

The background of the cover is a photograph of a vast field of sunflowers in full bloom. The sunflowers have bright yellow petals and dark brown centers. The field stretches towards a horizon under a sky with soft, colorful clouds in shades of pink, purple, and blue, suggesting a sunset or sunrise. The overall mood is peaceful and natural.

Federal Income Taxation: Fundamentals

5th Edition, 2012-2013, Study Guide Included

Robert E. Beam, F.C.A.
Stanley N. Laiken, Ph.D.
James J. Barnett, F.C.A.



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Taxation: Fundamentals

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5th Edition, 2012-2013

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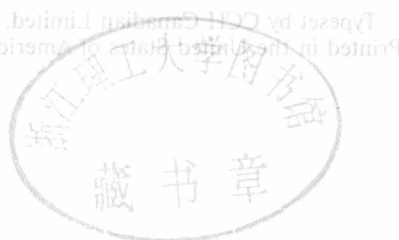
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About This Book

How the Text is Organized

The study of Canadian federal income taxation is made more complex, particularly at the introductory level, not because of the lack of good interpretive materials to guide the student, but, in the authors' opinion, because of the lack of organization in the presentation of these materials for systematic study. While the *Income Tax Act* (the Act), the statute governing the federal taxation of income in Canada, is organized generally by source of income, interpretive material available to students at the introductory level is often organized by topics which may cover elements of several sources.

Since the authors of these materials feel that it is important to the understanding of the Act that the student generally studies the major provisions of the statute in sequence, the chapters of this book generally follow the organization of the Act. The purpose of these materials is to guide the student in the study at the introductory level of the major provisions of the Act and some of the related provisions in the *Excise Tax Act* (the ETA) pertaining to the Goods and Services Tax/Harmonized Sales Tax. A copy of the Act plus the Canada Revenue Agency's (CRA's) Interpretation Bulletins, Information Circulars, and Advance Tax Rulings are considered to be important materials for the course. The purpose is to organize the student's reference to interpretive material in the order of presentation in the Act. This book is designed to encourage students to refer to the Act, case law, and the CRA's publications. CRA publications are available at no charge on the CRA website: www.cra-arc.gc.ca.

The Importance of Problem Material

The commentary presented in this book highlights key areas of the Act. The textbook provides additional interpretation of particularly difficult provisions of the Act or elements of the common law or case law in the area. The basic concepts and principles underlying the rules of the legislation are emphasized throughout these materials. Most important for the study of income taxation, the textbook provides fact situations or example problems which demonstrate the application of the provisions of the Act to realistic situations. In fact, the primary teaching approach used in this commentary is the presentation of example problems and exercises with solutions. These solutions demonstrate various methods of approaching actual problems in income taxation. The solutions also provide explanatory and interpretive notes, which are an important component of these materials, often expanding a topic beyond the confines of the particular facts under discussion.

These materials are designed to present situations which will help students to focus their attention on the reading and understanding of a particular provision or set of provisions with the objective of developing more generalized skills to be used in the interpretation of the Act.

References

References are provided in the outer margin of the text beside the paragraphs to which they pertain. These references are to the following sources:

- (1) ITA refers to the sections of the *Income Tax Act* to be discussed in the chapter;
- (2) ITAR refers to the *Income Tax Application Rules, 1971*, which are found in the volume containing the Act immediately following the provisions of the Act;
- (3) ITR refers to the Income Tax Regulations, which are also found in the volume containing the Act;
- (4) ETA refers to sections of the *Excise Tax Act* in which provisions of the Goods and Services Tax (GST)/Harmonized Sales Tax (HST) can be found;
- (5) IT, IC, TR, and ATR refer, respectively, to Interpretation Bulletins, Information Circulars, Tax Rulings, and Advance Tax Rulings — Second Series, and are available in a one-volume softcover edition published by CCH Canadian Limited;
- (6) Cda-U.S. TT refers to the *Canada–United States Income Tax Convention (1980)*; and
- (7) Doc refers to documents released by the federal government under *Access to Information* legislation and contained in the Tax Window Files of CCH Canadian's Tax Library.

An explanation of these references is provided in Chapter 1. References to sections of the Act are provided for exercises and assignment problems. It should also be understood that in the course of their use within the paragraph of the text, all references preceded by such specific terms as “section”, “subsection”, “paragraph”, “subparagraph”, etc., without any indication of the pertinent statute, refer to the provisions of the *Income Tax Act*. Similarly, the provisions of the Income Tax Regulations are preceded by the term “Regulation” without specifying the relevant legislation. In the margin, these references are preceded by “ITA” and “ITR”, respectively.

References to the *Excise Tax Act* are usually confined to the GST/HST part of a chapter and are specifically indicated as being to that legislation. References in the margin are preceded by “ETA”. An attempt has been made to integrate GST/HST with relevant transactions discussed under the *Income Tax Act* in the chapters where these transactions are discussed.

