CHAPTER 2:
Fundamentals of Tax Planning

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CHAPTER TWO
Fundamentals of Tax Planning

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

I. What is Tax Planning?

- **Tax Planning:**
  - legitimate arranging of financial activities that reduces or defers tax costs.
  - within the object and spirit of the law.
- **Tax Evasion:**
  - Very clear - an act with the intent to deceive.
  - includes knowingly failing to report revenue, or claiming the deduction of a false expense, or both.

I. What is Tax Planning?

- **Tax avoidance:**
  - Circumvents the law to avoid tax,
  - Transactions that do not reflect the real facts,
  - May be regarded as abuse.

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

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

II. Types of Tax Planning

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

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

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

Current tax rate
Lower than
Future tax rate

↓

Tax savings to recognize
Income now vs. later

Current tax rate
higher than
Future tax rate

↓

Tax cost to recognize
Income now vs. later

Shifting Income Example

The following is tax information for ABC corp.

- Tax rate on Income < $500,000 15%
- Tax rate on Income > $500,000 25%
- 20X1 income after reserve = $150,000
  - $20,000 Reserve can be delayed to 20X2
- 20X2 income is estimated to be $550,000

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

Shifting Income Solution

Increase in tax – in 20X1

if no reserve is taken ($20,000 x 15%) $ 3,000

Decrease in tax – in 20X2

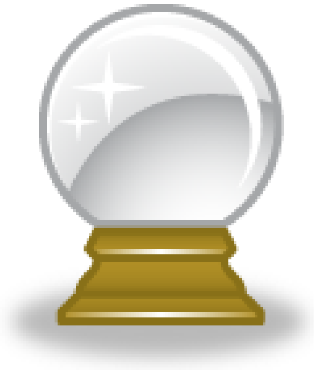
if reserve is taken in 20X2 ($20,000 x 25%) $ 5,000

Ultimate tax savings $2,000!
No consideration given to the reduced cash flows relating to the prepayment of tax.

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

In making a decision to shift income, must determine:

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



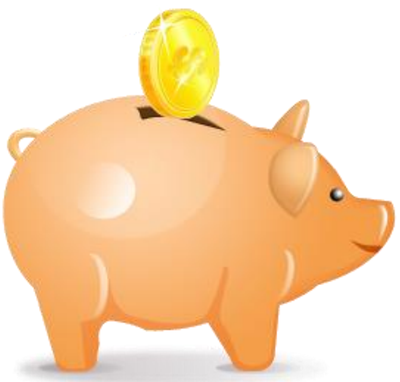
B. Transferring Income to Another Entity

- **Individuals can accumulate wealth by using different entities:**
  - Corporations, proprietorship, partnerships etc.

- The tax treatment varies with the entity chosen.

- Ultimately, the wealth leads back to the individual or family members.

- Shifting income to a different structure may reduce or delay tax payable.



B. Transferring Income to Another Entity (continued)

For example:

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

First $43,000	24%
Next $44,000	32%
Next $48,000	40%
Income over $135,000	45%

B. Transferring Income to Another Entity (con't)

	Unincorporated		Incorporated
Business Profits	$100,000	Bus. Profits Less Salary	$100,000 ($52,300)
Taxes	($29,600)	Corporate Taxes	($7,200)
Personal Expenses	($39,000)		
After-tax Cash Flows	$31,400		$ 40,500

Incorporation provides an extra $9,100 available for expansion

B. Transferring Income to Another Entity (con't)

Other factors to consider:

- Requirement for cash distributions from corporation.
- Corporate Income earned greater than $500,000.
- Business Losses incurred in corporation.
- Business failure, Sale of business, etc.
- Shareholder dies or leaves the country

Must anticipate Possible Future Events.

C. Converting Income from One Type to Another

Four basic types of income:

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

Amount of taxable income & the timing depends greatly on the type of income.

C. Converting Income from One Type to Another

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

IV. Restrictions to Tax Planning

- Tax planning is divided between acceptable and unacceptable activities.
- The *Act* specifically prohibits a number of activities.

anti-avoidance rules

GAAR stipulates:

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

Summary

- **Tax Planning** – conscious effort to maximize wealth within the spirit

  of tax laws.
  - Planning activities must be consistent with prudent business activities.
- Good tax planning involves applying business basics.