend gross up for non-eligible dividends.

Determine the amount of after tax cash that Ms. Cloister will retain if the maximum taxable dividend is paid by the corporation out of the available cash of $197,000.

Answer: As taxable dividends are not deductible for income tax purposes, corporate income tax will have to be paid prior to the payment of any taxable dividends. All of the $197,000 would be eligible for the SBD and the income tax rate would be 12% (38% - 10% - 19% + 3%). Given this, the maximum taxable dividend that could be paid would be calculated as follows:

Corporate taxable income $197,000

Corporate Income Tax at 12% ( 23,640)

Funds Available for Taxable Dividends $173,360

Personal income tax on this taxable dividend would be calculated as follows:

Non-Eligible Dividends $173,360

Gross Up at 15% 26,004

Taxable Dividends $199,364

Combined Tax on first $155,625 ($32,181 + $16,000) $ 48,181

Combined Tax on remaining $43,739 ($199,364 - $155,625)

at 41% (29% + 12%) 17,933

Combined Income Tax before Credits $ 66,114

Personal Tax Credits (Given) ( 3,375)

Dividend Tax Credit [(9/13 + 4/13)($26,004)] ( 26,004)

2022 Personal Income Tax $ 36,735

The after tax retention would be equal to $136,625 ($173,360 - $36,735).

Type: ES

Topic: Employee compensation - taxable dividends

84) Lisgar Ltd. is a CCPC with a December 31 taxation year end. For the 2022 taxation year, it has taxable income, before consideration of taxable dividends or salary paid to its sole shareholder, of $325,000. All of this income is from an active business. Its available cash balance is also equal to $325,000.

Harry Lisgar is the only shareholder of Lisgar Ltd. His only income is either salary or taxable dividends from Lisgar Ltd and he has tax credits of $4,550.

In his territory of residence, assume:

• The corporate income tax rate is 3% on income eligible for the SBD and 13% on other corporate income.

• Personal territorial income tax on the first $221,708 is $27,000. The rate on additional income is 18%.

• The dividend tax credit is 25% of the dividend gross up for non-eligible dividends.

Determine the amount of after tax cash that Mr. Lisgar will retain if the maximum taxable dividend is paid by the corporation out of the available cash of $325,000.

Answer: As taxable dividends paid are not deductible for income tax purposes, corporate income tax will have to be paid prior to the payment of any taxable dividends. All of the income would be eligible for the SBD and Lisgar's corporate income tax rate is 12% (38% - 10% - 19% + 3%). Given this, the maximum taxable dividend that could be paid is calculated as follows:

Corporate Taxable Income $325,000

Corporate Income Tax at 12% ( 39,000)

Funds Available for Taxable Dividends $286,000

Mr. Lisgar's personal income tax on this income would be calculated as follows:

Non-Eligible Dividends $286,000

Gross Up at 15% 42,900

Taxable Dividends $328,900

Combined Tax on first $221,708 ($51,345 + $27,000) $ 78,345

Combined Tax on remaining $107,192

($328,900 - $221,708) at 51% (33% + 18%) 54,668

Combined Income Tax before Credits $133,013

Personal Tax Credits (Given) ( 4,550)

Dividend Tax Credit [(9/13 + 25%)($42,900)] ( 40,425)

2022 Personal Income Tax $ 88,038

The after tax retention would be $197,962 ($286,000 - $88,038).

Type: ES

Topic: Employee compensation - taxable dividends

85) For the taxation year ending December 31, 2022, Ramsden Inc. has taxable income, before consideration of taxable dividends or salary paid to its sole shareholder, of $23,600. The Company's cash balance, prior to the payment of any income taxes for the year is $17,300. The Company's taxable income is subject to a combined federal/provincial income tax rate of 15%. There is no payroll tax in this province.

Ms. Ramsden, the Company's president and sole shareholder has no other income. She has combined federal/provincial personal tax credits of $4,120 and lives in a province that has a personal income tax rate on the first $50,197 of taxable income of 11%. The provincial dividend tax credit is 30% of the gross up for non-eligible dividends. Ms. Ramsden would like to remove all of the cash from the corporation and has asked you to determine whether it would be better to take it out in the form of all non-eligible dividends or all salary. Ignore the required CPP contributions and the Canada employment tax credit.

Answer: **Salary Alternative -** As the available cash is less than taxable income, some corporate income tax will have to be paid since there is insufficient cash to pay a salary equivalent to taxable income. To determine the maximum salary that can be paid (X), it is necessary to solve the following equation:

X = $17,300 - [($23,600 - X)(15%)]

X = $16,188

Corporate income tax of $1,112 [(15%)($23,600 - $16,188)] would have to be paid. The total cash outflow equals the cash available of $17,300 ($16,188 + $1,112).

Given this salary, Ms. Ramsden would be subject to the following personal income tax:

Income Tax before Credits [(15% + 11%)($16,188)] $4,209

Available Tax Credits (Given) ( 4,120)

Personal Income Tax on Salary $ 89

Given the preceding, Ms. Ramsden's after tax retention on salary would be $16,099 ($16,188 - $89).

**Taxable Dividend Alternative -** As taxable dividends paid are not deductible, corporate income tax would have to be paid on the full $23,600. These taxes would be $3,540 [(15%)($23,600)], leaving an amount available for taxable dividends of $13,760 ($17,300 - $3,540). As no individual income tax would be payable on this amount of taxable dividends, the full $13,760 would be retained. Given these calculations, it is clear that the preferred approach is to pay the maximum salary.

Type: ES

Topic: Employee compensation - salary vs dividends

86) For the taxation year ending December 31, 2022, Daly Inc. has taxable income, before consideration of taxable dividends or salary paid to its sole shareholder, of $34,500. The Company's cash balance, prior to the payment of any salary or dividends is $35,200. For the taxation year ending December 31, 2021, Daly Inc. had net income and taxable income of $12,700. The Company is subject to a combined federal/provincial income tax rate of 11.5% on all of its taxable income for 2021 and 2022.

Bryan Daly, the sole shareholder of Daly Inc., has annual employment income of over $250,000, and because of this, any additional income will be taxed at a combined federal/provincial income tax rate of 51%. The provincial dividend tax credit is equal to 20% of the gross up for non-eligible dividends. Mr. Daly has indicated that he would like to remove all of the $35,200 in cash from his Company and has asked you to determine whether it would be better to take it out in the form of all non-eligible dividends or all salary.

Answer: **Salary Alternative -** If all of the $35,200 in cash is removed as salary, no corporate income tax will be required. In fact, the removal of this amount of cash as salary will create a loss of $700 ($35,200 - $34,500) for the Company which can be carried back to 2021 to claim a refund of $81 [(11.5%)($700)]. If Bryan receives the $35,200 as salary, his after tax retention can be calculated as follows:

Salary Received $35,200

Income Tax [(51%)($35,200)] ( 17,952)

After Tax Amount Retained - Salary $17,248

**Taxable Dividend Alternative** - If all of the $35,200 is paid out as taxable dividends, there would be corporate income tax on the $34,500 of taxable income. The amount available as a taxable dividend would be calculated as follows:

Available Cash $35,200

Income Tax [(11.5%)($34,500)] ( 3,968)

Funds Available for Taxable Dividends $31,232

Bryan's income tax rate on non-eligible dividends would be 45.3% [(115%)(51%) - (9/13 + 20%)(15%)]. Given this, his after tax retention of the taxable dividend income would be calculated as follows:

Non-Eligible Dividends $31,232

Income Tax on Taxable Dividends [(45.3%)($31,232)] ( 14,148)

After Tax Retention - Taxable Dividends $17,084

The taxable dividend alternative provides after tax retention of $17,084. As this is $164 ($17,248 - $17,084) less than the amount retained with the salary alternative, the salary alternative is preferable. The $81 tax refund to the corporation due to the salary would reinforce this conclusion.

