***Canadian Tax Principles, 2022-2023* (Byrd/Chen)**

**Chapter 6 Income or Loss from a Business**

6.1 Online Exercises

1) What are the four major types of income that make up net income?

Answer: The major types of income that make up net income are:

• Income from an office or employment

• Income from a business

• Income from property

• Capital Gains.

Type: ES

Topic: Net income - ITA 3

2) A taxpayer can acquire property for (1) use in a business, (2) for resale by a business, or (3) as investments. For each of these three situations indicate (1) How each of the properties would be categorized for purposes of the ITA, and (2) the nature of the income from each property if the properties were sold.

Answer: Property used in a business is generally categorized as capital property which is further broken down into depreciable and non-depreciable capital property. Non-depreciable capital property generally refers to land and investments such as shares of corporations. The sale of non-depreciable capital property results in capital gains or capital losses. The sale of depreciable property results in recapture, terminal losses and capital gains but not capital losses.

Property purchased for investment purposes is generally categorized as non-depreciable capital property that would result in capital gains or capital losses on their sale. The income from investments however is generally considered income from property but may be considered business income depending upon the strength of the connection between the investments and the underlying business.

Property purchased for resale is generally categorized as inventory the sale of which either increases or decreases business income depending on the results of the sale.

Type: ES

Topic: Types of property

3) The sale of inventories is treated differently than the sale of non-depreciable capital property. Briefly describe the different treatments of these two types of properties.

Answer: The sale of inventory increases or decreases business income and may create a business loss, whereas the sale of non-depreciable capital property results in a capital gain or capital loss. All of the income or loss from the sale of inventory affects income where as only one-half of capital gains or capital losses affect income. In addition capital losses are generally restricted and can only be deducted to the extent there are capital gains.

Type: ES

Topic: Types of property

4) There are many similarities and differences as to the treatment of business income for accounting and income tax purposes. Identify at least four of the notable differences in treatment.

Answer: There are many differences with some of the more notable listed below:

• between CCA and amortization expense,

• warranty costs,

• pension costs,

• business meals and entertainment,

• capital gains,

• automobile costs, and

• scientific research and experimental development (SRED) costs.

At a more conceptual level, there are also differences in the treatment of unreasonable expenditures and expenditures that occur as a result of non-arms' length transactions.

Type: ES

Topic: Reconciliations (accounting to income tax)

5) What is a reserve? Explain briefly the reserve system that is used in the ITA with respect to income from a business.

Answer: A reserve is an income tax mechanism that generally adjusts certain amounts that are initially required to be included in income from a business. The reserves allow a reduction of business income for amounts that have been received in advance, amounts for certain sales that are payable over a number of years and the adjustment of accounts receivables where there is doubt as to the collectibility. The effect is to adjust the business income or loss to better match the realities of what is income that will be ultimately realized. The claiming of reserves is generally optional. A reserve claimed in one year must be added back to income in the second year and another reserve determined based on the circumstances in that year.

Type: ES

Topic: Reserves for businesses

6) List three reserves that can be claimed with respect to a business.

Answer: Although there are other reserves, the three main reserves are:

• reserve for doubtful debts;

• reserve for certain goods and services; and

• reserve for unpaid amounts.

Type: ES

Topic: Reserves for businesses

7) Compare the general process used to determine doubtful debts for accounting purposes with the process for income tax purposes.

Answer: Accountants may simply employ a flat rate percentage to outstanding receivables at year end based on past history and experience.

For income tax purposes a reserve can only be claimed with respect to identifiable receivables that, based on the facts, are likely to be uncollectible. The process requires first identifying the receivables that are doubtful of collection and then determining which specific receivables among those identified will likely not be collected.

Type: ES

Topic: Reserves for businesses

8) The ability to claim a reserve for receivables (e.g. unpaid amounts) produces results that are similar to those that would arise if only cash sales were required to be included in business income. However, the ability to claim this type of reserve is restricted. Describe the restrictions.

Answer: As described in the text, the restrictions are as follows:

• **ITA 20(1)(n)** provides that no reserve can be claimed unless some part of the sale proceeds are not due until at least two years after the date of the sale (this two year requirement does not apply to sales of real property inventory).

• **ITA 20(8)** specifies that no reserve can be claimed in a year if the sale took place more than 36 months before the end of that year. The result is that the reserve is only available for three years. There are additional restrictions that are designed to deny a reserve where the purchaser is a person closely connected to the seller such as a corporation controlled by the seller, or a partnership in which the seller has a majority interest.

Type: ES

Topic: Reserve for unpaid amounts ITA 20(1)(n)

9) ITA 18 lists a number of general limitations that affect what can be claimed as a deduction with respect to a business. Identify four of these limitations.

Answer: General limitations include:

• Must be incurred for the purpose of earning business income.

• No capital expenditures can be deducted unless authorized by the ITA.

• No personal living expenditures.

• No expenses for recreational facilities or club dues.

• No political contributions.

• No reserves unless authorized by the ITA.

• No interest or property taxes on vacant land.

• No safety deposit box fees.

• No prepaid expenses

• No lease cancellation payments unless authorized by the ITA.

Type: ES

Topic: General limitations ITA 18

10) Describe the income tax treatment that applies to interest and property taxes on land.

Answer: If the land is being used to earn business income or the primary reason for acquiring the land was to earn income from the land, interest expenses and property taxes associated with its ownership of that land are fully deductible. For example, the land on which a factory is situated is used as part of the income earning process of a business and, as a consequence, the interest and property taxes would be fully deductible.

If, however, the land does not meet one of the tests for full unrestricted deductibility, interest and property taxes can only be deducted to the extent of any profit earned with respect to that land. For example, if the vacant land is only being used for a parking lot, the interest and property taxes could be deducted to the extent of the profits from the parking.

To the extent that interest and property taxes cannot be deducted, they can be added to the adjusted cost base (ACB) of the land.

A special rule applies to real estate companies whose principal business is leasing, rental or sale, or the development of land. They are permitted to deduct a base level amount, defined as interest at the prescribed rate on a $1 million principal amount. This base amount must be shared amongst companies with a certain connection (e.g. associated corporations which are discussed in Chapter 12).

Type: ES

Topic: Land - interest and property taxes

11) Both employees and individuals carrying on a business as a sole proprietor can claim expenses for a home office. Is the income tax treatment the same? If not describe the differences.

Answer: All employees can deduct a pro rata share of maintenance and utilities where they are permitted by the employer and the facts to require a home office. Employees who receive a portion of their income in the form of sales commissions can claim a broader range of expenses such as property taxes and home insurance. A sole proprietor can claim a broadest range of expenses which are not restricted by the employment income rules. Additional expenses would include mortgage interest and CCA.

Type: ES

Topic: Employment - home office expenses (ITA 8(13))

12) Describe the restrictions imposed on the ability of a business to claim expenses for advertising in foreign media.

Answer: The general rule is that expenditures made in foreign print or foreign broadcast media where the advertising message is directed primarily at the Canadian market cannot be claimed. This restriction does not apply where such foreign media expenditures are focused on non-Canadian markets.

There is an exception to this general rule for foreign periodicals only. Canadian businesses can deduct 100% of advertising costs in foreign publications, without regard to whether it is directed at the Canadian market, provided 80% or more of its non-advertising content is original editorial content. If the periodical cannot meet the 80% threshold then only 50% of these foreign advertising costs are deductible.

Type: ES

Topic: Foreign advertising expenses ITA 19

13) ITA 67 provides a general restriction on the ability to claim a deduction for unreasonable expenses unless the outlay or expense is reasonable in the circumstances. Provide an example of an outlay or expense that would not be considered reasonable in the circumstances.

Answer: Examples include excessive payments to non-arm's length persons such as family members that is disproportionate to the services they have provided. Other examples include unreasonable expenses such as excessive transportation costs not consistent with general business practices such as the use of a private jet for short distance travel.

Type: ES

Topic: Unreasonable expenses ITA 67

14) List and briefly describe three of the exceptions to the rule that only 50% of the cost of meals and entertainment can be deducted.

Answer: The text describes the following exceptions, any three of which would satisfy the requirements of this question:

• Long-haul truck drivers can deduct 80% of these costs.

• The costs incurred by hotels and restaurants in providing meals and entertainment to their customers are fully deductible.

• Meals and entertainment expenses relating to a fund raising event for a registered charity are fully deductible.

• Where the taxpayer is compensated by someone else for the cost of food, beverages, or entertainment, the amounts will be fully deductible.

• When amounts are paid for meals or entertainment for employees and, either the payments create a taxable benefit for the employee, or the amounts do not create a taxable benefit because they are being provided at a remote work location, the amounts are fully deductible to the employer.

• When amounts are incurred by an employer for food, beverages, or entertainment that is generally available to all employees, the amounts are fully deductible. (Maximum of six such special events per year.)

• Meals included in the price of airline, bus, and rail tickets are viewed by the government as immaterial. The food component of the ticket price is deemed to be nil. The result is that there is no need to estimate the meal component of the ticket and therefore no limitation.

Type: ES

Topic: Meals and entertainment expenses ITA 67.1

15) There are two limitations that affect an employer for expenditures and costs incurred with respect to the ownership of automobiles and one that affects an employer when an automobile is leased. Describe these three limitations.

Answer: The three limitations are as follows: (1) The capital cost of a passenger vehicle to the employer is restricted to $30,000 for non-zero emission passenger vehicles and $55,000 for zero-emission passenger vehicles (ZEPV); (2) Interest expenses incurred for either type of passenger vehicles is restricted to a daily maximum of $10 and (3) Leasing expenses are also subject to the same restriction whether the passenger vehicles are Class 10.1 or ZEPVs in Class 54.

Type: ES

Topic: Automobile ownership restrictions (employer)

16) Describe the alternative methods of inventory valuation that can be used for income tax purposes.

Answer: In general inventories can be valued using either (1) FMV or (2) the lower of cost

and FMV.

Type: ES

Topic: Inventory valuation ITA 10

17) Compare the accounting treatment for estimated warranty costs with the income tax treatment.

Answer: For accounting purposes, estimated warranty costs are expensed annually. In general, ITA 18(1)(e) prohibits a warranty expense. Furthermore ITA 20(1) does not generally allow a reserve meaning that warranty costs can only be deducted for income tax purposes when an actual expense is incurred. ITA 20(1)(m.1) is an exception to this general treatment for a very restrictive situation.

Type: ES

Topic: Warranty expenses ITA 18(1)(e)

18) When a taxpayer raises capital by issuing debt obligations, these obligation may be issued at a discount from their principal amount due at maturity. For accounting purposes, this discount is amortized to income as an addition to interest expense. How are these discounts treated for income tax purposes?

Answer: For income tax purposes, discounts on issued debt obligations are not amortized or otherwise added to interest expenses as they are with accounting. This means that deductible interest is based only on cash amounts of interest actually paid. The income tax treatment for the actual discount looks to the maturity date of the debt obligations. If the debt obligations are issued for not less than 97% of their maturity amount and, if the effective yield is not more than 4/3 of the coupon rate, the full amount of the discount can be deducted in the taxation year the debt obligations mature as a business expense. If these conditions are not met, then only 50% of the discount paid on maturity is treated as a business expense in the year that the maturity amount is paid.

Type: ES

Topic: Discount on debt obligations - ITA 20(1)(f)

19) The ability to deduct losses from farming is dependent upon a number of factors. The ITA categorizes farming into three categories. Describe these categories and indicate whether the farm losses are deductible or not and if deductible whether there are any restrictions on deductibility.

Answer: **Hobby Farmers -** These are individuals who farm on a part-time basis primarily for personal purposes without an expectation of a profit. The level of activity is not sufficient to create a business therefore none of the losses can be claimed.

**Full Time Farmers -** These are taxpayers in which farming is generally their principal activity or where the level of the activity is unquestionably a business that is not secondary to any other source of income. The full amount of the farming losses can be deducted against all other sources of income. This category does not preclude the taxpayer having one or more other sources of income, provided these sources are subordinate to farming in terms of the level of activity.

**Part-Time Farmers -** As described in ITA 31, these are farmers whose chief source of income is neither farming nor a combination of farming and some other source of income that is a subordinate source of income. The farming activity would have to be meet the tests for the establishment of a business. Farming losses under this category are restricted by the rules of ITA 31. The first $2,500 of an annual farm loss plus one-half of the next $30,000 (overall maximum of $17,500) can be claimed against all sources of income but the remaining part of the farm loss is restricted and can only be claimed in previous or subsequent years to the extent of farm income from the same farming business in those years.

Type: ES

Topic: Farm losses

20) When a business is sold the business owner ceases to carry on the business. The sale of the business involves the sale of all of its remaining property. Since accounts receivable is a non-depreciable capital property the sale of the receivables would result in either a capital gain or capital loss. The purchaser and seller however can elect to treat the sale of the receivables in a different manner by filing an election under ITA 22. What are the income tax consequences of the election to both the purchaser and seller?

Answer: The sale of the receivables would represent a a capital transaction. This means that any gains and losses from the sale of receivables will, in the absence of any special rules of the ITA, be treated as capital gains and capital losses. In general the sale of receivables typically results in a sale for an amount less than the amounts actually receivable. In this situation the loss would be treated as a capital loss only one-half of which would be deductible on a restricted basis to the extent of capital gains.

With respect to the purchaser of the receivables no amount could be claimed for any doubtful debt reserves or as bad debts since the rules of the ITA only grant that privilege to the original business owner.

These results can be avoided with an election under ITA 22. The election allows the seller to recognize any loss on the sale of the receivables as a fully deductible business expense rather than a restricted capital loss. The election also allows the purchaser to claim any doubtful debt reserve or bad debts with respect to the purchased receivables. The one downside to the purchaser is that any deductible loss on the receivables to the seller is reciprocated to the purchaser who must include that same amount as business income in the year of the purchase of the receivables.

Type: ES

Topic: Accounts receivable election ITA 22

21) The income tax rules for determining business income are identical to those used for determining property income.

Answer: FALSE

Explanation: There are a number of differences between the business income and property income rules.

Type: TF

Topic: Business vs. property income

22) The deduction of CCA cannot be used to create or increase a business loss.

Answer: FALSE

Explanation: The deduction of CCA cannot be used to create a rental property income loss. It can be used however to create a business loss.

Type: TF

Topic: Business losses

23) Differences between business income for income tax purposes and business income for accounting purposes can result in reconciliation adjustments that can be either permanent or temporary.

Answer: TRUE

Type: TF

Topic: Reconciliations (accounting to income tax)

24) When a business incurs expenses that are unreasonable in the circumstances, the unreasonable portion of the expense cannot be deducted in the calculation of either accounting income or business income for income tax purposes.

Answer: FALSE

Explanation: While they cannot be deducted for income tax purposes, the unreasonable portion of an expense can be deducted for accounting purposes.

Type: TF

Topic: Reconciliations (accounting to income tax)

25) If a reserve is deducted for accounting purposes, it can also be deducted for income tax purposes.

Answer: FALSE

Explanation: A reserve can only be deducted for income tax purposes if it is specifically allowed by the ITA. ITA 18(1)(e).

Type: TF

Topic: Reserves for businesses

26) The amounts that can be expensed with respect to bad debts on accounts receivable will generally be the same for both income tax and accounting purposes.

Answer: TRUE

Explanation: While the procedures are somewhat different, the results are generally the same.

Type: TF

Topic: Reserve for bad debts

27) A self-employed individual (e.g. a sole proprietors) cannot claim CCA on a home office in the principal residence of the individual unless it is used exclusively for the purpose of earning income.

Answer: FALSE

Explanation: If the home office is the individual's principal place of business, it does not have to be used exclusively for income earning purposes.

Type: TF

Topic: Employment - home office expenses (ITA 8(13))

28) Landscaping costs can be deducted in the determination of business income, even if the costs include capital expenditures that would normally be disallowed because of ITA 18(1)(b).

Answer: TRUE

Explanation: The opening words of ITA 20(1) overrides the limitation of ITA 18(1)(b).

Type: TF

Topic: Landscaping expenses ITA 20(1)(aa)

29) For the hobby farmer, farming losses can be deducted against any source of income up to $2,500, plus one-half of the next $30,000 in each year.

Answer: FALSE

Explanation: A hobby farmer does not carry on a business there no losses are deductible. The limitation mentioned applies to farmers who are subject to ITA 31 for restricted farm losses.

Type: TF

Topic: Farm losses

30) For income tax purposes, inventories can be valued at FMV, which can mean replacement cost or net realizable value.

Answer: TRUE

Explanation: Inventories can be valued at FMV, which can mean replacement cost or net realizable value.

Type: TF

Topic: Inventory valuation ITA 10

31) When a business ceases to exist and property that was included in inventories is subsequently sold any gain or loss realized on the sale will be treated as a capital gain or capital loss unless an election is made by the seller.

Answer: FALSE

Explanation: The gain will be treated as if the business was still carried on. No election is required for this result. ITA 23.

Type: TF

Topic: Ceasing to carry on business (inventory) ITA 23

32) When almost all of the property used in a business including accounts receivables is sold any loss realized on the sale of the receivables will be treated as a capital loss unless a joint election is jointly filed by the purchaser and seller.

