Identifying Tax Issues

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Introduction

After many years of teaching tax to undergraduates, we've determined that key concepts in tax can be challenging for many students to grasp. As a result, they take a surface approach to learning – memorizing the basics to meet the requirements of our tax courses – rather than developing the deeper understanding needed to become competent tax professionals who can respond to the complex and evolving needs of clients.

Decoding Project

Learning stumbling blocks are referred to as "bottlenecks" within an area of the higher education teaching and learning literature called "Decoding the Disciplines" (DtD). Underlying each bottleneck are often disciplinary ways of thinking about a subject that are natural and tacit for experts, but difficult for students. "Decoding" bottlenecks therefore involves experts "reconstruct[ing] the steps that they themselves do when solving similar problems[1]," so that they may be modeled for students and integrated into teaching. Thus, DtD is also a methodology[2], as it provides a clearly-delineated, seven-step process for identifying and deconstructing bottlenecks and provides guidelines for designing instructional, motivational, and assessment strategies that support deep learning of the troublesome concepts.

During the Fall 2012 and Winter 2013 terms Jim Barnett and Julie Timmermans (Centre for Teaching Excellence at the University of Waterloo) spent time identifying topics in our undergraduate tax program that students found challenging (bottlenecks). Information gathered from students and faculty was used to develop and prioritize a list of topics that presented the greatest barriers.

Results

Students rated a list of potential bottlenecks in terms of their perceived level of importance and their perceived level of understanding. Two topics that were rated as the most important and least understood were:

1. Being able to identify tax-related issues in a non-directed fact situation

2. Being able to read and understand the Income Tax Act

We worked with tax faculty and tax practitioners to "decode" these bottlenecks – that is, to construct a series of steps that experts in the field would use to address these issues. By following these steps, students will be able to develop their skills faster and more completely than if they are left to figure out these steps on their own.

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[1] Middendorf & Pace, 2004b, p.5
[2] Diaz & Pace, 2012

In this section we will address the bottleneck of identifying tax-related issues[3].

Steps for Identifying Issues

What do we mean when we use the term "tax-related issue"? A tax-related issue is something that might have positive or negative implications that needs further analysis. Issues may relate to opportunities that can be taken advantage of or penalties to be avoided. They may be tax specific or related to financial accounting, finance, ethics, governance, business or personal matters that relate to the tax matters under consideration.

Don't wait until you reach step 7 to identify the issues. Identify them "as you gather, sort and analyze". Issues may be identified early or near the end but never stop looking for them. Issues that are identified can be addressed but those that are not identified represent a potential threat either as an opportunity missed or a penalty incurred; neither option is desirable.

We have decoded this bottleneck by setting out eight steps organized under three main headings. In this section we will describe in some detail our approach.

Gather and Sort Information

In this first section the goal is to find out all the information you can. You want to know about the parties involved and their relationships to each other and the details of their actual or planned transactions.

1. **Who is involved and what do we know about them?**
   a. **Draw a diagram**

      Start by drawing a diagram indicating all of the parties involved, their relationships to each other, and, if there is a transaction involved, the ownership of the assets both before and after. Relationships include parent- child, brother-sister, employer-employee and shareholder-corporation.

   b. Who is my "client" and what are their objectives?

      It is important to know who your client is, what "business" they are in and what their short and longer-term goals are. With this understanding it may be possible to find a more tax efficient way for them to achieve their objectives. It is also helpful to understand what they don't want to do or what their tax risk tolerance is (see below) as this may put some limits on what you might recommend.

   c. Develop a tax profile for each of the parties

      A tax profile is just an organized way of gathering all the information you need on your client. Not all of it will be directly related to the particular situation you are analyzing but sometimes it is difficult to determine this in advance. It is best to gather too much information than not enough.

[3] Barnett, J., & Timmermans, J. (2013). *Decoding bottlenecks in tax*. University of Waterloo, Waterloo, Canada.

Individual

For individuals you should know their age, significant relationships and, if possible, their estate plans.

