AY AU-YEUNG & COMPANY LLP
Chartered Accountants

CANADIAN CORPORATE TAXATION

A General Guide
January 31, 2011

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PART A

INCORPORATION OF A BUSINESS

Incorporation may be advantageous for a number of reasons:

1. limited liability
2. perpetual succession
3. possibility for greater employee participation
4. more external financing options
5. more flexibility upon death of owner or sale of business
6. tax reasons (income tax deferral and possible income tax savings)

Only the taxation aspects will be discussed in this booklet. The following information incorporates changes announced up to January 31, 2011.

POTENTIAL TAX ADVANTAGES OF INCORPORATION

1. A Canadian-controlled private corporation engaged in an active business can enjoy significantly lower income tax rates. For 2011, the first $ 500,000 of annual active business income of a Canadian-controlled private corporation in BC is subject to tax at 13.50% (2012: 13.50%).

   Annual active business income over $ 500,000 in BC is subject to tax at the general rate of 26.50% (2012: 25.00%).

2. Advantageous income splitting among individuals with different marginal tax rates is possible.

3. Facilitates estate planning.

4. For a qualified small business corporation (“QSBC” - a Canadian-controlled private corporation, all or substantially all of whose assets are used in carrying on active business in Canada), a lifetime capital gains exemption of $ 750,000 is available with respect to the disposition of SBC shares by individual shareholders. The shares must have been held throughout the 24-month period preceding the disposition by the taxpayer or related persons.

   At one time, there was a $ 100,000 exemption for ordinary capital gains, which was eliminated on February 21, 1994. Any previous amounts claimed by an individual taxpayer using the $100,000 capital gains deduction will reduce that individual’s $ 750,000 exemption.

5. Planning opportunities discussed in Part F.

POTENTIAL DISADVANTAGES OF INCORPORATION

1. Losses incurred by the corporation are not deductible against other personal sources of income.

2. Prepayment of taxes on investment income if the shareholders' personal tax rates are below the top marginal rate.

3. Total tax cost is approximately 1.9% higher if investment income is flowed through a corporation rather than earned personally (based on announced and planned 2011 tax rates).

4. Annual corporate maintenance expenses and filing of corporate tax return.

5. Complexities of setting up and winding up the company.

6. Possible provincial corporation capital taxes. British Columbia corporation capital taxes have been eliminated as of September 1, 2002 but some other provinces still charge provincial capital taxes. (Ontario's capital tax has been eliminated effective July 1, 2010.)

PART B

TYPES OF CORPORATION

1. Canadian-controlled Private Corporation ("CCPC"):

   A private corporation, resident and incorporated in Canada, and not controlled directly or indirectly by non-residents, a public corporation or any combination thereof.

2. Other Private Corporation:

   A private corporation, resident in Canada, not a public corporation, and not controlled directly or indirectly by one or more public corporations (or prescribed Federal Crown corporation).

3. Public Corporation:

   Resident in Canada, and having a class of shares listed on a prescribed Canadian stock exchange, or has elected to be a public corporation upon complying with certain conditions regarding size, number and dispersal of shareholders, or has been designated as a public corporation by the Minister of National Revenue.

4. Corporation controlled by a Public Corporation:

   Any Canadian corporation that is a subsidiary of a public corporation (not a public corporation for tax purposes).

5. Other Corporations:

   Includes any corporation that does not fall within the above definitions (most commonly, corporations resident in other countries with operations in Canada).

PART C

NET INCOME FOR INCOME TAX PURPOSES

1. Net income per financial statements may be different from net income for income tax purposes.
2. Certain expenses on the income statement are not deductible for income tax purposes (e.g. amortization, donations, 50% of business meals, income tax interest and penalties).
3. Certain gains and losses are adjusted for income tax purposes (e.g. accounting gain on sale of capital property).
4. Certain deductions are specified in the Act as deductible for income tax purposes (e.g. capital cost allowance, eligible capital expenditures).
5. A computation is used to reconcile the net income per financial statements with the net income for income tax purposes.

   Example:

Computation

Net income per financial statements			$ 10,000
Add:	Accounting amortization	$ 1,000	
	Taxable capital gains	1,500	
	Charitable donations	1,000	
	50% of business meals	250	
	Income tax interest and penalties	300	4,050
			14,050
Less:	Accounting gains on sale of capital assets	3,000	
	Capital cost allowance	1,500	4,500
Net income for income tax purposes			$ 9,550

TAXABLE INCOME

Taxable income is arrived at after certain deductions are taken from net income for income tax purposes.

