INTRODUCTION

The field of taxation is continually changing, and it is far too complex to be treated here in great detail. This appendix is a simple overview designed to provide some basic appreciation of taxation in Canada. Specific rules are considered to illustrate only key concepts, since the particular provisions noted are subject to frequent amendments.

Taxes at both the corporate and individual levels affect most financial decisions. They are usually not “neutral,” meaning that choices that appear best before taxes are often not optimal when taxes are taken into account. Because both firms and investors are ultimately interested in what they retain on an after-tax basis, a basic appreciation of the tax environment is essential for the study of finance.

The areas of tax that are particularly pertinent to financial decision-making include the following:

1. Taxation of Corporate Income
2. Business Expenses and Deductions
3. Taxation of Individual Incomes

We discuss each area in turn.

In Canada, both the federal and provincial governments levy taxes on individuals and corporations, with provincial tax rates varying by province. Both levies have to be considered because it is the combined tax bill that is relevant in deriving after-tax cash flows.

TAXATION OF CORPORATE INCOME

Because the Income Tax Act stipulates different treatments for public, private, and Canadian-controlled private corporations, we need to clarify the basic distinctions among these categories. Basically, a public corporation is one resident in Canada with at least
one class of its shares publicly traded in this Country.\footnote{By general rule of law, a corporation is resident in the country in which its central management and control is located. Additionally, however, the act provides that a company incorporated in Canada after April 26, 1965 is deemed to be resident in Canada as a simple consequence of such incorporation and regardless of any other factors. In the case of earlier corporations, Canadian residence is established either through the general rule of law or by carrying on business here. However, the minister of national revenue may designate a company to be a public corporation.} A \textit{private corporation} is one resident in Canada that is neither a public corporation nor controlled by one. Finally, a \textit{Canadian-controlled private corporation} (CCPA) is one that meets the following requirements:

1. It was at one time a resident corporation and was either incorporated in Canada or resident here after June 18, 1971.
2. It is not controlled directly or indirectly by non-resident persons (corporate or natural), by one or more public corporations, or by any combination of non-residents and public corporations.

\section*{Tax Rates}

In most developed countries, the tax rate on corporate income has been close to 45 percent. This uniformity is explained in part by the international mobility of capital: capital could move to countries with lower tax rates if significant discrepancies appeared.

In Canada, the combined federal and provincial tax levied on corporate income follows this pattern and is generally under 50 percent. Several variations can be noted, however, and any general figure applied indiscriminately can prove misleading. For example, provincial tax rates on corporate income vary significantly, and a number of abatements or special deductions exist. These deductions are particularly important in the taxation of small business income, income derived from manufacturing and processing operations in Canada, and income from the production of minerals, oil, and gas. Because details of such incentives are altered in some way by almost every new budget, no attempt is made here to provide specifics.

Capital taxes and temporary surtaxes aside, the general rate of corporate tax in Canada as of 2000 was 38 percent.\footnote{Effective January 1, 2001, the general corporate tax rate is to be reduced to 31 percent over the next 5 years. The first reduction of 1 percent takes effect January 1, 2001. This rate reduction applies to all corporate income not subject to the small business deduction and any income that qualifies for the reduced rate for manufacturing and processing.} The federal government then grants an abatement of 10 percentage points to accommodate varying taxes imposed by each province. Thus, the combined federal and provincial tax is computed as follows:

\[
\text{Total tax payable} = \text{general tax rate of 38 percent on taxable income} \\
\text{minus: 10 percent of the corporation’s taxable income earned in each province (abatement)} \\
\text{plus: provincial taxes with various rates applied against taxable income earned in particular provinces or territories}
\]
Although provincial and territorial tax rates on corporate income vary, the actual tax rate paid in 2000 was generally around 46 percent. A 4 percent federal surtax is currently imposed on a net federal tax of 28 percent (to establish a total federal levy of 29.12 percent).

The consequences of regional rate differentials are important, since they may affect decisions on business location. They could also influence decisions regarding transfer prices for goods and services between various operating subsidiaries located in different provinces in order to shift income to provinces with the lowest tax rates.

