



### Mid-Term Exam #2 (2 hours)

ADM 3345 – Tax I  
November 10, 2012

Student Name: ARIEL FREEDMAN  
Student I.D.: 6131312 Section: B

Question #1	13 /14	
Question # 2	13 /13	
Question # 3	12 /10 12	
Question # 4	28 /32	
Total:	66 /71	93 /100

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I have read the text on academic integrity and I pledge not to have committed or attempted to commit academic fraud in this examination.

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### Question #1: Business Income (14 Marks)

Customized Services Incorporated (CSI) sells a large variety business forms to businesses throughout Canada. CSI has just completed the company's financial statements for the year ended December 31, 2012. The Income Statement indicates the company realized a Net Income for the year of \$536,000. The following information was used in the preparation of these financial statements:

1. The company's Cost of Goods Sold was \$312,000. CSI's competitive advantage is the special printing process they use on their forms. This process guarantees that when the forms are prepared by hand, the last copy will be as legible as the top copy. Because the company warranties its product, the accountant has established a \$15,000 Warranty Reserve.
2. The company was forced to pay damages of \$25,000 to settle a breach of contract lawsuit arising from a failure to provide an elaborate customized form by the deadline stipulated in the contract. The amount was expensed on the Income Statement during 2012. During the current year, the company also deducted a loss of \$5,600 resulting from a theft by one of the company's employees.
3. The company's property tax expense of \$15,700 is for tax levies against two properties. A tax of \$11,450 was levied on the company headquarters property. Two years ago, the company purchased new land a short distance from the current property, with the intention of building new headquarters on that land. This year and last year, a tax of \$4,250 has been levied on that vacant land. For the last two years the land has been used as a temporary parking lot by the employees and the company has collected a nominal \$1,500 in parking revenues each year on the land.
4. The company's expenses include \$12,000 in charitable contributions.
5. Amortization expense on CSI's building, equipment, and furniture & fixtures was \$122,500.
6. The company spent \$23,500 in total landscaping costs in 2009. The accountant determined the amount should be amortized straight-line over a 5-year period commencing in 2009. As a result, \$4,700 of landscaping costs were expensed in the current year.
7. CCA is correctly calculated as 163,500.
8. The company's expenses include \$25,000 in bonuses to management declared at the end of 2012. These bonuses will be paid on February 1, 2013.
9. The company changed insurers during the year and as a result all of its assets had to be appraised. The cost of this appraisal was \$15,600 and the entire amount was expensed during the year.
10. Bad debt expense amounted to \$11,000.
11. The balance in the company's CEC account was 6,000 at January 1, 2012.
12. The company's legal expenses for the year amounted to \$11,150 and were related to the following transactions:

Review of sales contracts	\$6,550
Costs of amending articles of incorporation	\$4,600

13. The company's expenses included a total amount of \$22,200 for business meals and entertainment.

14. When the company purchased the vacant land (see item #3), it had been used for public parking by the previous owner. There was a small insulated metal kiosk on the land which had been used by the parking lot attendant and when the property was purchased, \$8,300 of the total purchased price was allocated to the kiosk. This year, the company sold the kiosk for \$8,000. The NBV of the kiosk was \$7,885 and the UCC was \$7,968. The kiosk was the only remaining asset in its CCA class. *Accounting gain = PCD - NBV = 8000 - 7885 = 115 gain*

15. In order to expand its business, the company has begun advertizing in well-known journals used by businesses which would be interested in CSI's products. It spent \$25,300 to place an ad in the *Canadian Business Journal*, printed in Toronto and distributed throughout Canada. It also spent \$36,700 to place an ad in the *North American Business Magazine*, printed in Buffalo, New York but containing mostly (65-70%) Canadian content and distributed in Ontario and the New England states. The company expensed these advertizing costs.

16. The company provides a company-owned vehicle for the company president. The vehicle had cost the company \$32,000 and the company pays all of the operating costs which it expenses annually. The president drove the vehicle a total of 117,000 kilometers, 112,000 of which were carefully documented business travel. The president did not reimburse the company for his personal usage of the company vehicle.