Trust

If the client is a trust then determine whether the person who set up the trust was alive at the time (inter-vivos trust) or whether the trust was established under someone's will on death (testamentary trust).

Corporation

Identifying the type of corporation is crucial for determining how the income earned in the corporation is taxed. The main classifications are Canadian-controlled private corporation (CCPC) or public corporation.

Within the CCPC category, consider whether the company meets the conditions to be a small business corporation (SBC), which is important for purposes of the capital gains exemption and the allowable business investment loss provisions.

Assets and liabilities of each client

The tax value of each asset is important information. For each significant asset identify the adjusted cost base (ACB), fair market value (FMV), undepreciated capital cost (UCC) or other tax attribute.

Debt plays a key role in financial planning. For any debt, identify the amount outstanding and the terms such as repayment terms and restrictive covenants.

Amount and type of income being earned by each client

It is very common for different types of income to be taxed in different ways for both individuals and corporations. As a result, it is important to identify the types of income being earned by the different types of taxpayers identified above. The following is a list to consider:

Individuals

- Employment
- Business – Canadian or foreign
- Property – Canadian or foreign
- Dividends from Canadian corporations – eligible dividends and non-eligible dividends
- Dividends from foreign corporations and tax withheld at source
- Taxable capital gains and allowable capital losses including whether QSBC shares were disposed of
- Income (loss) vs. capital gain (capital loss)
- Other income or deductions
- Net or non-capital losses from other years, capital gains exemption
- Personal tax – graduated tax rates, marginal tax rate, credits applicable

Corporation

- Personal service business

- Aggregate investment income – Canadian and foreign property income, net taxable capital gains less net capital losses
- Dividends from Canadian connected corporations
- Dividends from Canadian non-connected corporations
- Dividends from foreign corporations and tax withheld at source
- Income (loss) vs. capital gain (capital loss)
- Net or non-capital losses from other years
- Corporate tax – basic tax rate, provincial abatement, small business deduction, general rate reduction, foreign tax credit, additional refundable tax, Part IV tax, refundable Part I tax, dividend refund, ITCs

Shareholders

It is important to have detailed information on shareholders, particularly shareholders of closely-held private corporations. This section applies to all shareholders regardless of whether they are individuals, corporations, trusts or partnerships.

Details of shareholdings includes such information as number of shares owned, what they paid for the shares (ACB), what the voting rights of the shares are and what the paid-up capital (PUC) is.

It should also be determined whether the shareholder has any financial or other influence that, if exercised, could result in control (de facto) of the corporation.

The details of a shareholder agreement are also very important.

Has the shareholder ever reported an allowable business investment loss (ABIL) or claimed a capital gain deduction?

Relationships

Relationships need to be identified. Are the parties involved related or affiliated? If the shareholder is a corporation, are they connected or associated? Is the relationship one or more of employer/employee or corporation/shareholder or partnership/partner or trust/beneficiary?

Liability for tax

Are the parties Canadian residents and therefore subject to tax on their world-wide income or are they foreign residents and taxed in Canada, in some fashion, on their Canadian-source income?

Tax risk tolerance

Before making any recommendation to a client it is important to understand their risk tolerance, particularly as it relates to tax. Some taxpayers want to pay the least amount of tax and are willing to accept some risk of reassessment in order to do this. Others want to minimize any risk of reassessment.

You also need to assess your own risk tolerance as a professional advisor. There may be some transactions that you are not comfortable supporting because of the risk involved.

Risk is not simply the risk of reassessment and potential interest and penalties; it also involves risk to reputation and relationships. A significant reassessment could damage your reputation in the community as well as the relationship between the taxpayer and the professional advisor.

2. **What are the transactions or events?**

   Virtually all transactions or events have tax consequences so identify all those that are completed or proposed. Also, large transactions may be made up of a series of smaller transactions so identify each component. And don't just consider financial transactions. Events such as marriage and death have significant tax implications as well. Here are some things to consider.

   Identify all of the completed or planned transactions or events such as a sale, purchase, loan given or received, gift given or received and benefit given or received.