Type: ES

Topic: Employee compensation - salary vs dividends

87) For the year ending December 31, 2022, Hughes Ltd. has taxable income, before consideration of taxable dividends or salary paid to its sole shareholder, of $175,000. The Company's cash balance is over $300,000. It is subject to a combined federal/provincial income tax rate of 11.5%. Mr. Hughes, the Company's only shareholder, has employment income of over $250,000 and, under normal circumstances, does not make withdrawals from the corporation. However, he needs an additional $17,000 in cash.

Mr. Hughes lives in a province where the provincial income tax rate is 18% and the provincial dividend tax credit is equal to 23% of the dividend gross up for non-eligible dividends. He has asked your advice as to whether the payment of salary or, alternatively, the payment of non-eligible dividends, would have the lower income tax cost. Provide the requested advice.

Answer:

**Required Salary** - Mr. Hughes' combined income tax rate on additional salary is 51% (33% + 18%). In order to have $17,000 in after tax funds, he would have to receive salary of $34,694 [$17,000 ÷ (1 - .51)].

**Income Tax Cost of Salary** - The income tax cost of paying salary can be calculated as follows:

Income Tax on Receipt of Salary [(51%)($34,694)] $17,694

Income Tax Savings to Corporation [(11.5%)($34,694)] ( 3,990)

Income Tax Cost of Salary $13,704

**Required Taxable Dividend** - Mr. Hughes' income tax rate on non-eligible dividends is 44.8% [(115%)(51%) - (9/13 + 23%)(15%)]. In order to have $17,000 in after tax funds, he would have to receive taxable dividends of $30,797 [$17,000 ÷ (1 - .448)].

**Income Tax Cost of Taxable Dividend** - As the taxable dividend payment would not be deductible to the corporation, its payment would not change corporate income tax. This means that the income tax cost would be the $13,797 [(44.8%)($30,797)] in personal income tax that Mr. Hughes would pay on the taxable dividend.

**Conclusion** - As the income tax cost of the salary alternative is $3,897 ($17,694 - $13,797) higher, taxable dividends should be paid.

Type: ES

Topic: Employee compensation - salary vs dividends

88) Miriam Foster has annual employment income in excess of $300,000. This means that any additional income that she receives will be subject to a combined federal/territorial income tax rate of 51%. Because of some very bad real estate investments, she finds that, in addition to her employment income, she needs an additional $50,000 in cash during the coming year.

She is the sole shareholder of Foster Enterprises, a CCPC. It is expected that, for the taxation year ending December 31, 2022, Foster Enterprises will have taxable income, before consideration of taxable dividends or salary paid to its sole shareholder, of $225,000 which is subject to income tax at a combined federal/territorial income tax rate of 12%. While Ms. Foster does not normally remove funds from the Company, it has sufficient cash reserves to pay any amount of required salary or taxable dividends.

Ms. Foster has asked your advice as to whether it would be more tax efficient to receive the additional $50,000 as non-eligible dividends or as salary. In her territory of residence, the territorial dividend tax credit is equal to 4/13 of the gross up on non-eligible dividends. Provide the requested advice.

Answer:

**Required Salary -** Miriam's combined income tax rate is 51% on any additional salary. Given this, in order to retain $50,000, she will need salary of $102,041 [$50,000 ÷ (1 - 51%)].

The income tax cost of paying salary can be calculated as follows:

Income Tax on Salary [(51%)($102,041)] $52,041

Income Tax Savings to Corporation [(12%)($102,041)] ( 12,245)

Income Tax Cost of Salary Alternative $39,796

**Required Taxable Dividend** - Miriam's tax rate on non-eligible dividends is 43.7% [(115%)(51%) - (9/13 + 4/13)(15%)]. In order to have $50,000 in after tax funds, she would have to receive taxable dividends of $88,810 [$50,000 ÷ (1 - 0.437)].

**Income Tax Cost of Taxable Dividend** - As the taxable dividend payment would not be deductible to the corporation, its payment would not change corporate income tax. This means that the income tax cost would be the $38,810 [(43.7%)($88,810)] in personal income tax that Miriam would pay on the taxable dividend.

**Conclusion** - As the income tax cost associated with the payment of salary is $986 higher ($39,796 - $38,810), the taxable dividend alternative would have the lower income tax cost.

Type: ES

Topic: Employee compensation - salary vs dividends

89) Ms. Griet Naidu has $175,000 in cash that she does not currently require for personal expenses. As she has annual employment income in excess of $180,000, her marginal federal income tax rate is 29% with a provincial income tax rate of 16%. The provincial dividend tax credit for non-eligible dividends is 30% of the gross up.

In her province of residence, the combined federal/provincial income tax rate on investment income earned by a CCPC is 50-2/3%. This includes the ART at 10-2/3%.

Ms. Naidu would like to invest her $175,000 for the year ending December 31, 2022 in an investment that will pay annual interest of 3%. Her only investment income for the year will be the $5,250 of interest income that would be paid on this investment.

**Required:** Prepare calculations that will compare the after tax retention of income that will accrue to Ms. Naidu for 2022 if:

A. The investment is owned by her personally.

B. The investment is incorporated in a company in which she is the sole shareholder, and which pays out all available after-tax income as taxable dividends.

Answer:

***Part A - Investment owned Personally***

Ms. Naidu's marginal income tax rate is 45% (29% + 16%). If Ms. Naidu invests the $175,000 personally the after tax return can be calculated as follows:

Interest Income $5,250

Interest Income $5,250

Income Tax at 45% ( 2,363)

After Tax Retention $2,887

***Part B - Incorporating the Investment***

As investment income is involved, there will be no addition to the corporation's GRIP account. This means that any taxable dividends paid will be non-eligible. The refundable portion of Part I tax will be added to the Non-Eligible RDTOH.

The after tax return would be as follows:

Interest Income $5,250

Corporate Income Tax at 50-2/3% ( 2,660)

Corporate Income before Dividend Refund $2,590

Maximum Dividend Refund (See Note) 1,610

Maximum Non-Eligible Dividend $4,200

Gross Up at 15% 630

Taxable Dividend $4,830

Personal Income Tax Rate 45%

Personal Income Tax before Dividend Tax Credit $2,174

Dividend Tax Credit [(9/13 + 30%)($630)] ( 625)

Personal Income Tax $1,549

Taxable Dividends $4,200

Personal Income Tax ( 1,549)

After Tax Retention $2,651

**Note** - The available cash would support a taxable dividend of $4,200 ($2,590 ÷ .61667), including a dividend refund of $1,610 [(38-1/3%)($4,200)]. As this is equal to the $1,610 [(30-2/3%)($5,250)] balance in the Non-Eligible RDTOH, this amount of taxable dividends can be paid.

