TAX MARKING GUIDE
SABLETEL

In the taxation role, the candidate is expected to address the compliance issues and the tax planning issues. The compliance issues are directed to by John (calculate taxable income), and or hinted at in the case (SRED, Spacolli tax reassessment). To do the compliance part properly, they must recast the financial statements. Then they can discuss the tax planning for Star Nova in conjunction with SableTel. They need to consider the possible sale of Sable Tel and the use of loss carry-forwards. They are also asked to discuss the proposed bonus plan within the case.

(Note: Solutions have been created for illustration purposes only. The Board of Examiners will determine the actual number of opportunities and define the expectations that will be part of the assessment to ensure the four roles are equated.)

COMMON CORE -Financial Reporting
(will be broken down into multiple assessment opportunities by the BOE)

The candidate discusses the significant accounting issues related to the 2014 financial statements.

The candidate demonstrates competence in Financial Reporting.

CPA		CPA Competency Statement	Entry	Core
1.1.1		Evaluates financial reporting needs	B	A
1.2.1		Develops or evaluates appropriate accounting policies and procedures	B	A
1.3.1		Prepares financial statements	A	A

I have identified the following accounting issues with respect to the 2014 financial statements of SableTel and where possible I have estimated the misstatement. I have then adjusted the financial statements as presented..

Issue #1- Inventory – obsolescence provision

Guidance for accounting for inventory can be found in IAS 2 - Inventories

Inventory at SableTel consists of routers and modems that SableTel sells to its customers. Total inventory at August 31, 2014 had a book value of $3,219,431. The continuity of the inventory for the 2014 fiscal year can be presented as follows:

Inventory – Opening	$ 883,318
Purchases – Discounted Product	2,500,000
Purchases – Other (Regular)	515,972
Cost of Sales – Routers and Modems	(679,859)
Inventory – Closing	$ 3,219,431

The inventory level at year end would appear to be extremely high and may require write-down. The main reason for the substantial increase in inventory relates to the $2,500,000 of inventory which was purchased in September 2013. Given that the inventory tends to have a short life (typically 12 months), it is not clear why SableTel would purchase such a large quantity of inventory as its annual sales do not justify such a large purchase. It is now twelve months after this discounted product was purchased and therefore it is likely that much of this inventory can no longer be sold.

Sales of routers and modems for the 2014 fiscal year totaled $1,675,759. The costs associated with these sales totaled $679,859. Assuming similar sales in future years, SableTel has inventory on hand at August 31, 2014 which represents 4.74 years of sales ($3,219,431/$679,859). Given that these items have a short life (typically 12 months), a portion of the inventory is likely obsolete and requires write down. Further details would need to be gathered regarding the specific inventory items to determine an accurate obsolescence provision, but as an initial estimate, we could assume that items representing sales greater than one year will likely require a write down. Therefore the estimated obsolescence provision is $2,539,572 ($3,219,431 - $679,859). Therefore SableTel should reduce its inventory balance on the financial statements by $2,539,572 and increase its cost of sales by a similar amount (see the adjusted financial statements below).

Issue #2- Deferred Research and Development Costs

Guidance for research and development costs can be found in IAS 38 – Intangible Assets

Deferred research and development costs represents costs associated with the Wireless Technology Project from 2013 and 2014 that have been capitalized. The amounts have been capitalized as management has "declared its intention to carry this project to market". However, this is only one of the criteria that must be met in order for research and development costs to be capitalized.

IAS 38 paragraph 57 states:

"An intangible asset arising from development (or from the development phase of an internal project) shall be recognised if, and only if, an entity can demonstrate all of the following:

(a) the technical feasibility of completing the intangible asset so that it will be available for use or sale.

(b) its intention to complete the intangible asset and use or sell it.

(c) its ability to use or sell the intangible asset.

(d) how the intangible asset will generate probable future economic benefits. Among other things, the entity can demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset.

(e) the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset.

(f) its ability to measure reliably the expenditure attributable to the intangible asset during its development."

SableTel clearly does not meet all of the criteria for recognition as an intangible asset.

The first criterion requires that the technical feasibility be assured. However, Dan has indicated that SableTel is currently awaiting a third party feasibility study for this project. Therefore it is unlikely that this criterion has been met at year end.

The second criterion requires an intention to complete the intangible asset. Management has indicated that they intend to complete the Wireless Technology Project so this criterion is likely met.

The next criterion requires SableTel to prove that it will use or sell the intangible asset. We can assume that this criterion is met and the Industry Canada grant may provide further evidence supporting this criterion as Industry Canada wants to use the technology (indicating that SableTel may be able to sell the technology as well.)

The fourth criterion requires management to demonstrate how the asset will generate probable future economic benefits. SableTel will utilize the wireless technology internally, presumably to decrease costs and increase margins. Therefore SableTel likely meets this criterion as the technology is supposed to increase margins by 5% across all of its product lines. This would provide substantial benefits (5% of $65 million is $3.25 million on an annual basis). SableTel would need to provide some evidence to support this assertion. This may be available once the third party feasibility assessment has been completed.

The fifth criterion requires adequate technical, financial and other resources to complete the project. Dan has indicated that SableTel does not currently have the financial resources to finish this project and requires funding from StarNova to complete the project. Therefore this criterion is likely not met currently as StarNova has not committed itself to the funding. However, should

SableTel be able to provide support that StarNova or some other source will fund the remainder of the project then this criterion may be supportable.

Finally, SableTel must be able to demonstrate that it can measure reliably the expenditures attributable to the project. It is not clear if SableTel can do this. Dan has indicated that accounting came up with the $22 million necessary to complete the project but he is not sure how they came up with this number. As well, SableTel would also need to demonstrate that it had the necessary systems in place to track the costs associated with this project reliably. Therefore this criterion may be met but more information is required.

Since all six criteria must be met in order to capitalize the costs and at least two of the criteria are likely not met, the costs cannot be capitalized and must be expensed. As a result SableTel should reduce the deferred research and development costs from $9,160,250 to Nil and increase administration expenses by the same amount (see the adjusted financial statements below).

Even if SableTel met all of the criteria for capitalization of the development costs, it would not be able to go back to 2013 and capitalize those research and development costs in 2014. IAS 38 paragraph 71 states "Expenditure on an intangible item that was initially recognised as an expense shall not be recognised as part of the cost of an intangible asset at a later date."

From a presentation standpoint I would also recommend that consideration be given to separating the research and development costs from the administration expenses on the face of the statement of comprehensive income as it is a significant amount and is likely of interest to users of the financial statements.

Issue #3- Industry Canada Grant

Guidance for government assistance can be found in IAS 20 – Accounting for government assistance and disclosure of government assistance.

There are two issues associated with the government grant. The first issue is whether SableTel has met the criteria for recognition of the government grant. IAS 20 paragraph 7 states:

"Government grants, including non-monetary grants at fair value, shall not be recognised until there is reasonable assurance that:

(a) the entity will comply with the conditions attaching to them; and

(b) the grants will be received."

SableTel has received the $2,750,000 so we can safely state that the second criterion has been met. However, it is not clear if the first criterion, related to satisfying all of the conditions attached to the grant has been met. There is some evidence that the conditions have not been met as SableTel must share its technology with Industry Canada (IC) and IC must formally approve the technology. However, we would need to gather further details relating to the grant in order to determine if the first criterion has been met and as a result if the amount can be recognized.

Assuming that the above two criteria have been met then the second issue regarding the government grant relates to its presentation. IAS 20 paragraph 24 states:

> "Government grants related to assets, including non-monetary grants at fair value, shall be presented in the statement of financial position either by setting up the grant as deferred income or by deducting the grant in arriving at the carrying amount of the asset."

This government grant relates to the Wireless Technology Project. This project was initially recorded as an intangible asset. If the Wireless Technology Project was still recorded as an asset then SableTel would need to reverse the amount recorded as revenue and record the amount as either deferred income or by deducting the amount from the carrying value of the Wireless Technology Project.
However, due to the adjustment proposed above (see Deferred Research and Development Costs), the Wireless Technology Project is now expensed as administration on the statement of comprehensive income. The presentation of grants related to income is discussed in IAS 20 paragraph 29 which states:

> "Grants related to income are presented as part of profit or loss, either separately or under a general heading such as 'Other income'; alternatively, they are deducted in reporting the related expense."

I would recommend that the amount be recorded as a reduction of the related expense as it is clearly attributable to these expenditures. Therefore, the amount should be removed from revenue and recorded as a reduction of the research and development expenses (administration expenses) on the statement of comprehensive income (see the adjusted financial statements below). Note that the adjustment will have no net effect on the profit (loss) of SableTel.

Issue #4- Impairment of Mobile Network

Guidance for the impairment of assets can be found in IAS 36 – Impairment of assets.

In August 2014, Hurricane Baylee damaged several of the communication towers associated with SableTel's mobile network disabling the entire network. In total 60 of the 340 towers were damaged. Each tower has a carrying value of $35,000.

SableTel must determine if the communication towers require a write down at year end.

IAS 36 paragraph 9 states:

> "An entity shall assess at the end of each reporting period whether there is any indication that an asset may be impaired. If any such indication exists, the entity shall estimate the recoverable amount of the asset."

Clearly there is an indication that the assets may be impaired as the towers have been damaged. Therefore SableTel should estimate the recoverable amount.

IAS 36 paragraph 18 states:

"This Standard defines recoverable amount as the higher of an asset's or cash-generating unit's fair value less costs to sell and its value in use."

IAS 36 paragraph 22 states:

"Recoverable amount is determined for an individual asset, unless the asset does not generate cash inflows that are largely independent of those from other assets or groups of assets. If this is the case, recoverable amount is determined for the cash-generating unit to which the asset belongs (see paragraphs 65–103), unless either:

(a) the asset's fair value less costs to sell is higher than its carrying amount; or

(b) the asset's value in use can be estimated to be close to its fair value less costs to sell and fair value less costs to sell can be determined."

It would appear from the facts of the case that the towers, as a whole, make up a cash-generating unit as the entire mobile network has been disabled by the damage to 60 of the towers. Therefore it may be necessary to estimate the recoverable amount for the entire mobile network (i.e. the 340 communication towers) and not just the 60 towers that have been damaged.

IAS 36 paragraphs 66 and 67 state:

Paragraph 66 – "If there is any indication that an asset may be impaired, recoverable amount shall be estimated for the individual asset. If it is not possible to estimate the recoverable amount of the individual asset, an entity shall determine the recoverable amount of the cash-generating unit to which the asset belongs (the asset's cash-generating unit)."

Paragraph 67 – "The recoverable amount of an individual asset cannot be determined if:

(a) the asset's value in use cannot be estimated to be close to its fair value less costs to sell (for example, when the future cash flows from continuing use of the asset cannot be estimated to be negligible); and

(b) the asset does not generate cash inflows that are largely independent of those from other assets.

In such cases, value in use and, therefore, recoverable amount, can be determined only for the asset's cash-generating unit."

As stated above, there are two possible ways to determine an assets (or group of assets) recoverable amount. The first is to determine the assets fair value less costs to sell. We do not have a lot of information to determine this amount but it is unlikely that SableTel could sell the damaged towers for any significant amount. As well there is no indication that SableTel could sell its entire mobile network but it is possible that another telecom company may want this network. The mobile network, in its current state has no value as the entire mobile network has been disabled. It is important to note that the value in use is generally determined by its estimated future cash flows in its *current condition*. IAS 36 paragraph 44 states:

"Future cash flows shall be estimated for the asset in its current condition. Estimates of future cash flows shall not include estimated future cash inflows or outflows that are expected to arise from:

(a) a future restructuring to which an entity is not yet committed; or

(b) improving or enhancing the asset's performance."

SableTel has indicated that it is unclear if the mobile network can be fixed. It is also contemplating replacing the entire tower system with a new faster system. Therefore it is unclear what the recoverable amount of the towers, or the entire system (the cash-generating unit) is at year-end.

I believe that there is likely some impairment within the mobile network. Further information would need to be gathered to determine the exact amount of the impairment but as an estimate we could approximate that the recoverable amount of the 60 damaged towers is likely NIL. SableTel should therefore write-down the asset to this amount. The total for these six towers would be $2,100,000 (60 X $35,000) (see the adjusted financial statements below).

Note that it is possible that all 340 towers and the entire mobile system (the cash-generating unit) would need to be written down to NIL or the estimated recoverable amount (fair value less costs to sell) as the mobile network has no value in use based on its current condition. It is also not clear if the network can be fixed, or even if it can be fixed, if SableTel plans to repair the network. If the mobile network cannot be sold (i.e. the fair value less costs to sell is minimal) and SableTel does not plan to fix the network, then the entire network should be written down to NIL. At a minimum this amounts to $11,900,000 (340 towers X $35,000 per tower) for the towers and may need to be higher if there are additional capital assets associated with the mobile network. At this point we will assume that the 280 towers that were not damaged would not require a write-down as they may have a fair value in the open market or may be able to generate positive cash flows in the future.

The write-down should be recorded as an impairment loss as stated in IAS 36 paragraph 59:

> "If, and only if, the recoverable amount of an asset is less than its carrying amount, the carrying amount of the asset shall be reduced to its recoverable amount. That reduction is an impairment loss."

If there are any insurance proceeds that are likely to be received as a result of the damaged tower. Any proceeds would reduce the loss.

As well, given that SableTel is contemplating replacing the entire system, it would be prudent to analyze the estimated useful lives of the assets in question and/or the residual values.

Deferred Revenues (minor issue)

There are no deferred revenues on the face of the statement of financial position. Given the nature of the company, a telecommunications company, I would expect that certain of its revenues would be billed in advance (i.e. it is typical for companies in this industry to bill a month of service in advance and some also require substantial deposits). This should be investigated further. It is possible that this amount is buried in the Trade and other payables line item on the statement of financial position. It is also possible that these amounts have been incorrectly recorded as revenues. Further information would need to be gathered to determine any error that exists.

Issue #5- CRTC Fee

I have recalculated the estimated misstatement in the 2013 and 2014 CRTC Fees and the total estimated misstatement is $1,193,619. Of this amount $672,218 relates to 2013 and $521,401 relates to 2014. The amount relating to 2013 ($672,218) is an accounting error and as such the amount should be added to accrued liabilities and should reduce the 2014 opening retained earnings. The amount for 2014 ($521,401) should be added to cost of sales (CRTC Fee) and be added to accrued liabilities at August 31, 2014 as this amount relates to the 2014 fiscal year. This calculation based on preliminary information is as follows:

Description of Input	2014 Calculation	2013 Calculation
Revenues from long-distance, local and mobile services (see Note 1 to the financial statements)	$ 56,857,395	$ 60,712,173
Less: Related Party Revenues (assume = $0)	0	0
Less: Qualifying Costs (see Note 2 to the financial statements)	(25,215,367)	(25,333,908)
Add: Fees paid to non-Canadian entities (see Note 2 to the financial statements)	897,500	788,000
Add: 200% of negative margin customers (assume that the finance database is correct and assume 2013 = $0)	2,260,000	0
Add: Related Party Costs (see Note 2 to the financial statements)	1,357,850	1,458,760
Fee Base	36,157,378	37,625,025
Contribution Rate	12%	12%
Preliminary Fee Calculation	4,338,885	4,515,003
Fee as Calculated	3,817,484	3,842,785
Adjustment Required	$ 521,401	$ 672,218

Issue #6- Adjusted Financial Statements

The financial statements for 2014 will require adjustment due to the cumulative material effect of the misstatements noted above. The following schedule adjusts the financial statements:

Item Description	2014 Actual F/S's (unadjusted)	Required IFRS adjustments	JEs	2014 Actual F/S's (adjusted)
Current assets				
Cash	$ 351,018			$ 351,018
Accounts receivable	15,864,501			15,864,501
Inventory	3,219,431	(2,539,572)	**1**	679,859
Total Current Assets	19,434,950	(2,539,572)		16,895,378
Property, plant and equipment	62,532,502	(2,100,000)	**4**	60,432,502
Deferred taxes	35,629			35,629
Intangible assets	10,753,709	(9,160,250)	**2**	1,593,459
Total Assets	$ 92,756,790	(13,799,822)		$ 78,956,968
Current liabilities	$ 22,265,938	1,193,619	**5**	$ 23,459,557
Long-term debt	44,152,572			44,152,572
Total Liabilities	66,418,510	1,193,619		67,612,129
Total Shareholders' Equity	26,338,280	(14,993,441)	**(A),5**	11,344,839
Total Liabilities and Shareholders' Equity	$ 92,756,790	(13,799,822)		$ 78,956,968
Revenue	$ 65,072,224	(2,750,000)	**3**	$ 62,322,224
Cost of sales	30,714,869	3,060,973	**1,5**	33,775,842
Gross profit	34,357,355	(5,810,973)		28,546,382
Expenses:				
Selling and marketing	16,875,413			16,875,413
Administration	13,336,292	8,510,250	**2,3,4**	21,846,542
Interest expense	2,967,650			2,967,650
Total Expenses	33,179,355	8,510,250		41,689,605
Profit (loss)	$ 1,178,000	14,321,223	**(A)**	$ (13,143,223)

The adjusted financial statements present a much different financial picture for SableTel for its 2014 fiscal year.

Journal Entries (JEs)

JE #	**Account Description**	**Debit**	**Credit**
1	Cost of sales (routers and modems)	$ 2,539,572	
1	Inventory		$ 2,539,572
	To set-up a provision for inventory obsolescence		
2	Administration (R&D expenses)	$ 9,160,250	
2	Intangible assets		$ 9,160,250
	To reverse expenditures associated with the Wireless Technology Project that were capitalized		
3	Revenue (Government Grant)	$ 2,750,000	
3	Administration (R&D expenses)		$ 2,750,000
	To reclassify the Industry Canada grant received during the year		
4	Administration (Impairment charge)	$ 2,100,000	
4	Property, plant and equipment (Mobile Network Towers)		$ 2,100,000
	To record an impairment charge on the mobile network towers		
5	Cost of sales (2014 CRTC Fee adjustment)	$ 521,401	
5	Retained earnings (opening – 2013 CRTC Fee adjustment)	672,218	
5	Current liabilities (accrued liabilities)		$ 1,193,619
	To record the estimated misstatement in the CRTC Fee for 2013 and 2014		

Taxation
(will be broken down into multiple assessment opportunities by the BOE)

The candidate calculates taxable income for SableTel and discusses some of the components.

CPA		**CPA Competency Statement**	**Entry**	**Core**	**E3 Tax**
6.1.1		Assesses a corporate entity's general tax issues	B	B	A
6.1.2		Determines taxes payable for a corporation in routine situations	B	B	A

Calculation of 2014 Taxable Income (Loss)

Pre-tax 2014 accounting loss as revised in the Financial Reporting section of my report is -$13,143,223. This will serve as a starting point in calculating taxable income for 2014.

SableTel	
Taxation Year ended August 31, 2014	
T2 Schedule 1	
Accounting income (as revised in the Financial Reporting Section	$ (13,143,223)
Add:	
Capital asset impairment (Towers)	$ 2,100,000
Research and Development Expense - accounting	$ 5,702,390
Less:	
Government Grant (IF some of the grant assumed to be capital, subtract from taxable income)	$ -
SR&ED expenditures expensed in the year (Should tie into the discussion on loss planning)	$ -
Taxable Income	$ (5,340,833)

Candidates could also discuss adding back depreciation and deducting CCA, and that deducting CCA is optional.

Government grant

The government grant will be required to be included in income for tax purposes of SableTel. There is an elective provision in the ITA that allows some (or all) of the grant proceeds to be offset against the spending for which it was granted. To the extent that the elective provision applies, the amount of the grant used to fund capital purchases can offset the capital cost of those purchases. This would offset the undepreciated capital cost (UCC) of the asset class related to that asset. I need to read the grant documents to make the determination as to whether this provision can apply.

For now, I will assume that the full grant is included in taxable income and is not eligible for offset against the UCC. Since the full amount is included in accounting income, there is no adjustment necessary for tax purposes. If this changes, it will also impact my analysis of the unsolicited offer to purchase discussed below.

Towers damaged by hurricane

Several towers owned by SableTel were damaged by a hurricane in the 2014 fiscal year. For accounting purposes there was an asset impairment charged to income in the amount of $2,100,000 related to the damage done to the towers. For tax purposes, the towers would have been capitalized in a pool of UCC for all assets in the same asset class. Since not all towers owned by SableTel were damaged, SableTel will have assets left in that UCC pool for tax purposes.

A terminal loss is the only extraordinary write-down related to UCC pools that is allowed under the ITA. A terminal loss is allowed when there is a balance remaining in a UCC pool but the corporation no longer owns assets in that pool. Since SableTel owns assets in the UCC pool that included the damaged towers, a terminal loss is not allowed for SableTel's 2014 tax year. Therefore, for 2014, only normal Capital Cost Allowance (CCA) may be claimed for the pool.

I have added back the $2,100,000 impairment charge in calculating SableTel's taxable income for 2014.

Deferred R&D

SableTel has currently capitalized the full amount of its $9,160,250 of R&D spending in 2014 and 2013. For accounting purposes, the amounts will be adjusted such that the $3,457,860 related to 2013 will be expensed in that year, as was assumed to be done for tax purposes originally. Therefore, no adjustment to SableTel's 2013 tax filing is assumed to be required at this point for the 2013 R&D spending.

For 2014, the $5,702,390 spent on R&D may qualify for SR&ED tax credits. To the extent that the spending qualifies as SR&ED, SableTel has the option to deduct the amount for tax purposes, or carry it forward in a pool of SR&ED expenditures. The SR&ED expenditure pool can be carried forward indefinitely, so it is less restricted than non-capital losses in its carry forward. I have not deducted any of the SR&ED spending for 2014 since SableTel has already incurred a loss for tax purposes in 2014 and does not need the deduction.

Other accounting/tax differences

I have calculated the maximum capital cost allowance for 2014 as $9,894,897 and eligible capital expenditures amount as $48,383. This could be claimed to increase the loss for tax purposes for 2014, which would likely increase the loss carry forward for future years since we have enough losses to carry back to offset prior years' income.

Taxation

(will be broken down into multiple assessment opportunities by the BOE)

The candidate discusses the Spacolli tax losses in the context of the reassessment, SableTel's ability to object and likely outcome of the objection considering the loss rules and GAAR.

CPA		**CPA Competency Statement**	**Entry**	**Core**	**E3 Tax**
6.1.3		Determines taxes payable for a corporation in non-routine situations	-	-	B
6.3.1		Advises taxpayers with respect to assessment, notice of objection, and appeals	C	C	B

Spacolli Enterprises Inc. (Spacolli) Tax Losses

SableTel received a notice of reassessment from the Canada Revenue Agency (CRA) for its 2012 taxation year denying the use of the pre-acquisition of control losses of Spacolli.

The acquisition of Spacolli in 2012 appears to have been done, in part, so that SableTel could use the tax losses to offset future taxable income. The Income Tax Act contains rules governing the use of pre-acquisition of control losses. On an acquisition of control of a corporation from unrelated parties, like there was in Spacolli, the acquiring corporation can only use the losses of the acquired corporation: 1. to offset income earned in a same or similar business; and 2. Only if the business of the acquired company is carried on after the acquisition of control with a view to a profit.

The CRA has denied the use of the Spacolli losses. Without discussing the matter with the CRA, we cannot be sure of its position, but the loss denial is likely because either:

1) the CRA believes that the business carried on by SableTel is not a "same or similar business" to the one carried on by Spacolli; or

2) Spacolli's business was discontinued prior to the acquisition.

In the absence of one of these assertions, the CRA could be applying the General Anti-Avoidance Rule ("GAAR") and its provisions to the use of the Spacolli losses. The GAAR is a rule that can apply where a taxpayer has arranged their affairs to create a tax advantage where the primary motive is a non-business motive and the tax advantage created is an abuse of a provision of the Income Tax Act or a misuse of the provisions of the Act as a whole.

Same or similar business

With respect to the "same or similar business" argument: Spacolli was in the business of manufacturing and distributing cell phones. SableTel is in the business of providing telecommunications (i.e. phone and internet) services for its customers. On the surface these seem like different businesses. However, SableTel does sell modems and routers to its customers, which is similar to the sale of cellular telephones. Also, SableTel provides cellular telephone services to its clients. The two corporations carried on businesses in the telecommunications industry, which is another similarity. While it is not conclusive, there are some arguments in favour of the "same or similar business" test. Additional details will need to be provided to determine if this is actually the case.

Carry on the business with a view to a profit

With respect to the "carrying on the business of Spacolli with a view to a profit": During 2012, SableTel sold the cellular phone inventory that was held by Spacolli on the date of the acquisition of control (Jan 1 2012). However, Spacolli was the one holding inventory and was, according to the information I was provided, not active (inactive) prior to the date of the acquisition of control in attempting to dispose of that inventory. Spacolli's shareholders sold their shares in Spacolli, not the underlying inventory assets. However, the sale of the shares indicates some ongoing activity. We may want to interview one of the prior Spacolli shareholders to determine if there was any activity to sell the inventory assets prior to and including the date of the acquisition of control by SableTel. If there were ongoing sales efforts, the business may not have been inactive and the losses may be available to SableTel according to the second test.

GAAR

On the application of the GAAR: There are specific provisions in the Income Tax Act that attempt to prevent the trading of losses between corporations and their shareholders. The specific anti-avoidance provisions with respect to the type of loss trading undertaken by SableTel are addressed in the rules relating to the acquisition of control of corporations (the “acquisition of control rules” discussed above). To the extent that those rules were avoided by SableTel, they will have three arguments to defend themselves against the GAAR.

First, they would want to argue that there was no “tax benefit” to the series of transactions including the claiming of the Spacolli losses. This would be difficult to argue since the losses were carried forward to offset SableTel’s income and thus reduced SableTel’s tax liability, which is arguably a tax benefit.

Second, SableTel would want to make an argument that they acquired Spacolli for a business reason other than the tax savings afforded through the use of the tax losses. The argument would centre around the acquisition and sale of the inventory owned by Spacolli at the time of the acquisition of control. While not conclusive, there is some validity to this argument.

The third argument SableTel could make would be to refute that the use of the losses was an “abuse” or “misuse” of the loss trading provisions of the Act. This requires a more theoretical argument around the purpose of the loss trading rules and how those rules relate to the conduct of SableTel at the time. Without going into a lot of detail on the provisions and the rulings relating to the abuse and misuse, it would be important for SableTel to indicate that the transactions they undertook respected the rules as written and intended by Parliament.

Timing of objection

Note that the letter from the CRA is dated July 15, 2014. SableTel has 90 days from the date of the reassessment to submit a Notice of Objection should it wish to challenge the reassessment. There may also be penalties and interest associated with the reassessment. Penalties and interest on income tax assessments and reassessments are not tax deductible and will therefore not be deducted in arriving at taxable income (loss) in computing SableTel’s 2014 income tax liability or loss carry back/carry forward balances.