   Draw one or more diagrams showing the transactions or events and all of the parties involved. You may need to draw multiple diagrams if there is a series of transactions. This will help you identify each of the components involved in each of the transactions.

   Draw a timeline identifying dates of the completed or planned transactions or events. The order of transactions or when they occurred or will occur is often an important detail.

   Identify the taxpayer's purpose for the transaction. Examples include business expansion, creditor proofing, income splitting, loss utilization and estate planning. Understanding the purpose may help you identify problems or alternatives.

   What impact will this transaction have on the taxpayer's debt or share financing? Will any debt covenants be broken? Will the voting control change?

   How is the transaction or event accounted for under ASPE or IFRS? The accounting for a transaction can have a significant impact on how the outcome is viewed so it is important to address the accounting issues in advance.

3. **What is missing?**

   It is important to identify any information you think is missing by looking for gaps in the tax profile or missing information about a transaction or event. Clearly identify this information and list any assumptions you are making.

Analyze

Now that you have gathered all the information, you need to analyze the transactions or events to determine the tax consequences.

4. **What is the impact on income for each party to the transaction?**

   All transactions have more than one party involved. They may be individuals or corporations or partnerships or trusts. The transaction may, for example, be that of vendor/purchaser, donor/recipient or estate/beneficiary. And, all transactions will have an impact on income either now or in the future. It is important to identify the income effect on each of the parties involved, now or in the future.

   The types of income are identified above.

5. **What is the impact on tax attributes for each party to the transaction?**

   All transactions have an impact on the tax attributes of the property transferred and/or received.

These attributes include the cost, adjusted cost base (ACB), undepreciated capital cost (UCC) and paid-up capital (PUC).

6. **Does any anti-avoidance or other special provision apply?**

   This is a crucial part of the analysis. The Act is full of special rules and exceptions that impact income and tax attributes. In particular, look for these special provisions where:

   - A tax benefit is realized
   - Transactions are not at arm's length or not at fair market value
   - Transactions that allow losses to be utilized
   - Transactions that create losses, especially transactions between related parties
   - Income or expenses are moved to another taxpayer
   - A benefit is conferred on another taxpayer

Identify the Issues

Now that you have gathered and analyzed the information you need to condense it down into specific issues and determine which issues are more important in light of the taxpayer's objectives, the transactions involved and the level of risk. At this point you don't have to have all the issues resolved, just identified.

Remember what we mean when we use the term "tax-related issue". It is something that might have positive or negative implications that needs further analysis. Issues may relate to opportunities that can be taken advantage of or penalties to be avoided. They may be tax specific or related to financial accounting, finance, ethics, governance, business or personal matters that relate to the tax matters under consideration.

7. **Based on the above, what are the issues?**

   Identify all of the issues that are supported by the facts (tax, accounting, finance, ethical, governance, business, personal, etc.). Identify compliance (completed transactions) vs. planning (proposed transactions) issues. Assess whether the benefits of the plan are worth the cost of designing, implementing and maintaining the plan.

   Be able to explain why these issues are relevant to your client.

8. **Which issues are more important?**

   Use judgement to prioritize and group the issues in terms of importance to your role and importance to the client's objectives. Considerations include urgency, materiality and risk.

   Ask yourself what you are being asked to do and what extra value you can provide; there may be important tax issues your client is not aware of.

   Are there non-tax issues that must be decided first?

Case Example for Identifying Tax Issues

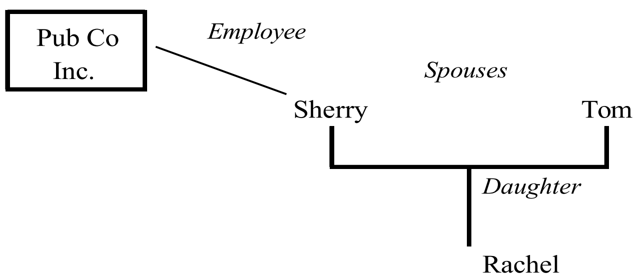
Sherry Huang works for a Pub Co Inc., a Canadian listed public company. Two years ago she was granted an option by her employer to buy 1,000 shares of Pub Co for $25 each. This year she exercised the stock option when the fair market value of the shares was $35; she sold the shares later in this year for $40. The fair market value at the grant date was equal to the exercise price of $25 per share.

