

Practice Examination

Chapter 6 (Business Income)

Instructions To Students

Create An Examination Environment

Your text and the accompanying Study Guide provide you with a large number of Exercises and Self Study Problems for which solutions are provided. These problems are designed to assist you with understanding the content of each Chapter. In contrast, the goal of this Practice Examination is to allow you to evaluate your ability to write the examinations in your tax course.

To get maximum benefits from this Practice Examination, you should write it under examination conditions. It is designed as a 90 minute examination and it should be written within that time constraint. You should make an effort to set aside 90 minutes of time during which you will not be interrupted. You should also pick a location where you will not be distracted by extraneous influences.

Materials To Be Used

The materials that you use while writing this Practice Examination should be consistent with the materials that will be available during the examinations that you will be writing in your tax course. These vary from course to course, and include the following possibilities:

- you may be allowed to bring a copy of the *Income Tax Act* into the examination room,
- you may be provided with the list of “Rates and Other Data” that is found in the front of your *Canadian Tax Principles* textbook and as a .PDF file on your Student CD-ROM,
- you may be allowed to bring a “cheat sheet” with various notes into the examination room, or
- you may be allowed to bring your *Canadian Tax Principles* textbook into the examination room.

You should determine, either from your course outline or directly from your instructor, which of these approaches applies in your situation. You should write this Practice Examination using only the materials permitted for your examination.

Types Of Questions

Different instructors use alternative types of questions on their examinations. This examination includes essay questions, true or false questions, and multiple choice questions. However, the majority of the marks on this examination are allocated to problems that are similar to the Exercises and Self Study Problems that are available in your *Canadian Tax Principles* text.

This content may not be consistent with the types of questions used by the instructor in the course you are taking (e.g., an instructor might choose to have an examination that contains only multiple choice questions, or only one comprehensive question). You should take this into consideration when you are evaluating your results on this examination.

How To Use The Marking Guides

For each question on this Practice Examination, we have provided information as to how marks would be allocated. In some cases, this allocation is very straightforward. For example, if a 12 mark question consists of 6 multiple choice questions, 2 marks will be allocated to each correct answer.

However, in other situations the allocation process is more complex. Consider, for example, an employment income calculation that has 11 separate components (i.e., salary, RPP contributions and so forth). If 15 grading marks were assigned to this problem, the marking guide could assign 1.36 marks (15 marks divided by 11 components) to each line or, alternatively, award more than one mark to some components. Both of these approaches can be awkward.

To resolve this problem, the marking guides that we provide in these more complex situations will be based on “grading points”. In the preceding example, 11 grading points would be assigned to this question — one for each component in the calculation. These “grading points” would then be converted into the relevant mark. Continuing the example, if you had 8 of 11 components in the calculation correct, this result would be converted to a mark as follows:

$$[(8 \div 11)(15\%)] = 10.9\%$$

In the solution that we have provided for this Practice Examination, these grading points have been identified with **highlighting** the appropriate number or word.

Practice Examination On Business Income

Examination Content

The content of this examination, along with the marks and times for each question, are found in the following table.

Question	Type Of Question Or Subject	Marks	Time In Minutes
1	Essay Question	9	8.1
2 - 7	True Or False	9	8.1
8 - 14	Multiple Choice	21	18.9
15	Reserves	12	10.8
16	Inventory Valuation	12	10.8
17	Business Income Reconciliation	37	33.3
Total		100	90.0

Question 1 (9 Marks)

List and briefly describe three criteria that have been used by the courts to distinguish between capital gains and business income.

Questions 2 Through 7 (9 Marks)

2. If a drill press is sold for more than it cost, the difference might be treated as either business income or a capital gain, depending on the nature of the taxpayer's business.

True or False?

3. If a reserve is deducted in the determination of the current year's net business income, it will have to be added back to net business income in the following year.

True or False?

4. Automobile mileage payments made to employees can be deducted, in full, in the determination of business income.

True or False?

5. A self-employed individual who is eligible to use space in his home for an office cannot deduct CCA on the property.

True or False?

6. There are no circumstances under which a taxpayer can deduct more than 50 percent of the cost of meals and entertainment.

True or False?

7. When a business ceases to operate and its accounts receivable disposed of with the other business assets, any loss on the receivables will always be treated as a business loss.

True or False?

Questions 8 Through 14 (21 Marks)

8. As a hobby, Jennifer Flowers collects antique music boxes. As she tires quickly of many of these items, she also sells them through advertisements in various antique oriented periodicals and websites. During the current year, she acquired 42 music boxes at a cost of \$146,000 and sold 32 for proceeds of \$154,000. The cost of the music boxes sold was \$123,000. Her advertising costs totaled \$12,000. For the current year, Jennifer will report which of the following amounts in her tax return?
- A. A taxable capital gain of \$19,000.
 - B. A taxable capital gain of \$9,500.
 - C. Because the collecting of music boxes is a hobby, she will not report any income from these activities.
 - D. Business income of \$19,000.
9. Jim's Music Ltd. (JML) has been in operation for six years. Its year end is January 31. In October 2012, JML started issuing gift certificates. The gift certificates are good for six months from the date of issue. As at January 31, 2013, JML had issued 2,000 gift certificates for \$15 each, for cash of \$30,000. By that date, 1,200 of the gift certificates had been redeemed for merchandise. What is the allowable reserve to JML at January 31, 2013 under ITA 20(1)(m)?
- A. Nil.
 - B. \$12,000.
 - C. \$18,000.
 - D. \$30,000.
 - E. None of the above.
10. With respect to insurance costs, which of the following items would not be deductible in the determination of business income for tax purposes?
- A. Damage insurance on the capital assets of the business.
 - B. House insurance for a home-based proprietor.
 - C. Liability insurance on the premises used by the business.
 - D. Life insurance on the proprietor's life.
11. Martine Fox uses an automobile in her unincorporated business. It cost \$89,000 in 2012, with maximum CCA being deducted in that year. The purchase was financed with a bank loan of \$72,000. For 2013, the interest on this loan was \$8,560. The automobile is used exclusively for business purposes, with the 2013 operating costs totaling \$6,300. In determining her 2013 business income, her maximum automobile related deduction will be:
- A. \$22,510.
 - B. \$18,950.
 - C. \$35,345.
 - D. \$17,600.
12. Barry Field operates a mail order business out of a dedicated space in his home. Which of the following statements is not correct?
- A. Barry can deduct a pro rata share of the maintenance costs of his home.
 - B. Home office costs that are not deductible in a given year can be carried forward for one year only and deducted against income generated from the same business.
 - C. Barry can deduct a pro rata share of CCA on his home.
 - D. Barry can deduct a pro rata share of mortgage interest on his home.

13. Which of the following methods of inventory valuation would not be acceptable for tax purposes?
- A. Cost determined under a FIFO flow assumption.
 - B. Lower of cost and market, with cost determined on the basis of average cost.
 - C. Lower of cost and market, with cost determined using specific identification.
 - D. Market determined using replacement cost.
14. Madeline Samson has an unincorporated accounting practice. At the end of 2012, she had unbilled work in progress of \$42,000, along with receivables of \$28,000. During 2013, she completes work with a billable value of \$172,000, bills her clients a total of \$153,000, and collects cash of \$164,000. What is Madeline's minimum business income inclusion for 2013?
- A. \$172,000.
 - B. \$153,000.
 - C. \$164,000.
 - D. \$130,000.

Question 15 (12 Marks)

During 2013, its first year of operation, John's Scent Shoppe has cash sales of \$105,000, as well as account sales of \$52,000. Of the cash sales, \$12,000 represents payments for goods that will be delivered during 2014. At December 31, 2013, \$17,000 of the accounts receivable remain uncollected. John identified \$1,700 of the accounts that he considers will be uncollectible. By what amount will the 2013 net business income of John's Scent Shoppe be increased by the preceding information?

Question 16 (12 Marks)

The following information relates to the year end inventories of Sandrine's Furniture:

Net Realizable Value	\$133,000
Replacement Cost	102,000
Value At FIFO Cost	112,000
Value At Average Cost	106,000

List the various inventory values that could be used to determine business income for tax purposes. Your answer should indicate the valuation method being used, as well as the resulting value.

Question 17 (37 Marks)

London Supplies is a proprietorship owned by John Forthwell. For the taxation year ended December 31, 2013, John has determined that his Net Income for accounting purposes is \$87,000. In calculating this figure, John used generally accepted accounting principles.

Other Information:

1. As the business is unincorporated, no taxes were deducted in calculating Net Income.
2. In determining accounting Net Income, John deducted \$33,200 in Amortization Expense. For the taxation year ending December 31, 2013, John has determined that maximum CCA would be \$43,500.
3. Accounting expenses included a reserve for bad debts of \$4,500 and a reserve for inventory obsolescence of \$8,500.
4. During the year, London Supplies spent \$5,300 for landscaping the grounds around its Winnipeg office. In accordance with generally accepted accounting principles, this amount was treated as a capital expenditure. As the work was done late in the year, no amortization was deducted for the current year.
5. Accounting expenses included \$12,000 in business meals, as well as \$2,300 in charitable donations.
6. The business spent \$3,500 for advertisements on a U.S. radio station. As the station is on the border with Manitoba, the audience for this station is largely Canadian residents.
7. John spent \$6,200 for advertising circulars, charging the full amount to expense. At December 31, 2013, one-half of these circulars were still on hand.
8. One of John's employees stole cash in the amount of \$1,100. As the individual has left town, this amount is unlikely to be recovered.
9. The following additional items were included in the accounting expenses:

Cost Of Sponsoring Local Hockey Team	\$ 2,100
Interest Paid On Building Mortgage	6,300
Appraisal Costs On Land To Be Sold	2,100
Damages Resulting From Breach Of Contract	1,400
10. Also included in the accounting expenses were \$2,000 in fees paid to John's 16 year old son for creating and maintaining the web site of London Supplies. In pricing this work, John found that it would cost at least \$3,000 to obtain the equivalent services from an outside consultant.

Required: Calculate the minimum net business income for London Supplies that will be included in John Forthwell's tax return for the year ending December 31, 2013. Indicate why you have not included any of the preceding items in your calculations.

END OF EXAMINATION