The difference between the two alternatives is $236 ($2,887 - $2,651) in favour of direct personal investment (not using a corporation).

Type: ES

Topic: Income tax savings & deferral - the decision to incorporate investments

90) As an employee of a public company, Carol Henderson has an annual salary of $175,000.

After years of purchasing losing tickets, Carol wins $600,000 in the provincial lottery. As her employment income is more than adequate for her current needs, she plans to invest all of these winnings in an investment in 2022 that will pay annual interest of 4%.

The following information is applicable to the province in which Carol is a resident:

• The maximum income tax rate for individuals is 14%.

• The provincial dividend tax credit on non-eligible dividends is 24% of the gross up.

• The provincial income tax rate on the investment income of CCPCs is 13%.

Other than the interest earned on her investment, Carol has no other source of investment income.

**Required:** Prepare calculations that will compare the after tax retention of interest income that will accrue to Carol for the 2022 taxation year assuming that she purchased the investment on January 1, 2022 and if:

A. The investment is personally owned by her.

B. The investment is incorporated to a CCPC in which she is the sole shareholder, and which pays out all after-tax income as taxable dividends.

Answer:

***Part A - Investment owned Personally***

Carol's marginal income tax rate is 43% (29% + 14%). If she invests the $600,000 personally, the after tax return can be calculated as follows:

Interest Income [(4%)($600,000)] $24,000

Personal Income Tax [(43%)($24,000)] ( 10,320)

After Tax Retention $13,680

***Part B - Incorporating the Investment***

The combined federal/provincial income tax rate on the investment income of the corporation is 51-2/3% (28% + 13% + 10-2/3%). As investment income is involved, there would be no addition to the corporation's GRIP meaning that any taxable dividends paid will be non-eligible. The refundable portion of Part I tax will be added to the Non-Eligible RDTOH.

Carol's after tax return would be calculated as follows:

Interest Income $24,000

Corporate Income Tax at 51-2/3% ( 12,400)

Corporate Income before Dividend Refund $11,600

Maximum Dividend Refund (See Note) 7,210

Maximum Non-Eligible Dividend $18,810

Gross Up at 15% 2,822

Taxable Dividend $21,632

Personal Income Tax Rate 43%

Personal Income Tax before Dividend Tax Credit $ 9,302

Dividend Tax Credit [(9/13 + 24%)($2,822)] ( 2,631)

Personal Income Tax $ 6,671

Taxable Dividends $18,810

Personal Income Tax ( 6,671)

After Tax Retention - With the use of a Corporation $12,139

**Note** - The available cash would support a taxable dividend of $18,810 ($11,600 ÷ .61667), including a dividend refund of $7,210 [(38-1/3%)($18,810)]. As this is less than the $7,360 [(30-2/3%)($24,000)] balance in the Non-Eligible RDTOH account, this amount of taxable dividends can be paid. There is additional refundable tax of $150 ($7,360 - $7,210) that is available, but only on the payment of additional taxable dividends.

The difference between the two alternatives is $1,541 ($13,680 - $12,139) in favour of direct personal investment (not using a corporation).

Type: ES

Topic: Income tax savings & deferral - the decision to incorporate investments

91) As an employee of a public company, Carol Henderson has an annual salary of $175,000.

After years of purchasing losing tickets, Carol wins $600,000 in the provincial lottery. As her employment income is more than adequate for her current needs, she plans to invest all of these winnings in preferred shares in the 2022 taxation year. The shares pay annual eligible dividends of 5%.

The following information is applicable to the province in which Carol is a resident:

• The maximum income tax rate for individuals is 14%.

• The provincial dividend tax credit on eligible dividends is 24% of the gross up.

• The provincial income tax rate on the investment income of CCPCs is 13%.

Other than the preferred share dividends, Carol has no other source of investment income.

**Required:** Prepare calculations that will compare the after tax retention of income that will accrue to Carol in 2022 if:

A. The investment is personally owned.

B. The investment is incorporated in a CCPC in which she is the sole shareholder, and which pays out all after-tax income as eligible dividends.

Answer:

***Part A - Share Investment owned Personally***

Carol's marginal income tax rate is 43% (29% + 14%). If she invests the $600,000 personally the after tax return can be calculated as follows:

Eligible Dividends Received [($600,000)(5%)] $30,000

38% Gross Up 11,400

Taxable Dividend $41,400

Personal Income Tax Rate 43%

Personal Income Tax before Dividend Tax Credit $17,802

Dividend Tax Credit [(6/11 + 24%)($11,400)] ( 8,954)

Personal Income Tax $ 8,848

Taxable Dividends $30,000

Personal Income Tax ( 8,848)

After Tax Retention - Personal ownership $21,152

***Part B - Share Investment Incorporated***

If Carol invests the $600,000 through her CCPC, the eligible dividends received would be classified as portfolio dividends, subject to Part IV tax at 38-1/3%. There would also be an addition to the corporation's GRIP account of $30,000 (notice that eligible dividends are not multiplied by 72% for the GRIP addition). The after tax retention on the flow through the corporation would be as follows:

Eligible Dividends $30,000

Part IV Tax at 38-1/3% (Portfolio Dividends) ( 11,500)

Earnings Retained by the Corporation $18,500

Dividend Refund when Dividends Paid 11,500

Eligible Dividends paid (See Note) $30,000

**Note -** The available cash would support a taxable dividend of $30,000 ($18,500 ÷ .61667), including a dividend refund of $11,500 [(38-1/3%)($30,000)]. This refund is available as the balance in the Eligible RDTOH account is also $11,500 [(38-1/3%)($30,000)].

As the taxable dividend payment is equal to the GRIP balance, the full amount of $30,000 can be designated as eligible.

At this point, the corporation has paid no net amount of tax and will be paying exactly the same amount of eligible dividends that it received. This will result in Carol paying exactly the same amount of income tax that she would have paid had the share investment not been incorporated. With the use of a corporation, the after tax retention would be identical to the after tax retention resulting from direct receipt of the dividends. There would also be no tax deferral since the Part IV tax of $11,500 exceeded the personal income tax of $8,848 that would have been payable had the share investments not been incorporated.

Type: ES

Topic: Income tax savings & deferral - the decision to incorporate investments (dividend income)

92) Ryan Taylor lives in a province with a combined federal and provincial corporate income tax rate on the investment income of CCPCs of 52-2/3%. This rate includes the ART of 10-2/3%. The provincial dividend tax credit is equal to 35% of the dividend gross up on eligible dividends and 25% of the gross up on non-eligible dividends.

Provincial income tax on individuals are $13,500 on the first $155,625 of taxable income, and 12% on any additional amounts of taxable income.

Ryan owns the following investments, and anticipates the following Canadian income and capital gains for 2022.

**Expected**

**FMV at Type of Income**

**31/12/2021 Income for 2022**

ABC Company Bonds $100,000 Interest $11,000

XYZ Canada Company Shares 400,000 Dividends 20,000

Ace Technology Shares 50,000 Capital Gains 10,000

Safe Bank of Canada Shares 50,000 Dividends 4,000

Capital Gains 3,500

Totals $600,000 N/A $48,500

Ryan only invests in the shares and debt of large, publicly traded companies. He does not own more than fraction of the shares or debt in any of these corporations. All of the taxable dividends received will be designated as eligible by the paying corporation.

