Canadian Income Taxation: Planning and Decision Making - 2012-2013 Edition

Exam Case Questions

Cases 1 – 4 address materials from the first ten chapters. Cases 5 – 9 cover both personal and corporate tax issues, though the cases have been designed to allow instructors to delete paragraphs that may be more advanced in nature, thus tailoring each case to the material that has been covered in class.

'Required' questions have been provided with the cases, though instructors may choose to omit these and simply request that reports be written for the individuals and or the businesses.

Case One addresses issues found in Chapters 3, 4, 6, and 9.

Case Two addresses issues found in Chapters 3, 4, 5, 8, and 10.

Case Three addresses issues found in Chapters 3, 8, 9, and 10.

Case Four addresses issues found in Chapters 7, 8, 9, and 10.

Case Five addresses issues found in Chapters 3, 4, 5, 6, 9, 10, 11, and 13.

Case Six addresses topics from Chapters 5, 6, 8, 10, 12, and 13.

Case Seven addresses concepts from Chapters 3, 4, 5, 6, 7, 8, 9, 10, and 11.

Case Eight addresses issues from Chapters 3, 4, 5, 6, 7, 8, 9, 10, 11, 12, 14, and 15.

Case Nine addresses issues from Chapters 3, 4, 5, 7, 8, 10, 13, 14, and19.

Exam Case One

It is March of 20X3 and George White has asked you to help him with his 20X2 taxes. George is thirty years old, divorced, and has an eight year old son from his former marriage. He pays $500 a month in child support.

George lives in City A, where he is a salesman for a large manufacturing plant. He receives a base salary of $4,000 per month plus a commission of 1% on sales he makes in the month. His sales were $50,000 every month in 20X2. George moved to City A from City B on December 1st of 20X1 when he was promoted and transferred with his company to the office in City A.
In order to perform his work duties, George is required to drive his own vehicle and pay for his expenses, for which he is not reimbursed. However, he does receive an allowance of $400 each month. George purchased a new car in 20X1 which he uses seventy-five percent of the time for business purposes. The undepreciated capital cost of the vehicle at the beginning of 20X2 was $28,000. Total costs to operate the vehicle are $800 per month. Interest expense on his car loan is $200 per month.

George spends $300 per month on suits for work. He also updates his cell phone regularly in order to keep up with technology and typically spends $500 per year on a new phone. George's cell phone bill is $80 per month, of which twenty-five percent is for personal use.

George takes his files home with him at the end of the day and reviews his sales calls in his home office. He then returns the files to his office at his place of employment in the morning prior to leaving for the day to make sales calls. George's monthly total expense for his home insurance, property taxes, maintenance, and utilities is $1,000. His home office occupies ten percent of the square footage in his home. George is curious if he can deduct his home office expenses.

George's moving expenses totaled $9,500 in 20X1. He did not receive a reimbursement from his employer. He claimed $4,500 of this amount on his 20X1 tax return. George took out a $120,000 mortgage to purchase his new home. His interest payments were $8,400 this year.

George maximizes his RRSP contribution each year. His earned income in 20X1 was $42,000 which consisted of $6,000 in commissions.

Required:

a) Calculate George's minimum net income for tax purposes for 20X2. Use the aggregating formula to show your answer.

b) Indicate why any items have been omitted from your calculations.

Solution:

a)

Segment A:

Employment income:

Salary (12 x $4,000)		$48,000	
Travel allowance (12 x $400) (unreasonably low)		4,800	
Commissions (12 x $50,000 x .01)		6,000	
		$58,800	
Salesperson expenses:			
Phone expense ($80 x 12)	$ 960		
Automobile operating costs			
12 x $800	$9,600		
	$10,560		
Employment portion 75% x $10,560	$7,920		
Limited to commission income		(6,000)	
Other automobile costs:			
Capital cost allowance			
30% x $28,000	$8,400		
Interest on car loan			
$200 x 12	2,400		
	$10,800		
Employment portion 75% x $10,800		(8,100)	
Employment income			$44,700

Segment C:

Other deductions:	
Moving expenses (carry-forward portion from 20X1)	(5,000)
RRSP contribution	
Lesser of : 18% x $42,000 (20X1 earned income)	(7,560)
2012 limit: $22,970	
Net income for tax purposes	$32,140

b) The following items have been omitted from the calculations:

a. Child support is not a deductible expense.
b. Clothing is not a deductible expense.
c. The cell phone purchase is a capital outlay, so denied as an expense, and CCA is not allowed on this type of an asset for an employee.
d. Home office expense: George would have to perform more than 50% of his duties from this office, or he would have to use the office exclusively to earn income on a regular and continuous basis to meet with clients. He has not met either of these tests.
e. Mortgage interest is not a deductible expense.