Answer: TRUE

Type: TF

Topic: Accounts receivable election ITA 22

33) In 2022, depreciable property with a capital cost of $100,000 and a UCC balance of $79,400 at the end of the taxation year, is sold for $103,000. The carrying value for accounting purposes was $83,400. What are the income tax consequences of the sale?

A) Recapture of $23,600.

B) A capital gain of $1,500.

C) A capital gain of $3,000 and recapture of $20,600.

D) A capital gain of $23,600.

Answer: C

Explanation: C) A capital gain of $3,000 and recapture of $20,600.

Type: MC

Topic: Types of income

34) Which of the following would be considered to be business income rather than property income or capital gains?

A) Gains from the sale of capital property that were used in a business

B) Gains from the sale of capital property used to earn property income

C) Gains from the sale of inventory

D) Both A and C

Answer: C

Explanation: C) Gains from the sale of inventory

Type: MC

Topic: Types of income

35) Fung Wo purchased vacant land on a remote island off the coast of British Columbia on January 1, 2019 for $50,000. She intended to re-sell it for a profit the next year but due to an oil spill, property values dropped. She was finally able to sell the vacant land for $45,000 on December 31, 2022. In the meantime, she paid property taxes of $500 each year. What are the income tax consequences of the sale in 2022?

A) an allowable capital loss of $2,500.

B) an allowable capital loss of $3,500.

C) a business loss of $5,000.

D) a business loss of $7,000.

Answer: D

Explanation: A) Allowable Capital Loss of $2,500 ($45,000 —$50,000) × 50% = $2,500

B) Allowable Capital Loss of $3,500[($45,000 - ($2,000 + $50,000)] × 50% = $3,500

C) Business Loss of $5,000 ($45,000 —$50,000) × 100% = $5,000

D) Business Loss of $7,000 [($45,000 - ($2,000 + $50,000)] × 100% = $7,000. Property taxes on the land would be subject to ITA 18(2) and added to the cost of the land. The sale of the land would be considered an adventure of concern in the nature of trade and treated as a business. with the land treated as inventory

Type: MC

Topic: Types of income

36) Jerry has collected baseball cards as a hobby for most of his life. During the current year, he acquired twenty-five specially selected cards at a total cost of $29,550. He sold the cards shortly thereafter for $55,900. What are the income tax consequences of the sale of the cards?

A) Jerry has a taxable capital gain of $26,350.

B) Jerry has a taxable capital gain of $13,175.

C) Jerry has business income of $26,350.

D) Because the collection was a hobby, the gain does not have to be included in income.

Answer: C

Explanation: C) Jerry has business income of $26,350.

D) The cards Jerry acquired were not part of his collection given that they were acquired for the purpose of a quick resale. At a minimum this would be an adventure or concern in the nature of trade which is treated as a business.

Type: MC

Topic: Types of income

37) Marvin purchased a large piece of land 5 years ago when a highway bypass was rumoured to have an exit being built nearby. He had planned to subdivide the land into building lots within 5 years, but has done no work on the land yet. He has rented the land each summer over the Labour Day weekend for $500. A local non-profit organization holds a huge neighbourhood garage sale on that weekend. A recent heart attack has convinced Marvin to slow down. As a result, he has advertised the land for sale online and an interested buyer is offering to purchase it at a price that would result in a large gain. What would be the character if the gain?

A) property income.

B) business income.

C) a capital gain.

D) a taxable capital gain.

Answer: B

Explanation: B) business income. It appears that a business has been created as Marvin has devoted time, attention and labour towards an activity with the intent of a profit. Given this finding the rental income earned would be incidental to the business and would be considered business income and not property income.

Type: MC

Topic: Types of income

38) Which of the following statements is **NOT** correct with respect to business income?

A) An income tax based business reserve that is claimed in the current taxation year, must be added back to income in the following taxation year.

B) Bad debts that are deducted in a previous taxation year and recovered in a subsequent taxation year must be added to business income in that subsequent year.

C) Amounts received in advance for goods to be delivered or services to be provided in a subsequent taxation year must be included in business income when received.

D) As long as some part of any sale proceeds for goods sold or services rendered is not collectible until a subsequent taxation year, a reserve for uncollected amounts can be claimed.

Answer: D

Explanation: D) While there are circumstances where this may be the case (ITA 20(1)(n)) there is no general rule that would allow reserves to be claimed in any situation involving uncollected amounts.

Type: MC

Topic: Reserves for businesses

39) A business may may receive advances for goods or services to be delivered or services to be provided in a subsequent taxation year. How are these advances treated for income tax purposes?

A) included in income when the goods or services are delivered or the services provided

B) included in income within 180 days of the end of the taxation year.

C) allocated to income over the period between the time the cash is received and the time the goods and services are delivered or services are provided.

D) included in income in the taxation year in which the advance is received.

Answer: D

Explanation: D) Required to be included in income in the taxation year in which the advance is received. An optional reserve is permitted to offset the inclusion.

Type: MC

Topic: Advances ITA 12(1)(a)

40) In 2021, Marg's Antiques claimed a reserve for doubtful debts of $12,000. In 2022, she had actual bad debt write-offs of $12,500 and recoveries of previously written off bad debts of $1,500. At the end of 2022, she claimed a reserve for doubtful debts of $14,000. Marg's 2022 net deduction for doubtful and bad debts would be:

A) $12,500.

B) $11,000.

C) $13,000.

D) $14,000.

Answer: C

Explanation: C) C. $13,000 ($12,000 (ITA 12(1)(d)) - $12,500 (ITA 20(1)(p)) + $1,500 -(ITA 12(1)(i)) - $14,000 (ITA 20(1)(l)))

Type: MC

Topic: Reserves for businesses

41) Ed's Appliances Ltd (Ed's) sold a furnace to a customer in October, 2022 for $10,000. The mark-up on the $5,000 cost of the furnace was 100%. The customer paid 20% of the purchase price on delivery, with the remainder of the purchase price due in March 2023. What is the maximum reserve Ed's can claim for the taxation year ending November 30, 2022?

A) $2,000.

B) $4,000.

C) $6,000.

D) $8,000.

E) None of the above.

Answer: E

Explanation: E) None of the above. No reserve is allowable under ITA 20(1)(n) as the entire proceeds are due within two years of the sale.

Type: MC

Topic: Reserve for unpaid amounts ITA 20(1)(n)

42) Myrle Cocco owns an automobile that she uses both in a business she carries on as a sole proprietor and for personal use. The cost of the automobile was $28,000 and, on January 1, 2022, the UCC was $11,662. The automobile is the only property in the class. During the year she drives the car a total of 42,000 kilometers of which 38,000 were for business purposes and 4,000 kilometers for personal use. Car insurance for the year was $950 and other operating costs were $6,500. What is the maximum amount she can claim in 2022 for the automobile?

A) $9,906.

B) $10,239.

C) $17,292.

D) $10,949.

Answer: B

Explanation: A) $9,906 [(30%)($11,662) + $950 + $6,500][38,000 ÷ 42,000]

B) $$10,239 [(30%)($11,662) + (38,000 ÷ 42,000)($950 + $6,500)].

C) $17,292 [(38,000 ÷ 42,000)($11,662 + $950 + $6,500)]

D) $10,949 [(30%)($11,662) + $950 + $6,500]

Type: MC

Topic: Automobile expenses (business)

43) Which of the following items can **NOT** be claimed as a business deduction?

A) Premiums on a life insurance policy on a business owner's life that is a requirement of a bank that has extended a business loan.

B) The cost of advertising on a U.S. television station that is directed to attracting customers in Florida.

C) Reasonable fees paid to the business owner's spouse for maintaining the books and records of the business.

D) Parking fines incurred by delivery vehicles making deliveries in congested areas.

Answer: D

Explanation: D) Parking fines incurred by delivery vehicles making deliveries in congested areas. These costs would be specifically disallowed by ITA 67.6.

Type: MC

Topic: Limitations on deductions

44) X Co. can deduct life insurance premiums paid providing:

A) the life insurance policy is required as security on a loan from a financial institution.

B) the interest payable on the loan for which the life insurance is required is deductible by X Co. for income tax purposes.

C) the premium paid is for insurance on the president of X Co.

D) Both A and B.

E) All of A, B, and C.

Answer: D

Explanation: D) Both A and B.

Type: MC

Topic: Life insurance premiums ITA 20(1)(e.2)

45) Maxine is the sole proprietor of a home based business. She paid $25,000 to her editorial assistant, $8,000 to her son as her computer technician, and $32,000 she withdrew from the business as salary. Had she not employed her son she estimates that the cost of equivalent work would have been $11,000. How much can she deduct as a business expense with respect to these three amounts?

A) Nil.

B) $25,000.

C) $33,000.

D) $65,000.

Answer: C

Explanation: C) $33,000 ($25,000 + $8,000). A sole proprietor cannot employ themselves therefor the withdrawal is not salary.

Type: MC

Topic: Business expenses (general)

46) Jon Bogen carries on a consulting business as a sole proprietor out of a dedicated space in his home. It is his principal place of business. Which of the following home office expenses can he deduct?

A) Jon can only deduct a pro rata share of operating costs and utilities.

B) Jon can only deduct a pro rata share of operating costs, utilities, and property taxes.

C) Jon can only deduct a pro rata share of operating costs, utilities, property taxes, and mortgage interest.

D) Jon can deduct a pro rata share of operating costs, utilities, property taxes, mortgage interest and CCA.

Answer: D

Explanation: D) Jon can deduct a pro rata share of operating costs, utilities, property taxes, mortgage interest and CCA.

Type: MC

Topic: Business - home office expenses (ITA 18(12)

47) Omar owns and manages a business he carries on as a sole proprietor. In 2022, an automobile which he leases was driven 10,000 kilometers for business purposes and 12,000 kilometers for personal use. The total automobile related expenses for 2022 were as follows:

Lease payments $7,200

Insurance 1,000

Other Operating Expenses 1,300

For income tax consequences are:

A) business deduction of $4,318 and a taxable benefit of $0.

B) business deduction of $5,182 and a taxable benefit of $0.

C) business deduction of $9,500 and taxable benefit of $8,280.

D) business deduction of $9,500 and taxable benefit of $7,700.

Answer: A

Explanation: A) Business deduction of $4,318 [($7,200 + $1,000 + $1,300) × 10,000/22,000]; and a taxable benefit of $0 Note: D would be the correct answer if the business was incorporated and owned the car. The business deduction would belong to the corporation.

Standby charge = $4,800 [(2/3)($7,200)].

Operating cost benefit would be $3,480 [12,000 @ $.29].

B) Deduction of $5,182 [($7,200 + 1,000 +1,300) × 12,000/22,000]; benefit of $0

C) Deduction of $9,500; benefit of $8,280(standby $4,800 + ops. cost $3,480)

D) Deduction of $9,500; benefit of $7,700 (standby $4,800 + ops. cost $2,900)

Type: MC

Topic: Automobile expenses (business)

48) Jean Brochet uses an automobile in a business he carries on as a sole proprietor. The automobile cost $53,000 in 2021 and is not a ero-emission vehicle, with maximum CCA claimed in that year. Assume that the automobile was eligible for the AccII. The purchase was financed with a bank loan of $37,000. In 2022, the interest on this loan totaled $4,440. The automobile is used exclusively for business purposes, with the 2022 operating expenses totaling $7,500. What is the maximum automobile deduction that can be claimed for 2022?

A) $16,100.

B) $16,890.

C) $24,665.

D) $19,875.

Answer: A

Explanation: A) $16,100 [($16,500)(30%) + (365)($10) + $7,500]

Type: MC

Topic: Automobile expenses (business)

49) Which of the following expenses would be denied as a deduction under the *Income Tax Act*?

A) A speeding ticket received by a truck delivering goods.

B) The costs of disability related building modifications.

C) Work space in a home costs for an individual carrying on a home-based business.

D) A reserve for doubtful accounts receivables.

Answer: A

Explanation: A) A speeding ticket received by a truck delivering goods for resale. ITA 67.6

Type: MC

Topic: Business expenses (general)

50) Antonio Capellini is an accountant providing tax and accounting services as a sole proprietor. He meets all of his clients in his office in the basement of his home. 800 square feet is considered to be attributable to his home office plus common areas. The house is 3,000 square feet of livable space. Antonio incurred the following expenses in the current year:

Business liability insurance $ 400

House insurance 880

House utilities 2,600

House repairs and maintenance 3,000

Mortgage interest 5,700

Property tax 1,600

Office supplies 760

What is the maximum expense that can be claimed with respect to the amounts listed above?

A) $1,160

B) $2,888

C) $3,675

D) $4,835

Answer: D

Explanation: A) 400 + 760 = $1,160

B) ($880 + $2,600 + $3,000)(26-2/3%) + 1,160 = $2,888

D) House insurance $ 880

House utilities 2,600

House repairs and maintenance 3,000

Mortgage interest 5,700

Property tax 1,600

Total $13,780

Percentage (800 ÷ 3,000) 26-2/3%

Deductible portion $3,675

Business liability insurance 400

Office supplies 760

Total $4,835

Type: MC

Topic: Business - home office expenses (ITA 18(12)

51) Kyle purchased a large lot on a lake in anticipation of building his home there within 3 years. In the current year, Kyle paid $650 in property taxes and $2,500 of interest on the demand loan he obtained to purchase the lot. January to March he rented out the lot to a local snowmobile club for $1,500. The amount charged is chosen to allow Kyle to recover some of his costs. Which of the following statements is correct?

A) .Kyle can deduct the $650 of property taxes paid and $850 of the interest paid

B) Kyle can deduct the $650 of property taxes paid, but none of the interest paid.

C) Kyle cannot deduct any of the property taxes or interest paid for the vacant lot.

D) Kyle can deduct all of the property taxes and interest paid.

Answer: C

Explanation: C) The limitation that restricts claiming interest and property faxes (ITA 18(2)) is premised on the ability to otherwise deduct those amounts which requires there to be a source of income. The land was acquired for personal purposes only and the subsequent fees charged were only enough to cover costs. In other words there is no source of income meaning that ITA 18(2) cannot apply. None of the interest and property taxes can be added to the cost of the land as a result.

Type: MC

Topic: Land - interest and property taxes

52) Tomas began carrying on a home-based business as a sole proprietor on January 1, 2022. In 2022, he received $40,000 cash for services rendered and paid $33,000 in business expenses. On December 31, 2022 there was an outstanding accounts receivable for amounts owed by a customers. of $1,200 There was also an account payable of $2,300 as an amount owing to a supplier.

In addition to any business expenses, Tomas can also deduct one-third of his house expenses since he utilizes the ground floor of his rented 3-storey home. Total house costs for 2022 were: rent of $19,200; home insurance of $800 and utilities of $2,100. What is Tomas' maximum 2022 home office expense?

A) $5,900.

B) $7,000.

C) $7,100.

D) $7,367.

Answer: A

Explanation: A) $40,000 — 33,000 +1,200 — 2,300 = $5,900 net income before home expenses (can't create a loss)

B) ($40,000 — 33,000) = $7,000 cash basis net income before home expenses

C) ($19,200 + 2,100) × 1/3 = $7,100

D) ($19,200 + 800 + 2,100) × 1/3 = $7,367

Type: MC

Topic: Business - home office expenses (ITA 18(12)

53) Busy Company incurred the following meal expenses in 2022:

Meals with Clients:

Cost of clients' and employees' meals $10,000

Gratuities (tips) 1,500 $11,500

Company Christmas Party 4,100

Management Dinner Meetings 1,800

Picnic (Management only) 1,200

Meal allowances paid to employees during eligible business travel

(100 days @ $51 per day) 5,100

Total $23,700

The total deductible meal expense is:

A) $11,100.

B) $11,850.

C) $13,300.

D) $13,900.

Answer: D

Explanation: A) ($23,700 — 1,500) × 50% = $11,100

B) $23,700 × 50% = $11,850

C) [ ($11,500 + 1,800 + 5,100) × 50% ] + (4,100 × 100%) = $13,300

D) [($23,700 - $4,100) × 50% ] + (4,100 × 100%) = $13,900

Type: MC

Topic: Meals and entertainment expenses ITA 67.1

54) 888 Company leased a passenger vehicle throughout 2022 for $950 per month, $75 of which was for insurance. The lease was entered into at the beginning of 2022. There was no down payment or refundable deposit. The manufacturer's suggested list price for the car is $48,000. Other costs incurred for the vehicle in 2022 were $1,600 for gas and $420 for repairs. What is the maximum amount that can be claimed for these expenses in 2022?

A) $10,770.

B) $12,670.

C) $11,670.

D) $13,420.