Acronyms

An alphabetical list of acronyms used in the book appears in the first section of the Study Guide, immediately following the Table of Contents. The list provides the meaning of the acronym and paragraph references where the term is used in this textbook.

Knowledge Reference List

A mapping of the Knowledge Reference List (KRL) to the book is provided in the next section of the Study Guide. Paragraph references and titles in the textbook are shown for each line of the KRL. Students who are interested in reviewing problems and questions on those topics can follow a paragraph listing in the KRL map to the Learning Charts for each chapter in the Study Guide.

Review Questions

A set of review questions is provided at the end of each chapter. These short-answer questions attempt to review key points made in the text or points that are not integrated into the example problems, multiple choice questions, exercises, or assignment problems in the chapter. Discussion notes on the review questions are provided in the Study Guide.

Multiple Choice Questions

Since multiple choice questions are common in professional examinations, this textbook provides six or seven such questions covering the material in each chapter, starting with Chapter 2. Annotated solutions are provided in the Study Guide to enhance learning through self-study.

Exercises

Exercises have been provided at the end of each chapter. These usually consist of short problems to highlight particular areas of the chapter. They are designed to be fairly narrow in scope, to provide the student with an opportunity to apply the material in the chapter to a specific problem situation. Solutions to these exercises have been provided in the Study Guide.

Assignment Problems

Assignment problems are provided for each chapter of these materials. These problems are designed to have the student apply the material discussed in each chapter to an actual fact or problem situation. While these problems focus on the key elements of the chapter in much the same way that the solved example problems in the commentary do, the problems are not identical in their coverage or presentation. As a result, it will be necessary for the student to read the assignment problems very carefully in preparing a solution. Solutions to these problems are not available. However, similar additional problems with solutions are provided on the accompanying DVD, as discussed below.

Additional Problems with Solutions

Students often request additional problems with solutions that they can use on a self-study basis for preparation for tests and examinations. For this purpose, a comprehensive compilation of problems similar to the assignment problems in this book and multiple choice questions are provided on the DVD accompanying this book. There are many problems and solutions on the DVD, classified by coverage of chapters in this textbook. The problems, most of which have previously been used as examination questions, will provide students with an opportunity to deal with problems of a comprehensive nature. Since these supplemental problems may cover material from several chapters, as examination questions often do, they provide an excellent source for review in preparation for examinations.

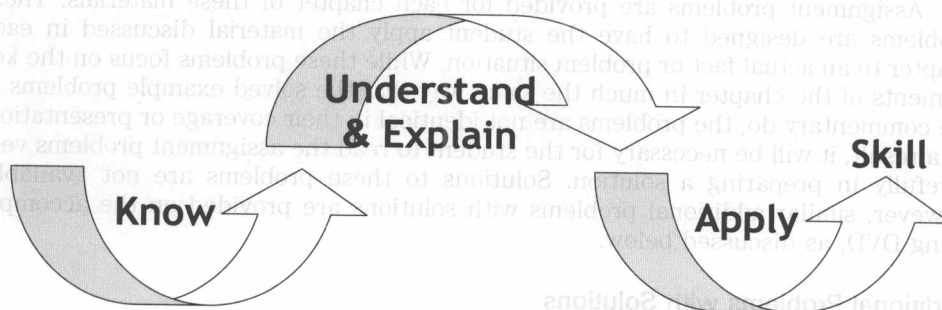
Suggested Approach

The authors suggest the following approach to the use of these materials. First, the students should identify the issue they need to research in an assignment problem and then scan the headings of the particular chapter and look for the topics that relate to that issue. Once the relevant parts of the chapter are identified, they should read the commentary, including any referenced material such as sections of the Act or Regulations, Interpretation Bulletins, Information Circulars, and Advance Tax Rulings. Reviewing any example problems to see how the provisions work will also help develop understanding. The solutions provided for these problems will demonstrate the approach that can be taken for the type of example problem under consideration. The solutions can also be used as a check on the student's understanding as well as a means of providing further interpretation and explanation of the material covered. The exercises at the end of the chapter can be used in a similar manner. The additional problems with the solutions provided on the accompanying DVD can be used as a means of self-study and reinforcement. Once the parts of a chapter have been completed in this manner, the student should be sufficiently prepared to attempt the assignment problems relevant to a particular part or to the whole chapter. When reviewing material for examination or other purposes, the multiple choice questions at the end of each chapter and the problems on the accompanying DVD can be attempted. The solutions in the Study Guide and on the

can be checked. Review might also focus on the approaches used to address the various types of problems presented.

Learning Goals

To be a successful tax adviser it is not enough to just know the technical material found in the Act and supporting materials. You need to understand the purpose behind the rules so you can explain to others why your tax plan does not violate either the provision as it is written or purpose behind the provision. You also need to be able to blend a number of complex provisions into a comprehensive plan to accomplish the goals of your client or employer. As shown in the learning model below, you need to know the technical provisions and understand them well enough to be able to craft a comprehensive plan. The end goal is the successful application of knowledge and understanding.



In each chapter of this book we will provide you with what you should Know, Understand & Explain, and Apply as a result of studying that chapter.

Materials at the introductory level on Canadian income tax legislation are not easy to study. A conscientious effort to do the work and, particularly, to do problems and apply what has been read is essential to a good understanding of this material. The authors have attempted to meet the challenge of presenting the material by setting out the work that must be done and by explaining, as best they can, the major provisions of the legislation. The challenge of learning the material is, of course, left to the student.

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July 2012

Note on Legislation

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To create the first and subsequent editions of the book, a very considerable editorial effort was required by CCH editors. Paul Love and Carrie Shimkofsky have done outstanding work under tight deadlines to produce an integrated text of consistent high quality. For this edition, Abby Egerter provided assistance to Paul with her editorial work on *Introduction to Federal Income Taxation in Canada*.

July 2012

Robert E. Beam

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Note on Legislation

This edition of the book has been updated to include draft legislation up to and including that resulting from the March 29, 2012 federal Budget.

Many people have participated in the preparation of these materials. In particular, we are greatly indebted and most grateful for the contributions of two individuals, Lisa Fell and Shirley Lamare, as the principal contributors on the previous CGA Taxation I course textbook, have used their knowledge and expertise to ensure that this textbook is a great element of the Taxation I course. Their help in reviewing those materials and suggesting improvements has been invaluable.

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Robert E. Beaman

July 2012

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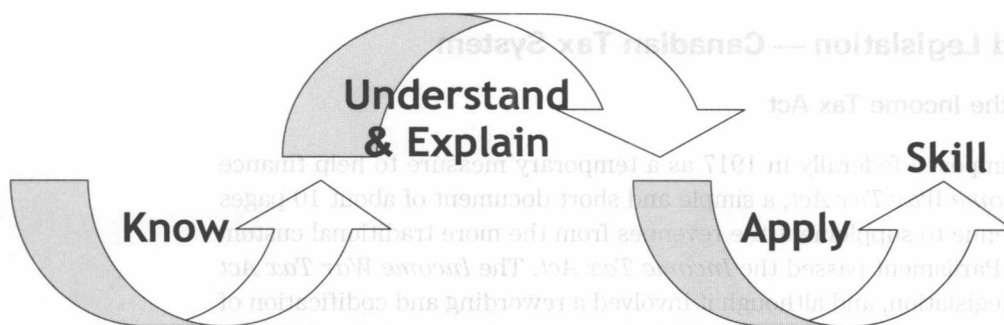
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LEARNING GOALS



Know

By the end of this chapter you should know some of the history of income tax in Canada and how the *Income Tax Act* and the *Excise Tax Act* (pertaining to the goods and services tax) are structured, interpreted, and administered.

Understand and Explain

You should understand and be able to explain how to find what you need in the Act and how to put together the calculation of income for tax purposes and taxable income. In addition, you should be able to explain how to interpret tax legislation. Completing the Exercises (§1,850) is a good way to deepen your understanding of the material.

Apply

You should be able to use your general knowledge and understanding of the calculation of income and the interpretation of tax laws to put together the calculation of income and taxable income and to find the meaning of certain words and phrases in the *Income Tax Act*. Completing the Assignment Problems (§1,875) is an excellent way to develop your ability to apply the material in increasingly complex situations.

OVERVIEW

This chapter covers the basic areas of income taxation in Canada. First, it provides a historical, legal, and theoretical perspective. Second, it introduces the *Income Tax Act* ("ITA" or the "Act"),¹ the legal statute governing income taxation in Canada, by providing an overview of the structure of this legislation. Third, it provides a general overview of the practice of taxation and the role of the professional accountant. Fourth, the materials introduce the concepts of income and taxable income. The last section presents an overview of the administration and enforcement of the legislation.

This chapter also introduces, on a conceptual basis, the goods and services tax (GST)/harmonized sales tax (HST). Subsequent chapters will discuss the related GST/HST implications of the topics described in those chapters. This chapter first gives an overview of the GST/HST system and, in particular, certain basic concepts such as taxable transactions, exempt transactions, and GST/HST refunds. It then describes the organization of the GST/HST in the context of its legislative authority, the *Excise Tax Act* (ETA),² and various interpretive sources.

¹ Unless otherwise stated, all statutory references are to the *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supplement), as amended (referred to as "the Act").