Example:

Net income for income tax purposes		$ 9,550
Less: Charitable donations (maximum 75% of net income for income tax purposes)	$ 1,000	
Taxable dividends (also see Part C note 8)	500	
Non-capital losses of previous tax years	800	
Net capital losses of previous tax years (cannot exceed net capital gains for the year)	200	2,500
Taxable income		$ 7,050

INCOME TAX ON INVESTMENT INCOME AND BUSINESS INCOME

1. Specified Investment Business

Investment income is income derived from property (including interest, dividends, rents or royalties).

A business whose principal purpose is to derive income from property is a specified investment business unless it employs throughout the year more than five full-time employees, who may be specified shareholders or related persons.

A specified shareholder is defined as a person who owns directly or indirectly 10% or more of any class of the issued shares of the corporation at any time in the year.

2. Personal Services Business

A personal service business is also referred to as an “incorporated employee”. This is when an individual provides services through a corporation, of which he or a related person is a specified shareholder, and the individual would reasonably be regarded as an officer or employee of the entity to which the services were provided if not for the existence of the corporation.

A specified shareholder is defined as having 10% or more of any class of issued shares of the business.

The personal service business rules do not apply where:

a) the corporation employs throughout the year more than five full-time employees (who may be specified shareholders or related persons); or
b) the services are provided to an associated corporation.

Income that is derived from a personal service business is not eligible for the small business deduction. Furthermore, no deductions are allowed in computing the corporation's income except for:

a) salaries and benefits paid to the incorporated employee;
b) expenses ordinarily deductible from employment income (e.g. selling expenses); and
c) legal fees paid to collect receivables.

Note: Common business expenses such as business meals, home office expenses, and capital cost allowance would not be deductible.

Whether the personal services business rules would apply or not depends on whether the relationship is one of employer and employee, or client and independent contractor. The most common factors generally considered in this determination are as follows:

a. the level of control the payer has over the worker;
b. whether or not the worker provides the tools and equipment;
c. whether the worker can subcontract the work or hire assistants;
d. the degree of financial risk taken by the worker;
e. the degree of responsibility for investment and management held by the worker;
f. the worker's opportunity for profit; and
g. any other relevant factors, such as written contracts

3. <u>Active Business Income</u>

Any business carried on by a corporation other than a specified investment business (see #1 above) or a personal service business (see #2 above) is included in the definition of active business.

Active business income is income derived from an active business, or from assets incidental or pertaining to an active business.

The following are included in computing active business income:

a) income from short-term investments of surplus cash, which is required for normal operations of an active business;

b) rental of property which is inventory of an active business;
c) interest on mortgage taken by a developer or real estate trader on properties sold;
d) interest on accounts receivable;
e) income which is a deductible expense in computing the active business income of an associated corporation (e.g. rent received from an associated corporation that is carrying on an active business).

4. Tax on Specified Investment Business Income

If a corporation is a CCPC throughout the taxation year, the tax rate on its specified investment business income for 2011 is 44.67% (2012: 44.67%), and there is a refundable portion of 26.67%, which is added to a tax account called "Refundable Dividend Tax on Hand" (see #9 below).

	%
Total federal tax	34.67
Provincial tax (BC)	10.00
Combined federal and BC tax rate if no dividends paid	44.67
Refundable portion if dividends paid	(26.67)
Corporate tax rate if taxable dividends paid to shareholders	18.00

A corporation that is not a CCPC will be taxed on its specified investment business income in 2011 at a rate of 26.5% (2012: 26.5%), without any refundable portion.

5. Tax on Active Business Income

If a corporation is a CCPC throughout the taxation year and has active business income, the applicable tax rates are as follows:

	Active business (threshold 1)	**Active business (threshold 2)**
	%	**%**
Total federal tax	11.00	16.50
Provincial tax (BC)	2.50	10.00
	13.50	26.50

Threshold 1: Active business, applies to taxable income below $ 500,000
Threshold 2: Active business, applies to taxable income above $ 500,000

A corporation that is not a CCPC will be taxed on its active business income in 2011 at a rate of 26.5% (2012: 26.5%).

6. Small Business Deduction

In computing the small business deduction, the Act provides a series of fairly complex rules, which are summarized as follows:

- only corporations that are CCPCs throughout the taxation year qualify for the small business deduction;
- the maximum amount of business income eligible for the tax reduction in a year is the least of:
  a) income from active business carried on in Canada
  b) taxable income for the year (to be reduced by any amounts in respect of foreign tax deductions)
  c) "annual business limit"

The "annual business limit" for the purposes of the small business deduction is $ 500,000.