Answer: B

Explanation: A) $8,750 + $1,600 + $420 = $10,770

B) $8,750 + ($75 × 12) + $1600 + $420 = $12,670

Lease payments — least of:

a) Actual lease payments ($950 -75) × 12 = $10,500

b) Basic formula ($900 × 365/30) = $10,950

c) Anti Avoidance formula [$10,500 × $34,000/(.85 × 48,000)] = $8,750

C) $8,750 + ($75 × 12) + $1,600 + $420 = $11,670

D) $10,500 + ($75 × 12) + $1,600 + $420 = $13,420

Type: MC

Topic: Automobile expenses (business)

55) With respect to In terms of the ability to claim a business expense which of the following statements is **CORRECT**?

A) A corporation can deduct the expenses of issuing new common shares in the year in which the shares are issued.

B) Any premium on the sale of new debt obligations by a corporation is amortized over the life of the obligations.

C) Cost of good sold can be determined using inventory valuation methods based on either replacement cost or net realizable value.

D) Landscaping costs are deductible in the year that the expenditures are accrued.

Answer: C

Explanation: C) Cost of goods sold can be determined using inventory valuation methods based on either replacement cost or net realizable value.

Type: MC

Topic: Business expenses (general)

56) For which of the following inventory valuation approaches **CANNOT** be used for income tax purposes to track inventory cost?

A) Last-In, First-Out.

B) First-In, First-Out.

C) Specific Identification.

D) Average Cost.

Answer: A

Explanation: A) Last-In, First-Out.

Type: MC

Topic: Inventory valuation ITA 10

57) Which of the following items is **NOT** deductible in calculating business income for the current taxation year?

A) An $11,000 legal fee paid for services rendered in conjunction with a new issue of the company's common stock.

B) A $125,000 management bonus paid 125 days after the end of the corporation's current taxation year.

C) An amount of $25,000 paid for planting large maple trees in various locations around a building of the business.

D) An unfunded accrued pension expense of the employer.

Answer: A

Explanation: A) The expense would be capital and therefore denied by ITA 18(1)(b). ITA 20(1)(e) however allows an expense but generally over a five year period and as a result the whole amount of $11,000 would not be deductible.

B) The management expense is allowed if reasonable and if paid within 180 days of the taxation year end.

C) Planting trees are capital expenditures and therefore disallowed by ITA 18(1)(b). ITA 20(1)(aa) however allows landscaping costs if the conditions of ITA 20(1)(aa) are met.

D) A pension contribution is generally considered a capital expenditure which would be denied by ITA 18(1)(b). ITA 20(1)(qq) however allows a deduction but only of the pension amount is actually paid.

Type: MC

Topic: Business expenses (general)

58) Which of the following business expenses is deductible?

A) $25 late filing penalty charged by CRA.

B) $50 speeding ticket incurred while delivering goods to a customer.

C) $15 late payment interest charged by utility company.

D) $20 late payment interest charged by CRA.

Answer: C

Explanation: A) ITA 18(1)(t) prevents an expense for amounts charged under the ITA including interest and penalties.

B) ITA 67.6

C) $15 late payment interest charged by utility company

D) ITA 18(1)(t) prevents an expense for amounts charged under the ITA including interest and penalties.

Type: MC

Topic: Business expenses (general)

59) Which of the following is a deductible business expense for a sole proprietorship?

A) Donation made to the United Way.

B) Contribution made to the Federal Green Party.

C) Estimated cost of providing warranty services in future taxation years.

D) Reasonable salary paid to a relative.

Answer: D

Explanation: A) Donations are considered eligible for tax credits for individuals and a taxable income deduction for corporations. There is no business expense allowed.

B) Same as "A" except political contributions are only eligible for tax credits for both sole proprietors and corporations.

C) Estimated warranties are not allowed as a result of ITA 18(1)(e).

D) Reasonable salary paid to a relative

Type: MC

Topic: Business expenses (general)

60) Old Time Company purchased a used Class 10 truck many years ago for $8,000. The truck has now become a collectors' item and was sold on August 1, 2022 for $10,000. The carrying value for accounting purposes on that date was $500. The UCC of the class was $11,525. There are other Class 10 property in the class on the last day of the taxation year. Accounting net income before tax for the year ended December 31, 2022 was $24,000. Accounting amortization was equal to the CCA claimed for income tax purposes. Net income for 2022 is:

A) $15,000.

B) $15,500.

C) $25,000.

D) $26,000.

Answer: B

Explanation: A) $24,000 — 10,000 + (2,000 × 50%) = $15,000

B) $24,000 - accounting gain (10,000—500) + taxable capital gain (2,000 × 50%) = $15,500

C) $24,000 + (2,000 × 50%) = $25,000

D) $24,000 + (2,000 × 100%) = $26,000

Type: MC

Topic: Reconciliations (accounting to income tax)

61) Maria carries on the business of an accounting practice as a sole proprietor in Victoria, B.C. In 2022 she paid $1,650 to attend the following conventions:

• $400 for a 2 day convention on "Tax issues for the owner/manager" held at Vancouver, B.C.

• $500 for a 3 day convention on "Attracting new clients" held at Kelowna, B.C.

• $750 for a 5 day convention on "IFRS implementation" held at Whistler, B.C.

The fees included all meals served during the convention. Maria's total deductible convention expense for tax purposes is:

A) $1,650.

B) $1,250.

C) $1,050.

D) $825.

Answer: C

Explanation: A) ($500 + 750 + 400) = $1,650

B) ($500 + 750) = $1,250

C) ($500 + 750) — [( 3 + 5) × ($50 × 50%) = $1,050 limit is 2 conventions, $50/day deemed meals × 50%. The interaction with the 50% meal restriction means that a choice must be made among the three conferences. The first conference results in a deduction of $350; the second a deduction of $425 and the third a deduction of $625 therefore conferences two and three are selected as resulting in the larger deductions.

D) ($500 + 750 + 400) × 50% = $825

Type: MC

Topic: Convention expenses ITA 20(10)

62) Widget Production Ltd. has a taxation year end of June 30. In February 2020, the Company borrowed $750,000 to fund an expansion. The Company paid $21,000 to obtain this financing. In January 2021, the Company repaid $250,000 of the principal and in June 2022, it repaid the remaining $500,000. The repayment was not financed from other borrowings. Describe the income tax treatment of the $21,000 in financing costs?

A) $4,200 is deducted n each of the 2020 to 2024 taxation years.

B) $4,200 is deducted in 2020 and 2021, and the remaining $12,600 in 2022.

C) $4,200 is deducted in 2020, $8,400 in 2021, and $8,400 in 2022.

D) $7,000 is deducted in 2021 and $14,000 in 2022.

Answer: B

Explanation: B) Financing costs may be deducted on a straight-line basis over a five-year period (ITA 20(1)(e)). However, if the debt is repaid in full without any new debt being incurred, the undeducted balance of financing costs may be deducted in the year the borrowings are repaid.

Type: MC

Topic: Financing expenses ITA 20(1)(e)

63) Quality Homes Ltd. (Quality) has a December 31 taxation year end. The controller has calculated the Company's 2022 net income as $50,000. However, in arriving at this amount, the controller deducted $30,000 of salary to an employee who is the sole shareholder of the Company and $5,000 of salary to an arm's length employee. Both of these amounts were paid on June 30, 2023. Which one of the following represents Quality's 2022 net income?

A) $50,000.

B) $55,000.

C) $80,000.

D) $85,000.

Answer: D

Explanation: D) $85,000 ($50,000 + $30,000 + $5,000). The salaries cannot be deducted because they are not paid by the 179th day which would be June 28, 2023.

Type: MC

Topic: Unpaid remuneration ITA 78(4)

64) Mary carries on business as a sole proprietor that generated $100,000 in net accounting income.

Included in this amount are:

• $7,000 of amortization expense;

• $4,000 for bad debt expense;

• $112,000 cost of goods sold; and

• $12,000 meals and entertainment with clients.

Mary's maximum CCA has been calculated at $10,000 for the year. What is Mary's business income for income tax purposes?

A) $113,000

B) $109,000

C) $107,000

D) $103,000

Answer: D

Explanation: A) $100,000 + $7,000 + $6,000 = $113,000

B) $100,000 + $7,000 + $12,000 - $10,000 = $109,000

C) $100,000 + $7,000 + $6,000 + $4,000 - $10,000 = $107,000

D) $100,000 + $7,000 (ITA 18(1)(b) amortization) + $6,000 (ITA 67.1 50% of meals and entertainment) - $10,000 (ITA 20(1)(a) CCA) = $103,000

Type: MC

Topic: Reconciliations (accounting to income tax)

65) Jon Avery commences carrying on business as a sole proprietor on December 1, 2022. Which of the following statements is correct with respect to the fiscal period of Jon's business?

A) Jon must select December 31 as his fiscal period.

B) Jon must select November 30 as his fiscal period.

C) Jon can choose any date for his fiscal period. However, if Jon chooses a non-calendar fiscal period he will have to adjust his income by an amount referred to as "additional business income".

D) Jon can choose any date for his fiscal period. However, if Jon chooses a non-calendar fiscal period he will have to include business income for his first two fiscal periods in his net income for 2023.

Answer: C

Explanation: C) Jon can choose any date for his fiscal period. However, if Jon chooses a non-calendar fiscal period he will have to adjust his income by an amount referred to as "additional business income".

Type: MC

Topic: Fiscal period

66) In 2022, a corporation sells its business in an arm's length transaction for proceeds equal to FMV. At the time of the sale the business has accounts receivable of $123,000. The corporate vendor of the business and the purchaser agree that the realizable value of the receivables is $118,500. In 2021, the vendor had deducted a reserve for doubtful debts of $6,800. Which of the following statements is correct?

A) If no joint election is filed under ITA 22, the vendor will have an addition to business income of $2,300.

B) If no joint election is filed under ITA 22, the vendor will have an addition to business income of $6,800 and an allowable capital loss of $2,250.

C) If a joint election is filed under ITA 22, the vendor will have a business deduction of $2,300.

D) If a joint election is filed under ITA 22, the vendor will have a business deduction of $4,500.

Answer: B

Explanation: A) $6,800 - $4,500 loss on the sale of receivables

B) $4,550 [$6,800 - (1/2)($23,000 - $118,500)]

Type: MC

Topic: Accounts receivable election ITA 22

67) Which of the following statements regarding farming income is correct?

A) A full time school teacher has income from farming on a part-time basis. The farming income must be determined on a cash basis.

B) A full time school teacher recognized a $9,500 loss this year from farming on a part-time basis. The maximum deduction allowed this year from the farm loss is $6,000.

C) A full time school teacher recognized a $9,500 loss this year from farming on a part-time basis. The maximum deduction allowed this year from the farm loss is $2,500.

D) A full time school teacher has income from farming on a part-time basis. No losses are deductible until a year in which there is farming income.

Answer: B

Explanation: B) $2,500 + [(1/2)($9,500 - $2,500)] = $6,000

Type: MC

Topic: Farm losses

68) Martin Elwood has purchased the rights to a number of songs written by the Ringtones. He estimates that these songs will produce annual royalties of $100,000 for at least 5 years. He does not have plans to acquire additional song rights. Explain whether the royalties he receives would be treated as business income or property income. In addition, indicate how any gain or loss on a disposition of the rights would be treated for income tax purposes.

Answer: In general is business is defined as time, attention and labour devoted to an activity that is potentially capable of generating a profit. A business is generally contrasted with investments that generate income from property where there is little effort involved and income is generated by awaiting investment returns. The limited facts suggest that the purchased of rights, which constitutes "property" for income tax purposes is an investment resulting in income from property. Had the rights been purchased and immediately sold an argument could be made that the purchase was part of an adventure or concern in the nature of trade although this is not supported by the limited facts. The conclusion is that the activity is property income and that the rights would be considered non-depreciable capital property. which would result in a capital gain or a capital loss on disposition.

Type: ES

Topic: Types of income

69) William Lemay acquired a six unit apartment building for $315,000 with the intention of operating it as a rental property. Three weeks after the purchase, he received an unexpected offer to purchase the building for $387,000. He accepts the offer. Should the $72,000 be treated as a capital gain or as business income? Justify your conclusion.

Answer: Based on the facts the rental property would be considered a source of property income and not inventory connected to a business that is an adventure or concern in the nature of trade. As a result a sale would be treated as a capital gain and not business income.

Type: ES

Topic: Types of income

70) Several years ago, John Martin purchased a number of internet domain names at a cost of $1,000 each, hoping at some point that he could sell them at a later date for a gain. Until this year, none of the names have been sold although efforts were made by John to sell them. During this year, two of the names were sold for $25,000 each. Should the resulting gains be treated as capital gains or as business income? Justify your conclusion.

Answer: An activity constitutes a business if time, attention and labour is devoted to an activity that is potentially capable of making a profit. The limited facts suggest that the activity is supportive of a business. In that case the property (e.g. the domain names) would be considered inventory. At a minimum the activity could also be considered an adventure or concern in the nature of trade withe the same result - a business and inventory. Any gains on the sale of the names would be considered business income.

Type: ES

Topic: Types of income

71) At the end of its 2021 fiscal period, Barton's Books, a sole proprietorship, has ending accounts receivable of $87,500. Of this amount, it is estimated that $3,400 are doubtful of collection. A reserve for income tax purposes is claimed for this amount. In 2022, $3,600 of accounts receivable are written off. as bad debts At the end of its 2022 fiscal period, accounts receivable total $103,200, with $4,100 of this amount considered doubtful of collection. What are the income tax consequences with respect to the accounts receivables for the 2022 fiscal period?

Answer: The accounts receivables events will result in a decrease in the business income for the 2022 fiscal period:

Add: 2021 reserve ITA 12(1)(d) $3,400

Deduct:

2022 Bad debt Write-Offs ITA 20(1)(p) ($3,600)

2022 Doubtful debt reserve ITA 20(1)(l) ( 4,100) ( 7,700)

2022 Net effect on business income ($4,300)

Type: ES

Topic: Bad debts and reserve for doubtful debts

72) During its 2022 fiscal period, Leslie's Boutique, a sole proprietorship, wrote off $13,000 in bad debts. At the end of its 2022 fiscal period the accounts receivable balance was $256,400. Based on past experience, it is expected that 4% of these accounts will prove uncollectible. A detailed analysis of 2022 receivables applying the approach acceptable to the CRA results in a doubtful debt reserve of $8,780. In its 2021 fiscal period, Leslie's Boutique had claimed a reserve for doubtful debts of $12,300. By what amount will the business income of Leslie's Boutique for the 2022 fiscal period be increased or decreased as a result of these accounts receivables transactions?

Answer: Business income for the 2022 fiscal period will decrease by $10,956 calculated as follows:

Add: 2021 reserve ITA 12(1)(d) $12,300

Deduct:

2022 Bad debt Write-Offs ITA 20(1)(p) ($13,000)

2022 Doubtful debt reserve ITA 20(1)(l) (8,780)

( 21,780)

2022 Net effect on business income ($ 9,480)

Type: ES

Topic: Bad debts and reserve for doubtful debts

73) Frank's Auto Body, a sole proprietorship, keeps its accounting books and records on a cash basis. During its 2022 fiscal period, its first year of operation, the business has cash sales of $71,200. At the end of the fiscal period, an additional $22,450 of revenues are receivable. Of the amounts received, $7,100 was for services that will only be delivered in the 2023 fiscal period. Frank estimates that $650 of the 2022 receivables are doubtful of collection. What is the business income for the 2022 fiscal period?

Answer: The amount to be included in business income for the 2022 fiscal period would be calculated as follows:

Cash Sales $71,200

Sales on account 22,450

Reserve for future services ITA 20(1)(m) ( 7,100)

Reserve for Doubtful Debts ITA 20(1)(l) ( 650)

Business income for 2022 $85,900

Type: ES

Topic: Reserve for doubtful debts and unearned advances

74) Bob's Hats is a business carried on as a sole proprietorship. During its 2022 fiscal period, its first year of operations, the business has cash sales of $123,000. It also has sales on account of $46,000, of which $22,000 remains outstanding at the end of the 2022 fiscal period. It is estimated that $4,000 of the accounts receivable will be doubtful of collection. Of the cash received, $9,500 represents advances is for merchandise that will only be delivered in the 2023 fiscal period. What is the business income for the 2022 fiscal period?

Answer: The amount to be included in business income for the 2022 fiscal period would be calculated as follows:

Cash Sales $123,000

Sales on account 46,000

Reserve for future services ITA 20(1)(m) ( 9,500)

Reserve for Doubtful Debts ITA 20(1)(l) ( 4,000)

Business income for 2022 $155,500

Type: ES

Topic: Reserve for doubtful debts and unearned advances

75) During the month of February, 2022, Jacob's Jewels sells a brooch for $428,000. The cost to the business of the brooch was $212,000, resulting in a gross profit of $216,000. The $428,000 sales price is to be paid in four equal annual instalments on December 31 in each of the 2023 through 2026 fiscal periods. Jacob's Jewels has a December 31 fiscal period year end. What are the income tax consequences for each of the 2022 to 2026 fiscal periods on the business income.