In 2022, in addition to the above investment income, Ryan expects to earn $110,000 in employment income. He has combined federal/provincial personal tax credits of $4,141. The total ACB of his investments is $450,000.

Ryan asks you whether it is financially beneficial to continue to own the investments personally or whether it would be preferable to incorporate the investments.

Ryan's lifestyle requires him to use all available income. As a consequence, he would like you to assume that, if the investments are incorporated that the corporation will pay out all available after-tax funds as capital or taxable dividends.

**Required:** Provide an appropriate analysis for Ryan Taylor.

Answer:

***Investments Owned Personally***

If Ryan continues to own the investments personally, his total taxable income will be as follows:

Employment Income $110,000

Interest Income 11,000

Eligible Dividends ($20,000 + $4,000) 24,000

Gross Up on Eligible Dividends [($24,000)(38%)] 9,120

Taxable Capital Gains [(1/2)($10,000 + $3,500)] 6,750

2022 Net Income and Taxable Income $160,870

The income tax on this income would be calculated as follows:

Tax Payable on first $155,625 ($32,181 + $13,500) $45,681

Tax Payable on remaining $5,245 ($160,870 - $155,625)

at 41% (29% + 12%) 2,150

Income Tax before Credits $47,831

Personal Tax Credits (Given) ( 4,141)

Dividend Tax Credit [(6/11 + 35%)($9,120)] ( 8,167)

2022 Personal Income Tax $35,523

Ryan would retain cash of $122,977 ($110,000 + $11,000 + $24,000 + $13,500 - $35,523).

***Investments Incorporated (Owned by a Corporation)***

If all of the investments are incorporated, the taxable income of the corporation would be as follows:

Interest Income $11,000

Eligible Dividends ($20,000 + $4,000) 24,000

Taxable Capital Gains [(1/2)($10,000 + $3,500)] 6,750

2022 Net Income $41,750

Less: Taxable Dividends - ITA 112(1) ( 24,000)

2022 Taxable Income $17,750

With the subtraction of the eligible dividends received, taxable income would be equal to aggregate investment income (AII), resulting in no addition to the Company's GRIP. However, there would be an addition to its GRIP equal to $24,000, 100% of the eligible dividends received.

The company's income tax would be calculated as follows:

Part I Tax [(52-2/3%)($17,750)] $ 9,348

Part IV Tax [(38-1/3%)($20,000 + $4,000)] 9,200

2022 Corporate Income Taxes $18,548

The refundable portion of the Part I Tax Payable would be the least of the following amounts:

• $5,443 = 30-2/3% of AII [(30-2/3%)($11,000 + $6,750)]

• $5,443 = 30-2/3% of Taxable Income [(30-2/3%)($17,750)]

• $9,348 = Part I Tax

The balances in the two RDTOH accounts would be as follows:

Non-Eligible RDTOH (Part I Refundable Tax) $5,443

Eligible RDTOH (Part IV Tax Payable) $9,200

The amount of cash available to the corporation for paying taxable dividends to Ryan would be calculated as follows:

Investment Income Received

($11,000 + $24,000 + $13,500) $48,500

Corporate Income Taxes ( 18,548)

Cash Available $29,952

Tax Free Capital Dividend ( 6,750)

Cash Available for Taxable Dividend $23,202

Dividend Refund (See Note) 14,423

Taxable Dividend $37,625

Eligible Dividend (GRIP Balance) ( 24,000)

Non-Eligible Dividend $13,625

**Note -** The available cash would support a taxable dividend of $37,625 ($23,202 ÷ .61667), including a dividend refund of $14,423 [(38-1/3%)($37,625)]. As this is less than the $14,643 ($5,443 + $9,200) balance in the combined RDTOH accounts, this amount of dividends can be paid. The eligible portion of the dividend is limited to the $24,000 balance in the corporation's GRIP account. As 38-1/3% of this amount is $9,200, the refund will reduce the Eligible RDTOH to nil.

The remaining $13,625 ($37,625 - $24,000) will be non-eligible and will result in $5,223 [(38-1/3%)($13,625)] being removed from the Non-Eligible RDTOH, leaving a balance of $220 ($5,443 - $5,223).

The after tax results with the use of a corporation would be as follows:

Employment Income $110,000

Eligible Dividend 24,000

Gross Up on Eligible Dividend at 38% 9,120

Non-Eligible Dividend 13,625

Gross Up on Non-Eligible Dividends at 15% 2,044

2022 Taxable Income $158,789

Income Tax on first $155,625 ($32,181 + $13,500) $45,681

Income Tax on remaining $3,164 ($158,789 - $155,625)

at 41% (29% + 12%) 1,297

Income Tax before Tax Credits $46,978

Personal Tax Credits (Given) ( 4,141)

Eligible Dividend Tax Credit [(6/11 + 35%)($9,120)] ( 8,167)

Non-Eligible Dividend Tax Credit

[(9/13 + 25%)($2,044)] ( 1,926)

2022 Personal Income Tax $32,744

Ryan’s after tax retention would be as follows:

Employment Income $110,000

Capital Dividend 6,750

Taxable Dividends

($24,000 + $13,625) 37,625

Total receipts $154,375

Personal Income Tax ( 32,744)

After Tax Cash Retention - With the use of a Corporation $121,631

***Conclusion***

In terms of after tax amounts of cash retained, the use of a corporation results in $121,631 of cash retained, while owning the investments personally results in $122,977 of cash retained. This $1,346 difference would clearly make holding the investments personally the preferable alternative, particularly when the additional costs of incorporation are taken into consideration.

Type: ES

Topic: Income tax savings & deferral - the decision to incorporate investments (with capital gains)

93) All of the shares of Dez Inc. are owned by Ms. Hannah Fernandez. Dez Inc. is a CCPC with a taxation year that ends on December 31. In addition to being the sole shareholder of Dez Inc., Hannah is employed by the company and works full time in its business.

Dez Inc. has established generous benefit policies in order to retain its employees. All of its employees who have more than 12 months of service are entitled to interest free loans as follows:

• The Company will provide a loan of up to $200,000 to assist an employee in acquiring a residence. The principal amount of the loan must be repaid in full at the end of five years.

• The Company will provide a loan of up to $25,000 to assist an employee in acquiring an automobile that will be used to carry out their employment duties. These loans must be repaid in full within three years.

During the taxation year ending December 31, 2022, Hannah received the following loans:

1. On February 28, Hannah borrows $200,000 interest free in order to purchase a new residence.

The loan will be repaid in two annual instalments of $100,000, beginning on March 1, 2023.

2. On May 1, Hannah borrows $185,000 to acquire a foreign sports car. She will use it for personal purposes only. The loan bears interest at an annual rate of 1% and will be repaid on May 1, 2027.

3. On July 1, Hannah borrows $40,000 to cover corrective back surgery in a U.S. hospital. The procedure will significantly relieve her back pain and is not available in Canada. The loan is interest free and will be repaid on June 30, 2023.

4. On August 1, Hannah borrows $100,000 in order to acquire furniture for her new residence. The loan is interest free and will be repaid on August 1, 2024.