**Small Business Deductions**

As an incentive to smaller Canadian-controlled private corporations (CCPAs), there is provision for a reduced rate of taxation as long as annual income does not exceed a specified limit. Reduced rates on such small business income are available on both federal and provincial taxes in most provinces.

**SMALL BUSINESS TAX RATES IN MANITOBA**

Based on figures for 2000, the net federal tax rate on eligible small business income was around 13 percent. Consider a province such as Manitoba with a 17 percent general corporate tax rate that is reduced to 7 percent for qualifying small business income. A CCPA operating in that province would pay the following tax rate on its first $200,000 (eligible limit) of income:\(^3\)

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>General federal tax rate</td>
<td>38.00%</td>
</tr>
<tr>
<td>Less: Abatement for provincial tax</td>
<td>10.00</td>
</tr>
<tr>
<td>Net federal tax</td>
<td>28.00</td>
</tr>
<tr>
<td>Federal surtax of 4%</td>
<td>1.12</td>
</tr>
<tr>
<td>Less: Small business deduction</td>
<td>16.00</td>
</tr>
<tr>
<td>Total federal tax</td>
<td>13.12</td>
</tr>
<tr>
<td>Assumed provincial tax</td>
<td>7.00</td>
</tr>
<tr>
<td>Total tax</td>
<td>20.12%</td>
</tr>
</tbody>
</table>

It should be stressed that the resultant tax saving is not available either to foreign-controlled corporations or to public corporations and is available only on the first $200,000 of annual income from an active business carried on in Canada.

---

\(^3\) The February 2000 federal budget announced that the rate applicable to income of a CCPC between $200,000 and $300,000 would be reduced from the current effective federal tax rate of 28 percent to 21 percent. This decrease will take effect January 1, 2001. At the time of writing, none of the provinces have indicated a willingness to reduce their tax rates on this level of income.
A1.3 BUSINESS EXPENSES AND DEDUCTIONS

Taxes are computed by applying tax rates to taxable income. In this section, we are concerned with factors that influence the calculation of taxable income and in particular with some of the more important expenses and deductions that can be claimed against gross income, thereby reducing a firm’s taxable income.

Financing Charges

Interest on debt is considered to be a business expense and is generally deductible in calculating taxable business income. Similarly, rent and lease payments are treated as deductible business expenses. On the other hand, repayments of principal on a loan, and dividends on both common and preferred shares, are not deductible and must be paid out of after-tax earnings.

Business Losses

Ordinary business losses incurred in a particular year can generally be carried back and applied as a deduction against income of the preceding three years (through the filing of amended returns) or carried forward and deducted from income of the next seven years starting with the earliest possible year. Thus, a loss in 2000 may be deducted from the income of 1997 to 1999 and 2001 to 2007 inclusive. While, the loss is applied in any order determined by the taxpayer, it is generally advantageous for the company to offset the loss against previous income (beginning with the most distant year permissible) provided it has generated income in previous years. This is because it enables the company to receive an immediate rebate. The Income Tax Act provides for detailed definition of a deductible loss. In addition, when there has been a change in the control of a corporation, the utilization of business losses carried forward is severely restricted.

Capital Cost Allowance (CCA)

In arriving at taxable income, businesses (both corporations and individuals) may deduct capital cost allowance (CCA) on depreciable assets. Through CCA, provision is made for an investor to recover over some time frame the original amount invested without having to pay tax on that portion of his proceeds.

Ideally, the cost of an asset with an economic life of 20 years should be charged against income over that same span of time. In practice, however, not only is the useful life of most assets difficult to anticipate, but taxpayers and tax collectors are unlikely to arrive at common estimates. Understandably, tax regulations leave little room for debate and set out detailed and specific rules for the recovery of invested capital over time.