Sherry is in the top tax bracket while her husband, Tom, and 16-year old daughter, Rachel, are not. Her goal is to split income with husband and daughter to reduce their overall tax burden. To accomplish this she plans to give her daughter $10,000 to buy shares on the stock exchange and to give her husband $30,000 to buy government bonds. She would like your advice on her plan.

Gather and Sort Information

1. **Who is involved and what do we know about them?**

    a. **Draw a diagram**



Before: Sherry has proceeds of $40,000 and owes tax on the option

Tom and Rachel have no assets that we know of

After: Sherry gives $40,000 away and is left with no cash and owes tax on the option

Tom has cash of $30,000 and will potentially earn interest and a capital gain or loss

Rachel has cash of $10,000 and will potentially earn dividends and a capital gain or loss

b. **Who is my "client" and what are their objectives?**

Sherry, an individual, is your client. She is an employee of a public company so earns employment income. She has no other income that we know of.

Sherry wants to split income with her husband and daughter because they are in a lower tax bracket than she is.

c. **Develop a tax profile for each of the parties**

Individual

We don't know much about Sherry except that she is married to Tom and they have a 16-year old daughter. We don't know anything about her estate plans.

Assets and liabilities of each client

Sherry has cash from the sale of her Pub Co shares of $40,000.

Rachel will have stock with an ACB and FMV of $10,000.

Tom will have bonds with and ACB and FMV of $30,000

Amount and type of income being earned by each client

Sherry with have employment income from the exercise of her stock option. She may also be able to claim a Division C deduction related to this stock option. These are issues to be determined.

Rachel may earn dividends on the shares she buys and realize a capital gain or capital loss when she sells the shares. The dividends will subject to the gross-up and credit as eligible dividends.

Tom may earn interest on the bonds he buys and realize a capital gain or capital loss when he sells the bonds.

Shareholders

Neither Sherry nor Tom will be shareholders at the end of the year.

Rachel will own shares in a public company.

Relationships

Sherry and Tom are spouses so they are related and affiliated.

As their daughter, Rachel is related to both Sherry and Tom.

Sherry is an employee of Pub Co Inc. but she is no longer a shareholder.

Liability for tax

We should confirm that Sherry, Tom and Rachel are residents of Canada and have been all year.

As residents, they will be taxed on their world income.

Tax risk tolerance

Sherry has not expressed her tolerance for tax risk. We need to ask her about this.

We need to be sure that our recommendations don't carry any risk.

2. **What are the transactions or events?**

   a. **Identify all of the completed or planned transactions or events**

      Completed: Sherry exercised her stock option and sold the shares

      Planned: Sherry will give $10,000 to Rachel and $20,000 to Tom

   b. **Draw one or more diagrams** showing the transactions or events and all of the parties involved.

Before

Sherry

Proceeds	$ 40,000
Tax owing	?

After

Sherry

Cash	$ -
Tax owing	?

Tom

Cash/bonds	$ 30,000

Rachel

Cash/shares	$ 10,000

c. **Draw a timeline** identifying dates of the completed or planned transactions or events.
   All events took place this year.
d. **What is the taxpayer's purpose** for the transaction or events?
   i. Tax planning – income splitting
e. **What is the impact on debt or share financing?**
   None
f. **How is the transaction or event accounted for?**
   N/A

3. **What is missing?**
   Are Sherry, Tom and Rachel Canadian residents?
   Will Sherry want the money back in the future?

Analyze

4. **What is the impact on income for each party to the transaction?**

Completed Transaction – exercise of stock option

Pub Co is a listed company therefore employment income is recognized when option is exercised

Employment income = 1,000 shares x ($35-$25) = $10,000

Sherry's ACB in these shares becomes $25 + ($35-$25) = $35/share

Since the option price was not less than the FMV at grant date Sherry is eligible for the Division C deduction of 50% x $10,000 employment income = $5,000

Sherry is in the top tax bracket of 46% so her tax owing on the stock option will be 46% x ($10,000-$5,000) = $2,300.

