

## **1 Lecture 3: Depreciable Property and Eligible Capital Property**

### **1.1 Coverage**

- Use the lecture notes for studying; if you think you need more materials please search for relevant materials in CTP Chapter 5
- Exercises 5-1 to 5-16
- Self-study problems 5-1, 5-2, 5-5, 5-6, 5-7

## **2 Capital Property [ITA 54]**

- ITA differentiates between capital property and items that can be deducted in the year that they are purchased
- Capital property has an economic life longer than one year
- According to the case law, it has an “enduring benefit”
- There are three types of capital property: Depreciable property, Eligible capital property, and non-depreciable capital property

### **2.1 Depreciable property [ITA 13(21)]**

- tangible property that goes down in value over time or as they are used, e.g. buildings and equipment
- intangible property with a fixed life that goes down in value over time, e.g. limited life franchises, licenses and patents

### **2.2 Eligible capital property [ITA 54]**

- intangible property with an indefinite life that goes down in value over time, e.g. incorporation costs, purchased goodwill and unlimited life licenses or franchises

### **2.3 Non-depreciable capital property**

- e.g. land or shares

## **3 No deduction can be claimed for capital property**

- Unless it is specifically allowed by the ITA due to ITA 18(1)(b)
- ITA 20(1)(a) and 20(1)(b) allows a deduction (discussed below)

### 3.1 Capital cost allowance (CCA)

- = Capital cost allowance on depreciable property
- = ITA 20(1)(a) deduction: the CCA rate varies and is set by the Regulations
- can be claimed on
  - tangible property that goes down in value over time or as they are used
    - e.g. buildings and equipment
  - intangible property with a fixed life that goes down in value over time
    - e.g. franchises, licenses, patents
- The Income Tax Act and Regulations set maximum rates
  - but taxpayer can take less than the maximum amount each year (including \$0)
- CCA is the tax equivalent of what accountants call depreciation or amortization

## 4 CCA: Details

- Assets are grouped in classes as set out in Schedule II of the Regulations
- When an asset is purchased its cost is added to the Class it belongs to
  - The cost of the asset includes GST and PST (or HST) and installation and freight costs etc.
  - The cost of the assets must be reduced by
    - GST/HST input tax credits (GST/HST registrants only)
    - Government grants (if any)
  - For example, if a taxpayer purchased computer equipment in 2016 for use in a business the taxpayer would add the cost of the computer equipment to CCA Class 50, which has a 55% CCA rate and the half-net rule applies

### 4.1 Mostly Declining Balance Approach

- The CCA rate depends on the class
  - Most CCA rates are declining balance rates
    - i.e. the rate is applied to the balance in the class at year-end (called the UCC)
      - UCC = undepreciated capital cost
        - rolling balance of acquisitions minus CCA minus amounts deducted for disposals
- Rates range from 4% to 100% [Regulation 1100]
- Assets must be "available for use" in order to claim CCA
  - Many assets are available for use on the same day as purchase/delivery; however some assets are not. Generally speaking, assets other than buildings will be considered available for use at the earliest of: (a) the time that the property is first used by the taxpayer for its intended purpose (to earn income); and (b) the beginning of the second taxation year following the year of purchase of the asset [ITA 13(27)]
  - Buildings are considered available for use at the earliest of: (a) the time that 90% or more of the building is first used by the taxpayer for its intended purpose (to earn income); (b)

the time that the construction of the building is complete; and (c) the beginning of the second taxation year following the year of purchase of the building [ITA 13(28)]

- Only class 13, 14 and 29 have straight-line CCA rates
- CCA claimed as a deduction is deducted in computing the UCC of the Class
- For example, if at the end of the year the taxpayer has a UCC balance of \$10,000 in CCA Class 8 (20% CCA rate), then (as long as the taxpayer still has assets in the CCA class) the taxpayer can claim a maximum of \$2,000 (i.e., \$10,000 x 20%) of CCA as a deduction from income for the year. Any CCA claimed will reduce the UCC balance

#### 4.2 Half-net Rule [Regulation 1100(2)]

- Half-net rule = temporarily deduct 1/2 of net additions from the class in order to claim CCA for the year
- half of net additions = excess of the purchases added to the class in the year over the cost deducted from the class in the year for disposals
  - if there are no disposals, you subtract half of the purchases
  - if there are no purchases, there is no adjustment needed
- the half-net rule is used for all declining balance classes except for certain class 12 items and class 52
- the rule does not apply to class 14
- the rule does not apply to certain non-arm's length transactions [i.e., when property is purchased from a non-arm's length vendor and the purchased property was owned by the vendor for at least the past 364 days (before the purchaser's year-end)]
- CCA rates for major CCA asset classes: See 5-37
- Read 5-34 to 5-42, see especially example at 5-40

#### 4.3 Class 13: Leasehold Improvements

- Leasehold improvements are improvements made to a building that is leased (i.e., not owned) by the taxpayer
- CCA= straight-line
- the maximum CCA is the lesser of:
  - 1/5 of the capital cost and
  - capital cost/[Remaining lease term + 1st renewal term]
  - The lease term is calculated by taking the number of 12-month periods starting from the beginning of the taxation year in which the lease began until the end of the lease [Schedule III of the Regulations]. A renewal term (if included in the lease) is an option in the lease that allows the taxpayer to extend the lease for an additional period of time
- half of this CCA can be claimed in the first year and
- the maximum write-off period is 40 yrs

#### 4.4 Class 14 - Limited Life Intangibles

- CCA = straight-line over the legal life of the intangible asset (in days)
- No half-net rule: use actual number of days instead

#### 4.5 Two options for claiming CCA on patents or rights to use patents

- class 14 (CCA based on the remaining legal life based on days) or
- class 44 (CCA 25% declining balance)
- Taxpayers should choose the class that produces the largest CCA deduction (usually this is class 44). Once you place the patent in a class (i.e., 14 or 44) it will stay in that class

#### 4.6 Class 14.1 Goodwill and Other Intangible Assets

- New CCA class as of January 1, 2017
- CCA = 5% declining balance for post-2016 additions
- Qualifying assets: goodwill, intangibles not belonging in another class (typically intangibles without a limited life)
  - Read 5-49 for a more detailed list of assets that qualify for this class
- Cumulative Eligible Capital (CEC) balances that were present December 31, 2016 are also transferred to this class
  - The transitional rules surrounding the transfer of CEC are complex and beyond the scope of this course

#### 4.7 Short taxation years [Regulation 1100(3)]

- Short taxation years (<365 days) happen when
  - a new corporation starts
  - a corporation requests a change in year-end (must provide a business reason and must get the CRA's approval)
  - an amalgamation (merger) occurs (because there is a deemed year-end for tax purposes)
- When a short taxation year occurs, CCA claims deducted in computing business income must be prorated based on the number of days in the year divided by 365 (or 366 in a leap year)
- Note: this rule is separate from the half-net rule (which applies in the year of an asset's purchase)
- This CCA rule is not applicable for property income (e.g. rental income)
- Read 5-43 to 5-47; see example at 5-45

