

## Desautels Faculty of Management

### McGill University

#### Business Taxation 2 - ACCT 486 Midterm Exam

October 20, 2017

## SOLUTION

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#### **Instructions:**

- This is a closed book exam.
- The Income Tax Act allowed.
- You are allowed a 1 page (8 ½ x 11) double sided index sheet
- You are allowed dictionaries.
- The use of regular calculators is allowed.  
Calculators which store text are **NOT** allowed
- This exam consists of 10 questions.
- Total number of pages including cover sheet: 8
- Answer all questions in your exam booklet.

**Question 1 (15 marks)**

Active Business Income – Canada (420,000 + 36,000)	456,000
Taxable Capital Gains	40,000
Interest income	2,000
Dividend Income (15,000 + 20,000)	<u>35,000</u>
Net Income	533,000
Taxable Dividends – S112	(35,000)
Net Capital Losses	<u>(26,000)</u>
Taxable Income	<u>\$472,000</u>

**a) Part I Tax**

Tax @ 38%	\$179,360
Federal Abatement (472,000 x 10%)	(47,200)
Small Business Deduction:	
17.5% of the lesser of:	
1. 456,000	
2. 472,000	
3. $260,000 - [260,000 \times ((13,000,000 - 10,000,000) \times .225\%)] / 11,250 = 104,000$	
	(18,200)
General Rate Reduction:	
13% of (472,000 – 104,000 – (42,000 – 26,000))	(45,760)
10 <sup>2</sup> / <sub>3</sub> % Investment Tax:	
10 <sup>2</sup> / <sub>3</sub> % of the lesser of:	
1. 472,000 – 104,000 = 368,000	
2. 42,000 – 26,000 = 16,000	
	<u>1,707</u>
Part I Tax	<u>\$69,907</u>

**b) Part I Refundable Tax**

Least of:	
A. 30 <sup>2</sup> / <sub>3</sub> % of the Lesser of:	
1. 472,000 – 104,000 = 368,000	
2. 42,000 – 26,000 = 16,000	\$4,907
B. Part I Tax	\$69,907
Refundable Portion is the lesser of the above	<u>\$4,907</u>

**Question 1 – Cont'd****c) Part IV Tax**

Taxable Dividends	
- Non – Connected	\$15,000
- Connected ( $\$27,000 \times 15\%$ )/.383333	<u>10,565</u>
	25,565
	<u>x 38.3333%</u>
	<u>\$9,800</u>

**d) RDTOH account balance at December 31, 2017**

Opening Balance	\$ 11,350
2016 Dividend Refund ( $24,000 \times 38.3333\%$ )	<u>(9,200)</u>
	2,150
Part I Refundable Tax	4,907
Part IV Tax	<u>9,800</u>
Balance 31/12/17	<u>\$16,857</u>

**e) 2017 Dividend Refund**

Lesser of:

- |                         |                  |
|-------------------------|------------------|
| 1. \$16,857             |                  |
| 2. $38,000 * 38.3333\%$ | <u>\$ 14,567</u> |

**Question 2 (10 marks)**ITC's Generated:

\$2,775,000* x 35% =	\$971,250
(\$4,700,000 – 2,775,000) x 15% =	<u>288,750</u>
	<u>\$1,260,000</u>

$$* [(8M - ((\text{greater of } \$500K \text{ or } (300K)) \times 10)] \times [(40M - (13M - 10M)]/40M = 2,775,000$$

ITC Refund:

\$971,250 x 100% =	\$971,250
\$288,750 x 40% =	<u>115,500</u>
	<u>\$1,086,750</u>

ITC Carry Forward:

ITC C/F – 01/01/2017	\$ 82,300
ITC Generated	1,260,000
Less: 2017 ITC Refund	<u>(1,086,750)</u>
ITC C/F – 31/12/17	<u>\$255,550</u>

R & D Carry Forward:

R&D C/F – 31/12/16	\$ NIL
2016 ITC refund	(934,000)
2017 Income inclusion	<u>934,000</u>
R&D C/F – 31/12/17	NIL
2017 ITC Refund	<u>(1,086,750)</u>
R&D C/F – 1/1/18	<u>\$(1,086,750)</u>

The company would also be entitled to CCA on the building which qualifies for the 10% rate.

$$CCA = \$3,000,000 \times 10\% \times \frac{1}{2} = \underline{\underline{\$150,000}}$$

**Question 3 (6 marks)****Total Deemed Dividend**

Redemption amount paid	\$190,000
Less: PUC of shares	<u>80,000</u>
Deemed dividend on redemption	110,000
Less: Capital dividend	<u>44,000</u>
Taxable deemed dividend	<u>\$66,000</u>

**Deemed dividend for Janet: \$6,600 [(800/8,000) x \$66,000]**

**Taxable dividend to be reported: \$6,600 x 1.17 = \$7,720**

**Capital Gain to Janet**

Proceeds of disposition [\$190,000 x (800/8,000)]	\$19,000
Less: deemed dividend	<u>11,000</u>
Adjusted proceeds of disposition	8,000
Less: ACB (800 x \$7)	<u>5,600</u>
Capital gain	<u>\$2,400</u>
Taxable Capital Gain	<u>\$1,200</u>

**Question 4 (5 marks)****Part A**

S256 of the ITA addresses situations when 2 or more corporations are considered to be associated or deemed to be associated.