Completed Transaction – sale of stock option shares

Proceeds (1,000 x $40)	$40,000
ACB (above 1,000 x $35)	(35,000)
Capital gain	$5,000
Taxable capital gain	$2,500
Tax owing @ 46%	$1,150

Planned Transactions – gift to Tom

Tom receives $30,000 and buys bonds to earn interest income and possibly a capital gain or loss on the sale.

Planned Transaction – gift to Rachel

Rachel receives $10,000 and buys shares to earn dividend income and possibly a capital gain or loss on the sale.

Since she will purchase public company shares the dividends will be eligible dividends with a dividend tax credit.

5. **What is the impact on tax attributes for each party to the transaction?**

Tom's ACB of the bonds he purchases will be $30,000.

Rachel's ACB of the shares she purchases will be $20,000.

6. **Does any anti-avoidance or other special provision apply?**

The exercise of the stock option and subsequent sale of the shares does not create a tax benefit nor does it shift income to anyone else.

The gifts to Tom and Rachel do result in a tax benefit. The interest and dividends earned by Tom and Rachel will be taxed at a lower rate than if Sherry earned them. Sherry has shifted income to and conferred a benefit on her husband and daughter.

Identify the Issues

7. **Based on the above, what are the issues?**

- How is Sherry going to pay for her tax liability of $3,450 on the stock option shares?
- Since Sherry is shifting interest income and potentially capital gain to Tom through a gift, the attribution rules will apply.
- Since Sherry is shifting dividend income and potentially capital gain to Rachel, who is under 18, through a gift, the attribution rules will apply.
- Does Sherry really want to give this money away permanently or would she prefer to keep it for her own retirement?
- Is there a better way for Sherry to accomplish her goals?

8. **Which issues are more important?**

- The completed transactions (exercise of stock option and sale of shares) are important for determining how much cash Sherry has to deal with. However, estimating the tax owing is not complicated.
- The planned transactions require more research to determine what Sherry's goals are and to develop options for her to consider.

Summary List

Gather and Sort Information

1. **Who is involved and what do we know about them?**
   a. **Draw a diagram**
      i. Indicate all of the parties involved and their relationships to each other
      - Parent, child, brother, sister
      - Shareholder, employee

      ii. Indicate the ownership of assets both before and after any transactions

   b. **Who is my "client" and what are their objectives?**
      i. Individual, corporation, partnership, trust
      ii. What is their "business"/how do they earn income?
      iii. What are my client's short, mid and long-term objectives and what is important to them?

   c. **Develop a tax profile for each of the parties**

      Individual
      i. Age
      ii. Significant relationships
      iii. Estate plans

      Trust
      i. Type of trust – inter-vivos or testamentary

      Corporation
      i. Canadian Controlled Private Corporation (CCPC)
         - Small Business Corporation

      ii. Private, public

      Assets and liabilities of each client
      i. For each significant asset identify the adjusted cost base (ACB), fair market value (FMV), undepreciated capital cost (UCC) or other tax attribute.
      ii. Identify the amount and terms of any debt

      Amount and type of income being earned by each client
      i. Employment/personal service business
      ii. Business – Canadian or foreign
      iii. Property/aggregate investment income – Canadian or foreign
      iv. Dividends – for individuals – Canadian eligible or not eligible or foreign
         - for corporations – Canadian connected or portfolio or foreign

      v. Taxable capital gains, allowable capital losses
      vi. Income (loss) vs. capital gain (loss)

vii. Other income or deductions

viii. Net or non-capital losses from other years, capital gains exemption

ix. Personal tax – graduated tax rates, marginal tax rate, credits applicable

x. Corporate tax – basic tax rate, provincial abatement, small business deduction, general rate reduction, foreign tax credit, additional refundable tax, Part IV tax, refundable Part I tax, dividend refund, ITCs