5. On October 1, Hannah borrows $18,000 from her company to finance a much needed week at a luxurious resort in British Columbia. Since she has already borrowed a significant amount of funds, she decides the loan will bear interest at 3%. It will be repaid in full on September 1, 2023.

All repayments and interest payments are made as scheduled. In all of the years under consideration, assume the relevant prescribed interest rate on shareholder/employee loans is 2%.

**Required:**

A. What are the income tax consequences to Hannah of receiving the loans. Briefly explain your conclusions for each loan for the taxation years that the loans are outstanding. Base any interest calculations on the number of months (rather than days) the loans are outstanding.

B. Identify any income tax planning issues that are relevant to these loans.

Answer:

**Part A - Income Tax Consequences**

***Loan 1 - Housing Loan***

As such loans are available to all employees, Hannah can claim that she has received the loan in her capacity as an employee. This means that the $200,000 principal does not have to be included in her net income for 2022. However, as the loan is interest free, there will be a taxable benefit included in her net income as follows:

2022 [($200,000)(2%)(10/12)] $3,333.33

2023 [($200,000)(2%)(2/12) + ($200,000 - $100,000)(2%)(10/12)] $2,333.33

2024 [($200,000 - $100,000)(2%)(2/12)] $333.33

***Loan 2 - Sports Car Loan***

While the term of the loan is consistent with the loans being given to other employees, the principal amount is far in excess of anything being provided to other employees. Given this, it is clear that the loan is being extended to Hannah in a shareholder capacity and not as an employee.

This means that the $185,000 principal amount would have to be included in her 2022 net income. When the loan is repaid in 2027, the $185,000 can be deducted from her income in that year.

As the principal amount is included in her income, there will be no taxable benefit for imputed interest associated with the loan.

***Loan 3 - Loan for Medical Expenses***

As the loan is repaid prior to December 31, 2023 (before the following taxation year of the corporation), the principal amount does not have to be included in Hannah's net income for 2022 However, as it is interest free, there will be a taxable benefit for imputed interest as follows:

2022 [(2%)($40,000)(6/12)] $400

2023 [(2%)($40,000)(6/12)] $400

Although the loan is being used to pay for medical expenses that will qualify for the medical expense tax credit, interest, or imputed interest on loans to fund medical expenses is not an allowable medical expense.

***Loan 4 - Furniture Loan***

As this loan is not repaid by December 31, 2023 (the end of the following taxation year of the company), it has to be included in Hannah's 2022 net income.

In 2024, the year it is repaid, the $100,000 can be deducted in determining net income for that year.

As the principal amount is included in her income, there will be no taxable benefit for imputed interest associated with the loan.

***Loan 5 - Vacation Loan***

This loan is repaid by December 31, 2023 and as a consequence, the principal amount is not included in Hannah's 2022 net income.

As the interest rate of 3% on the loan is higher than the prescribed rate of 2%, there will be no imputed interest benefit.

**Part B - Tax Planning Issues**

***Housing Loan***

There are no issues here in that the loan is structured to be consistent with other loans to employees. This allows Hannah to receive a home loan on an interest free basis and, because she has received it as a result of her employee status, she does not have to include the principal in her income.

***Sports Car Loan***

As the loan must be included in her income, it is not good tax planning for Hannah to pay any interest. The interest income will be subject to corporate income tax.

As the car is used only for personal purposes, she cannot deduct any of the interest paid. If she paid no interest on the loan, her income tax situation would not be changed and the corporation would pay less income tax since there would be no interest income.

***Loan for Medical Expenses***

The fact that the loan was interest free resulted in Hannah having a taxable benefit. If she had paid interest at the prescribed rate, the benefit could have been reduced or eliminated. However, the corporation would be subject to income tax on the interest income and she cannot deduct or claim the interest as a medical expense. In other words there is no symmetrical treatment to neutralize the income tax cost.

Whether making the loan on an interest free basis represents good tax planning depends on whether the corporation's income tax rate on investment income is higher than the income tax rate applicable to Hannah. It is also possible that the interest income to the company could be considered active business income if the funds used to make loans are temporary excess cash connected to the business. This position would likely be tenable for short term loans but not for long term loans.

***Furniture Loan***

As the principal of the loan must be included in income, the income tax planning question is whether it would have been more appropriate to simply pay an equivalent amount of salary to Hannah. The advantage of the loan is that it can be repaid and deducted in future years. In contrast, salary cannot generally be returned to the corporation, but it is deductible to the corporation as salary.

Given that the principal of the loan is included in Hannah's income, making the loan interest free is the appropriate choice. It would rarely be advisable for a corporation to charge interest on employee or shareholder loans.

***Vacation Loan***

It was clearly not appropriate to pay interest at a rate higher than the prescribed interest rate. The extra one percent did not reduce Hannah's imputed interest benefit as it would be nil with a 2% interest rate. In addition, the interest income will be included in the corporation's income with no offsetting interest deduction to Hannah.

There is also the question of whether any interest should have been paid on the loan. Making it interest free would create a taxable benefit for Hannah. However, it would eliminate the need to pay corporate income tax on the interest income received. As discussed under the comments on the medical expense loan, the answer to this question depends on the relative income tax rates for Hannah versus the income tax rate to the corporation.

Type: ES

Topic: Shareholder loans - ITA 15(2)

94) Marian Copps owns 100% of the outstanding shares of Copp's Copper Ltd., a CCPC that specializes in producing copper artifacts for various religious organizations. Ms. Copps is employed by the company and is the top salesperson.

The Company has an October 31 taxation year end. It is known for its generous treatment of its employees. This includes the extension of low-interest loans to all employees with more than 2 years of service with the Company. More specifically, the Company will:

• Provide a loan of up to $150,000 to assist an employee in acquiring a home. When granted, such loans charge interest of 1% and must be repaid in full at the end of five years.

• Provide a loan of up to $30,000 to assist an employee in acquiring an automobile that will be used in their employment duties. As with the home purchase loans, these loans also charge interest of 1% and must be repaid in full at the end of five years.

In 2022 Ms. Copps received the following loans:

1. On January 31, Ms. Copps borrows $150,000 in order to purchase a home. The loan will be repaid in two annual instalments of $75,000, beginning on February 1, 2023.

2. On March 1, Ms. Copps borrows $349,000 to acquire a new Ferrari F12. She will use it to cut down the driving time to and from her cottage. The loan charges interest of 1% and will be repaid in full on March 1, 2027.

3. On June 1, Ms. Copps borrows $35,000 to cover the costs of a surgery not covered by medicare. The loan is interest free and will be repaid in full on May 31, 2023.

4. On July 1, Ms. Copps borrows $100,000 in order to stock the wine cellar of her new residence. The loan is interest free and will be repaid in full on July 1, 2024.

5. On November 1, Ms. Copps borrows $25,000 from her company to finance a much needed week at a luxurious health spa. Since she has already borrowed a significant amount of funds, she decides the loan will charge 3% interest. It will be repaid in full October 1, 2024.

All repayments are made as scheduled. In all of the years under consideration, assume the relevant prescribed interest rate on employee/shareholder loans is 2%.

**Required:**

A. What are the income tax consequences to Ms. Copps of receiving these loans. Briefly explain your conclusions for each loan for the taxation years the loans are outstanding. Base any interest calculations on the number of months the loans are outstanding instead of the number of days.