The 2 simplest provisions:

S256(1)(a) states that if one corporation controls directly or indirectly in any manner whatsoever the other corporation, then these are associated;

S256(1)(b) states that if 2 or more corporations are controlled directly or indirectly in any manner whatsoever by the same person or group of persons, then these corporations are said to be associated.

**Part B**

The rules of Association would have an impact on the following:

1. Sharing of the Annual Business Limit: If not for the Association rules, then a full Small Business Deduction would be available to each corporation, hence having a multiplier effect on the ABL.
2. R&D Expenditures: CCPC's are entitled to a 35% credit on the 1<sup>st</sup> \$3 million of current R&D expenditures. This \$3 million base is to be shared among associated corporations. The ITC credit generated on the 1<sup>st</sup> \$3 million of current R&D expenditures are also fully (100%) refundable if not used against the federal tax liability. The Expenditure Limit Amount of \$3 million is to be shared among associated corporations.

**Question 5 (8 marks)**

Standby Charge:

$$\$525 \times 12 \times \frac{2}{3} \times [13,000 / (1,667 \times 12)] = \$2,729$$

OCB: lesser of:

$$1) \$2,729 \times 50\%; 2) 13,000 \times \$0.25 = \begin{array}{r} 1,365 \\ \underline{\underline{\$4,094}} \end{array}$$

**Question 6 (15 marks)**

1. An acquisition of control has taken place, since Special Lace Ltd. acquired more than 50% of the shares of Undies Ltd., an unrelated party.
2. There will be a deemed year-end on December 31, 2016, which is also the natural year-end of Undies Ltd.
3. Since there is no short year-end, Undies will not have to prorate amounts such as CCA (if claimed).
4. The net capital loss carried forward of \$65,000 as well as any 2016 net capital losses that arise due to the change in control rules cannot be carried forward after the change in control date. Note, an election under paragraph 111(4)(e) may be available which would result in a utilization of the net capital loss.
5. The \$320,000 of non-capital losses will be available to be and used against income of the same or a similar business, which is the case as the same or a similar business is carried on
6. Certain assets will have to be written down to FMV resulting in the following losses:

**Current-year non-capital losses**

Inventory write-down (\$94,000 – \$155,000)	\$61,000
Deemed CCA on machinery & equipment (\$90,000 – \$114,000)	<u>24,000</u>
	<u>\$85,000</u>

The \$85,000 of non-capital loss can be carried forward and used against income of the same or a similar business, which is the case as the same or a similar business is carried on

**Current-year allowable capital losses**

Write-down of securities (1/2 x (\$2,000 – \$8,000))	<u>\$6,000</u>
Net capital-loss	<u>\$3,000</u>

Total net-capital losses subject to expiry: \$68,000 (65,000 + \$3,000)

**Question 6 – Cont'd**Election under S111(4)(e)

Land: (1/2 x (230,000 – 110,000))	60,000
Building: (1/2 x (416,000 – 400,000))	<u>8,000</u>
Taxable capital gain resulting from election	<u>\$68,000</u>
Recapture on Building: (115,000 – 400,000)	<u>\$285,000</u>

Since the recapture resulting from electing on the building is significant for the sake of using \$8,000 of net-capital losses that would otherwise expire, management should not elect on the building.

Tax Accounts balances after the change in control:

Non-capital losses C/F at 31/12/15	\$320,000
Non-capital loss of 2016	<u>85,000</u>
Non-capital losses carried forward	<u>\$405,000</u>

The non-capital losses will be available after the change in control as the same business and/or a similar business will be carried on.

Values of various assets at January 1, 2017 (after the change in control)

	<b>ACB</b>	<b>UCC</b>
Inventory	\$94,000	N/A
Machinery & equipment	90,000	\$90,000
Marketable securities	2,000	N/A
Land	230,000	N/A
Building	400,000	115,000

**Question 7 (16 marks)****Part a:**

Net loss per F/S	\$ (434,000)
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## Add:

Depreciation	16,000
Salary paid to partners	80,000
Taxable capital gain on shares $(42,000 - 30,000) \times \frac{1}{2}$	6,000

## Deduct:

Gain on sale of equipment	(10,000)
Gain on sale of shares of SCFP	(12,000)
CCA	<u>(28,000)</u>
Net income (loss) for tax purposes	<u>\$ (382,000)</u>

**Nature of Income:**

Business loss	\$ (392,000)
Interest income	4,000
Taxable Capital Gain	<u>6,000</u>
	<u>\$ (382,000)</u>

**Part b:****Allocation of loss and income to each of Devlin & Will:**

Allocation of business loss:  $[(392,000) \times 40\%] = (156,800)$   
 Allocation of interest income:  $(4,000 \times 40\%) = 1,600$   
 Allocation of TCG:  $(6,000 \times 40\%) = 2,400$