Shareholders

i. Individuals, corporations, trusts or partnerships

ii. Relationships among shareholders

iii. Details of shareholdings – number of shares

iv. Legal control – voting rights

v. De facto control – financial or other influence

vi. Adjusted cost base (ACB), paid-up capital (PUC)

vii. Details of a shareholder agreement

viii. ABIL, capital gain exemption information

Relationships

i. With shareholders (related, affiliated, control, employees, etc.)

ii. With other corporations (related, affiliated, control, associated, connected, etc.)

iii. Employer/employee, corporation/shareholder, partnership/partner, trust/beneficiary

Liability for tax

i. Canadian residents – world-wide income

ii. Foreign residents – Canadian source

Tax risk tolerance

i. Taxpayer's risk tolerance

ii. Professional advisor's risk tolerance

iii. Risk to reputation, client/professional relationship, penalties

2. **What are the transactions or events?**

a. **Identify all of the completed or planned transactions or events** – sale, purchase, loan given or received, gift given or received, benefit given or received

i. Between shareholder and corporation

ii. Between employees and employer

iii. Between corporations

iv. Between individuals

v. Actual transactions – compliance, appeal

vi. Proposed transactions – planning

b. **Draw one or more diagrams** showing the transactions or events and all of the parties involved.

c. **Draw a timeline** identifying dates of the completed or planned transactions or events

d. **What is the taxpayer's purpose** for the transaction or events?
   i. Business planning e.g. expansion, creditor proofing
   ii. Tax planning/avoidance e.g. income splitting, loss utilization
e. **What is the impact on debt or share financing?**
f. **How is the transaction or event accounted for?**
   i. ASPE, IFRS

3. **What is missing?**
   a. Identify any information that you think is missing from what you have been given
   b. **Look for gaps** in the tax profile or missing information about a transaction or event
   c. **Identify/list any assumptions** you are making.

Analyze

4. **What is the impact on income for each party to the transaction?**
   - Identify the parties – vendor/purchaser, donor/recipient, estate/beneficiary
   - Identify the types of income impacted
   - Employment/personal service business
   - Business – Canadian or foreign
   - Property/aggregate investment income – Canadian or foreign
   - Dividends – for individuals – Canadian eligible or not eligible or foreign
   - for corporations – Canadian connected or portfolio or foreign
   - Taxable capital gains, allowable capital losses
   - Income (loss) vs. capital gain (loss)
   - Other income or deductions
   - Net or non-capital losses from other years, capital gains exemption
   - Personal tax – graduated tax rates, marginal tax rate, credits applicable
   - Corporate tax – basic tax rate, provincial abatement, small business deduction, general rate reduction, foreign tax credit, additional refundable tax, Part IV tax, refundable Part I tax, dividend refund, ITCs

5. **What is the impact on tax attributes for each party to the transaction?**
   a. ACB
   b. UCC
   c. PUC

6. **Does any anti-avoidance or other special provision apply?**
   a. A tax benefit is realized
   b. Transactions not at arm's length or not at fair market value
   c. Transactions that allow losses to be utilized
   d. Transactions that create losses, especially transactions between related parties
   e. Income or expenses are moved to another taxpayer

f. A benefit is conferred on another taxpayer

Identify the Issues

7. **Based on the above, what are the issues?**
   a. Identify all of the issues that are supported by the facts (tax, accounting, finance, ethical, governance, business, personal, etc.)
   b. Identify compliance (completed transactions) vs. planning (proposed transactions) issues
   c. Are the benefits of the plan worth the cost of designing, implementing and maintaining the plan?
   d. Be able to explain why these issues are relevant
8. **Which issues are more important?**
   a. Use judgement to prioritize and group the issues in terms of importance to your role and importance to the client's objectives. Considerations include urgency, materiality and risk.
   b. Ask yourself:
      i. What am I being asked to do?
   e. What extra value can I provide?
   f. Are there important issues you client is not aware of?
   c. Are there non-tax issues that must be decided first?

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