Answer: Since a part of the sale proceeds are only due more than 2 years, after the date of the sale a reserve can be claimed under ITA 20(1)(n). The maximum reserve, based on the gross profit of $216,000, would be as follows:

**Income Proceeds Rec'd**

2022 Reserve = [(100%)($216,000)] = $216,000 Nil Nil

2023 Reserve = [(75%)($216,000)] = $162,000 $ 54,000 $107,000

2024 Reserve = [(50%)($216,000)] = $108,000 54,000 107,000

2025 Reserve = Nil (>36 Months from date of sale) 108,000 107,000

2026 Reserve = Nil (All Proceeds Received) Nil 107,000

Totals $216,000 $428,000

As December 31, 2025 is more than 36 months after the sale was made, no reserve can be claimed for the 2025 or 2026 fiscal period. Note that the technically correct calculation of income involves adding back the previous year's reserve and deducting the new reserve. For example, the calculation for 2024 involves adding back the 2023 reserve of $162,000 and deducting the new 2024 reserve of $108,000.

Type: ES

Topic: Reserve for unpaid amounts ITA 20(1)(n)

76) In January, 2022, Marty's Fine Pens, a business carried on as a sole proprietorship, sells a limited edition fountain pen for $125,000. The cost of the pen is $63,000. There is a down payment of $50,000 in 2022, followed by 3 annual payments of $25,000 in the 2023, 2024, and 2025 fiscal periods. Indicate the amount of the reserve that can be claimed in each of the 2022 to 2025 fiscal periods.

Answer: Since a part of the sale proceeds are not due until more than 2 years after the date of the sale, a reserve can be claimed under ITA 20(1)(n). Based on the gross profit of $62,000 ($125,000 - $63,000), the maximum reserve for each of the four fiscal periods, as well as the amounts required to be included in business income is as follows:

**Income Proceeds Rec'd**

2022 Reserve = [(60%)($62,000)] = $37,200 $24,800 $ 50,000

2023 Reserve = [(40%)($62,000)] = $24,800 12,400 25,000

2024 Reserve = [(20%)($62,000)] = $12,400 12,400 25,000

2025 Reserve = Nil (All Proceeds Received) 12,400 25,000

Totals $62,000 $125,000

The 3 year time limit is not relevant in this case since all of the sale proceeds are received before the fourth year end. Note that the technically correct calculation of income involves adding back the previous year's reserve and deducting the new reserve. For example, the calculation for 2024 involves adding back the 2023 reserve of $24,800 and deducting the new and last available reserve for 2024 of $12,400.

Type: ES

Topic: Reserve for unpaid amounts ITA 20(1)(n)

77) During the current year, Janice Teason has the following expenses:

Utility costs for home $3,200

Maintenance and repairs for home 3,800

Property taxes for home 6,400

House Insurance 1,800

Interest on Mortgage 6,200

Home telephone:

Monthly Charge 480

Personal Long Distance Charges 275

Employment/Business Related Long Distance Charges 780

Home Internet Fees 675

Ms. Teason estimates that she uses 30% of her home, including a component for common areas, and 40% of her home phone and home internet service for employment/business related purposes. Maximum CCA on 100% of the home would be $15,000. Determine the maximum deduction that could be claimed with respect to the amounts shown above assuming:

A. She is an employee with $80,000 in income (no commissions).

B. She is an employee with $80,000 in employment income that is all commissions.

C. She carries on a business as a sole proprietor (e.g. self-employed )and earns $80,000 in business income.

Answer: The following home office expenses would be deductible in each of the three scenarios:

**Part A Part B Part C**

Utilities $3,200 $ 3,200 $ 3,200

Maintenance and Repairs 3,800 3,800 3,800

Property Taxes Nil 6,400 6,400

House Insurance Nil 1,800 1,800

Interest on Mortgage Nil Nil 6,200

House CCA Nil Nil 15,000

Subtotal $7,000 $15,200 $36,400

Percentage 30% 30% 30%

Subtotal $2,100 $ 4,560 $10,920

Monthly Phone [(40%)($480)] Nil Nil 192

Employment/Business Related

Long Distance Charges (100%) 780 780 780

Internet Service Fees [(40%)($675)] Nil Nil 270

Maximum Deduction $2,880 $ 5,340 $12,262

Type: ES

Topic: Home office expenses - comprehensive

78) During the current year, Jonathan Beasley has the following expenses:

Utility expenses for Home $2,500

Maintenance and Repairs for Home 3,100

Property Taxes for Home 5,400

House Insurance 1,300

Interest on Mortgage 4,600

Home Telephone Monthly Charge 600

Separate Line Monthly Charge 480

Employment/Business related Long Distance Charges 560

Home Internet Fees 720

Mr. Beasley estimates that he uses 18% of his home, including a component for common areas, and 30% of his home internet service for employment/business related purposes. Maximum CCA on 100% of the home would be $12,000. Determine the maximum deduction that could be claimed assuming:

A. The individual is an employee with $72,000 in income (no commissions).

B. The individual is an employee with $72,000 in commission income.

C. The individual carries on a business as a sole proprietor (e.g. self-employed )and earns $72,000 in business income.

Answer: The following home office expenses could be claimed in each of the three scenarios:

**Part A Part B Part C**

Utilities $2,500 $ 2,500 $ 2,500

Maintenance and Repairs 3,100 3,100 3,100

Property Taxes Nil 5,400 5,400

House Insurance Nil 1,300 1,300

Interest on Mortgage Nil Nil 4,600

House CCA Nil Nil 12,000

Subtotal $5,600 $12,300 $28,900

Percentage 18% 18% 18%

Subtotal $1,008 $ 2,214 $5,202

Home Telephone (See Note) Nil Nil Nil

Phone Line to Home Office (100%) 480 480 480

Employment/Business Related

Long Distance Charges (100%) 560 560 560

Internet Fees [(30%)($720)] Nil Nil 216

Maximum Deduction $2,048 $ 3,254 $6,458

Note With a separate phone line to the home work space the cost of which is fully deductible, it can be assumed that the home phone is not used for employment/business purposes.

Type: ES

Topic: Home office expenses - comprehensive

79) Mr. Alex Roddle acquires a non-zero-emission automobile to be used 100% of the time in a business that is carried on as a sole proprietorship. This business began several years ago. The purchase occurs on October 1, 2022 at a cost of $83,000. He finances $70,000 of the car purchase through his bank at an annual rate of 9%. Interest charges for the period October 1, 2022 through December 31, 2022 amount to $1,575. What amounts can Mr. Roddle claim as a deduction for the fiscal period ending December 31, 2022? Ignore GST/HST and PST considerations.

Answer: The base amount for the CCA calculation is limited to the Class 10.1 maximum of $34,000 for new or used vehicles purchased on or after January 1, 2022. The AccII provisions would also apply in this case. As a result, the maximum amounts that can be deducted are as follows:

CCA [(30%)(150%)($34,000)] $15,300

Interest Costs - Lesser of:

• Amount Paid = $1,575

• [($10)(92 Days)] = $920 920

Total Deduction for 2022 $16,220

Type: ES

Topic: Automobile expenses (business)

80) For a number of years, Ms. Alexandria Bouclair has carried on a business as a sole proprietor. Because of business travel needs, on September 1, 2022, a non-zero-emission automobile that is to be used exclusively for business purposes is purchased for $63,000, of which $50,000 is financed by the dealer. Interest charges for the period September 1, 2022 to December 31, 2022 are $2,000. What amounts can Ms. Bouclair claim as a deduction from her 2022 business with respect to the automobile? Ignore GST and PST considerations.

Answer: The base amount for the CCA calculation is limited to the Class 10.1 maximum of $34,000 for new or used vehicles purchased on or after January 1, 2022. The AccII provisions would also apply in this case. As a result, the maximum amounts that can be deducted are as follows:

CCA [(30%)(150%)($34,000)] $15,300

Interest Costs - Lesser of

• Amount Paid = $2,000

• [($10)(122 Days)] = $1,220 1,220

Total Deduction for 2022 $16,520

Type: ES

Topic: Automobile expenses (business)

81) On November 1, 2022, Ms. Sherry Boland leases a zero-emission automobile to be used 100% of the time in a business she carries on as a sole proprietor with a December 31 fiscal period. The lease cost is $862 per month, and a total of $1,724 was paid for the year. The manufacturer's suggested list price for the automobile is $53,000. Ms. Boland makes no down payment and there are no refundable deposits. Determine the maximum amount that can be deducted with respect to the lease payments for 2022. Ignore GST/HST and PST considerations.

Answer: The amount she can deduct is limited to $1,301, the least of:

• $1,724 [($862)(2)];

• $1,830 [($900)(61/30)]; and

• $1,301 {[$1,724][$34,000 ÷ (85%)($53,000)]}.

Type: ES

Topic: Automobile leasing costs ITA 67.3

82) On August 1, 2022, Mr. Jimmy Bond leases a zero-emission automobile that will be used 100% in a business he carries on as a sole proprietor with a December 31 fiscal period. The monthly lease payment is $797, with a total of $3,985 being paid during 2022. The manufacturer's list price for the vehicle is $61,000. Mr. Bond makes no down payment and there are no refundable deposit made. Determine the maximum amount that can be deducted with respect to the leases payments for 2022. Ignore GST/HST and PST considerations.

Answer: The amount he can deduct is limited to $2,613, the least of:

• $3,985 [($797)(5)];

• $4,590 [($900)(153/30)]; and

• $2,613 {[$3,985][$34,000 ÷ (85%)($61,000)]}

Type: ES

Topic: Automobile leasing costs ITA 67.3

83) Sharp Ltd. signs an 8 year lease of a property with an economic life of 9 years. The lease payments are $32,500 per year. Compare the income tax treatment of the lease with its treatment under accounting principles such as ASPE or IFRS.

Answer: For income tax purposes, the lease would be treated as an operating lease, with the deduction being based only on the required lease payments. Under ASPE/IFRS, the lease would be treated as a purchase and sale and capitalized. This is because during the lease term the lease transfers "substantially all of the benefits and risks of ownership related to the leased property from the lessor to the lessee". This means that the accounting rules would deduct amortization on the capitalized property and interest costs on any related financing.

Type: ES

Topic: Leases - income tax vs. ASPE/IFRS

84) Morton Ltd sells inventory which is a single product which it buys from various manufacturers. It has a December 31 taxation year end. In 2022, its first year of operations, purchases of inventory were as follows:

**Date Quantity Price**

February 1 7,500 $23.00

May 23 5,000 28.00

August 18 6,800 21.00

October 28 5,300 25.00

On December 31, 2022, 7,800 of these items are still on hand. Their replacement cost on this date is $24.00 and they are being sold for $31.00. It is estimated that selling costs average 20% of the sales price. It is not possible to identify the individual inventory items being sold. Calculate all the values that could be used for the 7,800 remaining units of inventory, identifying the method you used for each value.

Answer: The following calculations will be used in this solution.

FMV (Using Replacement Cost) [($24.00)(7,800)] $187,200

FMV (Using Net Realizable Value) [(80%)($31.00)(7,800)] $193,440

FIFO Cost [(5,300)($25.00) + (7,800 - 5,300)($21.00)] $185,000

Average Cost [($23.89\*)(7,800)] $186,342

\*Average per unit cost of $23.89 ($587,400 ÷ 24,600) calculated as follows:

**Price Units Total**

$23.00 7,500 $172,500

$28.00 5,000 140,000

$21.00 6,800 142,800

$25.00 5,300 132,500

Totals 24,600 $587,800

For income tax purposes, the inventory value can be determined by any of the following methods.

• FMV (Using Replacement Cost) = $187,200

• FMV (Using Net Realizable Value) = $193,440

• Lower of $185,000 Cost (FIFO) or $187,200 Market (Replacement Cost) = $185,000

• Lower of $185,000 Cost (FIFO) or $193,440 Market (Net Realizable Value) = $185,000

• Lower of $186,342 Cost (Average Cost) or $187,200 Market (Replacement Cost) = $186,342

• Lower Of $186,342 Cost (Average Cost) or $193,440 Market (Net Realizable Value) = $186,342

Type: ES

Topic: Inventory valuation ITA 10

85) Ms. Melinda Gabor begins carrying on a business as a sole proprietor May 1, 2022. After careful consideration, she decides on a fiscal period that ends on September 30. During the period May 1, 2022 to September 30, 2022, there is $23,500 of business income. Determine the amount of business income that will be required to be included in her 2022 net income?

Answer: Ms. Gabor's additional business income for 2022 will be $14,131 [($23,500)(92 Days ÷ 153 Days)]. The 92 days is for the period October 1 through December 31, 2022. The 153 days is for the number of days in the fiscal period May 1 through September 30, 2022. She will be required to include business income of $37,631 ($23,500 + $14,131) for her 2022 taxation year.

Type: ES

Topic: Additional business income ITA 34.1

86) Mr. Brian Brock is selling a business he carried on as a sole proprietor. The sale includes accounts receivables with a face value of $87,560. It has been agreed that the FMV of the receivables is equal to the net realizable value of $82,150. In 2021, Mr. Brock claimed a doubtful debt reserve of $4,800. Determine the income tax consequences of the sale of the receivables to Mr. Brock on the assumption that an election was jointly filed under ITA 22.

Answer: The income tax consequences would be the addition of the 2021 doubtful debt reserve of $4,800 and a reduction of $5,410 for the loss on the sale of the receivables. The net effect would be a decrease in business income of $610 [$4,800 - ($87,560 - $82,150)].

Type: ES

Topic: Accounts receivable election ITA 22

87) Ms. Brooke Besson is selling a business she carried on as a sole proprietor. The sale includes accounts receivables with a face value of $68,500. It has been agreed that the FMV of the receivables is equal to the net realizable value of $65,300. In 2021, Ms. Besson claimed a doubtful debt reserve of $4,200. Determine the income tax consequences of the sale of the receivables in 2022 to Ms. Besson assuming that:

• No election was made under ITA 22; and

• an election was jointly filed under ITA 22.

Answer: In the absence of an election under ITA 22, Ms. Besson will have to include the $4,200 doubtful debt reserve claimed in 2021 in her business income for 2022. In addition the loss on the sale of the receivables would be an allowable capital loss of $1,600 [(1/2)($68,500 - $65,300)].

If an election is jointly filed under ITA 22 she will still have to include the $4,200 doubtful debt reserve claimed in 2021 in her business income for 2022. However, in this case, the inclusion will be offset by a deduction of $3,200 ($68,500 - $65,300) with respect to the loss on the receivables. In this case the net addition to current year business income will be $1,000 ($4,200 - $3,200).

Type: ES

Topic: Accounts receivable election ITA 22

88) Coretta Kirkman carries on a business as a sole proprietor that sells security related products to both retail customers and to building contractors. The business began on January 1, 2022. The fiscal period of the business will be December 31.

The following information relates to the 2022 fiscal period:

• Cash sales of delivered merchandise total $375,000.

• Account sales of delivered merchandise total $130,000.

• As of December 31, uncollected Accounts Receivable balances total $55,000. Coretta expects $6,000 of the accounts to be doubtful of collection.

• Cash advances of $36,000 are received for merchandise to be delivered in 2023.

• In 2022, a comprehensive security system is installed in a 462 unit condominium development. The gross profit on this sale was $12,500. Because of the size of the contract, Coretta agrees to accept payment in three annual instalments as follows:

2022 $23,000

2023 32,000

2024 18,000

Total Contract Price $73,000

The following information relates to the 2023 fiscal period:

• A total of $5,800 of accounts receivable were written off as bad debts in the year.

• All of the merchandise on which 2022 cash advances were received was delivered.

• The $32,000 instalment on the condominium project was received.

• Sales of delivered merchandise and services totaled $520,000, with $150,000 of this amount being on account. As of December 31, $52,000 of the account sales had not been collected. Coretta anticipates that $7,500 of these outstanding accounts receivable will be doubtful of collection.

• Cash advances of $29,000 are received for merchandise to be delivered in early 2024.

**Required:** What are the income tax consequences on Coretta Kirkman's business income for the 2022 and 2023 fiscal periods? Include the full details of your calculations for each year, not just the net result for each year. Ignore GST/HST & PST considerations.

Answer: The results for the 2 years would be as follows:

**2022 2023**

Cash Sales $375,000

Cash Sales ($520,000 - $150,000) $370,000

Sales on Account 130,000 150,000

Reserve for Doubtful Debts:

Add Prior Year Reserve Nil 6,000

Deduct Current Year Reserve ( 6,000) ( 7,500)

Deduct bad debts Nil ( 5,800)

Cash Advances 36,000 29,000

Reserve for undelivered merchandise:

Add Prior Year Reserve Nil 36,000

Deduct Current Year Reserve ( 36,000) ( 29,000)

Gross Profit on Condominium Project 12,500 Nil

Reserve for unpaid amounts:

Add Prior Year Reserve Nil 8,562

Deduct Current Year Reserve\*

{[$12,500][($73,000 - $23,000) $73,000]} ( 8,562)

{[$12,500][($73,000 - $55,000) $73,000]} ( 3,082)

Net effect on business income $502,938 $554,180

\*As some of the proceeds on the sale of unused materials are not due until 2 years after the date of the sale, a reserve for unpaid amounts can be claimed. The 3 year time limit is not relevant as the full balance is paid off prior to the end of that period.