Exam Case Two

It is February 1st, 20X3 and Chloe and Bart have come to ask you some questions regarding their 20X2 tax returns. The couple lives in a common-law relationship. Bart is a chef at a luxury hotel and Chloe is an electrician for the nearby city. Bart's twelve year old daughter, Anna, lived with the couple during the year. Bart and his former partner have agreed that Bart will claim Anna on his tax return. Anna had no income in 20X2.

Bart's remuneration (salary) in 20X2 was $70,000. The following information is available from Bart's 20X2 T4 slip:

Deductions from pay:

CPP and EI	3,147
RPP Contribution	2,000
Income Tax	16,500

Bart's employer contributes an equal portion to Bart's RPP. Bart is also provided with a company car. The car is leased by the hotel. Lease payments are $550 per month. The hotel pays $400 per month for the operating costs for the vehicle. Bart drove the car a total of 22,000 kilometres last year. 9,000 of these were for personal travel. Bart also earned $3,000 in 20X2 from the restaurant's tip pool. His employer did not report the tips of Bart's T4.

Bart withdrew $10,000 from his RRSP in 20X2. Both Bart and Chloe contribute to their TFSAs each year. They each have a balance of $8,000 in accounts bearing 3% annual interest.

Chloe earns $65,000. As she is waiting for her T4 to arrive in the mail, she will address some other issues at this point in time which she believes might affect her 20X2 taxes.

1) She sold a small piece of land this year that she inherited in 20X1. The land was transferred to her at a fair market value of $50,000. She was able to negotiate a sale for the land in 20X2 for $68,000. Selling costs were $800. She received $35,000 of the proceeds in 20X2 and will receive the remainder of the funds this year.

2) Chloe began a small farming operation on the couple's acreage this year and she sells her produce at the local market on weekends. Her sales totaled $5,000 in 20X2. Her allowable costs for tax purposes were $17,000. She has never farmed before, but her business looks promising and she expects a significant increase in sales this year.

Required:

a) Calculate Bart's federal tax liability for 20X2.

b) Calculate any amounts from Chloe's points (1 and 2) above that she will have to include on her 20X2 tax return.

Solution:

a) Employment income:

Remuneration	$70,000		
Gratuities	3,000		
Standby charge	1,980	[($550 x 2/3 x 12) x 9,000/20,004]	
Operating benefit	990	[Lesser of 1,980 x .5 and 9,000 x 26 cents]	
Less: RPP contribution	2,000		
Employment income			$73,970
Other income:			
RRSP withdrawal			$10,000
Net income for tax purposes			$83,970
Taxable income			$83,970

Federal tax liability

$ 83,970.00			
$ 42,707.00	0.15		$ 6,406
$ 41,263.00	0.22		$ 9,078
$ -	0.26		$ -
$ 83,970.00			$ 15,484
NON-REFUNDABLE TAX CREDITS			
BASIC		$ 10,822	
CHILD		$ 2,191	
CPP/EI		$ 3,147	
EMPLOYMENT		$ 1,095	
	0.15	$ 17,255	$ 2,588
FEDERAL TAX LIABILITY			$ 12,896

b) 1. Capital gain on sale of land

Proceeds $68,000 – Adjusted cost base $50,000 – Selling costs $800 = Capital gain of $17,200

Capital Gain				$17,200
Less capital gain reserve: lesser of:				
33,000	x	17200	$ 8,347	$ 8,347
68,000				
0.8	x	17200	$ 13,760	
Capital gain				$8,853
Taxable capital gain				$4,426

Chloe will have a reduced taxable capital gain this year due to the deferral of a portion of the proceeds.

2. Farming income loss

Revenue	$ 5,000
Expenses	($17,000)
Net loss for tax purposes	($12,000)

Since farming is not Chloe's main form of income, the amount of her losses will be restricted against her other forms of income. She will be allowed to deduct $7,250* in 20X2.

*$2,500 + 50% ($12,000 - $2,500)

The difference between this year's $12,000 loss and the allowable deduction of $7,250 can be carried back three years or forwards twenty years and applied against her farming income. (Since she has never farmed before 20X2, the loss will have to be carried forward.)

Exam Case Three

It is February 1st of 2013 and Frank and Betty have come to you for assistance with their 2012 tax return. They are a married couple and have two children. Frank works full-time and Betty is a graduate student. Frank earned $90,000 in 2012. They have three questions for you, also, which are listed here:

<u>Q1. What is our residency status for 20X2?</u>

Frank and Betty and their two children, aged 12 and 7, returned to Canada this month following an eight month sailing trip in the southern hemisphere. Frank was performing oceanic research for his employer whilst away. He has worked for the same company out of the Vancouver office for twelve years.

