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CHAPTER 2

FUNDAMENTALS OF TAX PLANNING

Review Questions

1. "Tax planning and tax avoidance mean the same thing." Is this statement true? Explain.

2. What distinguishes tax evasion from tax avoidance and tax planning?

3. Does the Canada Revenue Agency deal with all tax avoidance activities in the same way? Explain.

4. The purpose of tax planning is to reduce or defer the tax costs associated with financial transactions. What are the general types of tax planning activities? Briefly explain how each of them may reduce or defer the tax cost.

5. "It is always better to pay tax later rather than sooner." Is this statement true? Explain.

6. When corporate tax rates are 15% and tax rates for individuals are 40%, is it always better for the individual to transfer his or her business to a corporation?

7. "As long as all of the income tax rules are known, a tax plan can be developed with certainty." Is this statement true? Explain.

8. What basic skills are required to develop a good tax plan?

9. An entrepreneur is developing a new business venture and is planning to raise equity capital from individual investors. Her advisor indicates that the venture could be structured as a corporation (i.e., shares are issued to the investors) or as a limited partnership (i.e., partnership units are sold). Both structures provide limited liability for the investors. Should the entrepreneur consider the tax positions of the individual investors? Explain. Without dealing with specific tax rules, what general tax factors should an investor consider before making an investment?

10. What is a tax avoidance transaction?

11. "If a transaction (or a series of transactions) that results in a tax benefit was not undertaken primarily for bona fide business, investment, or family purposes, the general anti-avoidance rule will apply and eliminate the tax benefit." Is this statement true? Explain.

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Solutions to Review Questions

R2-1 There is a distinction between tax planning and tax avoidance. Tax planning is the process of arranging financial transactions in a manner that reduces or defers the tax cost and that arrangement is clearly provided for in the *Income Tax Act* or is not specifically prohibited. In other words, the arrangement is chosen from a reasonably clear set of options within the Act.

In contrast, tax avoidance involves a transaction or series of transactions, the main purpose of which is to avoid or reduce the tax otherwise payable. While each transaction in the process may be legal by itself, the series of transactions cause a result that was not intended by the tax system.

R2-2 Both tax planning and tax avoidance activities clearly present the full facts of each transaction, allowing them to be scrutinized by CRA. In comparison, tax evasion involves knowingly excluding or altering the facts with the intention to deceive. Failing to report an amount of revenue when it is known to exist or deducting a false expense are examples of tax evasion.

R2-3 CRA does not deal with all tax avoidance transactions in the same way. In general terms, CRA attempts to divide tax avoidance transactions between those that are an abuse of the tax system and those that are not. When an action is considered to be abusive, CRA will attempt to deny the resulting benefits by applying one of the anti-avoidance rules in the *Income Tax Act*.

R2-4 There are three general types of tax planning activities:

- Shifting income from one time period to another.
- Transferring income to another entity.
- Converting the nature of income from one type to another.

Shifting income to another time period can be a benefit if it results in a lower rate of tax applying to the income. Even if a lower rate of tax is not achieved, a benefit may be gained from delaying the payment of tax to a future time period.

Shifting income to an alternate taxpayer (for example, from an individual to a corporation), the amount and timing of the tax may be beneficially altered.

There are several types of income within the tax system such as employment income, business income, capital gains and so on. Each type of income is governed by a different set of rules. For some types of income, the timing, the amount of income recognized, and the effective tax rate is different from other types. By converting one type of income to another, a benefit may be gained if the timing of income recognition, the amount recognized, and/or the effective tax rate is favorable.

R2-5 The statement is not true. Paying tax later may be an advantage because it delays the tax cost and frees up cash for other purposes. However, the delay may result in a higher rate of tax in the future year compared to the current year. In such circumstances there is a trade-off between the timing of the tax and the amount of tax payable.

R2-6 There is not always an advantage to transfer income to a corporation when the corporate tax rate is lower than that of the individual shareholder. While an immediate lower tax rate results, remember that the corporation may be required to distribute some or all of its

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after-tax income to the shareholder which causes a second level of tax. Whether or not an advantage is achieved depends on the amount of that second level of tax and when it occurs. Other factors may also be relevant such as the tax treatment of a possible business failure or sale.

R2-7 The statement is not true. Knowing the tax rules is, of course, a major element in the tax planning process, but, it does not guarantee the expected outcome. Planning means that certain steps are taken now in preparation for certain activities that may occur in the future. However, those anticipated activities might not occur and the desired tax result may not be achieved. Tax planning also requires that one must anticipate and speculate on possible future scenarios and relate them to the current tax planning steps. Those scenarios are never certain.

R2-8 To develop a good tax plan, one must be able to:

- Understand the fundamentals of the income tax system.
- Anticipate the complete cycle of transactions.
- Develop optional methods of achieving the desired business result and analyze each of their tax implications.
- Speculate on possible future scenarios and assess their likelihood.
- Measure the time value of money.
- Place the tax issue in perspective by applying common sense and sound business judgement.
- Understand the tax position of other parties involved in the transaction.

R2-9 Yes, the entrepreneur should consider the tax position of the potential investors. They will be taking a risk in accepting the investment. If the entrepreneur knows the tax effect on the investors, of each alternative organization structure, the entrepreneur can choose the one that provides investors the most favorable tax treatment (i.e., one that reduces their after-tax loss if the investment fails, or increases their after-tax income if it succeeds). Before making the investment the investor should determine the tax impact on:

- income earned by the venture,
- income distributed to the investor,
- losses incurred by the venture,
- the loss of the investment if the venture fails, and
- the gain on the investment when it is eventually sold.

R2-10 A tax avoidance transaction is a term used within the general anti-avoidance rule (GAAR) of the *Income Tax Act*. An avoidance transaction is a transaction or series of transactions that results in a tax benefit and was not undertaken primarily for bona fide business, investment or family purposes [ITA 245].

R2-11 The statement is not true. In order for the tax benefit to be denied under the general anti-avoidance rule (GAAR), the transaction, in addition to not being primarily for *bona fide* business, investment or family purposes, must be considered to be a misuse or abuse of the income tax system as a whole. What constitutes a misuse or abuse is not always clear. However, certain avoidance transactions are permitted and others are not [ITA 245(3), IC 88-2].

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Key Concept Questions

QUESTION ONE

The *Income Tax Act* contains a general anti-avoidance rule (GAAR) in section 245. Consider each of the following situations and determine whether the GAAR will likely apply. *Income tax reference: ITA 245(1),(2),(3),(4); IC 88-2.*

1. Chris transferred her consulting business to a corporation primarily to obtain the benefit of the low corporate tax rate.

2. Paul owns 100% of the shares of P Ltd. Paul provides services to P Ltd. In the current year he received no remuneration for his services because the payment of a salary to Paul would increase the amount of the loss that P Ltd. will incur in the year.

3. A Canadian-controlled private corporation pays its shareholder/manager a bonus that will reduce the corporation's income to the amount eligible for the low tax rate. The bonus is not in excess of a reasonable amount.

4. A profitable Canadian corporation has a wholly owned Canadian subsidiary that is sustaining losses and needs additional capital to carry on its business. The subsidiary could borrow the funds from its bank but could not obtain any tax saving in the current year by deducting the interest expense due to its loss situation. Therefore, the parent corporation borrows the funds from its bank and subscribes for additional common shares of the subsidiary. The parent corporation reduces its taxable income by deducting the interest expense. The subsidiary uses the funds to earn income from its business.

QUESTION TWO

John has owned all of the shares of Corporation A and Corporation B since their inception. In the current year, John had Corporation A transfer, on a tax-deferred basis, property used in its business to Corporation B. The reason for the transfer is to enable Corporation B to apply the income earned on the transferred assets against its non-capital losses.

Will the GAAR in ITA 245(2) apply to disallow the tax benefit? *Income tax reference: ITA 245(1),(2),(3),(4); IC 88-2.*

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Solutions to Key Concept Questions

KC 2-1

[ITA: 245(2) – GAAR]

The GAAR provision in ITA 245(2) is to be used when specific anti-avoidance provisions do not suffice. For the GAAR to apply, the following four conditions must be met:

1) A tax benefit results from a transaction or part of a series of transactions [ITA 245(1) – "tax benefit" definition],

2) The transaction is an avoidance transaction, in that, it was not undertaken primarily for *bona fide* purposes other than to obtain the tax benefit [ITA 245(3) – "Avoidance transaction" definition],

3) No other provision of the Act stops the taxpayer from achieving the intended tax advantage, and

4) The transaction is an abusive transaction, in that, it can reasonably be concluded that the tax benefit would result in a misuse or abuse of the Act, read as a whole [ITA 245(4)].

The transactions described in each of the four situations:

- A tax benefit results in each case,
- The transactions have been undertaken primarily to obtain a tax benefit and are, for that reason, avoidance transactions, and
- Are not subject to any other anti-avoidance rule in the Act,

Therefore, the issue to be determined is whether the tax benefit would result in a misuse or abuse of the Act, read as a whole.

Situation 1: There is nothing in the Act that prohibits Chris from incorporating her business. The incorporation is consistent with the Act read as a whole and, therefore, the GAAR would not apply.

Situation 2: There is no provision in the Act requiring a salary to be paid to Paul and the failure to pay a salary is, therefore, not contrary to the scheme of the Act read as a whole. The GAAR would not apply to deem a salary to be paid by P Ltd. or received by Paul.

Situation 3: The Act recognizes the deductibility of reasonable business expenses which include bonuses. The payment of the bonus is not an abusive transaction and, therefore, the GAAR should not apply to the payment.

Situation 4: The borrowing by the parent corporation is for the purpose of gaining or producing income as required by paragraph 20(1)(c) of the Act. The GAAR should, therefore, not apply. In fact, CRA has indicated, in comfort letters, that where one corporation (A Ltd.) borrows from a financial institution to invest in shares of another corporation (B Ltd.) and B Ltd. re-loans the funds back to A Ltd. and charges interest at a reasonable rate, thus, shifting income from A Ltd. to B Ltd., the transactions are permissible and will not be challenged.

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KC 2-2

[ITA: 245(2) – GAAR]

The GAAR provision in ITA 245(2) is to be used when specific anti-avoidance provisions do not suffice. For the GAAR to apply, the following four conditions must be met:

1) A tax benefit results from a transaction or part of a series of transactions,
2) The transaction is an avoidance transaction, in that, it was not undertaken primarily for *bona fide* purposes other than to obtain the tax benefit,
3) No other provision of the Act stops the taxpayer from achieving the intended tax advantage, and
4) The transaction is an abusive transaction, in that, it can reasonably be concluded that the tax benefit would result in a misuse or abuse of the Act, read as a whole.

In the case of John and his two corporations:

- The transaction does result in a tax benefit as using the losses will reduce tax,
- It appears that the transaction was undertaken primarily for the tax benefit, and
- There is no provision in the *Income Tax Act* prohibiting the transfer of the property on a tax-deferred basis to a related corporation nor the deduction of the losses by Corporation B,

So, the question that remains is whether the transaction is an abusive transaction.

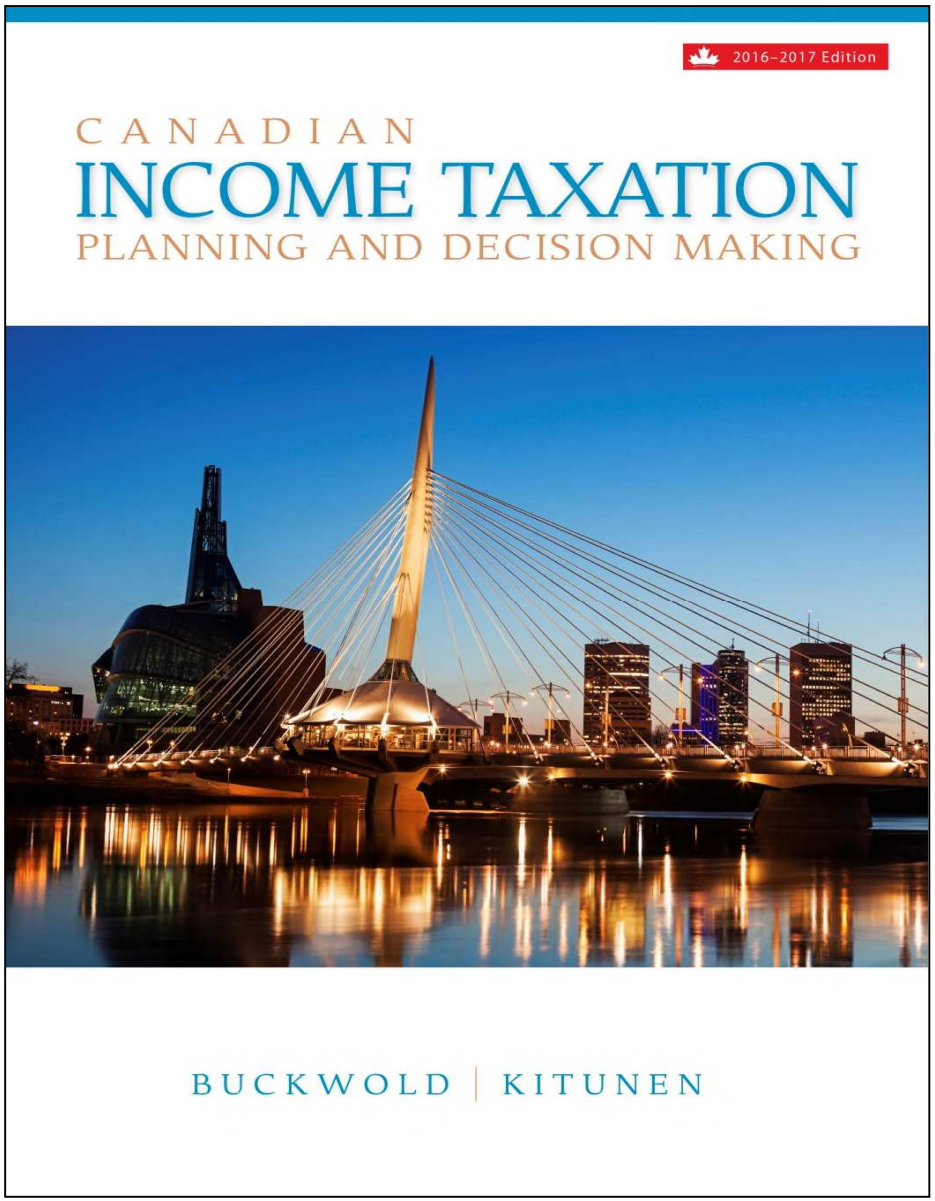
Since the Act contains specific provisions permitting the transfer of losses between related corporations, the transfer in question is consistent with the scheme of the Act and, therefore, is not an abusive transaction. Thus, the GAAR should not apply.

However, had the transfer of a property been undertaken to avoid a specific rule, such as a rule designed to preclude the deduction of losses after the acquisition of control of a corporation by an arm's length person, such a transfer would be a misuse of the provisions of the Act and be subject to the GAAR [IC88-2].

Where the GAAR applies, the tax benefit that results from an avoidance transaction will be denied. In order to determine the amount of the tax benefit that will be denied, the provision indicates that the tax consequences of the transaction to a person will be determined as is reasonable in the circumstances.

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CHAPTER 2: Fundamentals of Tax Planning

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CHAPTER TWO
Fundamentals of Tax Planning

I. What Is Tax Planning?
II. Types of Tax Planning.
III. Skills Required for Tax Planning.
IV. Restrictions to Tax Planning.

I. What is Tax Planning?

- **Tax Planning:**
  - legitimate arranging of financial activities that reduces or defers tax costs.
  - General anti-avoidance rule (GAAR) in the *Income Tax Act,* indicates what is **not** legitimate tax planning.

- **Tax Evasion:**
  - Very clear - an act with the intent to deceive.
  - includes knowingly failing to report revenue, or claiming the deduction of a false expense, or both.



I. What is Tax Planning?

- **Tax avoidance:**
  - Involves transactions which are planned and carried out mainly to avoid, reduce, or defer taxes,
  - Transactions that do not reflect the real facts,
  - May be regarded as abuse.



- Often, difficult to distinguish between legitimate tax planning and abusive tax avoidance.

- When CRA perceives tax avoidance transactions to be abusive, it will attempt to deny the resulting benefits.



II. Types of Tax Planning

- The objective of tax planning is to reduce and/or defer the tax cost of financial transactions.

- **All tax planning opportunities fall into one of three categories:**
  1. Shifting income from one time period to another.
  2. Transferring income to another entity or alternative taxpayer.
  3. Converting the nature of income from one type to another.

A. Shifting income from one time period to another.

- In most cases, there is little opportunity to choose between discretionary alternatives.
- Can sometimes choose between alternatives:
  - ie. Reserves - can choose to claim a deduction from income in a different time period.
- Must consider future tax rates in the decision to shift income.

A. Shifting income from one time period to another (continued)

Future tax rates may be greater than, less than, or the same as current tax rates.

Current tax rate lower than future tax rate

↓

Tax savings to recognize income now vs. later

Current tax rate higher than future tax rate

↓

Tax cost to recognize income now vs. later

Also consider finance costs to pay tax now rather than later

Shifting Income Example

The following is tax information for ABC corp.

- Tax rate on income < $500,000 15%
- Tax rate on income > $500,000 27%
- 20X1 income after reserve = $150,000
  - $20,000 reserve can be delayed to 20X2
- 20X2 income is estimated to be $550,000
- Cash is being used to take advantage of 2% early payment discounts (assume equivalent to an annual rate of 36%)

Determine the ultimate tax savings from shifting the reserve claim to 20X2.

Shifting Income Solution

If the $20,000 reserve is deducted in 20X2, income is shifted from 20X2 to 20X1.

Increase in 20X1 tax	($20,000 x 15%)	$ 3,000
Decrease in 20X2 tax	($20,000 x 27%)	(5,400)
Tax reduction		(2,400)

Shifting income solution

- Must also consider the financing cost of prepaying $3,000 tax one year in advance
- Purchasing costs would increase by $1,080 ($3,000 x 36%)
- These costs would be deductible and save tax of $292 ($1,080 x 27%
- Therefore, the net cost, after-tax is $788

- Overall savings:

Tax savings	$2,400
Finance cost of prepaying tax	(788)
	1,612

A. Shifting income from one time period to another (continued)

In making a decision to shift income, must determine:

- Future tax rates.
- Discretionary opportunities within the tax act (i.e. reserves).
- Time value of money.



B. Transferring Income to Another Entity

- **Individuals can accumulate wealth by using one or more different entities:**
  - Corporations, proprietorship, partnerships, trusts, etc.
- The tax treatment varies with the entity chosen.
- Ultimately, the wealth leads back to the individual or family members.
- Shifting income to a different structure may reduce or significantly delay tax payable.



B. Transferring Income to Another Entity (continued)

For example:

- An individual may run a business through a corporation or as a sole-proprietor.
- Individual needs $39,000 after-tax
- Corporate tax rates – 15% on first $500,000 – 25% on excess
- **Personal tax rates:**

First $45,000	24%
Next $45,000	32%
Next $50,000	40%
Next $60,000	45%
Income over $200,000	50%

B. Transferring Income to Another Entity (continued)

	Unincorporated		Incorporated
Business profits	$100,000	Bus. Profits Less Salary	$100,000 ($52,100)
Taxes	($29,200)	Corporate Taxes	($7,200)
Personal expenses	($39,000)		
After-tax cash flows	$31,800		$ 40,700

Incorporation provides an extra $8,900 available for expansion

B. Transferring Income to Another Entity (continued)

Other factors to consider:

- Future requirements for cash distributions from corporation.
- Corporate profits in excess of $500,000 incur higher rates of tax.
- Losses incurred in corporation.
- Business failure, Sale of business, etc.
- Shareholder dies or leaves the country

Tax planning involves anticipating possible future events.



C. Converting Income from One Type to Another

Four basic types of income:

1. Employment (Chapter 4)
2. Business (Chapter 5)
3. Property (Chapter 7)
4. Capital gains (Chapter 8)

Amount of taxable income to be claimed & the timing of that claim depends greatly on the type of income.

C. Converting Income from One Type to Another

- Can alter the amount of tax and its timing by adjusting a financial transaction to generate a different type of income.
- **It is not always simple to convert one type of income to another.**
  - converting income may also involve shifting that income from one entity to another.
- May also consider converting costs to acquire goods or services from one type of expenditure to another

III. Skills Required for Tax Planning

- **Anticipation** – envision the complete cycle.
- **Flexibility** – seek out alternative methods.
- **Speculation** – anticipate tax effects.
- Application of compound interest.
- **Perspective** – common sense must prevail.
- **Global approach** – consider all sides.





IV. Restrictions to Tax Planning

- Tax planning is divided between acceptable and unacceptable activities.

- The *Income Tax Act* specifically prohibits a number of activities.

anti-avoidance rules

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IV. Restrictions to Tax Planning

A. Specific Anti-Avoidance Rules:

- Two general types of financial transactions:
  - Between parties with a close relationship (not at arm's length), and
  - Between parties completely independent of each other

- Authorities are more concerned with those not at arm's length
  - Several provisions have been designed to limit tax avoidance activities

IV. Restrictions to Tax Planning

B. The General Anti-Avoidance Rule (GAAR)

GAAR stipulates:

When a person is involved in an “avoidance transaction,” the tax will be adjusted to deny the benefit.

IV. Restrictions to Tax Planning

Not an avoidance transaction if,

- Its primary objective is other than to obtain a tax benefit.
- Undertaken primarily for bona fide business, investment or family purposes.

Establishes a business purpose or economic reality test

- Helps distinguish between unacceptable and acceptable planning activities.

IV. Restrictions to Tax Planning

For a tax plan to be rejected it must:

- Fail the business purpose test and,
- Must be extreme - that it is not within the “spirit” of the tax system.

Conclusion

- **Tax Planning** – conscious effort to direct financial activities to eliminate, reduce, or defer tax
  - There is some flexibility in the tax system
  - Planning activities must be consistent with prudent business activities.

- Good tax planning involves applying business basics.