Type: ES

Topic: Reserves for businesses

89) In order to supplement his income working in a Calgary bookstore, Mr. Victor Larson has decided to start a home based business that will specialize in selling used textbooks to university and college students.

The business will be run out of space that he has set aside in his home. This space represents 18% of the livable space including a component for common areas.

The home was purchased on January 1, 2022 at a total cost of $426,000. It is estimated that $150,000 of this amount can be attributed to the land ands the remaining $276,000 attributable to the building. For the fiscal period ending December 31, 2022, Mr. Larson has the following home office expenses:

Utilities (Heat, Light, and Water) $ 3,200

Mortgage Interest 10,100

House Insurance 500

Property Taxes 4,300

Repairs and Maintenance 2,600

Total Home office expenses $20,700

The business commences January 31, 2022. On that date, Mr. Larson acquires the following properties for the new business:

Office Furniture and Storage Racks $18,500

Computer 1,430

Applications Software 570

In addition, he has a separate telephone line installed for dealing exclusively with the mail order business. The telephone charge includes charges for a toll-free number and a long distance package.

During the fiscal period January 31, 2022 to December 31, 2022, his mail order sales total $182,000. Costs associated with these sales are as follows:

Cost of goods sold $98,000

Unsold Merchandise (Lower of Cost and FMV) 23,500

Packaging Materials 2,400

Shipping expenses 4,600

Miscellaneous Office Supplies 560

Telephone (Total charge for the fiscal period) 1,100

Printing of posters and brochures distributed 420

**Required:**

A. Can Mr. Larson claim work space in the home expenses? Briefly explain your conclusion.

B. Compute the minimum business income or loss for the 2022 fiscal period.

C. Briefly describe any issues that should be discussed with Mr. Larson concerning the work space in his home and business expenses and costs.

Answer:

***Part A***

Under ITA 18(12), the following conditions must be satisfied in order for expenses related to a work space in a self-contained domestic establishment to be deductible:

• the work space is either the individual's principal place of business; or

• the work space is used exclusively for the purpose of earning income from business and is used on a regular and continuous basis for meeting clients, customers, or patients of the individual in respect of the business.

With respect to Mr. Larson's mail order business, the allocated space in his home would appear to be his principal place of business. This means that he would be able to claim work space in home expenses in determining his business income.

***Part B***

The calculation of the minimum business income for the 2022 fiscal period would be determined as follows:

Sales $182,000

Expenses other than home work space costs:

Cost of goods sold ($98,000)

Packaging Materials ( 2,400)

Shipping Costs ( 4,600)

Miscellaneous office supplies ( 560)

Telephone ( 1,100)

Printing of Posters and Brochures ( 420)

CCA (Note 1) ( 6,439) ( 113,519)

Income before Home Work Space Expenses $ 68,481

Less: Home Work Space Expenses (Note 2) ( 4,332)

2022 Business Income $ 64,149

**Note 1** - Maximum CCA amounts on property acquired for the business (not including CCA on the home) for the short fiscal period would be calculated as follows (alternative calculations shown in the two columns):

Short Fiscal Period

100% (335/365)

Class 8 [($18,500)(150%)(20%)] $5,550 $5,094

Class 50 [($1,430)(150%)(55%)] 1,180 1,083

Class 12 [($570)(1/2)(100%)] 285 262

Total $7,015

Short Fiscal Period Factor 335/365

Maximum CCA $6,439 $6,439

**Note 2 -** The work space in home expenses would be calculated as follows:

Utilities (Heat, Light, and Water) $ 3,200

Mortgage Interest 10,100

House Insurance 500

Property Taxes 4,300

Repairs and Maintenance 2,600

Total $20,700

Class 1 CCA [($276,000)(150%)(4%)]\* 16,560

Total expenses for the Home $37,260

Percentage of Floor Space 18%

Subtotal $ 6,707

Short Fiscal Period 335/365

Deductible Home Work Space Expenses $ 6,156

\*As Mr. Larson owned the home prior to using it for income producing purposes and CCA was never claimed on the home by anyone previously, the home is eligible for the AccII. This analysis reflect changes toe the AccII regulations that retractively became law in June 2021. See also Figure 5-2 which features a flowchart on the AccII analysis.

***Part C***

There are two issues that should be discussed with Mr. Larson.

• As this problem asks for "minimum" business income, CCA must be claimed on Mr. Larson's home. The problem with this is that, if CCA is claimed, it could jeopardize the principal residence exemption, resulting in the payment of income taxes on a portion of the taxable capital gain that might arise on any future sale of the property, assuming real estate prices are increasing. This is discussed in more detail in Chapter 8.

• Although it is not relevant for this year, Mr. Larson should be aware that the deduction of work space in home costs cannot be used to create a loss in the future. However, any amount not deductible because it is greater than the business income can be deducted in any subsequent year provided there is sufficient income from the same business in that year. This provides for an unlimited carry forward of unused work space in home costs (see IT-514, *Work Space in Home Expenses*).

Type: ES

Topic: Work space in home costs and CCA

90) Maxine's Cleaning Services is a Canadian controlled private corporation (CCPC) with a December 31 taxation year end. Maxine Brott is the sole shareholder of the corporation and actively participates in the business as an employee.

Because of the extensive travel required in supervising her employees, the Company provides Ms. Brott with a car. During the first 6 months of 2022, the provided car was a Honda Accord that had been purchased in 2020 for $29,000. During this 6 month period, she drove the car a total of 23,000 kilometers, of which 15,000 were for employment purposes and 8,000 for personal use. The Class 10 UCC balance at the beginning of 2022 was $15,950.

On July 1, 2022, the Honda Accord was sold for $25,000. It was replaced with a BMW 7 Series sedan at a cost of $105,000. During the period July 1, 2022 to December 31, 2022, she drove the vehicle a total of 37,000 kilometers, of which 18,000 were for employment purposes and 19,000 for personal use.

In 2022, the Company paid for all operating costs of both vehicles, a total of $12,300.

Other than the Honda Accord and the BMW sedan, the Company did not own any other vehicles in 2022. During the period January 1, 2022 to December 31, 2022, an automobile was always available to Ms. Brott.

**Required:** Determine the following:

A. The income tax consequences to Maxine's Cleaning Services that result from owning and selling the Honda Accord and owning the BMW sedan in 2022.

B. The minimum amount of the taxable benefit that Maxine will have to include in her 2022 employment income.

Ignore GST/HST and PST considerations in both parts of this question.

Answer:

***Part A***

The income tax consequences resulting from the sale of the Honda can be calculated as follows:

January 1, 2022 UCC $15,950

Disposition - Lesser of:

Capital Cost = $29,000

POD = $25,000 ( 25,000)

Negative Ending Balance ($ 9,050)

Recapture 9,050

UCC - January 1, 2023 Nil

The $9,050 of recapture would be included in the company's business income for 2022. No CCA would be deducted for Class 10 since there is not a positive UCC balance at December 31, 2022. Note that, because the BMW was purchased on or after January 1, 2022 and cost more than $34,000, it would be categorized as a separate Class 10.1 property. This means that its purchase would not eliminate the recapture in Class 10.

The maximum 2022 CCA deduction on the BMW would be calculated as follows:

Capital Cost (Limited to $34,000) $34,000

AccII Adjustment [(50%)($34,000)] 17,000

CCA Base $51,000

Rate 30%

Maximum CCA $ 15,300

The net effect on income due to the two automobiles would be as follows:

Recapture $ 9,050

CCA ( 15,300)

Operating Costs (Fully Deductible) ( 12,300)

Decrease in 2022 business income ($18,550)

***Part B***

Because the Honda was used primarily (more than 50%) for employment purposes, it is eligible for the reduced standby charge and the alternative operating cost benefit calculation. This is not the case with the BMW sedan.

The minimum total benefit on the two automobiles would be calculated as follows:

Standby Charge:

Honda [(2%)($29,000)(6)(8,000 ÷ 10,002\*)] $ 2,783

BMW - No Reduction [(2%)($105,000)(6)] 12,600

Total Standby Charge $15,383

Operating Cost Benefit for Honda - Lesser of:

• [($2,783)(1/2)] = $1,392

• [(8,000)($0.29)] = $2,320 $1,392

Operating Cost Benefit for BMW

[(19,000)($0.29)] 5,510 6,902

2022 Minimum Total Automobile Benefit $22,285

\*[(6)(1,667)]

Type: ES

Topic: Deductible automobile costs and taxable benefit

91) Jerry Reid will become an employee of Margo Ltd. as of January 1, 2022. His employment contract is for a period of three years and his annual salary will be in excess of $250,000. Given this, his combined federal/provincial income income tax rate on additional income will be 51%.

His employment duties are such that he will require an automobile. It is anticipated that he will drive the automobile a total of 55,000 kilometers in each year of his three year employment contract, with 40,000 of this for employment purposes and 15,000 for personal use. The automobile will be a Lexus ES that will cost $48,000. At the end of the employment contract, its estimated FMV will be $20,000.

Margo Ltd. has offered him the following two alternatives with respect to the Lexus. The Company is indifferent as to which alternative he chooses.

1. The Company will provide the automobile to Jerry and will pay all of the operating costs, including those related to Jerry's personal use of the vehicle. The automobile will be available to Jerry for 12 months in each year.

2. If Jerry provides his own Lexus and pays all of its operating costs, the Company will provide an annual flat rate allowance of $18,000 to cover the costs of using the automobile for employment purposes. Actual operating costs are expected to be $0.24 per kilometer throughout this period.

If Jerry chooses the second alternative, he will finance the purchase with funds borrowed from his margin account at a rate of 5%. He will repay the funds at the rate of $16,000 per year, payable on December 31, 2022, 2023, and 2024. He will sell the automobile at the end of the 3 year employment contract.

Assume that the prescribed rate for the operating cost benefit is $0.29 per kilometer in all of the years 2022 to 2024.

**Required:** Advise Jerry as to which of the alternatives he should accept. Base your decision on the undiscounted cash flows associated with the two alternatives.

Answer:

***Analysis***

The choice between the two alternatives will be based on the comparative cash flows of the two alternatives. The relevant calculations are provided in the sections which follow.

***Employer Provides Automobile***

If Jerry elects to have the employer provide the Lexus, he will have a taxable benefit in each year. Since his employment related kilometers are greater than 50%, he is eligible for the reduced standby charge and the alternative operating cost benefit calculation. The after tax consequence of this choice would be as follows:

Standby Charge (Reduced)

[(2%)(12)($48,000)(15,000 20,004)] $8,638

Operating Cost Benefit - Lesser of:

• [(1/2)($8,638)] = $4,319

• [($0.29)(15,000)] = $4,350 4,319

Total Automobile Benefit $12,957

Marginal Tax Rate 51%

Annual Increase in income tax $ 6,608

***Jerry Buys the Automobile***

The pre-tax cash inflows (outflows) associated with this alternative are as follows:

**2022 2023 2024**

Margin Loan Proceeds $48,000 N/A N/A

Lexus Purchase ( 48,000) N/A N/A

Allowance Received 18,000 $18,000 $18,000

Loan Repayment ( 16,000) ( 16,000) ( 16,000)

Proceeds from Sale of Car N/A N/A 20,000

Operating Costs [($0.24)(55,000)] ( 13,200) ( 13,200) ( 13,200)

Financing Cost

[(5%)($48,000)] ( 2,400)

[(5%)($32,000)] ( 1,600)

[(5%)($16,000)] ( 800)

Pre-Tax Cash Inflows (Outflows) ($13,600) ($12,800) $ 8,000

The income tax savings (costs) associated with this alternative are as follows:

**2022 2023 2024**

Operating Costs [($0.29)(55,000)] ($15,850) ($15,950) ($15,950)

Financing Costs (Less than $10/Day) ( 2,400) ( 1,600) ( 800)

CCA (See Note)

[(150%)(30%)($34,000)] ( 15,300)

[(30%)($34,000 - $15,300)] ( 5,610)

[(1/2)(30%)($18,700 - $5,610)] ( 1,964)

Total Automobile Costs ($33,550) ($23,160) ($18,714)

Employment Usage (40,000 55,000) 72.7% 72.7% 72.7%

Deductible Amount ($24,391) ($16,837) ($13,605)

Allowance 18,000 18,000 18,000

Inclusion in Taxable Income ($ 6,391) $ 1,163 $ 4,395

Marginal Tax Rate 51% 51% 51%

Increase (Decrease)in Income Tax ($ 3,259) $ 593 $ 2,241

**Note** - As a Class 10.1 vehicle is involved and the purchase was made on or after January 1, 2022, the CCA base is limited to $34,000 The AccII provisions are applicable. When the vehicle is sold, no recapture or terminal loss can be recognized on Class 10.1. However, one-half of the regular CCA can be claimed in the year of disposal.

The net after tax cash outflow would be calculated as follows:

2022 2023 2024

Pre-Tax Cash Inflow (Outflow) ($13,600) ($12,800) $8,000

Income Tax Inflow (Outflow) ( 3,259) 593 ( 2,241)

Net Cash Inflow (Outflow) ($16,859) ($12,207) $5,759

***Best Alternative***

A comparison of the two alternatives is as follows:

**Net Cash Inflows (Outflows) 2022 2023 2024 Total**

Employer Provided ($ 6,608) ($ 6,608) ($6,608) ($19,824)

Employee Purchase ( 16,859) ( 12,207) 5,759 ( 23,307)

There is only a difference of $3,483 in the outflows of the two alternatives with the employer provided vehicle being slightly more advantageous.

Other Considerations

There are a number of other considerations that could affect the choice of the best alternative, such as if the actual number of kilometers driven, or personal kilometers driven was different than estimated, or if the resale value of the Lexus was not actually $20,000.

Type: ES

Topic: Employment - employer owned vs. employee owned vehicle

92) Alphonse Bona carries on a business as a sole proprietor in which a single product is sold to retail customers. During his first year of business, his purchases are as follows:

**Date Quantity Price Total Cost**

January 20 10,300 $2.50 $ 25,750

March 12 11,400 $2.75 31,350

June 15 12,600 $3.15 39,690

October 8 10,200 $3.27 33,354

December 9 8,600 $2.85 24,510

Totals 53,100 $154,654

On December 31, the fiscal period of the business, there are 19,400 inventory units on hand. It is estimated that these units have a replacement cost of $2.90 per unit and a net realizable value of $3.18 per unit.

**Required:** Calculate the various closing inventory values that could be used to determine business income. Your answer should indicate the valuation method being used, as well as the resulting value.

Answer:

***Market Determination - Two Possible Values***

For income tax purposes, the business can measure market using either replacement cost or net realizable value. These values would be as follows:

Replacement Cost [($2.90)(19,400)] $56,260

Net Realizable Value [($3.18)(19,400)] $61,692

***Cost Determination - Two Possible Values***

In the determination of cost, taxpayers are permitted to use specific identification (this would not appear to be practical here), a First In, First Out (FIFO) assumption, or Average Cost. Using the First In, First Out method, the appropriate value for the ending inventory would be determined as follows:

8,600 Units at $2.85 $24,510

10,200 Units at $3.27 33,354

600 Units at $3.15 1,890

19,400 Units at FIFO Cost $59,754

Based on average cost, the ending inventory value would be calculated as follows:

Number of Units 19,400

Average Cost [($154,654 ÷ 53,100)] $2.91

19,400 Units at Average Cost $56,454

***Lower of Cost and Market - Four Possible Values***

For income tax purposes, the possible values here would be:

Lower of Replacement Cost and FIFO Cost $56,260

Lower of Replacement Cost and Average Cost 56,260

Lower of Net Realizable Value and FIFO Cost 59,754

Lower of Net Realizable Value and Average Cost 56,454

For accounting purposes, only the last two values would be acceptable.

Type: ES

Topic: Inventory valuation ITA 10

93) The Vernon Manufacturing Company, a Canadian controlled private corporation (CCPC), has just ended its first taxation year. During that year, a number of outlays were made for which the Company is uncertain as to the appropriate income tax treatment. You have been asked to advise them in this matter and, to that end, you have been provided with the list of outlays and expenditures that follows:

1. A part of the Company's raw materials had to be imported from Brazil. In order to obtain local financing for these inventories, the Company paid a $1,200 fee to a Brazilian financial consultant for assistance in locating the required financing.

2. Donations totalling $12,000 were made to various registered Canadian charities.

3. The Company paid $2,500 to the owner of a tract of land in return for an option to purchase the land for $950,000 for a period of 2 years. The land is adjacent to the Company's main factory and management believes it may be required for future expansion of the Company's manufacturing facilities.

4. Direct costs of $7,500, related to incorporating the Company, were incurred during the year.

5. An amount of $10,000 was paid for a franchise giving the Company the right to manufacture a Brazilian consumer product for a period of ten years.

6. Because of its rapid growth, the Company was forced to move into a building that they had originally leased to another company. In order to cancel the lease, it paid $8,000 to the tenant. In addition, $9,500 was spent to landscape around the building and another $13,000 was spent to construct a parking lot for employees.