Where a corporation is associated with other Canadian-controlled private corporations, the annual business limit must be shared amongst the group of associated corporations.

The small business deduction will be reduced if the corporation has taxable capital in excess of $ 10 million and will be eliminated if it has taxable capital in excess of $ 15 million.

7. Associated Corporations

Association is established by very specific rules set out in the Income Tax Act. Generally speaking, two corporations are associated if one controls the other, both are subject to common control, or if they are controlled by related persons or groups and certain cross-ownership (usually 25% or more) criteria are met.

The following associated corporation rules apply:

a) the meaning of control extends to circumstances of factual control (not necessarily legal ownership of more than 50% of voting shares);

b) shares held by a holding corporation are treated as being owned by the shareholders of the holding corporation;

c) shares of a corporation owned by minors are treated as being owned by each parent;

d) a corporation shall be deemed to be controlled by another person/corporation if the person/corporation owned more than 50% of the fair market value of all issued and outstanding shares (not necessarily voting shares).

e) if two corporations are associated with the same third corporation, the two corporations are considered associated even if they would not otherwise meet the association criteria.

Two or more corporations will be deemed to be associated if it may reasonably be considered that one of the main reasons for their separate existence is to reduce the taxes that would otherwise be payable. The ability to multiply the use of the small business deduction to reduce corporate tax on active business income through a group of companies has been significantly curtailed.

8. Part IV Tax

In general, private corporations receiving taxable dividends are subject to Part IV tax, which is refundable.

a) Taxable dividends received can be deducted from net income for tax purposes in computing taxable income for Part I tax.

b) 33 1/3% of the taxable dividend is payable as Part IV tax.

c) Such amount will be added to Refundable Dividend Tax on Hand.

Dividends received from a connected corporation (one in which the recipient corporation holds more than a 10% interest) are not subject to Part IV tax unless the payer received a dividend refund from the payment of the dividends.

9. Refundable Dividend Tax on Hand and Dividend Refunds

Refundable Dividend Tax on Hand (RDTOH) of a private corporation is the aggregate of:

a) RDTOH at end of preceding year;

b) plus refundable Part I tax (see #4 above) for the year;

c) plus Part IV tax (see #8 above) for the year;

d) less dividend refund for prior year.

A corporation with RDTOH is entitled to claim a dividend refund as long as it remains a private corporation.

The dividend refund is the lesser of:

a) RDTOH at the end of the taxation year;

b) 33 1/3% of the taxable dividends paid in the taxation year (i.e. $ 1 of refund for every $ 3 of taxable dividends paid).

10. "GRIP" Account – Eligible dividends

Effective in 2006, the government introduced proposed legislation that would reduce personal income taxes paid on "eligible" dividends from corporations. As a result, corporations should keep track of their "GRIP" (general rate income pool) account from which eligible dividends can be designated. Generally speaking, the GRIP account is comprised of income that was subject to the general rate, i.e. without the benefit from the small business deduction (see #6 above), or the refundable tax (see #9 above).

11. Accrued Remuneration

A company can deduct accrued remuneration only if the amount is paid within 179 days after the year-end. Otherwise, the remuneration would be deductible only in the fiscal period in which it is actually paid.

12. Capital Gains

Only 50% of capital gains are included in taxable income of the corporation.

13. Capital Dividend Account

This account consists of amounts that have been received by a Canadian private corporation which are not taxed, such as the untaxed 50% of capital gains, the untaxed portion of gains on the sale of eligible capital property, capital dividends received from another Canadian private corporation and certain life insurance proceeds.

Dividends paid out of this account are not taxable to the recipients who are Canadian residents. An election Form T2054 must be filed prior to the payment of capital dividends.

14. Capital Cost Allowance

An "available-for-use" rule applies to depreciable assets. An asset is not eligible for capital cost allowance or investment tax credit until it is available for use. The half-year rule will generally apply in the year the asset is first available for use.

15. Automobile Expenses (Passenger vehicles)

The following limitations apply with respect to automobile expenses for passenger vehicles:

a) capital cost allowance on passenger vehicles will be restricted to the first $ 30,000 of cost plus federal and provincial sales taxes (HST in applicable provinces) on $ 30,000;

b) the maximum deductible interest on borrowings to purchase a passenger vehicle will be restricted to $ 10 per day for which interest is payable;

c) the maximum deductible lease payments will be restricted to the least of:

- the actual lease costs;
- $ 800 per month plus any sales taxes; and
- the actual lease cost multiplied by the ratio of $ 30,000 plus sales taxes divided by 85% of the manufacturer's suggested list price.