Since they only resided in Canada for the first five months of 2012 (totaling 151 days) they are wondering if their residency status has been affected.

<u>Q2. How do we report the fees we paid for our children?</u>

The couple's eldest child attended boarding school prior to the sailing trip. The cost of the boarding school was $8,000.

The youngest child was enrolled in indoor soccer during 2012 from January 1st to April 30th. The fees were $200 per month.

<u>Q3. If we sell our home and cottage, will we be taxed?</u>

In addition to their family home, the couple owns a cottage that they usually visit in the summer. They are considering selling both properties this year and moving to New Zealand. Their family home cost $150,000 in 2004 and is now valued at $300,000. The cottage cost $160,000 in 2009 and has a current market value of $260,000. Frank and Betty understand that there will be a capital gain consideration if they sell the properties, and they would like to know which home they should designate as the principal residence in order to minimize taxes.

Required:

a) Answer Frank's and Betty's question regarding their residency. Does the fact that they were only in Canada for 151 days in 2012 affect their status?

b) Discuss how the boarding school and soccer costs incurred for the children will be handled on the couple's tax returns. (Do not calculate amounts; just describe the treatment of the items.)

c) Address the couple's question regarding principal residence. Show calculations to support your answer. (You do not have to show the taxable amount.)

Solution:

a) Frank and Betty will be considered full-time residents for all of 2012. They were fully expecting to return to Canada following their sailing trip, which was in fact, a work venture for Frank. The couple maintained a “continuing state of relationship” with Canada (ITA 250(3); IT-221R3). Other factors that would support full-time residency are: the maintenance of their home in Canada; continuing economic ties (employment); and the length of time in Canada prior to leaving.
The fact that they only lived in Canada for 151 days in 2012 does not affect their status as the 182 rule applies to those who do not typically have a continuing state of relationship to Canada.

b) Boarding school: Childcare costs are a type of ‘other expense’ which can be deducted directly against income in the aggregate formula. Childcare costs are usually deducted from the income of the lower income spouse. However, since Betty was a student while the child attended boarding school, Frank is able to make the deduction (within limits) on his tax return.

Soccer: Soccer qualifies as a ‘child fitness’ activity. A non-refundable tax credit, to a maximum of $500 per child, is allowed for children under the age of 16. Either parent may claim this credit. The amount is applied against a tax payer’s tax liability. As Betty had no income during the year, Frank will use the credit.

c) Selling the house and cottage: Both homes will have periods designated to them as ‘principal residence’.

In order to minimize the taxable income, it is important to determine the capital gain per year of each property.

House	Cottage
$300,000 - $150,000 = $150,000 Capital Gain	$260,000 - $160,000 = $100,000 Capital Gain
Years owned = 10	Years owned = 5
Capital gain per year = $15,000	Capital gain per year = $20,000

The capital gain on the cottage should be eliminated first as it is the highest gain per year of the two properties. Due to the “1+” in the numerator of the formula to reduce the capital gain on a principal residence, the cottage will be designated as the principal residence for four years and the house will be designated as the principal residence for six years.

Exam Case Nine

Albert retired last year in 2012 at the age of 65. He has come to seek your assistance with his 2012 tax return and would also like to know if he will have to repay any of his Old Age Security income. Albert's wife is 58 and has a high salary so Albert does not split his income with her.

Albert received the following income in 2012:

Old Age Security	$ 5,000
Eligible pension from his former employer	$50,000
Eligible dividend income	$20,000
Non-eligible dividend income	$ 8,000

Albert would also like to discuss the upcoming sale of his shares to his son.

Albert's son, Martin, opened a restaurant three years ago. At that time, Albert invested $100,000 through a common share purchase. The two agreed that Albert would sell his shares to Martin when Albert retired. Business has been very successful for Martin, and Albert's shares now have a market value of $350,000. (Albert has never claimed a capital gains exemption.)

Martin's restaurant is a Canadian controlled private corporation. He currently has a $500,000 mortgage on the building. All of his assets other than his long-term investment are used in active business. The asset values have remained constant for the past three years. Only Martin and Albert have held shares in the company. The fair market values of the company's assets are listed here:

Cash	$ 20,000
Inventory	$ 50,000
Investment	$400,000
Furniture	$200,000
Equipment	$500,000
Building	$800,000
Total Assets	$1,970,000

The restaurant generates generate sufficient cash flow to cover all expenses.

Required:

a) Inform Albert as to whether or not he will have to repay a portion of his Old Age Security pension, and calculate the amount, if any.

b) Discuss the implications of selling Albert's shares back to Martin.

Solution: