Tax Topics

October 13, 2020
Number 2536

CALCULATION OF MANUFACTURING AND PROCESSING INCOME

— *Frankie Fenton of Frankie Fenton, Tax and Accounting Services, Langley, BC*

The following overview is a preview of new content available now on CCH AnswerConnect. Topic pages provide readers with a concise overview of a particular subject. They succinctly explain the rules, provide helpful tips, flag potential issues, and provide references to key research sources.

The formula for the calculation of "Canadian manufacturing and processing profits" is contained in Regulation 5200. Schedule 27 is to be used in calculating the proportion of a corporation's income for tax purposes that is eligible for the manufacturing and processing tax credit. Regulation 5200 provides that the income eligible for the credit is based on the proportion of a corporation's manufacturing and processing labour and capital to total labour and capital. A corporation's manufacturing labour and capital is based on the labour and capital employed in "qualified activities".

Qualified Activities

Subject to the exclusions in "Manufacturing and Processing Income Credit" (see Tax Topics 2535), qualified activities include all activities directly related to manufacturing and processing of goods for sale or lease performed in Canada, plus the following activities:

(1) engineering design of products and production facilities;

(2) receiving and storing of raw materials;

(3) producing, assembling, and handling of goods in process;

(4) inspecting and packaging of finished goods;

(5) line supervision;

(6) production support activities including security, cleaning, heating, and factory maintenance;

(7) quality and production control;

(8) repair of production facilities;

(9) pollution control;

(10) all other activities performed in Canada directly in connection with manufacturing or processing in Canada of goods for sale or lease; and

(11) scientific research carried on in Canada.

The following activities are not qualified manufacturing and processing activities:

(1) storing, shipping, selling, and leasing of finished goods;

(2) purchasing of raw materials;

(3) administration, including clerical and personnel activities;

(4) purchase and resale operations;

(5) data processing; and

(6) providing facilities for employees, including cafeterias, clinics, and recreational facilities.

For the CRA's interpretation of the majority of the above items, see Income Tax Folio S4-F15-C1.

Part 1 — Small Manufacturing Corporations

Certain small manufacturers may be eligible for the full manufacturing and processing tax credit without the necessity of preparing detailed calculations. These rules apply only where the net active business income for the current year (including associated companies) does not exceed $200,000. Since active business income eligible for the small business deduction on the first $200,000 does not qualify for the manufacturing and processing ("M&P") credit, it is commonly the case that the small manufacturer derives no benefit from the M&P rule for small manufacturers. However, this is not always the case. Where the company is not a Canadian-controlled private company ("CCPC"), of course there is no small business deduction and the M&P credit will apply to all eligible income.

Even if the company is a CCPC, where the small business deduction is limited to less than net active business income, the active business income which has not been eligible for small business rates may benefit from the small manufacturers M&P rule.

A company that meets the criteria may claim all of its net active business income as M&P income in Part 1 of Schedule 27. A company that does not meet the criteria must calculate its credit in accordance with the formula provided in Part 2 and is required to complete Parts 2 – 9.

Part 2 — Other Manufacturing Corporations

If a corporation engaged in manufacturing or processing does not qualify for the small manufacturers rule, the formula set out in Part 2 is to be applied in determining the proportion of income eligible for the manufacturing and processing tax credit. The elements of the formula are described in more detail below.

Part 3 — Adjusted Business Income ("ADJUBI" on Schedule 27)

Part 3 of Schedule 27 is used to show the excess of a company's income from active businesses carried on in Canada over its losses from active businesses carried on in Canada during the year.

The "adjusted business income" of a corporation engaged in resource activities is the adjusted business income less the "net resource income" calculated in Part 8.

Part 4 — Cost of Capital ("C" on Schedule 27)

Cost of capital includes:

(1) 10% of the "gross cost" of the property falling under the following categories:

- depreciable assets eligible for capital cost allowance under Schedule II of the *Income Tax Regulations* (the "Regulations") (note that land would not be included);
- timber limits and cutting rights;
- immovable woods assets;
- industrial mineral mines;
- capital expenditures in connection with scientific research, deductible under section 37 of the *Income Tax Act* (the "Act"); and
- farming and fishing property (pre-1972)

that are used by the corporation at any time during the year and are owned by it at the end of the year.

(2) The rental cost and/or royalty payments incurred during the year for the use of property (excluding land) would also be included in cost of capital if the property was owned by the corporation. The rental amount is the required payments under the lease or rental agreement regardless of whether the agreement is on a "net" or "gross" basis.

"Gross cost" of depreciable property is generally the capital cost for tax purposes adjusted to reverse certain adjustments already made.

Part 5 — Cost of Manufacturing and Processing Capital ("MC" on Schedule 27)

Once the cost of capital is determined, it will be necessary to determine the portion of the cost of capital that reflects the extent to which the property is used directly in qualified activities, as defined above. Assets that are "used directly" are an integral and essential part of carrying on a qualified activity. Where property is used in both qualified and other activities, a reasonable allocation should be made to determine the cost of manufacturing and processing capital. It is the nature of the activity with which an asset is connected, and not the nature of the asset, that determines its use.

Part 6 — Cost of Labour ("L" on Schedule 27)

This represents the sum of:

(1) all salaries and wages paid or payable during the year to all employees; and

(2) all other amounts paid or payable during the year to any person for administration or management, scientific research and experimental development, or other services which normally would be performed by the employees of the corporation.

Deductions should be made for labour:

- related to foreign active business;
- included in computing the corporation's cost of capital;
- related to earning Canadian resource profits, or
- included in Canadian or foreign exploration and development expenses.

Part 7 — Cost of Manufacturing and Processing Labour ("ML" on Schedule 27)

This begins with the portion of the cost of labour and such contracted labour payments to third parties representing the extent to which employees were directly engaged in qualified activities in connection with manufacturing and processing in Canada. This amount is then grossed up by $^{100}/_{75}$ to give the cost of manufacturing and processing labour. The grossed-up amount cannot exceed the cost of labour.

Where employees and other persons are engaged in both qualified and other activities, employ an allocation based on the proportion of the time spent directly in qualified activities.

Resource Industries

Where a corporation undertakes resource activities, the amount of eligible income for credit purposes is reduced by the amount of "net resource income", and the resource portions of capital and labour are also excluded from the formula used to calculate the credit. Note, however, that while resource income, generally speaking, is not eligible for the manufacturing and processing credit, except for Canadian processing of foreign oil and tar sands as noted below, resource income has its own rate reduction, beginning with the 2003 taxation year.

Part 8 — Calculation of Net Resource Income

The purpose of this calculation is to arrive at the reduction to adjusted business income required on Part 3 of Schedule 27.

The "net resource income" for a taxation year is the total of:

(1) the resource profits, as defined in section 1204 of the Regulations (and subsection 1206(3) if a member of a partnership), and

(2) the excess of amounts from an active business in Canada in respect of dispositions of resource properties over reserves allowed in respect of such dispositions (essentially there are no such reserves except in respect of pre-November 13, 1981 dispositions or dispositions grandfathered at that date),

minus

(3) depletion allowances deducted in computing income under section 65 of the Act (unless already deducted to arrive at (1) above), and

(4) the amount by which the resource profits in (1) above exceed the aggregate of the *Canadian* portion of those resource profits plus the earned depletion base (per Regulation 1205(1)) of the corporation at the beginning of its immediately following taxation year.

Resource profits from the processing in Canada of ore and tar sands from resources located in foreign jurisdictions are eligible for the M&P credit (presumably since they are not subject to the other resource incentives). It follows that these special profits must be removed from the general calculation of resource profits in order to qualify for the credit. This is accomplished by removing them from the resource profits calculation under (4) above.

Partnerships

Where a corporation is a member of a partnership, adjustments are made to the calculations to incorporate the corporation's share of the partnership's income or loss for the year. This would apply to the determination of M&P profits as well as active business income or loss.

Part 9 — Manufacturing and Processing Profits Deduction — Calculation

Once eligible Canadian M&P profits are determined, the tax credit itself is calculated in Part 9 of Schedule 27.

The M&P calculation is based on the following limiting factors:

(1) Canadian Manufacturing and Processing Profits Rates

Canadian manufacturing and processing profits, as discussed above, are eligible for a tax credit. This tax credit has been 13% from 2012 onwards. It is intended that to the extent those profits are eligible for the small business deduction rate, they should not also be eligible for the M&P deduction.

However, to the extent that M&P profits would be subject to the full 38% basic federal tax rate, they are eligible for a special credit which reduces the effective basic federal tax rate, less federal abatement of 10% (before surtax and provincial tax) to 15% from 2012 onward.

(2) Taxable Income Subject to Full Rate

Manufacturing and processing profit should not in theory overlap income subject to other favourable treatment, such as income eligible for small business rates, investment income eligible for refundable dividend tax treatment, and foreign income as represented by amounts eligible for foreign tax credits. Accordingly, Part I taxes payable are reduced by the aggregate of the following items calculated and shown in the "Part I tax" section of the T2 return:

(1) the least of the small business deduction limitation amounts from the small business deduction calculation;

(2) for CCPCs only: aggregate investment income from the"Refundable portion of Part I tax" calculation; and

(3) the amount of the Foreign Business Tax Credit multiplied by the "relevant tax factor" (which is currently 4).

The result of this computation (at line (9H) in the M&P calculation box) is compared with the eligible income net of small business amounts and the lesser of the two receives the large business manufacturing and processing credit.

Electrical Energy and Steam Generation (Schedule 27, Parts 10 to 13)

The M&P credit at line 9I is supplemented by the results of the special calculation of M&P credit for electrical energy or steam (line 13L), found on Parts 10 to 13 of Schedule 27.

This element of the M&P credit extends to all corporations which produce steam for sale, whether or not for use in the production of electricity. The M&P tax credit for generating electrical energy for sale or producing steam for sale is calculated in a very similar manner to the more general M&P credit calculated in Parts 2 – 9 of Schedule 27.

COVID-19 UPDATE

Given the rapidly changing information related to COVID-19 we are providing continuously updated information at https://blog.intelliconnect.ca/.

Federal

New Support for Businesses (October 9, 2020)

On October 9, 2020, the Deputy Prime Minister and Finance Minister, Chrystia Freeland, announced that the federal government intends to introduce new support for businesses and other organizations to help them get through the second wave of COVID-19.

First, the new Canada Emergency Rent Subsidy would provide rent and mortgage support until June 2021 for qualifying organizations affected by COVID-19. The rent subsidy would be provided directly to tenants, while also providing support to property owners. The new rent subsidy would support businesses, charities, and non-profits that have suffered a revenue drop by subsidizing a percentage of their expenses, on a sliding scale, up to a maximum of 65 per cent of eligible expenses until December 19, 2020. Organizations would be able to make claims retroactively for the period that began September 27 and ends October 24, 2020. A top-up Canada Emergency Rent Subsidy of 25 per cent will be available to organizations temporarily shut down by a mandatory public health order issued by a qualifying public health authority, in addition to the 65 per cent subsidy.

Second, the government reiterated its commitment to extend the Canada Emergency Wage Subsidy ("CEWS") until June 2021. The subsidy would remain at the current subsidy rate of up to a maximum of 65 per cent of eligible wages until December 19, 2020.

And last, the Canada Emergency Business Account ("CEBA") will be expanded, which would enable businesses, and not-for-profits eligible for CEBA loans — and that continue to be seriously impacted by the pandemic — to access an interest-free loan of up to $20,000, in addition to the original CEBA loan of $40,000. Half of this additional financing would be forgivable if repaid by December 31, 2022. Additionally, the application deadline for CEBA is being extended to December 31, 2020. Further details, including the launch date and application process will be announced in the coming days. An attestation of the impact of COVID-19 on the business will be required to access the additional financing.

One-Time Payment to Persons with Disabilities Coming Soon (October 6, 2020)

Previously, the federal government announced a non-taxable, non-reportable, one-time payment of up to $600 in recognition of the extraordinary expenses faced by persons with disabilities during the COVID-19 pandemic. The federal government has now promised that the payment will be made to eligible persons on October 30, 2020.

Regional Relief and Recovery Fund Expanded (October 2, 2020)

The Regional Relief and Recovery Fund ("RRRF") is intended to support businesses that may not be eligible for other government programs. On October 2, the federal government announced an additional $650 million in funding for the RRRF, bringing its total funding to $1.5 billion.

Provincial

Québec

Aid for Businesses in Regions at Maximum Alert (October 1, 2020)

The government is improving the Temporary Concerted Action Program for Enterprises ("PACTE") and the Emergency Assistance for Small and Medium-Sized Enterprises ("PAUPME") program to help businesses subject to a shutdown order in the context of the second wave of COVID-19.

A new component of these programs, Aid for Businesses in Regions at Maximum Alert ("AERAM"), will allow businesses targeted by closure orders that will suffer loss of income to obtain non-refundable aid to pay their fixed costs.

The PACT and the PAUPME, set up at the start of the pandemic, continue to apply. AERAM is now added, which takes the form of loan forgiveness, according to the following criteria:

- Loan forgiveness applies to financial assistance granted through PACTE and PAUPME;
- The loan forgiveness will be equivalent to certain fixed costs disbursed for the closing period in question, namely:
  - municipal and school taxes;
  - rent (the portion not covered by another government program);
  - interest paid on mortgages;
  - costs related to public services (e.g., electricity and gas);
  - insurance;
  - telecommunications costs;
  - permits and association fees;
- The forgiven amount may not exceed 80% of the loan amount or $15,000.

CURRENT ITEMS OF INTEREST

Per-Kilometer Rates

When claiming travel costs for the medical expense tax credit, the moving expense deduction, and the northern residents deduction, taxpayers can use the simplified method to compute the amount of the claim by multiplying the total distance traveled by a per-kilometer rate. The rates for the 2020 tax year are as follows:

Province/Territory	Cents/km (taxes included)
Alberta	47.0
British Columbia	52.0
Manitoba	49.5
New Brunswick	50.5
Newfoundland and Labrador	54.5
Northwest Territories	59.5
Nova Scotia	51.0
Nunavut	59.0
Ontario	55.0
Prince Edward Island	49.0
Québec	52.0
Saskatchewan	49.0
Yukon	58.0

Ontario Real Estate Professionals Can Incorporate

On October 1, 2020, the Ontario government announced the first phase of regulatory changes related to the *Trust in Real Estate Services Act, 2020* ("TRESA"). Among these changes, the government is allowing real estate professionals to incorporate and be paid through Personal Real Estate Corporations ("PRECs"). A PREC is a corporation that meets certain prescribed criteria which are provided under O. Reg. 536/20 (see https://www.ontario.ca/laws/regulation/r20536).

RECENT CASES

Minister's reassessments based on allegations of sham or alternatively on transfer pricing rules vacated

The corporate taxpayers, AgraCity and Sask. Co., were two related corporations belonging to the same group of corporations. AgraCity had a Services Agreement with NewAgco Inc., a non-arm's length Barbados international business corporation ("NewAgco Barbados"). In reassessing AgraCity under the transfer pricing rules in paragraphs 247(2)(*a*) and (*c*) of the *Income Tax Act* (the "Act"), the Minister re-allocated all of NewAgco Barbados' profits to AgraCity. During the course of AgraCity's appeal to the Tax Court of Canada, the Minister sought to justify the reassessments in issue by alleging that: (a) the transactions in issue were a sham; (b) in the alternative, paragraphs 247(2)(*b*) and (*d*) applied to re-characterize the transactions; and (c) in the further alternative, paragraphs 247(2)(*a*) and (*c*) resulted in a transfer pricing adjustment. Penalties for gross negligence were also imposed.

The taxpayer's appeal was allowed. The taxpayer met the initial onus of demolishing the assumptions underlying the Minister's reassessments. In fact, the taxpayer went far beyond making out a *prima facie* case. Also, the Minister failed to produce satisfactory evidence from its own witnesses or from those of the taxpayer to prove on a balance of probabilities that its relevant assumptions, or its further allegations and positions, were correct. The Minister's reassessments were vacated accordingly.

¶50,547, *AgraCity Ltd. v. The Queen*, 2020 DTC 1066

Taxpayer trust liable for tax owing by corporation which paid it taxable dividends

At a time when it owed tax, a corporation, Global, paid the taxpayer trust taxable dividends (the "Dividends"). Global's tax owing exceeded the amount of the Dividends. The Minister assessed the trust under the transferor-transferee provisions of section 160 of the *Income Tax Act* (the "Act"). On appeal to the Tax Court of Canada, the trust argued, in part, that by applying section 160 of the Act to the full amount of the Dividends which had already been included in the trust's own income under subsection 82(1) of the Act, the trust was being subject to double taxation.

The taxpayer's appeal was dismissed. Subsection 160(1) does not impose tax, but merely assists in collecting tax owed by the transferor, so that the transferee is not subject to double taxation in this situation, and while the application of both subsections 82(1) and 160(1) of the Act might have created hardship for the trust in this case, the Act does not contain a provision to remedy that hardship.

¶50,549, *Mamdani Family Trust v. The Queen*, 2020 DTC 1068

INTERNATIONAL NEWS

Bahamas Commits to Tax Transparency Changes

The Government of the Bahamas will launch a new Tax Residency Certificate ("TRC") for individuals by the end of 2020, the Minister for Financial Services has said.