Also, since SableTel is a “large corporation” for income tax purposes, it will be required to pay the tax liability in full in order to be allowed to object to the reassessment, even if it has a valid position to dispute it. This also serves to prevent future interest from accruing on the amount owing in case the objection and any subsequent appeals are unsuccessful.

ABIL

The ABIL claimed on the disposition of the Spacolli shares on amalgamation will not be allowed. On a vertical amalgamation (where a subsidiary is amalgamated into its parent corporation) the ITA deems that any loss on the shares of the subsidiary is nil.

Taxation
(will be broken down into multiple assessment opportunities by the BOE)

The candidate discusses the 2014 loss in the context of the loss carryback rules and the impact of the 2012 amalgamation on the loss carryback.

CPA		CPA Competency Statement	Entry	Core	E3 Tax
6.1.1		Assesses a corporate entity's general tax issues	B	B	A
6.1.3		Determines taxes payable for a corporation in non-routine situations	-	-	B
6.1.4		Advises on the tax consequences or specific tax-planning opportunities for shareholders and their closely held corporations	C	C	A

SableTel has incurred a large non-capital loss for tax purposes in 2014, as shown in my previous calculation. This may have an impact on prior and future taxation years' calculation of taxes payable.

In order to consider the potential impact on taxes payable for prior taxation years, we must examine SableTel's corporate history.

Deemed Year End

SableTel acquired control of Spacolli from unrelated parties on January 1, 2012. The two corporations were amalgamated on the same date. These two events caused a deemed year end for income tax purposes for both Spacolli and SableTel. Therefore, tax returns should have been prepared with a December 31, 2011 year end for both Spacolli and SableTel. We should ensure this was the case. This will necessitate a separate set of financial statements as at that date as well.

The deemed year end for SableTel and Spacolli caused by the amalgamation will count as one year in the carry-forward and back of any losses or investment tax credits even if that year was shorter than 365 days.

<u>Amalgamation</u>

In addition to creating a taxation year end for both predecessor corporations, many of the rules in the ITA with respect to amalgamations consider both predecessor corporations to be different corporations than the amalgamated corporation. This is notwithstanding the corporate law which may in most cases consider the amalgamated corporation to be a continuation of each predecessor corporation. This will impact the use of the losses as discussed below.

Non-Capital Losses

There appears to be a loss carry-back available to SableTel because of non-capital losses in 2013 and 2014. If those losses are carried back, they may be used to offset taxable income (if any) for SableTel's August 31, 2012 taxation year. This could be especially helpful to SableTel for the 2012 taxation year where it is in dispute with the CRA over the use of losses from the acquisition of Spacolli.

For the two taxation years ending in 2011 (August 31 and December 31, see discussion under "Deemed Taxation Year"), the rules governing the carry back of losses to pre-amalgamation years must be followed. For those years, the post amalgamation losses can only be carried back to offset income earned by the parent amalgamating corporation. Since SableTel was the parent amalgamating corporation, the post amalgamation losses may be used to offset pre-amalgamation income of SableTel. The post amalgamation losses for 2013 and 2014 may reduce taxable income in those two additional previous years to nil, resulting in refunds of any taxes previously paid for both of those years. To the extent that the 2013 and 2014 tax losses exceed taxable income for the prior years, the remaining losses can be carried forward to offset taxable income in the next 20 years (to 2033 for the 2013 losses and 2034 for the 2014 losses).

Taxation
(will be broken down into multiple assessment opportunities by the BOE)

The candidate discusses the tax impacts of the Proposed Management Compensation Plan.

CPA		CPA Competency Statement	Entry	Core	E3 Tax
6.2.1		Assesses general tax issues for an individual	B	B	A
6.2.2		Determines income taxes payable for an individual in routine situations	B	B	A
6.2.3		Determines income taxes payable for an individual in non- routine situations	-	-	B

Proposed Management Compensation Plans

There are three aspects to the proposed new Management Compensation Plans from a tax point of view.

Cash bonus payments

A cash bonus accrued in one taxation year and paid in another taxation year can be deducted for income tax purposes in the year accrued only if it is paid within 180 days of the year end of the corporation. For cash bonuses accrued and paid in this fashion, a tax deferral is achieved because, for example, the 2014 bonus accrual is deductible by SableTel in August 2014 while it does not need to be paid until near the end of February 2015. The source deductions for the bonus payment must be deducted from the payment in the pay period of the bonus payment, so there is really no deferral of tax for the individual receiving the bonus payment. The deferral is for the remittance of tax which is potentially extended 6 months from the end of the tax year in which the bonus was accrued.

Stock Options

Since SableTel is a subsidiary of a public company, the rules relating to stock options granted by public companies will apply.

When a stock option is granted by a public corporation, the employee is deemed to receive a taxable benefit equal to the amount by which the value of the stock that was issued to the employee exceeds the price of the shares granted by the option (i.e. called the strike price) on the date of exercise of the option. Note that the benefit is earned for tax purposes on the exercise of the option even if the employee holds the stock and does not cash out their shareholding. In some circumstances, the corporate employer is required to withhold and remit tax on the option benefit in the time period including the exercise of the option.

SableTel will need to develop systems to calculate, record and administer the reporting of the benefits relating to the stock option plan for tax purposes relating to the employees' T4's and tax remittances.