**Required:** Indicate which of the preceding expenditures that the Vernon Manufacturing Company will be able to deduct in the calculation of business income for the current year, and the income tax treatment of the non-deductible expenditures. Explain your conclusions.

Answer: 1. Costs of obtaining financing with respect to current operations are generally deductible under ITA 9 and consequently the payment to the Brazilian consultant would be deductible. In general financing costs that are disallowed by ITA 18(1)(b) would be deducted over a five year period as a result of ITA 20(1)(e). Since the costs relate to current ongoing operations these costs would not be denied by ITA 18(1)(b) as capital expenditures and therefore ITA 20(1)(e) would not apply.

2. Donations to registered Canadian charities are taxable income deductions and not business expenses.

3. The cost of the option on the land is a capital expenditure that is non-depreciable capital property and cannot be deducted in the calculation of business income (ITA 18(1)(b)).

4. Costs of incorporation are considered capital expenditures that would be initially denied by ITA 18(1)(b). ITA 20(1)(b) however allows the first $3,000 of costs incurred in the incorporation of a corporation to be deducted. The remaining $4,500 ($7,500 - $3,000) will be added to Class 14.1. As these costs are not related to a specific property, they will become part of the capital cost of goodwill.

5. The cost of the franchise is a capital expenditure that is a right that is depreciable capital property. The cost will be added to Class 14 and allowed a CCA deduction under ITA 20(1)(a)which applies a straight-line method method over its 10 year life.

6. The landscaping costs are fully deductible when paid (ITA 20(1)(aa)). With respect to the cost of cancelling the lease, these amounts can only be deducted on a pro rata basis over the remaining term of the lease (ITA 20(1)(z)). The cost of the parking lot is a capital expenditure that will be added to Class 17 and written off at a rate of 8% on a declining balance basis.

Type: ES

Topic: Business expenses (general)

94) Morgon Inc. carries on a business and uses a taxation year ending December 31. The sole shareholder of the Company is Helen Morgon. For the current taxation year, Ms. Morgon's daughter, Summer, who maintains the books and records of the Company, has calculated 2022 net income of $193,200. In determining net income Summer begins with accounting income applying ASPE.

**Other Information:**

1. During the year, Morgon Inc. spent $12,700 for landscaping the grounds around its office. In accordance with ASPE, this amount was treated as a capital expenditure. As the work was done late in the year, no amortization was claimed for the current year.

2. The following items were included in the expenses claimed for accounting purposes:

Amortization expense $69,300

Golf club membership fees for Helen and Summer 15,000

Cost of sponsoring local soccer teams 7,200

Advertising on a foreign television station

(Directed at Canadian market) 9,600

Advertising circulars (Only one-quarter distributed) 12,400

Business meals and entertainment 22,000

Charitable donations 31,900

Loss from theft 16,200

Interest paid on building mortgage 24,200

Interest paid on late income tax instalments 1,400

Appraisal costs on land to be sold 4,200

Damages received resulting from breach of contract 3,800

3. Included in the accounting expenses were $14,000 in fees paid to Summer's 16 year old son for creating and maintaining the web site of Morgon Inc. In determining the fee, Helen found that it would cost at least $25,000 to obtain the equivalent services from an outside consultant.

4. Maximum CCA has been determined to be $94,200 for the current taxation year.

5. Had the contract in which damages were paid been completed, it would have increased business income.

**Required:** Calculate Morgan Inc.s' 2022 business income. Explain the reason for excluding any of the amounts.

Answer: The 2022 business income of Morgon Inc. would be calculated as follows:

Accounting Income $193,200

Additions:

Amortization Expense $69,300

Golf club membership fees for Helen and Summer

(Note 1) 15,000

Cost of Foreign Advertising (Note 2) 9,600

Unused Advertising Circulars

[(3/4)($12,400)] (Note 3) 9,300

Business Meals and Entertainment -

Non-Deductible 50% 11,000

Charitable Donations (Note 4) 31,900

Interest paid on late Income Tax Instalments (Note 5) 1,400

Appraisal Costs on Land to be Sold (Note 6) 4,200 151,700

$344,900

Deductions:

Landscaping Costs ($12,700)

CCA ( 94,200) ( 106,900)

2022 Business income $238,000

**Note 1** - Golf club membership fees cannot be deducted for income tax purposes (ITA 18(1)(l)).

**Note 2** - In general, when a Canadian business advertises in foreign print or broadcast media that is directed at the Canadian market the advertising expenses 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** - Items such as advertising circulars are required to be treated as inventory (ITA 10(4) and 10(5)). This means that the expense for the period would be limited to the amount distributed of $3,100 (1/4) ($12,400)]. The outstanding circulars are not allowed to be deducted until they are actually distributed in a subsequent taxation year.

**Note 4** - Donations to charities are a taxable income deduction to a corporation and cannot be claimed as a business expense.

**Note 5** - Interest paid on late income tax instalments is not deductible. ITA 18(1)(t).

**Note 6** - The appraisal costs on land to be sold are capital expenditures (ITA 18(1)(b)) and are generally either added to the cost of the land or represent costs and outlays of the disposition. In either case they cannot be claimed as a business expense.

**Other Items**

Further explanation related to the items not included in the preceding calculation of business income are as follows:

**Soccer Sponsorship —** As a rule the costs would normally be a deductible promotion or advertising expense however the expenses could also be a donation or a personal expense in which case the amounts would not be a deductible business expense.

**Loss from Theft —** Losses of this type, unless they result from the activity of senior officers or shareholders, are considered to be deductible as a normal cost of doing business. ITA 9

**Mortgage Interest —** The interest would be deductible as the building is a capital property used in the business. ITA 20(1)(c).

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

**Fees paid to Grandson —** Since the fees paid by the Company to Ms. Morgon's grandson are reasonable when compared to those charged by a non-arm's length party, they are deductible.

Type: ES

Topic: Reconciliations (accounting to income tax)

95) For the taxation year ending December 31, 2022, the income statement of Markham Ltd., prepared in accordance with ASPE, is as follows:

Revenues $973,000

Expenses:

Cost of Goods Sold ($272,000)

Selling and Administrative Costs ( 132,000)

Amortization Expense ( 156,000)

Other Expenses ( 137,000) ( 697,000)

Income before Income Tax Expense $276,000

Income Tax Expense:

Current ($ 97,000)

Future ( 32,000) ( 129,000)

2022 Net Accounting Income $147,000

**Other Information:**

1. The Company spent $6,000 during the year on landscaping for its new building. For accounting purposes this was treated as an asset. The Company will not amortize this balance as it believes the work has an unlimited life.

2. Selling and Administrative Costs include $15,000 in business meals and entertainment.

3. Selling and Administrative Costs include membership fees for several employees in a local golf and country club. These fees total $3,400.

4. Other Expenses include donations to registered charities of $3,700.

5. Other Expenses includes bond discount amortization of $2,500.

6. In 2022, Markham Ltd. purchased a competing business at a price that included goodwill of $70,000. For accounting purposes, there has been no impairment or write-down of the goodwill since its purchase.

7. As the Company expects to issue more shares in 2023, it made a number of amendments to its articles of incorporation in 2022. Legal costs, included in Other Expenses, totalled $6,000.

8. On January 1, 2022, the Company has UCC balances for the following classes of depreciable property:

Class 1 $400,000

Class 8 575,000

Class 10 45,000

Class 13 68,000

The Class 1 balance relates to a single building acquired in 2002 at a cost of $550,000. It is estimated that the value of the land at this time was $50,000 and the building $500,000. On February 1, 2022, the building is sold for $612,000. It is estimated that the value of the land is unchanged at $50,000 and that the value of the building was $562,000. For accounting purposes, the carrying value of the property was $507,000, $457,000 for the building and $50,000 for the land. The resulting gain on the building is included in the accounting revenues.

The old building is replaced on February 15, 2022 with a new building acquired at a cost of $683,000 of which $60,000 is for the land and $623,000 for the building. The Company chose not to put the new building into a separate Class 1 so it does not qualify for the 6% CCA rate. No elections are made with respect to the replacement of the building.

There are no dispositions of any Class 8 property in 2022 however there were purchases of Class 8 property of $126,000.

As the Company has decided to lease all of its vehicles in the future, all of the Class 10 properties are sold during the year. The capital cost of the properties sold was $93,000 and the sale proceeds were $37,000. The carrying value for accounting purposes was $52,000 and the resulting accounting loss of $15,000 ($37,000 - $52,000) was included in Other Expenses.

The Class 13 balance relates to a single lease that commenced on January 1, 2020. The lease has an initial term of seven years, with two successive options to renew for three years each. Expenditures on this leasehold were $50,000 in 2020 and $27,000 in 2021. There were no further expenditures in 2022. The write-off of these expenditures for accounting purposes is included in Amortization Expense.

9. Other Expenses includes interest on late income tax instalments of $500 and on late municipal tax payments of $275.

10. Markham Ltd. claims maximum CCA in each year.

**Required:** Determine Markham Ltd.'s 2022 net income. In addition, calculate the January 1, 2023 UCC for each CCA class.

Answer: The calculation of Markham Ltd.'s 2022 net income would be as follows:

Accounting Net Income $147,000

Additions:

Amortization Expense (Income Statement) 156,000

Income Tax Expense (Income Statement) 129,000

Item 2 - Non-Deductible Meals and Entertainment

(50% of $15,000) 7,500

Item 3 - Golf Club Membership Fees 3,400

Item 4 - Contributions to Registered Charities 3,700

Item 5 - Bond Discount Amortization 2,500

Item 7 - Articles of Incorporation Amendment Costs 6,000

Item 8 - Taxable Capital Gain on building sale

[(1/2)($562,000 - $500,000)] 31,000

Item 8 - Gain on Land ($50,000 - $50,000) Nil

Item 8 - Accounting Loss on Class 10 property 15,000

Item 9 - Interest on late Income Tax Instalments 500

Subtotal $501,600

Deductions:

Item 1 - Landscaping Costs ( 6,000)

Item 8 - Accounting Gain on Building Sale

($562,000 - $457,000) (Land ACB = $50,000) ( 105,000)

CCA (Note One) ( 189,880)

Item 8 - Terminal Loss (Note One) ( 8,000)

2022 Net Income $192,720

**Note One** - Maximum CCA and other related inclusions and deductions can be calculated as follows:

**Class 1**

January 1, 2022 UCC $400,000

Addition $623,000

Disposition - Lesser of:

• POD = $562,000

• Capital Cost = $500,000 ( 500,000) 123,000

AccII Adjustment [(50%)($123,000)] 61,500

CCA Base $584,500

2022 CCA at 4% ( 23,380)

AccII Adjustment Reversal ( 61,500)

January 1, 2023 UCC $499,620

**Class 8**

January 1, 2022 UCC $575,000

Additions 126,000

AccII Adjustment [(50%)($126,000)] 63,000

CCA Base $764,000

2022 CCA at 20% ( 152,800)

AccII Adjustment Reversal ( 63,000)

January 1, 2023 UCC $548,200

**Class 10**

January 1, 2022 UCC $45,000

Disposition - Lesser of:

• POD = $37,000

• Capital Cost = $93,000 ( 37,000)

Positive Balance with no remaining property = Terminal Loss $ 8,000

2022 Terminal Loss ( 8,000)

January 1, 2023 UCC Nil

**Class 13**

January 1, 2022 UCC $68,000

2022 CCA:

2020 Expenditures ($50,000 ÷ 10 Years) ( 5,000)

2021 Expenditures ($27,000 ÷ 9 Years) ( 3,000)

January 1, 2023 UCC $60,000

**Class 14.1**

The required calculations for 2022 are as follows:

2022 Additions ($70,000 + $6,000) $76,000

AccII Adjustment [(50%)($76,000)] 38,000

CCA Base $114,000

2022 CCA at 5% ( 5,700)

AccII Adjustment Reversal ( 38,000)

January 1, 2023 UCC $ 70,300

**Summary of CCA Results (Not Required)**

The maximum 2022 CCA and January 1, 2023 UCC balances can be summarized as follows:

**Class Maximum CCA UCC**

Class 1 $ 23,380 $ 499,620

Class 8 152,800 548,200

Class 10 (Terminal Loss = $8,000) Nil Nil

Class 13 8,000 60,000

Class 14.1 5,700 70,300

Total $189,880

**Other Notes**

• While there is a specific prohibition against the deduction of interest and penalties charged under the ITA (ITA 18(1)(t)), there are no restrictions on interest and penalties charged outside of the ITA (and ETA). As a result the interest due to late municipal taxes, is deductible.

• As the old building is not a rental property, the new building can be added to the same Class 1 that contained the old building. If this were not the case, this transaction would have resulted in recapture of CCA on the disposition of the old building.

Type: ES

Topic: Business income reconciliation with CCA - corporation

96) Carol Basque is an experienced lawyer who carries on a business of a professional practice as a sole proprietor. She carries on the business out of a new building which she purchased several years ago for $725,000 with $175,000 paid for the land and $550,000 for the building. The building is used exclusively for business purposes, and an election was filed to include it in a separate Class 1. The UCC on January 1, 2022 is $447,831.

As her practice specializes in cases where lack of anger management has caused legal difficulties, she has had to replace her office furniture several times. The latest was during 2022, when the divorcing owners of a martial arts club could not come to a peaceful resolution on an equitable split in family assets. A registered charity, Ex-Cons R Us, hauled her destroyed furniture away to be used for training purposes and as spare parts in their furniture repair shop. No insurance or other amounts were received with respect to the damage.

The old furniture had a capital cost of $53,000 and the new furniture was purchased for $78,000. The Class 8 UCC at January 1, 2022 was $38,160.

In January, 2020, Carol acquired a $92,000 Lexus that she uses largely for business purposes. She has concluded that, given the nature of her clientele, this car appears too luxurious. Based on this view, she trades it in on the purchase of a $28,000 Toyota. The January 1, 2022 UCC for the Lexus is $17,850. Neither of the vehicles are zero-emission vehicles.

Because the Lexus had been badly damaged by an exiting client who lost his case, the trade-in allowance that she receives is only $22,000. In 2022, the Toyota is driven 41,000 kilometers with 38,000 driven for business purposes and only 3,000 for personal use. The vehicle operating costs for the year were $6,150. Assume that the operating expenses for the Lexus were correctly calculated and included in the accounting expenses.

Other 2022 purchases include the following:

New Computer $ 1,250

Applications Software 1,475

Client List from retiring lawyer 32,000

Other 2022 business expenses, determined on an accrual basis, include the following:

Building current expenses $27,300

Payments to Assistants (Note\*) 46,100

Miscellaneous Office Expenses 13,600

Meals with Clients (not billed to clients) 15,500

**\*Note —** The payments include $25,000 paid to her 17 year old daughter. She works part time during the school year and full time during the summer doing online research for Carol's practice. The fees paid to the daughter are considered reasonable (ITA 67).

In 2022, business revenues were $297,800.

**Required:** Calculate the 2022 business income. In preparing your solution, ignore GST/HST and PST considerations and any CPP implications.

Answer: Carol's minimum 2022 business income can be calculated as follows:

**Carol Basque**

**Statement of Business Income**

**For Fiscla Period Ending December 31, 2022**

Total Revenue $297,800

Vehicle Operating Costs

[($6,150)(38,000 ÷ 41,000)] ($ 5,700)

Building Operating Expenses ( 27,300)

Payments to Assistants

(Payment to Daughter is reasonable) ( 46,100)

Miscellaneous Office expenses ( 13,600)

Business Meals [(50%)($15,500)] ( 7,750)

CCA (Note) ( 76,427) ( 176,877)

2022 Business Income $120,923

**Note** - The total CCA deductible would be as follows:

Class 1 [(6%)($447,831)] $26,870

Class 8 (Calculation Follows) 31,032

Class 50 [(150%)(55%)($1,250)] 1,031

Class 12 [(1/2)(100%)($1,475)] 738

Class 10 [(150%)(30%)($28,000)(38,000 ÷ 41,000)] 11,678

Class 10.1 (Calculation Follows) 2,678

Class 14.1 [(150%)(5%)($32,000)] 2,400

Total CCA for 2022 $76,427

**Class 1** - As the building is used 100%for non-residential purposes, it is eligible for the enhanced rate of 6%.

**Class 8** - The required calculations are as follows:

Opening UCC $ 38,160

Additions $78,000

Disposal - Lesser of:

• POD = Nil

• Cost = $53,000 Nil 78,000

AccII Adjustment [(50%)($78,000)] 39,000

CCA Base $155,160

Rate 20%

Class 8 CCA $ 31,032

The proceeds of disposition were nil as the property was worthless given the extent to which it was damaged.

**Class 10.1** - As the Lexus cost over $30,000, it was allocated to a separate Class 10.1. While neither terminal losses nor recapture of CCA can be recognized on the disposition of the Lexus, Carol will be allowed to take one-half year's CCA. This amount would be $2,678 [(1/2)(30%)($17,850)].