Minister of Financial Services, Trade and Industry and Immigration Elsworth Johnson said that the TRC is a high priority on his Ministry's agenda. He noted that there has been mounting international pressure to formally identify the expatriate residents and investors who are domiciled within Bahamian borders in order to ensure greater transparency of income and financial records, particularly for taxation purposes.

Johnson added that the Government's ultimate goal is to fully comply with international information exchange agreements under the OECD's Common Reporting Standard, on overseas financial accounts.

Johnson also said a number of amendments to existing statutes will be tabled before parliament in the coming weeks, including changes to:

- The Companies Act;
- The International Business Companies Act;
- The Property (Execution of Deeds and Documents) Act;
- The Rule Against Perpetuities (Abolition) Act; and
- The Foundations Act.

He said:

> Several other pieces of legislation are being drafted and reviewed with the objective of creating a modern legislative framework for the long-term stabilization and growth of the Financial Services Sector. Many of these changes have been requested by our industry partners for many years, and, once again, my ministry has made it a priority to deliver results.

Netherlands To Offer New Investment Tax Credit

The Dutch Government has submitted legislation for a temporary investment incentive to parliament.

Under the proposed job-related investment discount scheme ("BIK"), businesses purchasing new equipment will be able to offset part of the purchase costs against payroll tax liabilities.

The scheme allows businesses to offset three per cent of purchase costs against payroll tax for investments up to €5 million, and 2.44 per cent of purchase costs for investments over €5 milion.

The scheme applies to equipment purchased on or after October 1, 2020. Purchases must be fully paid for in the period from January 1, 2021 to December 31, 2022, and put to use within six months of full payment.

Companies wishing to qualify for the scheme can submit an application from September 1, 2021. A decision will be made within 12 weeks, after which they may set the costs against their payroll tax liabilities.

Australia Announces Tax Reliefs in 2020–21 Budget

The Australian Government has announced that it will bring forward personal tax cuts that had been scheduled for 2022 and announced new reliefs for businesses.

The Government released its Budget on October 6, 2020. It said stage two of its personal income tax reform plans will be brought forward to the 2020–21 income year. Specifically, the Government will increase the top threshold for the 32.5 per cent tax bracket from AU$90,000 to AU$120,000, and increase the threshold for the 19 per cent income tax band from AU$37,000 to AU$45,000. The low-income tax offset will also be increased to AU$700.

For businesses, the Government announced that, from October 6, 2020 until June 30, 2022, businesses with turnover up to AU$5 billion will be able to deduct the full cost of eligible depreciable assets of any value in the year they are installed. The cost of improvements to existing eligible depreciable assets made during this period can also be fully deducted.

The Government also intends to enhance tax incentives for research and development. For small claimants (turnover less than AU$20 million), the Government will increase the refundable research and development tax offset and there will be no cap on annual cash refunds. For larger claimants, the intensity test will be streamlined and the non-refundable research and development tax offset will be increased. The cap on eligible research and development expenditure will be lifted from AU$100 million to AU$150 million per year. These changes will apply from July 1, 2021.

The Budget further announces that companies with turnover up to AU$5 billion will be allowed to offset losses against previous profits on which tax has been paid, to generate a refund. Losses incurred up to the 2021–22 fiscal year can be carried back against profits made in or after 2018–19. Eligible companies may elect to receive a tax refund when they lodge their 2020–21 and 2021–22 tax returns, the Government said.

The Budget featured the Government's earlier announced plans also, including that it will exempt from the 47 per cent fringe benefits tax ("FBT") employer-provided retraining activities to employees who are redeployed to a different role in the business; improve SMEs' access to tax reliefs; and reduce the small business corporate tax rate to 25 per cent in the 2020–21 income year.

TAX TOPICS

Published weekly by Wolters Kluwer Canada Limited. For subscription information, see your Wolters Kluwer Account Manager or call 1-800-268-4522.

For Wolters Kluwer Canada Limited

Email: cservice@wolterskluwer.com *Phone: 1-800-268-4522 or (416) 224-2248 (Toronto)*

Notice: *Readers are urged to consult their professional advisers prior to acting on the basis of material in Tax Topics.*

Wolters Kluwer Canada Limited
300-90 Sheppard Avenue East
Toronto ON M2N 6X1
1 800 268 4522 tel
1 800 461 4131 fax
www.wolterskluwer.ca