17. CSI deducted an Income Tax Expense of \$86,000 for the current year, including \$15,000 in future income taxes.

**Required:**

Calculate Custom Services Incorporated (CSI)'s Net Income for Tax Purposes (NIFTP) for the year ending December 31, 2012 on the assumption that CSI claims the maximum deductions available to them for tax purposes.

*Kiosk*  
 b. UCC 7968  
 Disp.  
 - CC of 3000 - 8000  
 - PCD 8000  
 CCA comp.  
 Add to NI 32

CC of 3000  
 FMV 8000  
 UCC 7968

(15) 65-90%  
 → 50% deductible  
 - expensed 36700  
 deductible amt = (18350)  
 add back 18350

No Canadian content is 0% deduction.

50% Canadian content < 90% Canadian is 50% deduction

**Solution to Question #1:**

Net Income for Accounting Purposes

Additions

1. Warranty Reserve	\$ 15,000	✓ 1
3. Property Tax	2750	✓ 1
7. Charitable Donations	12000	✓ 1
1. Amortization Exp.	122,500	✓ 1
2. Amending Articles of Incorporation	4600	✓ 1
3. Business Meats & Entertainment	11,100	✓ 1
5. Foreign Advertising (50% deductible)	19,350	✓ 1
7. Income Tax expense.	86000	✓ 1
<del>5. Canadian Advertising</del>		
LA Recapture #14 see reverse for calc.	32	✓ 1

Deductions

- CCA Expense	\$ 163500	✓ 1
- CEC Amortization	661.5	✓ 2

Accounting Gains & Losses - Deduct Loss on sale of truck <sup>14</sup>

Net Income for Tax Purposes

Calculation: Tax 4250 less per (1500) add to ACR & not deduct 2750

① 8 ②	CEC Accr
6.	6000
additions	(.75 x 4600)
	<u>3450</u>
	9450
ann. exp	<u>661.5</u>

⑬ 602 meals ÷ 2 = 22200  
= 11100 add back

Accr gain - see reverse

\$ 536 000  
536 000

272332  
(164161.5)  
(115) ✓ 1  
\$ 644055.5

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**Question #2: Issues for Landlords (13 Marks)**

**Part A: Rental Income and CCA**

The taxpayer owns two rental properties, with the following relevant information:

	<u>Building #1</u>		<u>Building #2</u>	
ACB	\$ 95,000	+	\$108,000	=
UCC	\$ 90,000	+	\$ 98,000	=
FMV	\$135,750	+	\$176,500	=

~~Total  
207,000  
188,000  
395,250~~

Both buildings are class 1 assets which are depreciated for tax purposes at 4% per annum. The taxpayer has decided that for strategic purposes, whenever the amount he can deduct for CCA purposes is restricted, he would prefer to first take the maximum CCA possible on Building #2 and the remainder of deductible CCA on Building #1.

While the role of landlord went smoothly for many years, 2012 proved problematic for the taxpayer. The tenants of Building #1 quickly fell into arrears and by the time they were evicted, Building #1 had sustained a fair amount of damage. The taxpayer experienced the following results in 2012:

	<u>Building #1</u>		<u>Building #2</u>	
Gross Rental Revenues	\$3,250	+	\$22,000	=
Mortgage Interest	4,200	+	5,000	=
Property Taxes	2,700	+	3,300	=
Repairs & Maintenance	5,050	+	200	=

25,250  
9,200  
6,000  
5,250

**Required:**

Calculate the amount of net rental income that the taxpayer must include on their income tax return. Show all of your calculations to obtain full marks! Available CCA → 4800

**Total Revenues** \$ 207,000

	B1	B2	CCA 1. = .04
<b>Revenue</b>	90,000	98,000	
<b>Max CCA exp.</b>	6300	6860	
<b>CCA Exp. Deducted</b>	(0)	(4,800)	
<b>e. UCC</b>	90,000	93,200	.04 × 98,000 = 3,920
<b>Max CCA exp. = .04 × UCC</b>	3,600	3,920	
<b>end UCC</b>	86,400	89,300	

**Net Rental Income before CCA** \$ 4,800

**CCA Exp.**

- Building 2 (3,920)
- Building 1 (4,800 - 3,920)

**Net Rental Income** \$ 0

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**Part B: Becoming a Landlord**

The taxpayer purchased her personal residence in 1989 for \$150,000. This year, she will be moving into a downtown condo.