² Unless otherwise stated, the *Excise Tax Act*, R.S.C. 1985, c. E-15, will be referred to as the "ETA".

¶11,000 BACKGROUND AND INTRODUCTION

¶11,001 History and Legislation — Canadian Tax System

¶11,010 Brief history of the Income Tax Act

Income tax was first imposed federally in 1917 as a temporary measure to help finance World War I under the *Income War Tax Act*, a simple and short document of about 10 pages in length. It generated revenue to supplement the revenues from the more traditional custom and excise taxes. In 1948, Parliament passed the *Income Tax Act*. The *Income War Tax Act* was merged into this new legislation, and although it involved a rewording and codification of the old law, there were few changes in policy. Essentially, income tax introduced in 1917 as a temporary measure persists today.

A major reform of federal income tax legislation began in 1962 with the setting up of the Royal Commission on Taxation under the chairmanship of the late Kenneth Carter. The Carter Commission presented its seven-volume report in 1967 recommending fundamental changes in tax legislation that would use a comprehensive tax base including capital gains, which were previously tax-free.

This report led to the issuing of the November 1969 White Paper on Tax Reform followed by the Budget address on June 18, 1971 and Bill C-259 to amend the *Income Tax Act*. This bill was given Royal Assent on December 23, 1971, and became effective January 1, 1972. Since then, every Budget address has presented a considerable number of amendments to the tax legislation to both “fine-tune” the existing legislation and introduce new fiscal policy.

Sixteen years later, on June 18, 1987, the government released a White Paper on Tax Reform which was to be implemented in two phases. Phase One, implemented in 1988, included changes to the personal and corporate income tax systems and interim changes to the existing federal sales tax. Phase Two replaced the existing federal sales tax with a broad-based multi-stage sales tax referred to as the goods and services tax (GST), effective January 1, 1991.

The fact that income tax, introduced in 1917 as a temporary measure, is still in existence, albeit in a substantially modified form, is easily explained. In order to finance public expenditures and implement its economic and social policy, the government has had to collect revenues in various forms. Taxing the income of individuals and corporations has provided it with a reliable and increasing source of revenue.

Currently, based on 2012-2013 projections, income taxes comprise about 62% of total federal government revenues, with personal income taxes raising almost four times the amount of revenue as corporate income taxes. Sales and excise taxes, including the GST, represent about 20% of total federal government revenues. Exhibit 1-1 gives some indication of the relative importance of various taxes.

EXHIBIT 1-1
Government of Canada Budgetary Revenues
(2012-2013 Forecast)

Revenue item	Billions of dollars*	Percentage
Personal income tax	125.4	49.2
Corporate income taxes	32.4	12.7
Employment insurance contributions	20.1	7.9
Goods and services tax	30.9	12.1
Customs import duties	4.1	1.6
Other tax revenue	16.4	6.4
Non-tax revenue	25.7	10.1
Total budgetary revenues	<u>255.0</u>	<u>100.0</u>

* Source: Table 6.5, "Outlook for Budgetary Revenues", Chapter 6 "Fiscal Outlook", *Jobs, Growth and Long-Term Prosperity*, Department of Finance Canada, March 29, 2012.

¶1,015 Constitutional basis for income taxation

The *British North America Act, 1867*, renamed the *Constitution Act, 1867* in the process of the repatriation of the Constitution, granted authority for all taxation in Canada, separating federal and provincial powers to impose income taxes. Subsection 91(3) of the *Constitution Act, 1867* provides the federal government with unlimited powers of taxation by permitting the "raising of money by any mode or system of taxation". On the other hand, subsection 92(2) of the same Act limits provincial powers to direct taxation of income earned in the province and of income of persons resident in the province. Even with a fairly liberal interpretation of the provincial powers of direct taxation, in order to meet increasing provincial requirements over the years, there has been a constant trading of tax points through federal-provincial taxation agreements. Nevertheless, intergovernmental problems of raising revenues through taxation persist.

¶1,020 Introduction to Income Tax Legislation

¶1,021 The federal budgetary process

There are special procedures for adopting fiscal legislation and several levels of government are involved in the passage of new or amended tax law. (See Figure 1-1.)

All proposals for change originate in the Department of Finance. A bill to amend the ITA cannot be tabled before a "Notice of Ways and Motion to Amend the *Income Tax Act*" has been presented to the House of Commons. The Minister of Finance will clear major proposals with the Prime Minister and Cabinet before presenting a *Notice of Ways and Means Motion to Amend the Income Tax Act* to the House of Commons. Once permission is granted in the House of Commons, a bill is introduced. Before the bill receives Royal Assent by the Governor General, it is reviewed and discussed in detail by the Standing Committee on Finance and Economic Affairs and a total of three readings take place in the House of Commons and the Senate. A discussion of this process follows.

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