B. Identify any tax planning points that may be relevant to these loans.

Answer:

**Part A - Income Tax Consequences**

***Housing Loan***

As such loans are available to all employees, Ms. Copps can argue that she has received the loan in an employment capacity. This means that the $150,000 principal does not have to be included in her income for 2022. However, as the interest rate on the loan is below the prescribed rate, there will be a taxable benefit.

The interest benefit for 2022 is $1,375 [($150,000)(2% - 1%)(11/12)].

For 2023, the amount is $812.50

[($150,000)(2% - 1%)(1/12) + ($150,000 - $75,000)(2% - 1%)(11/12)].

For 2024, the amount is $62.50 [($150,000 - $75,000)(2% - 1%)(1/12)].

***Luxury Car Loan***

While the term of the loan and the applicable interest rate are consistent with the loans being given to other employees, the principal amount is far in excess of anything being provided to other employees. Given this, it is clear that the loan is being extended to Ms. Copps in a shareholder capacity and not an employee capacity.

This means that the $349,000 principal amount would have to be included in her income for 2022. When the loan is repaid in 2027, the $349,000 repayment can be deducted from her income for that year (2027).

As the principal amount is included in her income, there will be no taxable benefit for imputed interest.

***Medical Expense Loan***

As the loan is repaid prior to October 31, 2023 (the following taxation year end of the company), the principal amount does not have to be included in Ms. Copps' income for 2022. However, as it is interest free, there will be a taxable interest benefit.

For 2022, the amount will be $408 [(2%)($35,000)(7/12)].

For 2023, the benefit will be $292 [(2%)($35,000)(5/12)].

***Wine Purchase Loan***

As this loan is not repaid by October 31, 2023 (the following taxation year of the company), it has to be included in Ms. Copps' income for 2022.

In 2024, the year it is repaid, the $100,000 can be claimed as a deduction in that year (ITA 20(1)(j)).

As the principal amount is included in her income, there will be no taxable interest benefit.

***Vacation Loan***

This loan is repaid by the end of the following taxation year of the company and therefore the principal amount does not have to be included in Ms. Copps' 2022 income.

As the interest rate of 3% is higher than the prescribed interest rate of 2%, there will be no interest benefit.

**Part B - Income Tax Planning Issues**

***Housing Loan***

There are no issues here in that the loan is structured in a manner that is consistent with loans to employees. This allows Ms. Copps to receive a home loan at a very favourable rate and, because she has received it as a result of her employee status, she does not have to include the principal in her income.

***Luxury Car Loan***

As the loan must be included in her income, it is not good tax planning for Ms. Copps to pay any interest. The interest income will be subject to corporate income tax, likely at the unfavourable investment income rates which frequently exceed 50%.

As the car is used only for personal purposes, she cannot deduct any of the interest paid. If she had paid no interest on the loan, her tax situation would not have changed and the corporation would pay less income tax since there would have been no interest income.

***Medical Expense Loan***

The fact that no interest is paid on the loan results in a taxable benefit for Ms. Copps. If she had paid interest, the benefit would be reduced. However, the corporation would be subject to income tax on the interest income.

Whether making the loan on an interest free basis represents good tax planning depends on whether the corporation's income tax rate is higher than the rate applicable to Ms. Copps.

***Wine Purchase Loan***

As the principal of the loan must be included in income, the tax planning question is whether it would have been more appropriate to simply pay an equivalent amount of salary to Ms. Copps. The advantage of the loan is that it can be repaid and deducted in future years.

Given that the principal of the loan is included in Ms. Copp's income, making the loan interest free is the appropriate choice.

***Vacation Loan***

It was clearly not appropriate to charge interest at a rate in excess of the prescribed interest rate. The extra one percent did not reduce Mr. Copps' imputed interest benefit. In addition, it will be subject toe corporate income tax.

There is also the question of whether any interest should have been paid on the loan. Making it interest free would create a taxable benefit for Ms. Copps. However, it would eliminate the need to pay corporate income tax on the interest income. As discussed under the comments on the medical expense loan, the answer depends on the relative income tax rates for Ms. Copps as compared to the income tax rates on investment income to the corporation.

Type: ES

Topic: Shareholder loans - ITA 15(2)

95) Jeannette Gutierrez is the sole shareholder of Gutierrez Inc., a CCPC. All of its income qualifies for the SBD and, in the province where it carries on its business, the combined federal/provincial income tax rate on such income is 12%.

Jeannette's income places her in the 33% federal income tax bracket on any additional income. Her marginal income tax rate on additional income at the provincial level is 19%, resulting in a combined rate of 52%. The dividend tax credit in her province for non-eligible dividends is 29% of the dividend gross up.

For the taxation year ending December 31, 2022, Jeannette expects Gutierrez Inc. to have $249,000 in net income. This is after a deduction of $232,000 in salary to her.

Jeannette needs an additional $25,000 in cash in order to pay for renovations to her principal residence. Gutierrez Inc. has sufficient cash to pay either additional salary or additional taxable dividends in order to provide the necessary funds. The Company has no balance in its GRIP account.

**Required:** Determine the amount that would be required in the way of salary and in the way of taxable dividends, in order to provide Jeannette with the required after tax cash of $25,000. Which alternative would have the lowest income tax cost to Jeannette and the corporation?

Answer:

***Required Salary***

Given her personal income tax rate of 52%, a salary of $52,083 [($25,000, (1 - .52)] would be required to provide Jeannette with an additional $25,000 in after tax cash.

***Tax Cost of Salary Alternative***

The net income tax cost of this alternative would be calculated as follows:

Personal Income Tax on Salary [(52%)($52,083)] $27,083

Income Tax Savings to the Corporation [(12%)($52,083)] ( 6,250)

Income Tax Cost of Salary Alternative $20,833

***Required Taxable Dividend***

Jeannette's income tax rate on non-eligible dividends would be calculated as follows:

{[(115%)(52%)] - [(9/13 + 29%)(15%)]} = 45.07%

This gives after tax retention of dividend income in the amount of 54.93% (1 - .4507). This means a taxable dividend of $45,512 ($25,000, .5493) will be required to provide an additional $25,000 of after tax cash.

***Income Tax Cost of Taxable Dividend Alternative***

The personal income tax on the taxable dividend would be calculated as follows:

Non-Eligible Dividends Received $45,512

Gross Up at 15% 6,827

Additional Income $52,339

Income Tax Rate 52%

Income Tax before Dividend Tax Credit $27,216

Dividend Tax Credit [(9/13 + 29%)($6,827)] ( 6,706)

Personal Income Tax on Taxable Dividend Alternative $20,510

Subtracting the income tax of $20,510 from the actual dividends received of $45,512 gives the required $25,002 in after tax cash (the extra $2 is a rounding error).

As the taxable dividend payment would not be deductible to the corporation, its payment would not change corporate income tax. This means that the only income tax cost would be the $20,510 in personal income tax that Jeanette would pay on the taxable dividends.

***Conclusion***

The salary alternative has an income tax cost which is $323 ($20,833 - $20,510) higher than the income tax cost of paying taxable dividends. The taxable dividend alternative would have the lower income tax cost.

Since Jeanette has already received a salary of $232,000, CPP contributions and the Canada employment credit are not relevant to this analysis as they would have already been accounted for and would not affect the conclusion.

Type: ES

Topic: Employee compensation - salary vs. dividends (required amount)

96) Waylon Salas is the only shareholder of Wasal Inc., a CCPC. For the taxation year ending December 31, 2022, the Company has taxable income, before any consideration of salary to Waylon or the payment of taxable dividends, of $135,000. All of the taxable income qualifies for the SBD.

Despite its taxable income of $135,000, repayment of a large loan has left Wasal Inc. with only $54,000 in cash that can be used to pay income tax, salaries, or dividends.

Waylon's only income is either taxable dividends or salary from Wasal Inc. For 2022, he has personal tax credits of $5,200 (combined federal and provincial).

Relevant information with respect to his current province of residence is as follows:

• The income tax rate for individuals on the first $50,197 of taxable income is 8%.

• The provincial dividend tax credit is equal to 32% of the gross up on non-eligible dividends.

• All of the company's activities are confined to a province in which the applicable corporate income tax rate is 3% on income eligible for the SBD. The province does not charge any payroll taxes.

**Required:** Ignore the required CPP contributions and the Canada employment tax credit when answering Parts A to D.

A. Determine the after tax amount of cash that Waylon will retain if all of the company's cash is used to pay income tax and salary.

B. Determine the after tax amount of cash that Waylon will retain if the Company pays the maximum possible taxable dividend.

C. Can Waylon improve his after tax cash retention by using a combination of salary and taxable dividends? Explain your conclusion.

D. If your answer to Part C is yes, determine the combination of salary and/or taxable dividends that will produce the maximum after tax cash retention for Waylon. Calculate the amount of this after tax cash retention.

E. Briefly describe any other factors that Waylon should consider in deciding whether to receive taxable dividends or salary.

Answer:

***Part A - Income Tax and Salary***

The combined federal/provincial income tax rate for Wasal Inc. is 12% (38% - 10% - 19% + 3%).

As the corporation's taxable income exceeds the amount of cash available, the maximum amount of salary that can be paid (X) must be determined using the following simple equation:

X = $54,000 - [(12%)($135,000 - X)]

Solving this equation for X results in maximum salary of $42,955. This can be verified by the following calculation:

Corporate Income before Salary $135,000

Maximum Salary ( 42,955)

Corporate Taxable Income $ 92,045

Corporate Income Tax Rate 12%

Corporate Income Tax $ 11,045

Payment of this amount of income tax will leave $42,955 ($54,000 - $11,045) available for the payment of salary.

With this amount of salary, Waylon would have the following amount of after tax cash:

Salary Payment $42,955

Income Tax before Credits [(15% + 8%)($42,955)] ($9,880)

Personal Tax Credits (Given) 5,200 ( 4,680)

After Tax Cash Retained (All Salary) $38,275

***Part B - All Taxable Dividends***

As taxable dividend payments are not deductible to the Company, income tax of $16,200 [(12%)($135,000)] will have to be paid. This leaves a maximum of $37,800 ($54,000 - $16,200) to be used for the payment of non-eligible dividends. When this is paid, the after tax retention by Waylon will be as follows:

Non-Eligible Dividends $37,800

Gross Up [(15%)($37,800)] 5,670

Taxable Dividends $43,470

Personal Income Tax Rate (15% + 8%) 23%

Income Tax before Tax Credits $ 9,998

Personal Tax Credits (Given) ( 5,200)

Dividend Tax Credit [(9/13 + 32%)($5,670)] ( 5,740)

Income Tax ($942 in unused credits) Nil

As there is no income tax payable, Waylon will retain all of the $37,800 in taxable dividends.

***Part C - Possible Improvement***

While the income tax for Waylon is nil in Part B, subtracting personal and dividend tax credits from the tax balance gives a negative figure of $942. This means that the all taxable dividend approach leaves unused personal tax credits. While not conclusive, this suggests that there may be a better solution than either all salary or all taxable dividends.

***Part D - Salary/Dividend Combination***

To examine the possibility of an optimum solution using both salary and taxable dividends, consider the result that occurs when $1,000 in salary is paid in lieu of some taxable dividends. Because the deductible salary payment would reduce corporate income tax, taxable dividends would only have to be decreased by $880 [($1,000)(1 - 0.12)]. The income tax effects of this are calculated as follows:

Increase in Salary $1,000.00

Decrease in Dividend [($1,000)(1 - .12)] ( 880.00)

Decrease in Dividend Gross Up [(15%)($880.00)] ( 132.00)

Decrease in Waylon’s Taxable Income ($ 12.00)

Personal Income Tax Rate 23%

Decrease in Income Tax Payable before Dividend Tax Credit ($ 2.76)

Decrease in Dividend Tax Credit [(9/13 + 32%)($132.00)] 133.62

Increase in Personal Income Tax $ 130.86

The rate on a $1,000 increase in salary is 13.086% ($130.86 ÷ $1,000). Applying this rate to the unused credits of $942 (see Part C), gives a required increase in salary of $7,199 ($942 ÷ 0.13086).

Payment of this amount of salary would result in corporate income tax as follows:

Corporate Income before Salary $135,000

Salary ( 7,199)

Corporate Taxable Income $127,801

Corporate Income Tax Rate 12%

Corporate Income Tax $ 15,336

Based on available cash of $54,000, the amount of taxable dividend that could be paid is as follows:

Cash Available $54,000

Corporate Income Tax ( 15,336)

Salary Payment ( 7,199)

Available for Taxable Dividends $31,465

After tax retention to Waylon would be as follows:

Non-Eligible Dividends Received $31,465

Gross Up [(15%)($31,465)] 4,720

Taxable Dividends $36,185

Salary 7,199

Waylon’s Taxable Income $43,384

Personal Tax Rate (15% + 6%) 23%

Income Tax before Tax Credits $ 9,978

Personal Tax Credits (Given) ( 5,200)

Dividend Tax Credit [(9/13 + 32%)($4,720)] ( 4,778)

Income Tax Nil

Amounts Received ($31,465 + $7,199) $38,664

Personal Income Tax Nil

After Tax Cash Retained (Salary and Taxable Dividends) $38,664

The comparative results for the three alternatives are as follows:

All Salary $38,275

All Dividends $37,800

Salary/Dividend Combination $38,664

The combination of salary and taxable dividends will produce the maximum after tax cash retention for Waylon. It is a $389 ($38,664 - $38,275) improvement over the all salary alternative and an $864 ($38,664 - $37,800) improvement over the all dividend alternative.

***Part E - Other Factors***

Other factors that might be considered include:

• The Canada employment tax credit was ignored in the calculations as it is not a credit against provincial or territorial income tax. However, it would allow the first $1,287 of salary to be received tax free.

• If the effect of CPP was considered, both Waylon and Wasal Inc. would pay CPP contributions if salary was paid. Paying CPP contributions would allow him to receive CPP payments in the future, but would require both a personal and a corporate cash outflow at the present time.

• If Wasal Inc. has benefits for employees, such as a private health services plan (PHSP), this could make being an employee (by taking salary) more advantageous.

• Taxable dividends are not earned income for RRSP or child care expense purposes.

• If Waylon has a CNIL balance, taxable dividend payments would reduce the account increasing the amount of the available capital gains deduction.

• Waylon should consider declaring a bonus (a form of salary) to be paid after the end of the calendar year if he does not require the cash immediately. This would defer the personal income tax without affecting corporate income tax as long as the bonus was paid within 180 days of the taxation year of the corporation.

• Though not relevant in this problem, some provinces and territories have payroll taxes.

Type: ES

Topic: Employee compensation - salary vs dividends (optimum mix)

97) Ms. Barbra Stickle is the only shareholder of Stickle Ltd., a CCPC. The Company has a December 31 taxation year end and, at December 31, 2022, Ms. Stickle determines that the taxable income of the Company for the year will be $24,200. The Company has this amount available in cash, prior to the payment of income tax, taxable dividends, or salary.

All of the Company's income qualifies as active business income and any taxable dividends that it pays will be non-eligible. The Company's activities are confined to a province in which the corporate income tax rate is 3% on income eligible for the SBD. The province does not levy a payroll tax.

Ms. Stickle has no other income. In her income tax bracket, the combined federal/provincial income tax rate for individuals is 25%. For non-eligible dividends, the provincial dividend tax credit has been set at 30% of the dividend gross up. Ms. Stickle has combined personal tax credits for the 2022 taxation year of $3,423.

**Required:**

A. Determine the after tax amount of cash that Ms. Stickle will retain if all of the Company's income is paid to her in the form of salary. Ignore CPP contributions and the Canada employment tax credit.

B. Determine the after tax amount of cash that Ms. Stickle will retain if the Company pays the maximum possible taxable dividend.

C. Can Ms. Stickle improve her after tax cash retention by using a combination of salary and taxable dividends? Explain your conclusion.

D. Determine the combination of salary and/or taxable dividends that will produce the maximum after tax cash retention for Ms. Stickle. Calculate the amount of this after tax cash retention.

E. Briefly describe any other factors that Ms. Stickle should consider in deciding whether to receive taxable dividends or salary.

Answer:

***Part A - All Salary***

As salary payments can be deducted by the corporation, the entire $24,200 can be paid as salary. Given this deduction, no income tax required of the Company for 2022. With a salary payment of $24,200, Ms. Stickle's after tax cash balance would be as follows:

Salary Payment $24,200

Income Tax before Credits [(25%)($24,200)] ($6,050)

Personal Tax Credits (Given) 3,423 ( 2,627)

After Tax Cash Retained (All Salary) $21,573

***Part B - All Taxable Dividends***

The income tax rate for Stickle Ltd. would be 12% (38% - 10% - 19% + 3%). As taxable dividend payments are not deductible to the Company, income taxes of $2,904 [(12%)($24,200)] will have to be paid, leaving a maximum of $21,296 to be used for the payment of taxable dividends. When this is paid, the after tax retention by Ms. Stickle will be as follows:

Non-Eligible Dividends $21,296

Gross Up [(15%)($21,296)] 3,194

Taxable Dividends $24,490

Personal Income Tax Rate 25%

Income Tax before Credits $ 6,123

Personal Tax Credits (Given) ( 3,423)

Dividend Tax Credit [(9/13 + 30%)($3,194)] ( 3,169)

Income Tax Payable ($469 in unused credits) Nil

Taxable Dividends $21,296

Income Tax Nil

After Tax Cash Retained (All Taxable Dividends) $21,296

***Part C - Possible Improvement***

While Ms. Stickle's income tax is nil in Part B, subtracting personal and dividend tax credits results in $469 of unused tax credits. While not conclusive, this suggests that there may be a better solution than either all salary or all taxable dividends.

***Part D - Salary/Taxable Dividend Combination***

To examine the possibility of an optimum solution using both salary and taxable dividends, consider the result that occurs when $1,000 in salary is paid in lieu of some taxable dividends. Because the deductible salary payment would reduce corporate income tax, taxable dividends would only have to be decreased by $880 [($1,000)(1 - 0.12)]. The income tax effects of this can be calculated as follows:

Increase in Salary $1,000.00

Decrease in Taxable Dividend [($1,000)(1 - .12)] ( 880.00)

Decrease in Dividend Gross Up [(15%)($880.00)] ( 132.00)

Decrease in Ms. Stickle’s Taxable Income ($ 12.00)

Personal Income Tax Rate 25%

Decrease in Income Tax before Dividend Tax Credit ($ 3.00)

Decrease in Dividend Tax Credit [(9/13+ 30%)($132.00)] 130.98

Increase in Personal Income Tax $ 127.98

The rate on a $1,000 increase in salary is 12.798% ($127.98 ÷ $1,000). Applying this rate to the unused credits of $469 (see Part C), gives a required increase in salary of $3,665 ($469 ÷ 0.12798)

Based on this payment of salary, corporate income tax and funds available for payment of taxable dividends would be calculated as follows:

Pre-Salary Corporate Income $24,200

Salary ( 3,665)

Corporate Taxable Income $20,535

Corporate Income Tax [(12%)($20,535)] ( 2,464)

Available for Taxable Dividends $18,071

After tax retention to Barbra would be as follows:

Non-Eligible Dividends Received $18,071

Gross Up [(15%)($18,071)] 2,711

Taxable Dividends $20,782

Salary 3,665

Ms. Stickle’s Taxable Income $24,447

Personal Income Tax Rate 25%

Income Tax before Credits $ 6,111

Personal Tax Credits (Given) ( 3,423)

Dividend Tax Credit [(9/13 + 30%)($2,711)] ( 2,690)

Income Tax Payable ($2 rounding difference) Nil

Amounts Received ($3,665 + $18,071) $21,736

Personal Income Tax Nil

After Tax Cash Retained (Salary and Taxable Dividends) $21,736

The comparative results for the three alternatives are as follows:

All Salary $21,573

All Dividends $21,296

Salary/Dividend Combination $21,736

The combination of salary and taxable dividends will produce the maximum after tax cash retention for Ms. Stickle. It is a $163 ($21,736 - $21,573) improvement over the all salary alternative and a $440 ($21,736 - $21,296) improvement over the all dividend alternative.

***Part E - Other Factors***

Other factors that might be considered include:

• The Canada employment tax credit was ignored in the calculations as it is not a credit against provincial or territorial income tax. However, it would allow the first $1,287 of salary to be received with a nil federal income tax cost.

• If the effect of CPP was considered, both Ms. Stickle and Stickle Ltd. would pay CPP contributions if salary was paid. Paying CPP contributions would allow her to receive CPP payments in the future, but would require both a personal and a corporate cash outflow at the present time.

• If Stickle Ltd. has benefits for employees, such as a private health services plan (PHSP), this could make being an employee (by taking salary) more advantageous.

• Taxable dividends are not earned income for RRSP and child care expense purposes.

• If she has a CNIL balance, dividend payments will reduce the account balance and increase the available amount of the capital gains deduction.

• Ms. Stickle should consider declaring a bonus (a form of salary) to be paid after the end of the calendar year if she does not require the cash immediately. This would defer the personal income tax without affecting corporate income tax as long as the bonus was paid within 180 days of December 31 (by day 179).

• Though not relevant in this problem, some provinces and territories have payroll taxes which could be incurred.

Type: ES

Topic: Employee compensation - salary vs dividends (optimum mix)