Who Pays Tax on What?

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Who Pays Income Tax on What?

[This Chapter is a work in progress. This notation will be removed when the chapter is complete and no longer in Draft form]

This Chapter deals with the question of who has to pay income tax and what the tax is calculated in reference to under the Income Tax Act, RSC 1985 c 1 (5th Supp) ("ITA"). This Chapter will begin by presenting the current rules in a general manner, and then will proceed to deal with the statutory provisions and case law in detail. The Chapter will end by discussing the policy rationale behind the current legislative approach and provide some analysis of how the current rules measure up to the ideal.

Contents

1. Broad Strokes

"Who has to pay tax?" is a question that asks us to look at the economic unit(s) that are subject to tax. This is called the "tax unit". "What is tax payable on?" or "What is the tax assessed on" are questions that ask us to look at what items or receipts of a particular tax unit are taxed. This is called the "tax base". These two questions are somewhat intertwined because depending on "who" is taxable, "what" is taxable may change. Another important part of the income tax structure is the "tax period" - the artificial choice of time over which the income is calculated so as to determine income tax liability.

Although both Canadian Residents and Non-Residents of Canada are liable to tax under the ITA, their tax liability is different. A "person" who is a "resident" of Canada at any point in a year is required to pay tax on that person's worldwide "taxable income" in the year. Thus, a Canadian resident is taxable on ALL that person's "income" no matter where it is from. What counts as "income" is generally office income, employment income, business income, income from property, and some other items.

A “person” who is a non-resident of Canada is liable to pay income tax if that person was either employed in Canada, carried on a business in Canada, or disposed of a Taxable Canadian Property in that year or in a previous year. Thus, a non-resident is only taxable on certain income that is linked to Canada - the non-resident's Canadian sourced income.

The definition of “person” for purposes of the *Income Tax Act* is not limited to natural persons (individuals) but also includes artificial persons – corporations and trusts – but not partnerships. Partnership income is still taxed, but it is the individual partners and not the partnership itself that pay tax on (their portion of) the partnership’s income. Real persons, corporations, and trusts pay tax on their own incomes.

In short, "persons" are liable to pay income tax - they are the tax units.   Depending on whether the person is a resident of Canada or a non-resident of Canada, the tax base is different. Canadian residents pay income tax on theirworldwidee income, while non-residents of Canada pay tax only on their Canadian source income.

To the Top

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2. The Details

The provisions of the ITA relevant to the discussion of who is liable to tax and on what – the tax unit and the tax base – are:

- Section 2 – Liability for Tax
- Section 3 – Income for Taxation Year

Section 2 sets out who is liable to Canadian Income Tax and what that person is taxable on. Subsections 2(1) and (2) deal with “residents” and subsection 2(3) deals with non-residents. Section 3 provides more guidance about the definition of the tax base by providing a non-exhaustive definition of "income", which is a component of the definition of "taxable income" in subsection 2(2).

To the Top

A) Canadian Residents' Liability for Income Tax

A Canadian resident individual, trust, or corporation is liable for income tax to Canada on that person’s taxable income. A resident taxpayer’s taxable income for a taxation year is the sum of that person’s “income” (including that from office, employment, business, and property), other income (ss 56-59.1), net “taxable capital gain[s]”, and

"taxable net gain[s]", less permissible deductions. The period over which income is calculated for a Canadian resident human individual and a non-testamentary trust is the calendar year, corporation or partnership is the fiscal year, and testamentary trust is the period over which the accounts of the trust are made up.

Subsection 2(1) reads:

> 2(1) An income tax shall be paid, as required by this Act, on the taxable income for each taxation year of every person resident in Canada at any time in the year.

This subsection will be dealt with in more detail than the rest to serve as an example of how to approach reading a provision of the *Income Tax Act*. The other sections will not be broken down to the same extent. In reading any provision, it is important to identify the key words, concepts, or phrases that are (i) defined in the ITA itself, or (ii) must be defined in some other manner so as to make sense of the provision. In considering subsection 2(1), we can break the provision into the following parts:

- ***"An income tax shall be paid"*** – there is a legal requirement to pay an income tax
- ***"as required by this Act"*** – the rules of what constitutes an income tax are found in this legislation
- ***"on the taxable income"*** – we would need to know what the phrase "taxable income" means as this is what the income tax is payable in reference to – we find that the phrase is defined in three places in the ITA – subsections 2(2) and 248(1) and section 114 (we will come back to what this phrase means later). Thus "taxable income" is the tax base.
- ***"for each taxation year"*** – we would need to know what constitutes a "taxation year" since this defines the tax period – we find that the phrase is defined in three places in the ITA – subsections 249(1) and (2), and paragraph 250.1(a) (we will come back to what this phrase means later). Note that the "tax period" is an important element of the structure of any tax, and sets out the time period over which the tax base is computed.
- ***"of every person"*** – we would need to know what the word "person" captures since this is the tax unit – we find that the word is defined in subsection 248(1) (we will come back to what the word means later)
- ***"resident"*** – we need to be able to be able to determine when a "person" will be a "resident" as this modifies the tax unit– we find that the ITA contains a deeming provision in section 250 dealing with resident status, and we need to turn to case law to see what the common law definition is (we will come back to how to determine residency for ITA purposes later)
- ***"in Canada"*** – we need to know what counts as "Canada" as this further modifies the tax unit– we find that section 255 provides an expansion of the normal definition of Canada (note that the Interpretation Act, RSC c I-21, also provides definitions that expand the term Canada).
- ***"at any time in the year"*** – this phrase also modifies the tax unit indicates that the income tax liability under subsection 2(1) arises so long as the "person" meets the conditions at any time in the year – we note that the word "year" is not defined in the ITA, meaning that the normal common meaning of the word applies.

Subsection 2(1) sets out three of the structural elements of the income tax by providing that: (i) the tax unit is "a person resident in Canada at any time in the year"; (ii) the tax base is "taxable income"; and (iii) the tax period is the "taxation year".

Subsection 2(2) goes on to define what "taxable income" is, and states that the "taxable income" of a "taxpayer" ("taxpayer" s. 248(1)) for a "taxation year" (s. 249(1)) is that taxpayer's "income" (s. 3) for the year, plus the additions and minus the deductions permitted by Division C of Part I the ITA. Subsection 248(1) defines "taxable income" to be what is provided for in subsection 2(2), and also states that a taxpayer's taxable income may never be less than nil. To make sense of the definition of "taxable income" we need to determine what the definition of "income" is.

The *Income Tax Act* does not exhaustively define "income" (see this page for a more detailed discussion of the definition of "income"). Section 3 describes "income" by providing a number of examples of what income includes. Specifically, Section 3 provides that the income of a taxpayer or a taxation year, for purposes of Part I of the ITA, is the income determined by applying the rules found in paragraphs (a) to (f) of section 3. The details of the computation of "income" will be dealt with later in this Chapter. For now, it is enough to note that a Canadian resident person's income includes both income from a source inside Canada and a source outside of Canada. Therefore, Canadian resident persons are taxable on their world-wide income. Also, a taxpayer's income includes all of that taxpayer's "income" which, without restricting the generality of the word "income", includes the income for the year from each "office", "employment", "business", and "property" of the taxpayer.

Additionally, Section 3 defines the taxpayer's income for a taxation year to include the net "taxable capital gain" of the taxpayer resulting from "dispositions" of "property" in that year, and the "taxable net gain" of the taxpayer resulting from "dispositions" of "listed personal property" in that year. To get at a taxpayers "income" for a "taxation year", the Act requires some other deductions to be made were applicable (will be discussed later), and requires the inclusion of other listed income items under Subdivision d of Division B of Part I of the ITA (ss 56 to 59.1).

A "taxpayer" includes any person whether or not liable to pay tax (s. 248(1)). Therefore we need to identify who counts as a "person" under the ITA. Subsection 248(1) defines a "person" as including any corporation and any entity exempt from Part I tax under subsection 149(1), as well as the heirs, executors, liquidators of a succession, administrators, or other legal representatives of a person according to the law of that part of Canada. Note that the definition of "person" uses the term "includes", which indicates that the definition is not exhaustive and is only an expansion of the word's ordinary meaning. To get the ordinary meaning of a word we turn to the dictionary definition. Oxford Dictionaries defined "person" to be a "human being regarded as an individual".

However, this is not the end of our search for the definition of "person". Subsection 248(1) defines "individual" to mean a person other than a corporation, and defines a "corporation" to include an incorporated company. This doesn't seem to add much to what we have so far. However, we find that in subdivision k, Division B, Part I of the ITA (Computation of Income of

Trusts and Their Beneficiaries), subsection 104(1) states that a "trust shall, for the purposes of this Act, [...] be deemed to be [...] and individual". We also find that the definition of "trust" in subsection 108(1) provides that "trust" "includes an *inter vivos* trust and a testamentary trust". We will consider the question of what counts as an *inter vivos* trust or a testamentary trust in the Chapter dealing with the taxation of trusts and estates. The preceding shows that, in interpreting the ITA, we have to follow the various interconnected definitions through the Act.

A “taxation year” is generally (unless expressly otherwise provided): (i) the fiscal period of a corporation or a Canadian resident partnership; (ii) the calendar year for an individual (other than a testamentary trust); and (iii) the period for which the accounts of the trust are made up for purpose of assessment under the ITA for a testamentary trust (s. 249(1)). The phrase "fiscal period" is defined in subsection 249.1(1). Generally, the fiscal period for a corporation is any 12 month period (the details will be dealt with elsewhere). Subsection 249(2) provides that a taxation year or fiscal period ending in another year includes a taxation year or fiscal period ending coincidentally with the year. Paragraph 250.1(a) defines a non-resident person’s taxation year (dealt with below).

To the Top

B) Non-Resident Persons' Liability to Tax

Subsection 2(3) provides that a person other than a person who is a resident of Canada for a taxation year– i.e. a non-resident person – is liable for income tax where that person either (i) was "employed" in Canada, (ii) carried on “business” in “Canada”, or (iii) disposed of a “taxable Canadian Property” at any time in that year or in a previous year. This combination of sources of income is the non-resident persons "taxable income earned in Canada". The subsection also provides that the non-resident person’s “taxable income earned in Canada” for the year is determined by applying the rules in Division D, Part I, of the ITA. There is a great deal to unpack in subsection 2(3). Therefore the "tax unit" is a "person" other than a Canadian resident person, being a non-resident corporation, human individual, or trust (see discussion of "person" above). The "tax base" is the non-resident person's "taxable income earned in Canada".

Subsection 248(1) defines the phrase "taxable income earned in Canada" to mean the amount determined in accordance with Division D, Part I of the ITA, and states that this amount can never be less than nil. Subsection 115(1) further provides that the "taxable income earned in Canada" of a person who at no time in the year is resident in Canada is the amount that would be that non-resident person's income determined under Section 3 if a number of enumerated assumptions are made (the details of this will be discussed in the chapter dealing with taxation of non-resident persons).

A person is “employed in Canada” where the person is performing the duties of employment in Canada (see s. 115(1)(a)(i)) – this applies only to individuals as only real persons can be employed (be an employee under a contract of service).

A person carries on “business” in “Canada”, where that person engages in activities that constitute a business at common law, or engages in a “profession, calling, trade, manufacture or undertaking of any kind whatever” and (subject to some limitations) “an adventure or concern in the nature of trade” in "Canada" (“business" s. 248(1)). A business does not include an “office” or “employment”.

A person disposes (see “disposition” s 248(1)) of “Taxable Canadian Property” if that person disposes of “property” (s 248(1)) of the taxpayer that is:

i. real or immovable property situated in Canada, or

ii. property that is inventory of a business carried out in Canada (except property used in an insurance business, or a non-resident’s ships and aircraft used in international traffic in that person’s country of residents gives reciprocal treatment), or

iii. designated insurance property of an insurer, or

iv. shares of private non-mutual fund corporations, interests in partnerships, or interest in a non-mutual fund trust (except income interests in Canadian resident trusts), IF at any time in the 60 months before the time under consideration more than 50% of the fair market value (FMV) of the share or interest was directly or indirectly from one or a combination of (a) real or immovable property situated in Canada, (b) Canadian resource properties, (c) timer resource properties, or (d) options, interests, or civil law rights that relate to any of the foregoing. Note that an indirect interests arising through corporations, partnerships, or trusts whose shares or interests do not otherwise meet the definition of “taxable Canadian property” are not considered, or

v. Shares of public corporations (listed on a “designated stock exchange”)or mutual fund corporations, or units of mutual fund trusts, if at any time in the 60 months before the time under consideration (a) 25% or more of the issues shares or units were owned by one or a combination of the taxpayer and non-arm’s length persons to the taxpayer, AND (b) more than 50% of the FMV of the shares or units was from one or a combination of (b.1) real or immovable property situated in Canada, (b.2) Canadian resource properties, (b.3) timer resource properties, or (b.4) options, interests, or civil law rights that relate to any of the foregoing, or

vi. An option, interest, or civil law right in any of the above, whether or not the property exists; and

vii. For purposes of determining liability for income tax (and ss 107(2.001), 128.1, 150, 85(1)(i), and (97(2)(c)), includes (a) a Canadian resource property, (b) a timber resource property, (c) an income interest in a Canadian resident trust, (d) a right of a former partner to share of income or loss of a partnership carrying on business in Canada (see 96(1.1)(a)), and (e) a lie insurance policy in Canada.

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Back To Top OR Home