The term depreciation is sometimes used to denote the economic deterioration of an asset as a consequence of its productive use. CCA is more narrowly defined as the depreciation claimed for tax purposes. As we will see shortly, these two concepts can differ substantially; however, in everyday usage, both terms are often used interchangeably.
Asset Classes

As a general rule, depreciable assets fall into one of over 30 asset classes that are defined for tax purposes. CCA and book values are not computed for individual assets but for the aggregate of all assets that comprise an asset class. Maximum CCA rates ranging from 4 to 100 percent per year are prescribed for each class. As will be detailed below, these rates generally are applied against declining asset balances in each class. If a new investment is made, the purchase price of the new asset is added to the total undepreciated capital cost (UCC), or book value, of the asset class. The treatment of a disposition of assets is somewhat more complex and requires the following distinctions:

1. If the selling price of the asset exceeds the asset’s original cost, only the original cost is deducted from the UCC of the asset class. The excess becomes subject to capital gains tax, which will be discussed in Section A1.4.

2. If, as is normally the case, the selling price is lower than the asset’s original cost, the UCC of the asset class is simply reduced by the proceeds from the sale.

Determining the Ending UCC

Investments in general machinery are usually combined in asset Class 8. A firm that currently has an UCC of $100,000 in this class replaces an old machine with a new model costing $30,000. The old machine, purchased several years ago for $10,000, is sold for $5,000. The resulting change in the asset class is as follows:

\[
\begin{align*}
\text{UCC (beginning) of asset class} & \quad $100,000 \\
\text{plus: Purchase price of new machine} & \quad 30,000 \\
\text{minus: Selling price of old machine} & \quad 5,000 \\
\text{UCC (ending) of asset class} & \quad $125,000
\end{align*}
\]

The net effect has been a $25,000 increase in the asset class, which in turn will increase the amount of CCA that can be claimed in subsequent periods.

If the old machine could have been sold for $15,000, the effects would be as follows:

\[
\begin{align*}
\text{UCC (beginning) of asset class} & \quad $100,000 \\
\text{plus: Purchase price of new machine} & \quad 30,000 \\
\text{minus: Original purchase price of old machine} & \quad 10,000 \\
\text{UCC (ending) of asset class} & \quad $120,000
\end{align*}
\]

In addition, a capital gain of $5,000 would have been realized on the sale of the old machine.

Exceptions to this treatment of sales arise only if all assets in a class are sold and a balance still remains in the asset class or if sales of assets and the consequent adjustment to the UCC of the class result in a negative value for the asset class. In general terms, the legislation states the following:
1. If all assets in a class are sold and a positive UCC balance remains in the class (in other words, if on disposal of such assets the amount realized is less than the UCC of the particular class) the difference may be viewed as a terminal loss and deducted from business income in the same way as normal CCA deductions.

2. If the sale of any part or all of the assets would render the UCC balance remaining in the class negative (that is, if proceeds on a disposition exceed the UCC in the class), the excess to the extent of capital cost already taken is treated as normal business income. Any part of the sale price not absorbed by past UCC is held to be a CCA recapture.

Selected examples of assets, the classes to which they are normally assigned, and the maximum rates of annual CCA that applied in 2000 are provided in Table A1.1. It should be noted that not all assets are depreciable. For example, land is deemed to have an indefinite economic life and does not deteriorate with use. Thus, no provisions are made for a gradual reduction of its book value and corresponding deductions for tax purposes.

<table>
<thead>
<tr>
<th>Assets</th>
<th>Class</th>
<th>Max. Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chinaware, cutlery, tableware</td>
<td>12</td>
<td>100%</td>
</tr>
<tr>
<td>Computers and systems software</td>
<td>10</td>
<td>30%</td>
</tr>
<tr>
<td>Automobiles</td>
<td>10</td>
<td>30%</td>
</tr>
<tr>
<td>Photocopiars</td>
<td>8</td>
<td>20%</td>
</tr>
<tr>
<td>General machinery</td>
<td>8</td>
<td>20%</td>
</tr>
<tr>
<td>Buildings acquired after June 18, 1987</td>
<td>1</td>
<td>4%</td>
</tr>
</tbody>
</table>