If the value of the stock on the date of the granting of the option is equal to or exceeds the strike price of the option, the employee is allowed a deduction for tax purposes equal to ½ of the stock option benefit, essentially adding to the employee's income the amount that would have been added had the stock option been a capital gain on the stock. However, this deduction will not be available to employees under the current design of the stock option plan since the granting of the options is at a discount to the market price as at the grant date.

Another tax issue related to stock options is that any reduction in the value of the stock subsequent to the exercise of the stock option (purchase of the stock) is treated as a capital loss for tax purposes. If the stock price rose from grant date to exercise date, and then subsequently fell, the amount of the rise is taxable as employment income (and likely only ½ of the increase is taxed) while the loss subsequent to the exercise date is treated as a capital loss. Since capital losses cannot be used to offset employment income, an employee who exercises their option when the stock is "in the money" will receive an employment benefit that cannot be offset with any future decrease in the stock price prior to sale. This can lead to some incongruous and anomalous results because employees may sell their stock at a loss post exercise just to pay the taxes on the employment income and not receive any offsetting tax benefit from the capital loss which can only be used to offset capital gains.

DSUs

DSUs are not specifically addressed in the Income Tax Act. Therefore, the payment by the employer to the employee in respect of a DSU would be considered to be employment income in the year of the payment. However, DSUs may fall into the rules of either a Retirement Compensation Arrangement (RCA) or a Salary Deferral Arrangement (SDA). In either case, the rules can be quite punitive.

As currently designed, the SableTel DSU plan would be a RCA for income tax purposes. This is because SableTel plans to fund a portion of the DSU. An RCA requires the Trustee/Administrator of the account to remit 50% of SableTel's contributions to the Canada Revenue Agency. The 50% tax also applies to any investment income earned within the RCA. At the time that cash is paid to retirees under the RCA, the 50% tax is refunded by the government to the Plan.

The SDA rules can apply to an unfunded plan where the plan rules offend the provisions for an RCA. Assuming that the plan is fixed to avoid the RCA rules, the SDA rules must be considered. The SDA rules require that the payment from the plan can only be paid to the employee in certain conditions, including retirement. The rules also contain certain provisions around vesting for plan members and the potential length of the deferral. If the plan is a SDA, the amount of the salary deferred is taxable in the year it vests with the employee, whether they receive any cash or not. We would need to review the plan documents in more detail to determine if the SDA rules would apply.

Taxation
(will be broken down into multiple assessment opportunities by the BOE)

The candidate suggests planning ideas for the tax issues (including loss carry back, deferral of claims for SRED deductions, avoiding the RCA and SDA rules for the management compensation plan, optimizing the stock option plan and insurance planning for the tower damages).

CPA		**CPA Competency Statement**	**Entry**	**Core**	**E3 Tax**
6.1.4		Advises on tax consequences or specific tax-planning opportunities for shareholders and their closely held corporations	C	C	A
6.1.5		Analyzes the tax consequences or planning opportunities for complex corporate transactions	-	C	B
6.2.4		Advises on specific tax-planning opportunities for individuals	C	C	A

Tower damages

In the future, SableTel may be entitled to insurance proceeds in relation to the damages of its towers. The amount of insurance proceeds received in any particular taxation year (actually "received", not "receivable") will be treated as proceeds of disposition of the related assets and will reduce the UCC pool for that asset in the year received. This may result in recaptured CCA (RCCA). That is, if the insurance proceeds exceed the balance in the UCC pool at the end of the year the insurance is received, the amount of the excess is taxable in that year. So, unless there are funds spent to replace the towers in that year or a prior year to build up the UCC pool, RCCA could occur. Since the insurance claim is $2,000,000 and the UCC in the pool is only $1,689,993 as at September 1, 2013, this is a very real possibility.

SableTel should undertake to plan properly to ensure that RCCA is not created in one year with the subsequent spending of the insurance proceeds not matched with the receipt of the insurance proceeds. For example, if there is a big cheque to be received on August 31 of a taxation year with inadequate spending and UCC pools to offset the cheque, they may want to encourage the insurance company to write the cheque September 1 and plan to offset the funds with spending in that year. Another alternative is to use a special tax election that can be made to combine multiple UCC pools to offset a large disposition in the year. Planning for this now is required to think about how to handle the outcome of any insurance claim.

Proposed Management Compensation Plan

Above, I identified some adverse income tax consequences to the current structure of the proposed management compensation plan. Since the plan is currently in draft, the following comments should be taken into account in structuring the final plan.

SableTel may want to modify the stock option plan to set the strike price to be equal to or greater than the stock price at the date of grant of the options. This will enable the employees to deduct ½ of the stock option income inclusion, potentially saving significant taxes. Because this would increase the strike price, SableTel may want to make up for the lost stock price discount in some other manner. The ½ deduction may be quite significant if the stock price has risen significantly between the grant date and the purchase date, meaning that the taxes saved would likewise be significant.

The 50% tax on RCAs is punitive, as is the potential acceleration of tax liability related to SDAs. The plan could be redesigned to have no contributions by the employer to fund the DSUs, avoiding the RCA rules. The downside to this is that SableTel may not be able to fund the plan at the time the members retire, while a partially funded plan would provide some comfort to employees that they will receive their payments. The benefit of knowing the funds are available and set aside should be balanced against the reduced investment income in the fund due to the 50% RCA tax liability.

As far as the SDA rules are concerned, it is important that the plan be designed not to offend the rules because the consequences are a current tax liability for cash that may or may not be received in the future.

Potential sale of assets

The unsolicited offer will result in some income in fiscal 2015, if it is accepted (see my exhibit below). Depending on the status of the tax losses generated by SableTel for prior years, and the relative profitability of StarNova's other Canadian entities, it may be that the generation of terminal losses that are denied would be beneficial. In that case, some planning should be done to clear assets from those classes so that SableTel will have its terminal losses on the sale, if it should occur.

We will need to review the profitability of other corporations in the StarNova group. If the asset sale is undertaken, it may be that the losses can be used to offset profits to save corporate income tax within the group as a whole.

Taxation
(will be broken down into multiple assessment opportunities by the BOE)

The candidate calculates the tax liability related to the unsolicited offer to purchase certain assets of SableTel.

CPA		CPA Competency Statement	Entry	Core	E3 Tax
6.1.3		Determines taxes payable for a corporation in non-routine situations	-	-	B

StarNova has received an unsolicited offer to purchase some of SableTel's assets. The purchaser proposed a purchase price allocation of the $46 million of proceeds of disposition.

Calculation of taxes:

Taxable income generated on the transaction, as proposed, is $2,491,469. The tax rate applicable to the income generated on the sale is 25% (combined Federal and Provincial rates). Taxes payable would be $2,491,469 x 25%. However, SableTel has tax losses from prior taxation years as detailed above. Depending on the quantum of those losses, the cash taxes payable on the sale could be nil.

However, using the tax losses to reduce the income tax liability on the sale of assets to nil has an opportunity cost. SableTel's tax losses can be used, through tax planning, against income generated by any of StarNova's Canadian businesses.

Note that the taxable income calculation excludes any terminal losses on Class 8 and Class 13 property. SableTel can only claim a terminal loss on an asset pool if SableTel no longer owns any assets in the pool at the end of its taxation year. Since SableTel is going to continue to own some furniture (Class 8) and to rent its office space at head office (Class 13), it cannot claim a terminal loss on those asset pools at this time.

The offer includes a break fee of $500,000. This fee will be forfeited by the purchaser if the transaction does not close after the signing of a letter of intent. If the break fee is forfeited and the purchase/sale transaction does not close, the break fee will be business income to SableTel.

The offer includes contingent proceeds related to the Wireless Technology Project. SableTel is likely going to get SR&ED treatment for the expenditures related to the WTP. The contingent proceeds, if received, would be an offset to the un-deducted pool of SR&ED costs, if any, at the time of receipt of the contingent proceeds. If the pool has been completely deducted by SableTel, then the contingent proceeds will be income. The contingent proceeds are not taxed currently because they would not be considered to be receivable until the conditions precedent to earning those contingent proceeds have been satisfied.

The sale of inventory at proceeds less than its book value will result in a business loss at the time of sale.

T2 Schedule 8				
	UCC	Rate	CCA	UCC
CCA calculation	beginning		available	ending
Class 1	$ 2,132,688	4%	$ 85,308	$ 2,047,380
Class 3	$ 7,689,993	5%	$ 384,500	$ 7,305,493
Class 8	$ 21,322,891	20%	$ 4,264,578	$ 17,058,313
Class 10	$ 11,805,302	30%	$ 3,541,591	$ 8,263,711
Class 13	$ 744,559	*	$ 148,912	$ 595,647
Class 42	$ 13,991,008	12%	$ 1,678,921	$ 12,312,087
	$ 57,686,441		$ 10,103,809	$ 47,582,632
ECP	$ 691,191	7%	$ 48,383	$ 642,808
* accept any reasonable assumption for this number				
The Capital Cost Allowance claim is a discretionary deduction				
On the sale of assets calculation, the calculation of the tax on sale should follow the candidate's CCA calculation for the 2013 year end. If they claimed CCA they should use the smaller UCC balance. If they did not claim CCA, then the UCC will be higher.				
Tax on sale calculation				
	UCC		Recaptured CCA	
	beginning	Proceeds	(Terminal Loss)	
Class 1	$ 2,047,380	$ 1,000,000	$ (1,047,380)	
Class 3	$ 7,305,493	$ 9,500,000	$ 2,194,507	
Class 8	$ 17,058,313	$ 12,900,000	$ -	Note 1
Class 10	$ 8,263,711	$ 12,000,000	$ 3,736,289	
Class 12	$ -	$ 2,000,000	$ 2,000,000	
Class 13	$ 595,647	$ -	$ -	Note 2
Class 42	$ 12,312,087	$ 8,000,000	$ (4,312,087)	
Proceeds	CCA Class			
Buildings	1	$ 1,000,000		
Towers and support structures	3	$ 3,500,000		
Copper and silver wire and cable	3	$ 6,000,000		
Fibre Optic cable	42	$ 8,000,000		
Trucks, trailers, automotive	10	$ 3,000,000		
Electrical generating equipment	8	$ 12,000,000		
Telecommunication switches hardware	10	$ 9,000,000		
Desks etc.	8	$ 900,000		
Software	12	$ 2,000,000		
Inventory sold at a loss	$ 679,859	$ 600,000	$ (79,859)	
Taxable income from sale of assets - $46,000,000 proceeds			$ 2,491,469	
Tax rate applicable to sale proceeds	Federal	15%		
	Provincial	10%	25%	
			$ 622,867	
Note 1 - there is no terminal loss on Class 8 since SableTel is keeping the furniture in its head office.				
Note 2 - there is no terminal loss on Class 13 since SableTel is keeping its leased premises to wind down its operations.				