The taxpayer is debating whether she should:

- a. sell her current house, which the realtor valued at \$360,000, or
- b. whether she should borrow against it for the down payment on the condo and rent the house to tenants.

Ultimately the taxpayer decided to keep the house and rent it to tenants.

**Required:**

Identify (describe/explain) **all the tax consequences** associated with the decision to keep the original personal residence and rent it to tenants. Include the dollar amounts associated with each of the tax consequences, where possible.

This is a change in use. Change in use is a deemed disposition.  
No capital gains on principal residence.  $\$0$  <sup>taxable</sup> capital gain on change in use from residence to rental property. Capital gain is  $\frac{360000}{-150000}$   
Tax. CG  $\frac{210000}{0}$

But.  
New Adjusted Cost Basis and UCC of house rental property will be the FMV of \$360,000 → according to appraisal of realtor. Capital gain will be taxed upon disposition of rental property in future.

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**Question #3: Property Income (10 Marks)**

During the current year, the taxpayer sold the following assets:

		<u>Proceeds</u>	<u>ACB</u>	<u>Selling Expenses</u>
PVP	Boat	\$ 20,000	\$32,000	\$100
LPP	Jewellery	\$ 3,500	\$ 800	Nil
LPP	Stamp Collection	\$ 900	\$ 2,500	Nil
LPP	Rare 1 <sup>st</sup> Edition Book	\$13,500	\$ 6,200	\$100

**(A) Required:**

For each item, calculate the amounts of capital gain or loss that the taxpayer incurs when she sells that item. Show all your calculations to obtain full marks!

**A)**

**Solution:**

<p>1. Jewellery</p> <p>POD 3500</p> <p>Adjusted ACB (1000) ✓</p> <p>Capital Gain 2500 ✓</p>	<p>2. Stamps</p> <p>POD 1000 ✓</p> <p>Adjusted ACB (2500) ✓</p> <p>Capital Loss 1500 ✓</p>	<p>3. Rare Book</p> <p>POD 13500</p> <p>ACB (6200)</p> <p>Sell Exp (100) ✓</p> <p>Capital Gain 7200 ✓</p>
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Handwritten notes: 000 floor to CB & POD, 1000 > 800

**PVP Boat**

POD \$20000

ACB (32000)

Selling Exp (100) ✓

Capital Loss (12100) ✓

**B) LPP**

<p>- Capital Gains (Jewellery 2500, Book 7200) = 9700</p> <p>- Tax. Cap. Gains 4850</p> <p>- Capital Loss (Stamps 1500)</p> <p>- Allowable Capital Loss (750)</p> <p>Total Tax. Cap. Gains from LPP 4100</p>	<p><b>PVP</b></p> <p>Capital Loss of 12100 but no allowable capital loss for PVP</p> <p>tax effect of 0 ✓</p>	<p><b>Total PVP → 0 Tax Effect</b></p> <p><b>LPP</b></p> <p>TCA 4850</p> <p>ACL (750)</p> <p>Incremental Income</p> <p>TCH. \$4100 ✓</p>
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**(B) Required:**

How will the taxpayer report her capital gains or losses on her income tax return from the sale of her boat, her jewelry, her stamp collection and her rare book?

**Show all your calculations to obtain full marks!**

See  
reverse

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**Question #4: Short Answer Problems (32 Marks at 2 Marks per answer)**

Provide only the answer in the right hand column.