**Allocation of loss and income to each of Julia & Desmond:**

Allocation of business loss:  $[(392,000) \times 10\%] = (39,200)$   
 Allocation of interest income:  $(4,000 \times 10\%) = 400$   
 Allocation of TCG:  $(6,000 \times 10\%) = 600$

**Question 7 – Cont'd****Part c:**

Since Julia & Desmond are limited partners, they will only be able to deduct the allocated loss up to their "At Risk Amount" as determined on December 31, 2017:

Partnership ACB	\$100,000
Add: share of TCG	600
Add: share on non-taxable capital gain	600
Add: share of interest income	400
Less: amount owed	(40,000)
Less: amount guaranteed above FMV by the general partners	<u>(25,000)</u>
At Risk Amount	<u>\$36,600</u>

Julia & Desmond can each only deduct \$36,600 of the \$39,200 allocated loss in 2017. The balance of \$2,400 is carried forward to future years as a limited partnership loss and may be deducted against future partnership income.

**Part d:**

Partnership ACB at December 31, 2017	\$100,000
Add: share of TCG	600
Add: share on non-taxable capital gain	600
Add: share of interest income	400
Less: 2017 deductible partnership loss	<u>(36,600)</u>
Partnership ACB at January 1, 2018	<u>\$65,000</u>

**Question 8 (12 marks)**

<u>Effect on Income</u>		
Investments: ACL $\frac{1}{2} \times (\$21,500 - \$60,000)$ .....		<u>\$(19,250)</u>
Land: TCG $\frac{1}{2} \times (\$190,000 - 40,000)$ .....		<u>75,000</u>
Building: TCG $\frac{1}{2} \times (\$119,000 - 70,000)$ .....		<u>24,500</u>
Building: recapture $(\$45,000 - \$70,000)$ .....		<u>25,000</u>
Equipment: recapture $(\$8,600 - 1,000)$ .....		<u>7,600</u>
Customer list: TCG: $\frac{1}{2} \times (\$60,000 - 40,000)$		<u>10,000</u>
Income effect .....		<u><u>\$122,850</u></u>

Capital Dividend Account

Investments: $\frac{1}{2} \times (\$21,500 - 60,000)$ .....	<u>\$(19,250)</u>
Land: $\frac{1}{2} \times (\$190,000 - 40,000)$ .....	<u>75,000</u>
Building: $\frac{1}{2} \times (\$119,000 - 70,000)$ .....	<u>24,500</u>
Customer list: $\frac{1}{2} \times (\$60,000 - 40,000)$ .....	<u>10,000</u>
Increase in the CDA.....	<u><u>\$90,250</u></u>

RDTOH Account

Increased by 30  $\frac{2}{3}$ % of \$90,250 (the TCG amount) = \$27,677

**Question 9 (6 Marks)**

Impact on Dana:

If Peppy Ltd. pays the rent for the condominium, Dana will receive a benefit from the corporation. Benefits conferred on a shareholder by a corporation are included in the shareholder's income by virtue of S15(1). There are a few specific exceptions in that subsection, but they relate to the disposition or acquisition of additional shares, none of which is applicable to this particular case. The benefit could not be considered an employee benefit, which would be included in employment income, because the rental payment by the corporation would be made because of Dana's capacity as a shareholder. (It would be unlikely that the corporation would offer similar arrangements to other non-related employees.)

Impact on Peppy Ltd.:

In addition to the amount being taxable to Dana, the amount would not be deductible for tax purposes to Peppy Ltd. An expense is not deductible unless it was incurred for the purpose of earning income from the business. In this case, it is clear that there is no such purpose. The expense would be a personal or living cost. Even if the amount was incurred for purposes of earning income, it would still not be deductible as it is considered a shareholder benefit.

Alternative Plan:

Instead of having the company pay the rent on the condo, Dana should consider receiving additional salary or a bonus to cover the rental cost. As long as the additional remuneration is reasonable, the amounts will be deductible by the corporation.

**Question 10 (7 marks)****Benefit on share purchase loan:**

As there are *bona fide* arrangements in place for repayment of the share purchase loan within a reasonable time, and the loan is one of those within the exceptions of subsection 15(2), the loan amount is not included in Taylor's income.

Interest benefit under section 80.4

$$2015: \$150,000 \times 1\% \times 9/12 = \quad \underline{\$1,125}$$

$$2016: \$125,000 \times 1\% \times 12/12 = \quad \underline{\$1,250}$$

$$2017: \$100,000 \times 1\% \times 12/12 \quad \underline{\$1,000}$$

Under S80.5, the taxable benefit is deemed to be interest paid for the purposes of paragraph 20(1)(c). As the loan is for investment purposes, any actual interest paid, plus the taxable benefit interest, is deductible by Taylor in determining her income for tax purposes.

**Benefit on the motor home and boat loan:**

As the loan for the motor home and boat is not within one of the exceptions provided for under S15(2), and it was not repaid within one year after the 2015 fiscal year end, it is fully included in Taylor's 2015 income.

No imputed interest benefit applies to this loan as S80.4(3) exempts any loan included in income from the imputed interest benefit.

In 2017, Taylor will be able to deduct the \$75,000 she repaid as a deduction under S20(1)(j).