

Practice Examination Solution

Chapter 6 (Business Income)

Examination Summary

The marks you have received on each question can be added in the final column.

Question	Type Of Question Or Subject	Total Marks	Your Mark
1	Essay Question	9	
2 - 7	True Or False	9	
8 - 14	Multiple Choice	21	
15	Reserves	12	
16	Inventory Valuation	12	
17	Business Income Reconciliation	37	
Total		100	

Solution 1 (9 Marks)

The text discusses six criteria for making this distinction, any three of which would satisfy the requirements of the question. The six are as follows:

Intent Did the individual intend to hold the asset to produce income or, alternatively, to resell at a profit?

Number Of Transactions If the taxpayer has a large number of closely spaced sale transactions in a given period, this would indicate that he is acquiring assets for resale, not to produce income.

Relationship To The Taxpayer's Business If the asset sale in some way relates to the taxpayer's normal business activities (e.g., a real estate agent selling a renovated house), it would indicate that he is acquiring the assets for resale, not to produce income.

Supplemental Work On Property Additional work on the property that appears to be directed towards enhancing its marketability would indicate that the intent was to resell the property and that any gain would be business income.

Nature Of Assets The accounting distinction between current and fixed assets may be used to distinguish between business income and capital gains.

Objectives Declared In Articles Of Incorporation If the transaction fell within the scope of these objectives, the result would be business income.

2 grading point for each of 3 correct answers. Total 6

Your Mark = [(# of grading points ÷ 6)(9%)] = ____%

Solutions 2 Through 7 (9 Marks)

2. **True.** If the drill press was used to produce income, the disposition would produce a capital gain. If it was sold by a dealer in drill presses, the result would be business income.
3. **True.**
4. **False.** The payments cannot exceed an amount that is specified by the *Income Tax Regulations*.
5. **False.** While it may not be desirable to deduct CCA on a principal residence, it is not prohibited.
6. **False.** There are a number of exceptions to the 50 percent rule (e.g., meal costs incurred by long-haul truck drivers).
7. **False.** Unless a joint election is made, the loss will be treated as a capital loss.

1 grading point for each correct answer. Total 6

Your Mark = [(# of grading points ÷ 6)(9%)] = ____%

Solutions 8 Through 14 (21 Marks)

8. **D.** Business income of \$19,000 (\$154,000 - \$123,000 - \$12,000).
9. **B.** Gift certificates not yet redeemed and not yet expired as at January 31, 2013:
800 @ \$15 per certificate = \$12,000
10. **D.** Life insurance on the proprietor's life would not be deductible unless the interest on the loan was deductible and the creditor required the insurance.
11. **D.** After CCA of \$4,500 [(\$30,000)(30%)(1/2)] for the first year, the Class 10.1 UCC is \$25,500 (\$30,000 - \$4,500). The maximum automobile related deduction is \$17,600 [(\$25,500)(30%) + (365)(\$10) + \$6,300].
12. **B.** Home office costs that are not deductible in a given year can be carried forward indefinitely and deducted against income generated from the same business.
13. **A.** Inventories must be determined using either market or lower of cost and market. Cost is not acceptable.
14. **B.** \$153,000, the amount billed.

1 grading point for each correct answer. Total 7

Your Mark = [(# of grading points ÷ 7)(21%)] = ____%

Solution 15 (12 Marks)

The total inclusion would be calculated as follows:

Cash Sales	\$105,000
Accounts Receivable	52,000
Reserve For Undelivered Goods	(12,000)
Reserve For Doubtful Debts	(1,700)
Total Increase	\$143,300

1 grading point for each highlighted item. Total 4

Your Mark = [(# of grading points ÷ 4)(12%)] = ____%

Solution 16 (12 Marks)

Inventories can be valued at either market or lower of cost and market. They cannot be valued at cost.

If market is used, the two values that could be used are as follows:

- Market based on Net Realizable Value \$133,000
- Market based on Replacement Cost 102,000

If lower of cost and market is used, there are several possibilities:

- Lower of Net Realizable Value and FIFO Cost \$112,000
- Lower of Net Realizable Value and Average Cost 106,000
- Lower of Replacement Cost and FIFO Cost 102,000
- Lower Replacement Cost and Average Cost 102,000

1 grading point for each highlighted item. Total 6

Your Mark = [(# of grading points ÷ 6)(12%)] = ____%

Solution 17 (37 Marks)

The minimum net business income of London Supplies would be calculated as follows::

Accounting Income		\$ 87,000
Additions:		
Amortization Expense	\$33,200	
Reserve For Inventory Obsolescence	8,500	
Business Meals - Non-Deductible 50 Percent	6,000	
Charitable Donations (Note 1)	2,300	
Cost Of Advertising On A U.S. Radio Station To The Canadian Market (Note 2)	3,500	
Unused Advertising Circulars [(1/2)(\$6,200)] (Note 3)	3,100	
Appraisal Costs On Land To Be Sold (Note 4)	2,100	58,700
		\$145,700
Deductions:		
Landscaping Costs	(\$ 5,300)	
CCA	(43,500)	(48,800)
Net Business Income		\$ 96,900

Note 1 Donations to charities cannot be deducted in the calculation of net business income. They will be the basis for a tax credit in the calculation of Tax Payable for Mr. Forthwell.

Note 2 In general, when a Canadian enterprise places advertising directed at the Canadian market in foreign print or broadcast media, the costs of the advertising are not deductible. ITA 19.01 exempts certain foreign periodicals from this rule. However, the rule is still applicable to foreign broadcast media.

Note 3 As noted in ITA 10(4)(b), items such as advertising circulars would be viewed as a form of inventory. As we do not have information on the market value for these items, they would have to be valued at cost.

Note 4 The appraisal costs on land to be sold must be added to the adjusted cost base of the asset.

Other Items Further explanation related to the items not included in the preceding calculation of Net Business Income are as follows:

Reserve For Doubtful Debts This reserve is deductible as it is specifically provided for in the Income Tax Act. [ITA 20(1)(l)]

Loss From Theft Losses of this type are considered to be deductible as a normal cost of doing business.

Cost Of Sponsoring Local Hockey Team This would appear to be a legitimate advertising expense.

Mortgage Interest The interest would be deductible as the building is a capital asset of the business.

Damages As the damages relate to a transaction that produces business income, they are considered a business expense.

Fees Paid To Son Since the fees paid to John's son are reasonable when compared to those charged by a non-arm's length party, they are deductible.

1 grading point for each highlighted item. Total 16

Your Mark = [(# of grading points ÷ 16)(37%)] = ____%