Question	Answer ONLY
<p>During the current year, the taxpayer receives \$750 in ineligible dividends from taxable Canadian corporations. What is the amount of Taxable Dividend the taxpayer must report on their Income Tax Return?</p>	<p><math>750 \times 1.25</math>  <math>= \\$937.5</math> ✓ 2</p>
<p>What is the federal dividend tax credit on ineligible dividends?</p>	<p><math>\frac{2}{3}</math> of gross up ✓ 2</p>
<p>The taxpayer has lived in his personal residence continuously since purchasing it in 1996 for \$150,000 and owns no other residences. This year (2012), he sold his house for \$260,000 in a private sale, therefore he did not pay real estate fees. The purchaser paid \$50,000 down and will pay the outstanding balance at a rate of \$70,000 per year over the next three years.</p> <p>The taxpayer would like to defer as much of the tax on the capital gains as possible and has heard of a reserve formula which will accomplish this. Since he is unfamiliar with tax, he has come to you for assistance with this objective. He would like to use the reserve formula to minimize the amount of capital gains he must include in his income tax return in each of the years until the entire proceeds of disposition are collected.</p>	<p>What will be the amount of capital gains the taxpayer must include in this year's (2012) income? ✓ 2  <i>no capital gain for personal residence</i></p> <p>What will be the amount of capital gains the taxpayer must include in next year's (2013) income? ✓ 2  <i>here too</i></p>
<p>During the current year, the taxpayer has been purchasing shares of ATCO Limited, a publicly traded company. Specifically, she purchased 100 shares for \$12.48/share in February, 200 shares for \$13.00/share in April and 500 shares for \$16.50/share in November. Calculate the taxpayer's average cost per share.</p>	<p><math>15.1225/\text{share}</math> ✓ 2  <math>\\$15.12/\text{share}</math></p>
<p>The taxpayer (above) became concerned that the share value will decline. Therefore in December of 2012, the taxpayer sold 500 of the ATCO shares for \$19.00 per share and paid \$230 in broker's fees on the sale. The Broker charged a fee of \$230.00 to handle the transaction. What is the taxpayer's taxable capital gains upon the disposition of her ATCO shares?</p>	<p>* Proceeds 9500          Less cost (7560)          less exp. (230)          CG \$1710 ✓ 2          Tax. Cap. Gain. \$855</p>
<p>What is the amount of the Dividend Gross-up on eligible dividends?</p>	<p>38% ✓ 2</p>

\* NOTE → assume the 230 represents only one cost. if two then deduct  $.5 \times 230$  from Tax. Cap. Gain  
 CG = 1480 & TCG = 740

<p>The taxpayer is a courier, delivering mail and parcels throughout downtown Ottawa. Because the downtown is so crowded, the taxpayer frequently receives parking tickets in the normal course of business and expenses them on the Income Statement. Are these fines deductible for tax purposes also?</p>	<p>NO. ✓ 2</p>
<p>What is the amount of Federal Tax Credit on eligible dividends?</p>	<p><math>\frac{6}{11}</math> of gross up. ✓ 2</p>
<p>Some of the Capital Gains on small business, farming and fishing property is exempt from tax under the Lifetime Capital Gains Exemption. What is the current amount of the Lifetime Capital Gains Exemption?</p>	<p>\$750,000 ✓ 2</p>
<p>How far back can you carry a capital loss?</p>	<p>3 yrs ✓ 2</p>
<p>How far forward can you carry a capital loss?</p>	<p>Indefinitely → ∞ ✓ 2 Indefinitely</p>
<p>How far forward can you carry a loss which occurs from the disposition of Listed Personal Property?</p>	<p>Indefinitely, ∞ years. X Indefinitely.</p>
<p>Several years ago, the taxpayer had purchased shares in a corporation which is publicly-listed on a European stock exchange. The taxpayer sold those shares this year (2012), incurring a \$437 foreign exchange gain. How much of this gain must be reported on the taxpayer's Income Tax Return?</p>	<p><del>gain 437</del> <del>less deductible amt (000)</del> <del>237</del> report full amount of \$437. ✓</p>
<p>For every book he has ever written, Stephen King receives \$1.00 whenever one of those books are sold. What does tax call this type of income?</p>	<p>Royalty. ✓ 2</p>
<p>When a business has an involuntary disposition (for example due to fire, flood or other disaster), they have a specific number of months in which to get their affairs in order and make the election to reverse the capital gains and CCA recapture associated with the involuntary disposition. How many months does the business have?</p>	<p>24 months after year end of business. ✓ 2</p>

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