16. Income attribution – Transfers and Loans to a Corporation

Section 74.4 (2) of the Income Tax Act provides that if an individual transfers or loans property to a corporation other than a small business corporation, in which the spouse and/or related child has a direct or indirect shareholding of 10% or more, interest shall be deemed to have been received by the individual.

There are several conditions for the above attribution to apply:

a) transfer or loan is made after October 27, 1986;

b) individual is a resident of Canada;

c) corporation is not a small business corporation, which is defined as a Canadian-controlled private corporation in which substantially all the assets (90% or more) are used in an active business in Canada;

d) corporation has one or more designated persons, who own 10% or more of any class of the corporation's capital stock; a designated person with respect to an individual is a:

- spouse
- related minor child
- partnerships, trusts, non-small business corporation involving the spouse or related minor child;

16. Income attribution – Transfers and Loans to a Corporation (continued)

e) one of the main purposes of the transfer or loan must have been to reduce the income of the individual and to benefit the spouse and/or related minor child.

Amount attributed = prescribed interest rate x amount of loan/fair value of property transferred x relevant period during the year

The individual must treat the amount attributed as interest income received from the corporation. Actual interest received or amounts included in the individual's income in respect of taxable dividends received will reduce the income attributed.

17. General Anti-Avoidance Rules (GAAR)

The general anti-avoidance rules became effective in September 1988 to prevent artificial tax avoidance arrangements. Each transaction, or each step in a series of transactions, should be carried out primarily for bona fide business purposes. The reduction, avoidance, deferral or refund of tax shall not be considered to be bona fide business purposes.

PART D

CAPITAL TAXES

Corporations which do not have any taxable income could still be liable to pay capital taxes. Capital taxes are computed on the basis of a corporation’s “paid-up capital”, which is essentially comprised of shareholders’ equity and liabilities, excluding current liabilities.

1. Large Corporation Tax (Part I.3 Tax)

The federal large corporation tax has been eliminated effective January 1, 2006 for all corporations other than financial institutions.

2. Provincial Capital Taxes

BC corporation capital tax has been eliminated effective September 1, 2002. However, several other provinces still levy capital taxes on corporations other than financial corporations (Quebec, Manitoba, Saskatchewan), with varying thresholds, limits and capital tax rates.

PART E

BOOKS AND RECORDS

The Income Tax Act sets out the obligation of taxpayers to keep proper books and records. Certain books and records (i.e. minutes, share registers, general ledger and special contracts or agreements) must be retained for two years following the date when the corporation is dissolved. Generally, other information needs to be retained for **six years** after the related taxation year. However, records related to long-term acquisition, disposal of property, share registry and others which have an impact upon sales or close of business should be kept indefinitely. The retention period may be reduced if written permission is received from the Minister for earlier disposal.

FILING, PAYMENTS AND DUE DATES

There are numerous filings and due dates which the corporation must carefully observe.

An important factor in determining many due dates is the corporation's year-end, which does not have to coincide with the calendar year-end. The corporation can select any year-end during its first fiscal period as long as that period does not exceed 53 weeks. Once a year-end is selected, it cannot be changed without the consent of the Minister of National Revenue and sound business reasons must be provided when a request for a change of year-end is made.

Item		Due Date(s)
Corporation income tax return (T2)	-	6 months after year-end
Income tax instalments	-	last day of each month
Balance of income tax due	-	Part I tax: 3 months after year-end for CCPCs earning active business income, for which the taxable income of the associated group does not exceed the small business limit in the previous taxation year; 2 months for other corporations
	-	Part IV tax: 3 months after year-end for all corporations (CCPCs and non-CCPCs)
T1135 Foreign Property holdings; T106 Non-arm's length transactions with non-resident persons; T1141 Transfers and Loans to Foreign Trusts; T1142 Distributions and Debts from Foreign Trusts	-	6 months after year-end
T1134-A or T1134-B Foreign Affiliate Information Returns	-	15 months after year-end

LATE OR DEFICIENT FILINGS AND PAYMENTS

Interest and penalties may be assessed for late or deficient filings and payments. Some major items are summarized below:

Item	Interest / Penalty
Late corporation income tax return	- penalty of 5% of unpaid tax, plus 1% for each complete month the return is past due up to 12 months (second offence within 3 years: penalty increased to 10% plus 2% per month up to 20 months)
Late or deficient income tax instal- ments	- interest at CRA's prescribed rates - penalty equal to 50% of instalment interest that exceeds the greater of: 1. $ 1,000 2. 25% of interest that would have been payable if no instalment had been made for the year
Late income tax payments	- interest at prescribed rates
Late T4, T5 corporate information return	- penalty of $ 25 per day (min. $ 100, max. $ 2,500)
Late T1135, T106, T1141, T1134-A and T1134-B	- penalty of $ 25 per day (min. $ 100, max. $ 2,500) - if late filing was done deliberately or there was gross negligence, $ 500 per month up to 24 months (Max. $ 12,000) for each failure to comply (doubled to $ 1,000 and $ 24,000 if demanded by CRA and not filed)
Late T1142	- penalty of $ 25 per day up to $ 2,500 (min. $ 100) - if deliberate or grossly negligent omissions, greater of $ 2,500 or 5% of distributions/debt from trust
Late clearance certificate (T2062A)	- penalties ranged from $ 100 to $ 2,500 - note: a clearance certificate must be filed with CRA within 10 days after the disposition by a non-resident of taxable Canadian property (e.g shares in a private corporation that derives its value principally from real estate situated in Canada)

Prescribed rates are set quarterly in relation to Treasury Bill rates. The rate on amounts owed to the government is 2% higher than the Treasury Bill rate, while the rate on amounts owed by the government is the Treasury Bill rate.

Penalties may be greater if the filer knowingly or negligently makes false statement filings or omissions.

PART F

TAX PLANNING

The following are some tax planning notes which may be helpful to the reader:

1. Deferring incorporation for start-up businesses

   Deferring incorporation may be worthwhile if the new business is not expected to be profitable for the first few years, the business risks involved are relatively low, and the operator of the business has other sources of personal income. By deferring incorporation until the business starts to become profitable, the initial losses can be used to offset other personal income. Naturally, the costs and complexities involved in transferring the business (assets, borrowings, contracts, etc.) to a corporation at a later date would need to be considered.

2. Reinvesting within the corporation

   The lower small business tax rate allows a corporation engaged in an active business to retain more after-tax funds. If these funds are immediately distributed to the shareholders, then essentially no tax benefit is obtained through incorporation. However, where the funds are reinvested within the active business, the corporation will have more funds available for growth than an unincorporated business.

3. Drawing sufficient salaries

   Although there is a tax deferral advantage to reinvesting earnings within a corporation, sufficient salaries should be drawn to take advantage of the shareholders' personal deductions and non-refundable tax credits, as well as to allow the shareholders to make RRSP contributions. Furthermore, it should be considered whether additional salaries/bonuses should be drawn by active shareholders who are involved in the day-to-day operations of the corporation to keep active business income of the corporation within the small business limit.

4. Thin capitalization rules

   If a non-resident shareholder advances a loan to the corporation, a portion or all of the interest on the outstanding loan may be deductible to the corporation. The deductible interest is calculated based on the thin capitalization rules, which limit the interest-bearing loan principal to an amount that is two times the corporation's equity contributed by non-resident shareholders. For calculating the thin capitalization limits, the average of the highest amount of debt at any time during each month and the average of the equity balances at the beginning of each month during the taxation year are used.

5. Home purchase loans

If a corporation makes an interest-free or low-interest home purchase loan to an employee or an employee's relative, the difference between the interest charged ($ nil in the case of an interest-free loan) and interest at the prescribed rate will be a taxable benefit to the employee. This deemed interest benefit may be acceptable if the prevailing prescribed interest rates are low and the interest benefit amount will be taxed at a low tax rate in the hands of the employee.

6. Private health services and dental plans

A corporation can deduct the cost of premiums paid to private health services and dental plans and employees are not required to report these amounts as taxable benefits.

7. Retiring allowances and death benefits

A corporation can pay retiring allowances and death benefits. A retiring allowance of up to $ 2,000 per year of service before 1996 plus an additional $ 1,500 per year before 1989 can be transferred by an employee into an RRSP without immediate tax consequence.

As for employee death benefits, there is a $ 10,000 exemption. Accordingly, the employee's beneficiary is required to include in income only that portion of the death benefit which exceeds $ 10,000.

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This information booklet is necessarily general in nature and does not serve as a guide to any specific tax problem. Before applying your own plans, please consult with your professional advisors to ensure that all relevant issues and legal aspects have been considered.

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January 31, 2011