Type: ES

Topic: Business income reconciliation with CCA - sole proprietorship

97) Darby Inc. has just completed its 2022 taxation year ending December 31. Using ASPE, the accountant has determined that, the Company has experienced a business loss of $113,000 before income taxes and amortization expense. The accountant provides the following information that was used in the determination of the accounting loss:

1. The Company was forced to pay damages of $12,300 for failure to perform a service contract. The amount was paid when the client threatened to bring action for breach of contract. The $12,300 was expensed in the current year.

2. The Company's property tax expense of $19,500 includes an amount of $1,100 that was paid to a regional municipality in which the Company maintains a fishing lodge for its employees.

3. The Company's expenses include donations to registered charities of $13,700.

4. The Company's expenses include costs of new landscaping at their administration building in the amount of $9,800 all of which was paid in the year.

5. The Company deducted a loss of $10,100 resulting from a theft by one of its clerical employees.

6. Effective December 31, 2022, as the result of a change in its distribution system, the Company was forced to cancel a tenant's lease that would have been in force until January 1, 2029. During the 2022 taxation year, the Company agreed to pay, and deducted, damages in the amount of $17,000. On December 31, 2022, $5,000 of this amount had not been paid.

7. The current salary expense included a bonus payable to the Company's president in the amount of $14,500. It will be paid on February 1, 2023.

8. The insurance expense included the premium on a whole life policy on the life of the president's wife in the amount of $9,500. This was not a group life policy and the Company is the beneficiary of the policy.

9. As the Company changed property and casualty insurers during the year, all of its assets had to be appraised. The cost of this appraisal was $4,150, with the entire amount being expensed in the year.

10. The Company's wage expense included $51,000 in management bonuses (other than that of the president described in item 7) that will not be paid until May 1, 2022. In addition, $34,000 in bonuses, which were deducted for both tax and accounting purposes in 2021, were paid in March, 2022.

11. Bad debt write-offs amounted to $11,000.

12. Renovation costs in the amount of $153,000 were charged to expense during the year. This amount resulted from the need to completely renovate one of the Company's offices and involved the installation of plumbing and air conditioning systems, as well as rewiring and installation of new concrete foundations.

13. The president and his wife attended a convention that resulted in $5,200 in travel expenses for the Company. Of this amount, $1,900 related to the fact that the president's wife chose to accompany him on this trip when her attendance was not required.

14. The Company's interest expense included bond discount amortization in the amount of $950.

15. The Company's legal expenses for the year amount to $10,500 and were related to the following transactions:

Defense of breach of contract (see item 1) $2,450

Cost of amending articles of incorporation 3,600

Defense costs related to income tax reassessment 4,450

16. The Company's expenses included a total amount of $12,500 for business meals and entertainment.

17. The Company's calculations for CCA have not yet been completed for the 2022 taxation year.

**Required:** Compute the Company's 2022 net income before the consideration of CCA. Indicate why you have not included any of the preceding items in your calculations.

Answer: The required calculations would be as follows:

Accounting Income (Loss)

Before Income Taxes and Amortization Expense ($113,000)

Additions:

Item 2 - Property Taxes on Fishing Lodge 1,100

Item 3 - Charitable Donations (Note 1) 13,700

Item 6 - Lease Cancellation Payment (Note 2) 17,000

Item 8 - Insurance Premium (Note 3) 9,500

Item 12 - Renovation Costs (Note 4) 153,000

Item 13 - Wife's Convention Expenses 1,900

Item 14 - Bond Discount Amortization 950

Item 15 - Legal expenses ($3,600 + $4,450) (Note 5) 8,050

Item 16 - Non-Deductible Portion of

Meals and Entertainment [(50%)($12,500)] 6,250

2022 Business Income (Before CCA) $ 98,450

**Note 1 -** Donations to registered charities create a taxable income deduction for a corporation and not a business expense.

**Note 2 -** ITA 20(1)(z) requires that lease cancellation payments be amortized over the term of the lease remaining immediately before cancellation. The amount to be deducted is a pro rata calculation based on the number of days remaining subsequent to the cancellation. As the cancellation occurred on December 31, 2022, none of the amount would be deductible during the current year. The $17,000 would be deducted over the 7 years that would have remained of the lease term, at the rate of $2,429 per year ($17,000 ÷ 7). The fact that $5,000 of the amount had not been paid as of December 31, 2021 is not relevant.

**Note 3** - Life insurance premiums where the employer is the beneficiary are not considered to be incurred for the purpose of earning income and are therefore not deductible except where they are required by a creditor in relation to financing.

**Note 4** - These amounts serve to extend the life of the relevant property and are therefore capital expenditures. When they are added to the relevant UCC balances, they would result in increased CCA. However, the problem indicates that you do not have to consider CCA amounts.

**Note 5** - The payment to amend the articles of incorporation are capital expenditures that would added to Class 14.1. While the Company would be able to deduct CCA for this Class, you have been instructed to ignore such deductions in this problem. Legal expenses to defend against the breach of contract are deductible business expenses and costs to defend an income tax assessment are deductible under ITA 60(o) as other expenses and not deductible business expenses.

**Other Items**

Further explanation related to the items not included in the preceding calculation of 2022 net income are as follows:

**Item 1** - Since the damages relate to an income earning transaction the payment of damages is considered a current year business expense.

**Item 2 -** Costs related to a fishing lodge are not permitted (ITA 18(1)(l))

**Item 4** - Landscaping costs are fully deductible under ITA 20(1)(aa).

**Item 5** - Losses of this type, unless they result from the activity of senior officers or shareholders, are considered to be deductible as a normal cost of doing business.

**Item 7** - The bonus to the president would be deductible in 2022 since it is paid by the 179th day measured from December 31, 2022.

**Item 9** - Such appraisal costs are considered to be deductible as a normal cost of doing business.

**Item 10** - The $51,000 in management bonuses would be deductible in 2022. The 2021 bonuses would require no adjustment since the amounts would have been deductible in 2021.

**Item 11** - The bad debts would be fully deductible.

**Item 13** - The $3,300 in costs associated with the president attending the convention would be deductible. ITA 20(10).

Type: ES

Topic: Reconciliations (accounting to income tax)

98) Porsha Tortora is the sole proprietor of Tortora's Tarts, a business that she has been carrying on successfully for a number of years. She has recently decided to sell the business to Martin Bunn, an arm's length individual. Mr. Bunn will continue to carry on the business and will use a December 31 fiscal period. He will carry on the business as a sole proprietor.

The sale is finalized on June 3, 2022. Information related to the accounts receivable of the business at that date of the sale is as follows:

• Accounts Receivable $346,000

• Estimated Realizable Value $328,000

• Doubtful debt reserve claimed in 2021 $24,000

Between June 3, 2022 and December 31, 2022, $333,000 of the accounts receivable are collected, with the remaining $13,000 being written off as bad debts.

Both Ms. Tortora and Mr. Bunn have heard of an election under ITA 22 that may have some influence on the income tax treatment of the sale of the accounts receivable. They would like to have your advice on this matter. They will both have significant taxable capital gains in 2022.

**Required:**

A. Determine the income tax consequences of the accounts receivable sale to both Ms. Tortora and Mr. Bunn, and the subsequent 2022 collections and write-offs, assuming:

• that no joint election is filed under ITA 22.

• that a joint election is filed under ITA 22.

B. Indicate, from the point of view of each individual, whether the election would be beneficial. Would your conclusion for each individual differ if the amount collected by the purchaser had been $321,000, rather than the $333,000?

Answer:

***Part A - No Election***

If the ITA 22 election is not made, the 2022 income tax consequences for Ms. Tortora would be as follows:

Add: 2021 Doubtful Debt Reserve $24,000

Deduct Capital Loss:

POD $328,000

ACB ( 346,000)

Capital Loss ($ 18,000)

Non-Deductible One-Half 9,000 ( 9,000)

2022 Income Effect - Ms. Tortora (No Election) $15,000

Note that the $9,000 allowable capital loss can only be deducted to the extent of Ms. Tortora's taxable capital gains. In the absence of such taxable capital gains, the income inclusion would have been $24,000.

If the ITA 22 election is not made, the income tax consequences to Mr. Bunn would be as follows:

POD (Amount Collected) $333,000

ACB ( 328,000)

Capital Gain $ 5,000

Non-Taxable One-Half ( 2,500)

2022 Income Effect - Mr. Bunn (No Election) $ 2,500

***Part A - Election***

The CRA requires that the election be filed in the income tax return of the individuals for the year of the purchase and sale of the accounts receivables. This means that the individuals have until the filing due date of the 2022 taxation year of June 15, 2023 to decide. If the ITA 22 election is made, the income tax consequences for Ms. Tortora would be as follows:

Add: 2021 Doubtful Debt Reserve $24,000

Deduct: Loss on the sale ($346,000 - $328,000) ( 18,000)

2022 Income Effect - Ms. Tortora (With Election) $ 6,000

If the ITA 22 election is made, the income tax consequences to Mr. Bunn would be as follows:

Add: Face Value - Price Paid ($346,000 - $328,000) $18,000

Deduct: Actual Write-Offs ($346,000 - $333,000) ( 13,000)

2022 Income Effect - Mr. Bunn (With Election) $ 5,000

***Part B - Proceeds at $328,000***

For Ms. Tortora, the ITA 22 election is clearly desirable, converting a $15,000 income inclusion into a $6,000 inclusion. The conclusion is that the election is beneficial to the seller when the receivables are sold at a loss. The collection of an additional amount by the purchaser would not have changed this outcome to the seller.

For Mr. Bunn, the actual collections are $5,000 ($333,000 - $328,000) more than the price he paid for the Accounts Receivable. This means that making the election would result in this gain being treated as fully taxable business income, rather than a capital gain, only one-half of which would be included in income. With the election, his income inclusion would be $2,500 higher which is an undesirable outcome. In conclusion a purchaser of receivables generally prefers not to use the election when the sales are sold by the seller at a loss. The election results in a benefit to one person and a disadvantage to the other. In practice this difference can be mitigated by adjusting the price of the receivables. There may however be other income tax consequences to manipulating the sales price to achieve mutual advantages (ITA 69).

***Part B - Proceeds of $321,000***

A change in the proceeds would have no effect on the results for Ms. Tortora. She would still have a $15,000 income inclusion without the election and a $6,000 inclusion in income with the election.

However, the situation would change for Mr. Bunn. If the ITA 22 election is not made, the income tax consequences to Mr. Bunn would be as follows:

POD (Amount Collected) $321,000

ACB ( 328,000)

Capital Loss ($ 7,000)

Non-Deductible One-Half 3,500

2022 Income Effect - Mr. Bunn (No Election) ($ 3,500)

If the ITA 22 election is made, the income tax consequences to Mr. Bunn would be as follows:

Add: Face Value - Price Paid ($346,000 - $328,000) $18,000

Deduct: Actual Write-Offs ($346,000 - $321,000) ( 25,000)

2022 Income Effect - Mr. Bunn (With Election) ($ 7,000)

In this case, the election would be desirable as the loss would be treated as a fully deductible loss, rather than a capital loss, only one-half of which would be deductible.

Type: ES

Topic: Accounts receivable election ITA 22

99) ***Family Information***

Jamine Ramiz is 46 years old. She is married to Raul Ramiz. Raul is 41 years old and has 2022 net income of $5,650.

The couple have two children:

**Diego** — Their son, Diego, is 15 years old and has 2022 net income of $6,420.

**Isabella** — Their daughter, Isabella is 20 years old and has 2022 net income of nil. She attends university on a full time basis for 8 months of the year. Jamine pays for all of Isabella's education costs, including $10,200 for tuition and $2,200 for textbooks and supplies. She has agreed to transfer the maximum tuition credit to her mother.

The family's 2022 medical expenses, all paid for by Jamine, are as follows:

Jamine $ 3,200

Raul\* 7,800

Diego 2,450

Isabella 7,235

Total $20,685

\*$4,800 was for hair transplants and the remaining $3,000 was for plastic surgery on his nose as a result of a collision with a tree while bike riding.

In 2022, Jamine makes donations of $2,150 to a registered charity. In addition, she makes donations to registered federal political parties in the amount of $450.

***Employment Income***

Jamine is employed by Dominion Steel, a large public company, in their human resources department. In 2022, her basic salary is $143,000. In addition, she earned $18,500 in commissions. For the year, her employer withheld the following amounts from her income:

CPP Contributions $3,500

EI Premiums 953

RPP Contributions\* 4,200

Union Dues 625

Payments for Personal Use of a Company Car 1,800

\*In 2022, her employer makes a matching contribution to her RPP of $4,200.

Dominion Steel provides Jamine with a car that was purchased in 2020 for $40,000. In the Company's records, this Class 10.1 passenger vehicle has a January 1, 2022 UCC balance of $17,850. In 2022, the car was available to Jamine for 10 months, of the year during which she drove it a total of 42,000 kilometers. Of this total, 15,000 kilometers were for personal use and 27,000 for employment purposes. The Company pays all of the operating costs, a total of $7,560 for the year.

Several years ago, Jamine was granted options to purchase 2,000 shares of her employer's stock. The option price was $25 per share and, at the time the options were granted, the stock was trading at $27 per share. In March, of 2022, she exercises all of the options. At this time, the shares are trading at $32 per share and, immediately after exercising the options, she sells 1,000 of the shares at $32 per share. She is still holding the other 1,000 shares at the end of the year when they are trading at $20 per share.

In recognition of her 10 years of service with the Company, Dominion Steel gives Jamine a $600 watch. In addition, all of the Company's employees were given a $300 gift certificate for online purchases at Amazon for Christmas.

Jamine is provided with a flat rate travel allowance of $600 per month to cover hotel and meal costs during employment related travel. Her actual travel costs for 2022 were as follows:

Hotels $4,200

Meals 2,900

It is the policy of Dominion Steel to reimburse tuition paid by employees when taking college or university courses. In 2022, Jamine received $3,400 in reimbursements for two courses:

• $2,800 was for a two week course in negotiating skills which was encouraged by her employer

• $600 was for a weekend course in music appreciation

Business Income

On January 1, 2022, Jamine began to carry on a management consulting business that assists people with making sales contacts. Information related to this business is as follows:

**Office Space —** Jamine rents space on the ground floor of the mixed use building in which she lives. She does not use of the employer provided vehicle in her business. The rental agreement with the building's management company has a term of 3 years and there are no options for renewal.

The office rent is $750 per month and, in order for the space to suit her needs, she makes improvements at a cost of $18,000.

**Revenues —** In 2022, Jamine issued invoices for her services totaling $63,450. In addition, she has unbilled work in progress of $5,055. This amount is what is expected to become receivable with respect to the work that has been completed.

**Capital Expenditures —** In 2022, Jamine acquired office furniture and fixtures at a cost of $16,300. In addition, she purchased a computer for $1,230 and application software for $723.

**Business Expenses —** In 2022, the following expenses were incurred:

Part Time employees $6,340

Office Supplies 623

Web Hosting Fee

(A simple web page for informational purposes only) 240

Cell Phone Plan (for business use only) 462

Meals and entertainment with clients (not billed to clients) 4,340

Required: Calculate Jamine’s 2022 net income, taxable income and her minimum federal income tax payable or refund. Ignore GST/HST and PST considerations and estimates of any amounts that were withheld for income taxes by her employer.

Answer:

***Employment Income***

The 2022 employment income would be calculated as follows:

Salary $143,000

Additions

Commissions 18,500

Automobile Benefit (Note 1) 9,000

Stock Option Benefit [(2,000)($32 - $25)] 14,000

Gifts (Note 2) 400

Travel Allowance (Note 3) Nil

Music Course Tuition Benefit (Note 4) 600

Deductions

RPP Contributions ( 4,200)

Union Dues ( 625)

2022 Employment Income $180,675

**Note 1** - The automobile benefit would be calculated as follows:

Standby Charge [(2%)($40,000)(10)(15,000 ÷ 16,667)] $ 7,200

Operating Cost Benefit - Lesser of:

• [($0.29)(15,000)] = $4,350

• ($7,200 ÷ 2) = $3,600 3,600

Total Benefit Before Repayment $10,800

Repayment ( 1,800)

Taxable Automobile Benefit $ 9,000

**Note 2** - The gift certificate of $300 would be considered a near cash gift and would have to be included in employment income. In addition, the $100 excess of the value of the watch over $500 would also have to be included. This gives a total inclusion of $400.

**Note 3** - As the travel allowance (12 @ $600 = $7,200) appears to be reasonable given her actual costs ($4,200 + $2,900 = $7,100) it does not have to be included in Jamine's income. Given her allowance is greater than her actual costs, this would be advisable. As a result, she cannot deduct the actual travel expenses incurred. Note that the determination of whether an allowance is reasonable is a question of fact. When actual costs approximate the allowance this is a suggestion that the allowance may be reasonable but that fact alone is not determinative.

**Note 4** - Tuition for the negotiating skills course would appear to be employment related and, as a consequence, the reimbursement for it would not be included in Jamine's employment income.

Taxable Capital Gain

As the shares were sold immediately after being acquired with options, their ACB of $32 per share would be equal to the $32 sale proceeds. As a result there would be no gain or loss on the sale.