## 4.8 Disposals of Depreciable Property

- The special rules relating to Class 10.1 luxury cars costing over \$30,000 are different (and are not covered here; they are covered in ADMS 4561). These are the normal rules:
- Disposals may either trigger
  - recapture (income) [ITA 13(1)]
  - recapture (income) and capital gains (1/2 taxable)
  - a terminal loss (100% deductible) [ITA 20(16)] or
  - just a reduction of the UCC
- The lesser of cost or proceeds of disposition is deducted from the UCC of the class in which the disposed asset belongs to
  - This is because if proceeds > cost then there will be a capital gain which is taxed under a different set of rules
  - Half of the capital gain is a taxable capital gain which is included in income under subdivision c
- If the amount subtracted makes the UCC negative at year-end, there is recapture to report as income
  - Example
    - A truck costing \$10,000 is sold for \$8,000. The UCC of Class 10 at the beginning of the year was \$7,000. There were no acquisitions of Class 10 assets during the year. What are the tax consequences?
    - Answer
      - Recapture of \$1,000 (\$7,000 minus \$8,000) is taxed as business income. The lesser of cost (10k) and proceeds of disposition (8k) is 8k. The UCC of Class 10 is 0 at the end of the year (after the recapture)
- If the UCC balance is still positive but no assets are left at year end, there is a terminal loss to claim
  - Example
    - A truck costing \$10,000 is sold for \$3,000. The UCC of Class 10 at the beginning of the year was \$7,000. There were no assets in Class 10 at the end of the year. What are the tax consequences?
    - Answer
      - Terminal loss of \$4,000 (\$7,000 - \$3,000) is deducted as a business loss. The lesser of cost (10k) and proceeds of disposition (3k) is 3k. The UCC of Class 10 is 0 at the end of the year (after the terminal loss)
- If the UCC balance is still positive and there are assets left in the class, you can claim CCA (i.e., the normal CCA rules apply and there is no recapture and no terminal loss)
  - Example
    - A truck costing \$2,000 is sold for \$10,000. The UCC of Class 10 at the beginning of the year was \$7,000. There were two other assets in Class 10 at the end of the year. What are the tax consequences?

- Answer
  - the \$8,000 gain over cost (\$10,000 - \$2,000) is a capital gain and  $\frac{1}{2}$  of this amount (the taxable capital gain) is included in income
  - Only \$2,000 is subtracted from the CCA class. The lesser of cost (2k) and proceeds of disposition (10k) is 2k. The UCC of the class is therefore \$5,000 (\$7,000 - \$2,000)
  - because there are other assets in the CCA class and a positive UCC balance, CCA can be claimed
    - The maximum CCA is \$1,500 (30% x \$5,000)
- Read 5-68 to 5-85

#### 4.9 Separate CCA Asset Classes

- The ITA requires separate classes for
  - rental properties costing over \$50,000 (separate Class 1) [Regulation 1101(1ac)]
    - to force taxpayers to recognize recapture immediately (if applicable, upon sale)
  - luxury cars (Class 10.1): to be covered in ADMS 4561
  - The ITA allows for (but does not require) separate classes for certain high tech and manufacturing equipment (Class 8, 43) [Regulation 1101(5p),(5s)]
    - because these assets depreciate quickly. The rules allow a taxpayer to write off terminal losses right away if the asset is sold for < UCC
      - these rules apply to
        - Class 8 photocopiers, fax machines, electronic communications equipment
        - Class 43 manufacturing equipment
- Taxpayers can elect (choose) to put these assets in separate classes for the first 5 years, if they cost > \$1,000
  - i.e. no pooling with other assets of the same class
  - If not sold, they are pooled with other assets of the same class after 5 years (i.e., they no longer stay in a separate class)
  - For buildings purchased after March 18, 2007 used 90% or more in manufacturing or processing in Canada, taxpayers can elect to place the building in a separate Class 1 (CCA rate 10% instead of the usual 4%)
  - For other buildings purchased after March 18, 2007 used 90% or more for non-residential purposes, taxpayers can elect to place the building in a separate Class 1 (CCA rate 6% instead of the usual 4%)
  - For machinery and equipment purchased after March 18, 2007 and before 2016 used in manufacturing or processing, taxpayers can elect to place the machinery/equipment in Class 29 (50% CCA straight line). Note: class 29 is typically better than class 43 (even if you elect to place the equipment in a separate class 43)
  - For 2016 and subsequent year, the April 21, 2015 federal budget proposes a new Class 53 for manufacturing and processing assets (50% CCA declining balance, with half-year rule)
- Read 5-99 to 5-108

**\*\*Becoming an Accountant – Learning the Necessary Skills\*\***

- There are several required competencies that need to be demonstrated before an accounting designation can be obtained. These competencies are tested through the various examinations required in order to become a designated accountant.
- This lecture deals with analyzing information to determine the tax treatment (CCA class, etc.). It ties directly into the competency map as all candidates are required to demonstrate professional skills through examining and interpreting information and ideas critically.
- All course content can be tied back to one or many of the competencies that need to be demonstrated in order to successfully become a designated accountant.