**Declining Balance CCA**

The mechanics of applying a specified maximum rate of CCA against declining balances in the asset class is best explained through a numerical illustration. Assume that $C = $100,000 of general machinery is included in Class 8, where the maximum rate of annual CCA is $d = 20$ percent. As shown in Table A1.2, the maximum CCA that can be claimed each year is the UCC at the beginning of the year multiplied by the specified rate of 20 percent. For the first year following acquisition, however, the claim is generally limited to one-half of the amount otherwise allowable.\(^4\) To simplify our exposition, we assume for all formulations and illustrations that follow that asset acquisitions are made at the beginning of the year and that CCA is claimed at year end.

\(^4\) Strictly speaking, the limit in the first year is applicable when acquisitions exceed dispositions and a net increase in the asset class is experienced for the period.
### Table A1.2

*Illustration of Maximum Capital Cost Allowance*

<table>
<thead>
<tr>
<th>Undepreciated Taxation capital at start of year</th>
<th>Maximum rate (%)</th>
<th>Maximum capital cost allowance</th>
<th>Undepreciated capital at end of year</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1)</td>
<td>(2)</td>
<td>(3)</td>
<td>(4) = (2) × (3)</td>
</tr>
<tr>
<td>1 $100,000</td>
<td>$10,000</td>
<td>$90,000</td>
<td></td>
</tr>
<tr>
<td>2 90,000</td>
<td>18,000</td>
<td>72,000</td>
<td></td>
</tr>
<tr>
<td>3 72,000</td>
<td>14,400</td>
<td>57,600</td>
<td></td>
</tr>
</tbody>
</table>

or in notation:

<table>
<thead>
<tr>
<th>Undepreciated Taxation capital at start of year</th>
<th>Maximum rate (%)</th>
<th>Maximum capital cost allowance</th>
<th>Undepreciated capital at end of year</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1)</td>
<td>(2)</td>
<td>(3)</td>
<td>(4) = (2) × (3)</td>
</tr>
<tr>
<td>1 $C$</td>
<td>$Cd/2$</td>
<td>$C(d/2)$</td>
<td></td>
</tr>
<tr>
<td>2 $C(1−d/2)$</td>
<td>$d$</td>
<td>$Cd(1−d/2)$</td>
<td></td>
</tr>
<tr>
<td>3 $C(1−d/2)(1−d)$</td>
<td>$d$</td>
<td>$Cd(1−d/2)(1−d)$</td>
<td></td>
</tr>
<tr>
<td>$n$</td>
<td>$d$</td>
<td>$C(1−d/2)(1−d)^{n−2}$</td>
<td></td>
</tr>
</tbody>
</table>

where:

- $C = \text{beginning undepreciated capital cost}$
- $d = \text{maximum rate for CCA}$

The CCA claimed gives rise to a tax shield or reduction in taxes. Based on column 4 in Table A1.2, tax deductible expenses of $10,000, $18,000, and $14,400 are available in each of the next three years to reduce taxable income. Assuming a corporate tax rate of $T = 46\%$, actual taxes to be paid would be reduced by the tax rate times the deduction, or $4,600, $8,280, and $6,624 in the respective years. Therefore, the tax savings for year 1 equals $CdT/2$, and for every year $n$ beyond that, we have:

$$\text{Tax saving in year } n \text{ from claiming maximum} = CdT(1−d/2)(1−d)^{n−2} \quad \text{(A1.1)}$$

CCA
The cumulative tax shield that accrues over the next several years is given as:

Cumulative tax savings  = \( \frac{CdT}{2} + CdT(1 - d/2) + CdT(1 - d/2)(1 - d) \)

= \( + \ldots + CdT(1 - d/2)(1 - d)^{n-2} \)

Cumulative tax savings  = \( \frac{CdT}{2} + CdT(1 - d/2) [1+(1-d)+(1-d) + (1-d)^2 \]

= \( + + (1-d)^{n-2} \)