***Business Income***

The 2022 business income would be calculated as follows:

Amounts Billed $63,450

Unbilled Work in Progress (Note 5) 5,055

Total Inclusions $68,505

Deductions:

Office Rent (12 Months at $750) ($ 9,000)

CCA (Note 6) ( 11,667)

Part Time Office Help ( 6,340)

Office Supplies ( 623)

Web Hosting Fee ( 240)

Cell Phone Charges ( 462)

Meals and Entertainment

[(1/2)($4,340)] ( 2,170) ( 30,502)

2022 Business Income $38,003

**Note 5** - Unbilled WIP would generally be considered to have the quality of income and would be required to be included income. In addition the ITA requires (ITA 10(4)(a)) that individuals value WIP at an amount equal to the amount that would become receivable with respect to that work. The effect would be to increase income by that same $5,055 amount.

**Note 6** - Maximum CCA would be calculated as follows:

Class 13 [(150%)($18,000 ÷ 5\*)] $ 5,400

Class 8 [(150%)(20%)($16,300)] 4,890

Class 50 [(150%)(55%)($1,230)] 1,015

Class 12 [(1/2)(100%)($723)] 362

Total CCA $11,667

\*With respect to the Class 13 amount, this is a straight line Class eligible for the AccII provisions. While the term of the lease is only 3 years, the deductible amount is the lesser of 150% of:

• the capital cost divided by the term of the lease plus the first renewal option, and

• one-fifth of the capital cost.

In this case, the deduction is limited to 150% of one-fifth of the capital cost.

2022 Net Income and Taxable Income

Jamine has 2022 Net and Taxable Income as follows:

Employment Income $180,675

Business Income 38,003

Deductible CPP ($3,500 - $3,039) (Note 7) ( 461)

2022 Net Income $218,217

Stock Option Deduction (Note 8) Nil

2022 Taxable Income $218,217

**Note 7**  - Individuals who carry on a business as a sole proprietor are potentially responsible for CPP contributions with respect to their business profits which would create a business deduction under ITA 60(e) and an income tax credit. However if the individual is also employed in the year and making the maximum CPP contributions of $3,500 then no additional CPP contributions are required with respect to the business profits. Part 5 of Schedule 8 of the federal income tax return addresses this situation.

**Note 8**  - When the options were granted, the option price of $25 was below the market price of $27. Given this, the ITA 110(1)(d) deduction is not available. As Dominion Steel is a publicly traded company, the ITA 110(1)(d.1) deduction that applies to options granted by CCPCs cannot be used.

2022 Federal Income Tax Payable (Refund)

The required calculations are as follows:

Tax on first $155,625 $32,181

Tax on next $62,592 ($218,217 - $155,625) at 29% 18,152

Income Tax Before Credits $50,333

Tax Credits:

BPA (Note 9) ($12,808)

Spouse ($12,808 - $5,650) ( 7,158)

EI Premiums ( 953)

CPP Contributions ( 3,039)

Canada Employment ( 1,287)

Jamine's Tuition Credit (Note 10) ( 600)

Transfer of Isabella's Tuition - Lesser of:

• Maximum Limit of $5,000

• Actual Tuition of $10,200 ( 5,000)

Medical Expenses (Note 11) ( 13,406)

Total Credit Base ($44,251)

Rate 15% ( 6,638)

Charitable Donations (Note 12) ( 670)

Political Contributions [(3/4)($400) - (1/2)($50)] ( 325)

2022 Federal Income Tax Payable $42,700

**Note 9** - Since the net income is between $155,625 and $221,708 the BPA is prorated as follows:

$14,398 - [$1,679][($218,217 - $155,625) ÷ $66,083] = $12,808

**Note 10** - As Jamine included the reimbursement of the music course in her employment income as a taxable benefit, she can claim the tuition fee credit.

**Note 11** - The amount of medical expenses that can be included is calculated as follows:

Medical Expenses For:

Jamine $3,200

Raul ($7,800 - $4,800) 3,000

Diego 2,450 $ 8,650

Lesser of:

• [(3%)($218,217)] = $6,547

• 2022 Threshold Amount = $2,479 ( 2,479)

Balance Before Dependants 18 and Over $ 6,171

Isabella’s Medical Expenses $7,235

Reduced by the Lesser of:

• $2,479

• [(3%)(Nil)] = Nil Nil 7,235

Total Medical Expense Claim $13,406

**Note 12** - The charitable donations tax credit would be calculated as follows:

15% of $200 $ 30

33% of the Lesser of:

$2,150 - $200 = $1,950

$218,217 - $221,708 =$Nil 619

29% of $73 [$2,150 - ($200 + $1,877)] 21

Total Credit $670

Type: ES

Topic: Comprehensive case covering chapters 1 to 6

100) Joan Galley is a salesperson for Goodship Lollipop Ltd., a Canadian public corporation. The company produces various sweets such as candy and chocolate bars.

It has been a stressful time for Joan these last 18 months. In the summer of 2021, her spouse passed away. Joan has two children: Ryan who is 13 and Julie who turned 18 on April 30, 2022.

Joan's 2022 employment contract states that she will be paid an annual base salary of $50,000 plus a commission of 1.5% of her annual cash sales. Her 2021 sales totaled $3,200,000, with $200,000 of this total collected by the company in 2022. Her 2022 sales amounted to $2,800,000, but the company had yet to collect $300,000 of these by December 31, 2022.

In 2022, her employer paid Joan her base salary plus her commission income. A review of her last pay stub for 2022 reveals the following was withheld from her salary for the year:

Contributions to the Company RPP $3,000

CPP Contributions 3,500

EI Premiums 953

Premiums for the Company's Dental and Health Plan\* 1,500

Federal Income Tax Withheld 15,000

\* The plan is funded 50/50 by the employees and the employer and is a Private Health Services Plan (PHSP).

Joan is covered by the company's group term life insurance. Her coverage is equal to her annual base salary. The company pays a premium of $5 for every $1,000 of coverage to the Sweet Life Insurance Company.

In January of 2022, Joan detected a packaging problem with a particular line of candies before these were to be shipped. Her keen eye saved the company an estimated $360,000 in product recalls. This helped her win the employee of the year reward of an iPad2 which cost the company $900.

In September of 2021, her employer transferred her from Montreal to Toronto. She thought the change would be beneficial after the death of her spouse a few months earlier. Her employer paid for all her moving expenses. Unfortunately, due to the quick sale of her Montreal home, she incurred a $30,000 loss on its sale. Goodship Lollipop agreed to reimburse her $20,000 of the $30,000 loss, but only in January of 2022. The $20,000 was actually received on January 14, 2022.

In April of 2021, Joan's employer granted her the right to purchase up to 5,000 shares of the company for $17 per share under the employee stock option plan. At the time the option was granted, the shares were trading for $15. On February 1, 2022, when the shares were trading at $20 per share, she exercised her option on 3,000 shares. She sold 2,000 shares at $22 per share with a settlement date of December 30, 2022.

In order to purchase the 3,000 shares, Joan negotiated an interest free loan from her employer for the purchase price. The loan was received on February 1, 2022. Joan repaid the loan in full on December 31, 2022.

Throughout 2022 her employer provided her with an automobile, which it leases for $450 per month. The automobile was also available for her personal use. During the year, Joan drove a total of 35,000 kilometers, 8,000 of which were personal and 27,000 of which were for employment purposes. Except for $2,200 of car insurance, Goodship Lollipop did not pay for any of her automobile operating expenses as these were Joan's responsibility.

Joan is responsible for her salesperson expenses (including the automobile operating expenses). During the year she incurred the following:

Total Automobile Expenses (Excluding Insurance) $5,400

Meals and Entertainment with clients (not billed to clients) 2,600

Hotels 1,500

Joan is a member of the Confectioners’ Association of Canada, a professional association. Her annual membership dues are $1,400.

Joan meets all of the conditions of ITA 8(1)(f) (deductible salesperson expenses).

Joan has a sideline business which she carries on as a sole proprietor. The business is called The Cup Cake Diva. She started her business venture a few years ago and has continued it in Toronto. Joan prepares and sells cupcakes and other pastries from her home. Most of her sales are made for social events which are typically held on weekends.

Joan provides you with the following information for 2022 with respect to her business:

Sales Revenues $40,000

Supplies (Flour, Sugar, Boxes, Etc.) Purchased 12,000

Purchase of New Commercial Oven

(For Business use only) 2,200

Purchase of new automobile for cash (Not zero-emission) 39,000

Automobile operating expenses 3,000

With respect to the supplies, she had an opening inventory of $1,600. On December 31, 2022 the inventory of supplies was $900.

Early in January, 2022, Joan sold her old automobile for $12,000. It had cost $35,000. Both the old and the new automobiles were used exclusively for her business. Any personal use is limited to the employer provided automobile.

Her daughter Julie helps in the business. She is making the deliveries to practice her driving and shows real aptitude for dealing with clients. Joan has not offered her any monetary compensation as Julie is just happy to be driving a new car at this point in time.

Joan uses 20% of the livable space in her home (including a component for common areas) for the business. Her 2022 household expenses include the following:

Utilities $5,400

Property Taxes 3,800

Maintenance 1,600

Dedicated Phone Line for the business 800

Home Insurance 1,900

Mortgage Interest 12,300

The UCC balances at January 1, 2022 are as follows:

Class 8 $3,100

Class 10.1 9,000

Joan does not claim CCA on her home as she realizes that if she did, this would result in future recapture and capital gain implications.

Her son Ryan is in high school and has no income of his own.

Her daughter Julie, not knowing which university program she would like to attend was enrolled part-time (4 months) at a local college. Joan agreed to pay her tuition of $1,600 as long as Julie agrees to transfer any related credit to her (Joan). Julie’s 2022 net income is $7,200.

During the year, Joan paid $5,000 for orthodontic work (braces) for Ryan. She was reimbursed 50% of the amount through the company’s dental and health plan.

In 2022, Joan made $1,600 of donations to registered charities.

Assume the prescribed interest rate for loan benefits during all four quarters of 2022 is 1%.

**Required:**

A. Determine Ms. Galley’s minimum:

1. 2022 Net Income,

2. 2022 Taxable Income,

3. 2022 Federal Income Tax Liability or Refund.

In determining these amounts, ignore GST/HST & PST considerations.

B. Do you have any income tax planning advice for Joan Galley? Discuss.

Answer:

**Part A(1) - 2022 Net Income**

***2022 Employment Income***

2022 Employment Income would be calculated as follows:

Base Salary $50,000

Commission Income

[(1.5%)($2,800,000 + $200,000 - $300,000)] 40,500

Group Term Life Insurance Premium [($5)($50,000 ÷ $1,000)] 250

Award ($900 — $500) 400

Eligible Housing Loss [(1/2)($20,000 — $15,000)] 2,500

Stock Option Benefit [(3,000)($20 — $17)] 9,000

Interest Benefit on Employee Loan [(1%)(3,000)($17)(334/365)] 467

Standby Charge [(2/3)($450)(12)(8,000 ÷ 20,004)] 1,440

Operating Cost Benefit (See Part B) - Lesser of:

• [(8,000)($0.29)] = $2,320

• [(1/2)($1,440)] = $720 720

RPP Contributions ( 3,000)

Salesperson Expenses (Note 1) ( 6,966)

Professional Membership Dues ( 1,400)

2022 Employment Income $93,911

**Note 1 -** Salesperson expenses would be calculated as follows:

Automobile expenses [($5,400)(27,000 ÷ 35,000)] $4,166

Meals and entertainment [(50%)($2,600)] 1,300

Hotels 1,500

Total Expenses (Less than Commissions) $6,966

***2022 Business Income***

2022 Business Income would be calculated as follows:

Revenues $40,000

Supplies Used ($1,600 + $12,000 - $900) ( 12,700)

Business Telephone ( 800)

Work Space in the Home Expenses (Note 2) ( 5,000)

Automobile Operating Expenses (100%) ( 3,000)

CCA (Note 3) ( 17,930)

2022 Business Income $ 570

**Note 2 -** Work space in the home expenses would be calculated as follows:

Utilities $ 5,400

Property Taxes 3,800

Maintenance 1,600

Insurance 1,900

Mortgage Interest 12,300

Total House Expenses $25,000

Business Use of Residence 20%

2022 Work Space in yhe Home Expenses $ 5,000

**Note 3 -** The CCA would be calculated as follows:

Class 8

Opening UCC $ 3,100

Additions 2,200

AccII Adjustment [(50%)($2,200)] 1,100

Balance $ 6,400

Rate 20% $ 1,280

Class 10.1- Old Car

[($9,000)(30%)(1/2)] (Note 4) $ 1,350

Class 10.1- New Car in Separate Class

[($34,000)(30%)(150%)] 15,300 16,650

Total 2022 CCA $17,930

**Note 4 -** The recapture rules do not apply to Class 10.1. Also with respect to Class 10.1, in the year of disposition, the individual is entitled to claim one-half of the normal CCA.

***Taxable Capital Gains***

The taxable capital gain on the sale of the option shares would be calculated as follows:

POD [($22)(2,000)] $44,000

ACB [($20)(2,000)] ( 40,000)

Capital Gain $ 4,000

Inclusion Rate 1/2

Taxable Capital Gain $ 2,000

***Minimum 2022 Net Income***

Minimum 2022 Net Income would be calculated as follows:

Employment Income $93,911

Business Income 570

Taxable Capital Gain 2,000

Loss from Property (Note 5) ( 467)

Deducible CPP ($3,500 - $3,039) (Note 6) ( 461)

2022 Net Income $95,553

**Note 5 -** As the loan was used for investment purposes, the employment income interest benefit of $467, which is deemed to be interest paid by virtue of ITA 80.5, would be deductible by virtue of ITA 20(1)(c).

**Note 6**  - Individuals who carry on a business as a sole proprietor are potentially responsible for CPP contributions with respect to their business profits which would create a business deduction under ITA 60(e) and an income tax credit. However if the individual is also employed in the year and making the maximum CPP contributions of $3,500 then no additional CPP contributions are required with respect to the business profits. Part 5 of Schedule 8 of the federal income tax return addresses this situation.

**Part A(2) - 2022 Taxable Income**

Minimum Taxable Income would be calculated as follows:

2022 Net Income $95,553

Stock Option Deduction [(1/2)(($9,000)] ( 4,500)

2022 Taxable Income $91,053

**Part A(3) - 2022 Federal Income Tax Payable (Refund)**

Minimum 2022 Federal Income Tax Payable or Refund would be calculated as follows:

Tax on first $50,197 $ 7,530

Tax on next $40,856 [(20.5%)($91,053 - $50,197)] 8,375

Tax Before Credits $15,905

Tax Credits:

BPA ($14,398)

Eligible Dependant (Ryan) ( 14,398)

CPP Contributions ( 3,039)

EI Premiums ( 953)

Canada Employment ( 1,287)

Transfer of Tuition - Lesser of:

• Maximum Limit of $5,000

• Actual Tuition of $1,600 ( 1,600)

Medical Expenses (Note 7) ( 1,521)

Subtotal ($37,196)

Rate 15% ( 5,579)

Charitable Donations (Note 8)

[(15%)($200) + (29%)($1,600 — $200)] ( 436)

2022 Federal Income Tax Payable $ 9,890

Federal Taxes Deducted At Source ( 15,000)

2022 Federal Income Tax Refund ($ 5,110)

**Note 7 -** The base for the medical expense credit is calculated as follows:

Premiums Paid on Dental and Health Plan $1,500

Ryan’s Orthodontic Work $5,000

Employer Reimbursement (50%) ( 2,500) 2,500

Total Eligible Expenses $4,000

Reduced by the Lesser of:

• [(3%)($95,553)] = $2,867

• 2022 Threshold Amount = $2,479 ( 2,479)

2022 Base for Medical Expenses $1,521

**Note 8 -** As none of her income is taxed at 33%, this rate will not be applicable to the calculation of the charitable donations tax credit.

**Part B - Tax Planning Advice**

The following points are relevant:

**Car Insurance -** As her employer pays the insurance cost portion of her operating expenses, the usual operating cost benefit is applicable, despite the fact that Joan pays all the other operating costs. If alternatively, this was treated as a taxable allowance, the $720 operating cost benefit would be eliminated. The net effect of this change would be as follows:

Elimination of Operating Cost Benefit ($ 720)

Taxable Allowance Received 2,200

Deduction of Insurance Costs [($2,200)($27,000 ÷ $35,000)] ( 1,697)

Decrease in Employment Income ($ 217)

**Compensation for Daughter -** Joan should pay Julie a reasonable salary for her services to the business. Since Julie’s net income is currently reported as $7,200, a salary payment of up to $8,485 ($14,398 + $1,287 - $7,200) would not attract any federal income tax as her BPA of $14,398 and Canada employment credit amount of $1,287 would offset the income tax. Although Julie would have a tuition tax credit to offset more income, this would mean the credit could not be transferred to Joan.

The payment of salary would be deductible to Joan, but would attract some employer EI premiums as well as some CPP premiums for Joan and Julie.

Type: ES

Topic: Comprehensive case covering chapters 1 to 6