Using the well-known formula for geometric series, this equation can be simplified and rewritten as:\(^5\)

\[
\text{Cumulative tax savings} = \frac{CdT}{2} + CT[1 - d/2] + [1 - (1 - d)^{n-1}] \tag{A1.2}
\]

during the first \( n \) years

**DETERMINING CCA TAX SAVINGS**

The total tax savings for the first three years in the example set out in Table AI.2 were computed as 4,600 + 8,280 + 6,624 = $19,504. Using equation AI.2, we obtain this same result directly as:

\[
\frac{CdT}{2} + CT[1 - d/2][1 - (1 - d)^{n-1}] = \frac{100,000 \times .2 \times .46}{2} + 100,000 \times .46[1 - \frac{2}{2}][1 - (1 - .2)^2] \]

= $19,504

We saw earlier that acquisitions and dispositions of assets affect the UCC of the asset class and, thus, the amount on which CCA is based. Any addition of assets will increase subsequent CCA and, hence, tax savings, whereas dispositions will have the opposite effect.

Under normal circumstances, it is in the best interest of a firm to claim the maximum allowable amount of CCA as calculated above, since this will provide the largest possible reduction in tax payments. However, total CCA should not exceed earnings from

---

\(^5\) The formula for a finite and decreasing geometric series specifies \( 1 + x + x^2 + \ldots + x^{n-1} = (1 - x^n)/(1 - x) \). Setting \( x = (1 - d) \), the above result is obtained.
operations. Thus, a company that faces disappointing earnings in a particular year would be better off not using the CCA it is allowed to claim.

The significance of the time pattern of tax shields created in applying CCA is discussed in Chapter 10. We recognize, however, that accelerating CCA, which increases the size of earlier tax savings, is an important element of government policy designed to stimulate business investments. Periodically, tax incentives that permit particularly fast write offs of selected assets are set out in federal budgets.

The larger tax savings that result from accelerated CCA in the early years give rise to larger accumulations of funds within the firm that can be used for early reinvestment.

**Investment Tax Credits**

Investment tax credits are a tax incentive to stimulate capital investment. However, they are available in Canada only on a very limited basis. The credits vary in amount and are restricted to particular types of investments and to prescribed regions of the country that are economically depressed. The investment tax credit can be deducted from federal taxes otherwise payable, and unused credits may be applied against specified past and future taxes. The credit, when available, is deducted from the value of the acquired asset for CCA purposes. For example, if an asset is purchased for $100,000 and a $10,000 investment tax credit is available, CCA may only be based on $90,000.

**Deferred Taxes**

The amount of CCA deducted from income for tax purposes is usually different from the depreciation that a firm shows on its own books. To reduce taxes payable, maximum CCA may be claimed on the company’s tax returns, whereas the depreciation deducted in computing income that is reported to shareholders may be based on economic or accounting concepts of income measurement. For example, an unusually large deduction available through an accelerated write-off provision could reduce the firm’s taxable income to abnormally low levels that bear little resemblance to the true economic performance of the business as seen by management.

**ACCELERATED CCA AND DEFERRED TAXES**

Consider a company that just purchased $100,000 in new machinery qualifying for accelerated CCA of 50 percent per year over two years. Income from operations next year is expected to be $50,000. However, the amount of depreciation charged against the equipment for accounting purposes is only 20 percent per year based on straight-line depreciation. The firm’s tax rate is 40 percent.

---

6 Accountants now refer to deferred taxes as “future tax liabilities.”
For tax purposes, the organization would file the following statement:

- Income from operations: $50,000
- minus: CCA: 50,000
- Income before tax: 0
- minus: Tax payable: 0
- Income after tax: $0

The firm faces no tax liability and retains the entire operating profit of $50,000.

In its account statements, however, management would reflect a more positive earnings performance as follows:

- Income from operations: $50,000
- minus: Depreciation: 20,000
- Income before tax: $30,000
- minus: Tax expense: 12,000
- Income after tax: $18,000

This latter statement reflects a tax liability of $12,000. However, because of the accelerated CCA claimed on the tax return, no taxes were actually paid. The company therefore has $12,000 more cash than it should have according to its own income statement. As a correcting entry for this cash that was not paid in taxes, the firm will show a matching liability of $12,000 on the liability side of the balance sheet under the heading deferred taxes. That is, the following two entries are required in the business's balance sheet:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash +12,000</td>
<td>Deferred taxes +12,000</td>
</tr>
</tbody>
</table>

Clearly, if in one year the company's books show a lower depreciation than the CCA claimed on its tax return, some subsequent year's results will have to compensate for this discrepancy, and the depreciation shown on the firm's books will exceed the CCA claimed. Pursuing the above example, the fast write off of the asset for tax purposes would have been completed at the end of year 2. However, if internally the business takes depreciation at 20 percent on a declining balance, this internal depreciation would continue beyond year 2. Although the firm builds up its cash and deferred taxes during the first two years, both of these accounts will be drawn down in subsequent years. Hence, the deferred tax account is a reminder that sometime in the future the company will have to pay taxes that exceed the taxes computed on its internal financial statements.

**REVERSING DEFERRED TAXES**

We pursue the previous example for the first five years after the acquisition of the machinery. Assuming that income from operations remains constant at $50,000 per year, we obtain the results given in the table below.
Column 4 reflects the difference between the tax payable according to the firm's internal statements and the tax actually paid. The deferred tax account represents the sum of all these discrepancies from previous years. It increases as long as the CCA claimed for tax purposes exceeds the depreciation taken on the accounting statements and vice versa. Unless new investments are undertaken, the deferred tax account gradually reverts back to zero.

<table>
<thead>
<tr>
<th>Year</th>
<th>Accelerated CCA</th>
<th>Accounting depreciation</th>
<th>Difference in tax payable</th>
<th>Deferred tax account</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$50,000</td>
<td>$20,000</td>
<td>$12,000</td>
<td>$12,000</td>
</tr>
<tr>
<td>2</td>
<td>50,000</td>
<td>20,000</td>
<td>12,000</td>
<td>24,000</td>
</tr>
<tr>
<td>3</td>
<td>0</td>
<td>20,000</td>
<td>−8,000</td>
<td>16,000</td>
</tr>
<tr>
<td>4</td>
<td>0</td>
<td>20,000</td>
<td>−8,000</td>
<td>8,000</td>
</tr>
<tr>
<td>5</td>
<td>0</td>
<td>20,000</td>
<td>−8,000</td>
<td>0</td>
</tr>
</tbody>
</table>

For many firms, particularly those in industries in which investments subject to accelerated write-off provisions are common, deferred taxes can represent substantial sums, which some analysts view as a liability. However, since CCA is charged against the UCC for an entire asset class, as long as a company grows and increases its investments, its deferred tax account may continue to grow, reflecting the continued tax savings from accelerated CCA. As a result, the reversal of deferred taxes that is illustrated in the example above may never occur. Based on this rationale, a number of analysts do not view deferred taxes as a liability when determining a company’s net worth; some regard it as equity, while others disregard it entirely.

TAXATION OF INDIVIDUAL INCOMES

Personal taxes are payable on individual income. Although there is no general statutory definition of income, examples of the many items that individuals must normally declare as income for tax purposes include wages, salaries, interest, dividends, rental income, and the income derived from proprietorships and partnerships net of allowable business deductions. As will be detailed below, different tax provisions may apply depending on the particular source of income.

Various tax credits are available as deductions from the computed federal tax to arrive at the basic federal tax. Personal exemptions, medical expenses, tuition fees, and charitable donations are examples of such tax credits, which are calculated by taking a specific percentage (generally 17 percent) of the allowable expense or exemption.

For a variety of social and political reasons, the tax payments faced by individuals in Canada are progressive rather than proportional. In other words, successive increments to incomes are taxed at increasingly higher rates. This is consistent with the tax system of most other industrialized countries.
In addition to federal taxes, each province imposes its own levy on individual income earned within the province. In all cases except Quebec, the provincial tax rate is expressed as a percentage of the basic federal tax. In 2000, for example, apart from any surtax, this percentage ranged from 44 to 62 percent.

**General Information**

The basic federal income tax rates (as of July 1, 2000) are:

1. 17 percent for taxable income up to $29,590;
2. $5,030 + 24 percent on the next $29,590 up to $59,180
3. 12,132 + 29 percent on any amount above $59,180 (plus a 5 percent surtax on income over $85,000).

These rates are scheduled to be replaced in January 2001 to the following format:

1. 16 percent for taxable income up to $30,000
2. $4,800 + 22 percent on taxable income between $30,000 and $60,000
3. $11,400 + 26 percent on taxable income between $60,000 and $100,000
4. $21,800 + 29 percent on taxable income over $100,000.

Generally, provincial taxes are levied as a percentage of the basic federal tax liability. For example, a Saskatchewan resident in the 24 percent bracket in 2000 is also subject to a 48 percent provincial tax resulting in a combined marginal tax rate of 24 percent + 0.48 \times 24 = 35.52 percent. The marginal tax rate is of importance in determining which investments offer higher after-tax yields.

**Interest Income**

Interest income from debt securities (including bonds and money market securities) is taxable at the full marginal rate. However dividends and capital gains afford investors a tax break.

**INTEREST TAX TREATMENT**

If a Saskatchewan investor receives $100 in interest, the full amount would be added to taxable income. If the investor is in the 24 percent bracket, this produces a federal tax figure of $100 \times 0.24 or $24. The 2000 Saskatchewan provincial tax would be 48 percent of $24 or $11.52, and total taxes payable would be $35.52. Thus, the net interest amount would be $64.4, resulting in a 35.52 percent marginal tax rate.

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7 Effective January 1, 2001, all of the provinces will move to a “tax on income” process. Each of the provinces will calculate their portion of an individual's tax liability by multiplying the provincial rate(s) by the federally determined taxable income amount.
Dividend Income

Dividends received by a Canadian corporation from another Canadian corporation are exempt from taxation. However, dividends (whether they are cash, stock, or reinvested dividends) received by Canadian individuals from Canadian corporations are taxable in the following manner for all provinces except Quebec. First, the amount of the dividend is grossed-up by 25 percent to obtain the taxable amount of dividend, which is used in determining net income. The taxpayer is then able to claim a tax credit (reduction in taxes payable) in the amount of 13.33 percent of the taxable amount of dividend. Finally, the provincial tax is calculated after the tax credit is claimed.

DIVIDEND TAX TREATMENT

If a Saskatchewan investor receives $100 in dividends, the grossed-up amount of $125 would be added to taxable income. If the investor is in the 24 percent bracket, this produces a federal tax figure of $125 \times 0.24 = $30. This amount is then reduced by $16.66 (13.33 percent of $125) to arrive at the federal taxes payable figure of $13.34. The 2000 Saskatchewan provincial tax would be 48 percent of $13.34 or $6.40, and total taxes payable would be $19.74, so the net dividend amount would be $80.26. The marginal tax rate on dividends is therefore 19.74 percent, which is well below this investor’s combined marginal tax rate of 35.52 percent. Foreign dividends are usually taxed by the source country, and there is an allowable credit that is essentially the lower of the foreign tax paid and the Canadian tax payable on foreign income subject to certain adjustments.

Capital Gains Income

Capital gains are taxed in the same manner for individuals and corporations in Canada. A capital gain arises from the disposition of capital assets for proceeds in excess of their cost. As a result of the October 18, 2000 tax plan announcement, only one half of net capital gains are taxable as long as the transaction involved a taxpayer whose ordinary business does not involve the trading of securities or that Canada Customs and Revenue Agency (CCRA) (formerly Revenue Canada) did not determine the trading to be speculative in nature. This reduction in the taxable amount of capital gains follows the previous reduction to two-thirds, which was announced in the February 2000 federal budget, from the previous level of 75 percent. The general rule is that capital gains equal the proceeds from distribution minus the adjusted cost base (which includes commission costs, etc.) plus any costs of disposing of assets.

EXAMPLE

Quebec calculates taxes payable on dividends differently. In particular, the federal tax payable is reduced further by a standard federal tax abatement (currently 16.5 percent). For the example above this amount would be 0.165 \times $13.34 = $2.20, leaving federal taxes payable at $13.34 - $2.20 = $11.14. The provincial tax rate (assume 26 percent) and provincial tax credit (rate is currently 8.87 percent) are both applied to the grossed-up amount of $125 which implies provincial tax of 0.26 \times $125 = $32.50 less the credit of 0.0887 \times $125 = $11.10, which leaves provincial taxes payable of $21.40 and total taxes payable of $11.14 + $21.40 = $32.54.
The adjusted cost base is complicated when shares were purchased at different purchase prices and is based on the average cost method. For example, if 200 shares were purchased for $5 (including commission) and an additional 300 shares were purchased for $6 (including commission), then the average adjusted cost per share would be \((\frac{1,000 + 1,800}{500}) = $5.60\) per share. Taxes on disposition of debt securities are applied as above; however, the accrued interest portion of a bond purchase price is not included as part of the adjusted cost base and is treated as taxable income in the hands of the bond seller.

**CAPITAL GAINS TAX TREATMENT**

If a Saskatchewan investor receives $100 in capital gains after October 18, 2000, only one half of this amount would be added to taxable income. If the investor is in the 24 percent bracket, this produces a federal tax figure of \(\frac{100 \times 0.24}{2} = 12\). The 2000 Saskatchewan provincial tax would be 48 percent of 12 or $5.76, and total taxes payable would be $17.76. The net interest amount would be $82.24 resulting in a 17.76 percent marginal tax rate.

**Other Tax Items of Interest**

Capital losses can only be used to offset capital gains income; they can be carried back three years, and forward indefinitely. Capital losses cannot be claimed by the security holder unless ownership is transferred in writing to another person. One exception to this rule is when the security becomes worthless due to bankruptcy of the underlying company. Superficial losses result from the sale and purchase of the same security within a given time frame and are not tax deductible. However, the taxpayer eventually receives the tax benefit since the amount of the superficial loss is added to the cost base of the repurchased shares, which lowers the ultimate capital gain. A superficial loss occurs when securities are sold at a loss but are repurchased within 30 calendar days of the sale and still held at the end of 30 days after the sale. They do not apply to losses resulting from leaving Canada, death of a taxpayer, expiry of an option, or a deemed disposition of securities by a trust or to a controlled corporation.

Certain items related to investment income are tax deductible including carrying charges such as interest on borrowed funds, investment counselling fees, fees paid for administration or safe custody of investments, safety deposit box charges, and accounting fees paid for recording investment income. Interest on borrowed funds is deductible only if the investor had a legal obligation to pay the interest, the purpose of the borrowing was to earn income and the income earned from the investment is not tax exempt. (Note that it does not need to be an arms-length transaction.) In addition, the interest charge:

1. cannot exceed the amount of interest earned on debt securities unless they are convertible
2. is disallowed as a deduction if it exceeds the grossed-up amount of preferred dividends
3. is for the most part deductible if it is for the purchase of common shares.
TAXES AND FORMS OF BUSINESS ORGANIZATION

The business income of a proprietorship and each partner’s share of partnership income is treated as personal income. Such income is subject to taxation at the proprietor’s or partners’ individual rates regardless of whether it is drawn out or retained in the business. Whether incorporation of the business will result in overall tax savings is a complicated issue. The owner or owners may become employees of the corporation and be paid a salary. Such salaries become a tax-deductible expense for the corporation and taxable income in the hands of the recipients. Additional withdrawals can be made in the form of dividend payments. It is easy to see that an assessment of the tax effects of incorporation requires detailed calculations that depend not only on applicable corporate and personal tax rates but also on the tax status of the firm (for example, applicability of small business deductions) and on the anticipated earnings and withdrawals over time. Furthermore, tax considerations are but one of many factors that influence the selection of an appropriate form of organization.