Spring 2011	AFM 361: Taxation I Midterm Examination II	All Sections
Thursday, July 7, 2011		**120 minutes**

Instructions:

1. One copy of the *Income Tax Act* is allowed. The *Act* can have writing in it, but no paper can be pasted, stapled or otherwise attached into the *Act*. Tabs are permitted if they are less than 10 cm^2, used solely for the purpose of allowing the student to find a location quickly, and used judiciously. If an *Act* is not brought to the exam, the student will be allowed three sheets of paper of standard size (21.6 cm by 28 cm) with **handwritten** notes (on both sides). Nothing may be attached to these pages and no machine-generated notes or images are permitted. Failure to comply with these rules will cause the *Act* or notes pages to be confiscated immediately and the student will be required to write the exam without aids.
2. Calculators are also allowed (with no other functionality); and **no other** electronic devices are permitted.
3. **Time allotments are provided at the beginning of each question as a guide to ensure that you spend the appropriate amount of time on each question. Do not exceed these times.**
4. Do not cite sections of the *Act* unless specifically required. However, when necessary to convey your understanding, provide brief reasons for you answers indicating justification for the tax treatment determined.
5. Indicate clearly all calculations whether or not they seem relevant to the final answer.
6. If you feel you require more information in a fact situation, outline the exact information you need and specify how it would affect your decision, but do not contradict fact or assume the abnormal.
7. There are 2 questions and 6 pages in this examination.
8. Answer all questions in the examination booklets provided.

Question One (50 marks; 60 minutes)

Red Rose (or 'Rose' as she likes to be called) has come to you for some tax help; it is now November 2010. Rose is a businessperson; her husband is a lawyer. After completing a degree in psychology, Rose obtained a real estate oriented MBA and her real estate license.

In 2001, while selling residential and commercial real estate, she created a corporation, Earl Grey Realty, Ltd. to acquire small commercial buildings. According to the articles of incorporation, the company was to "own and operate real estate and engage in real estate transactions as necessary to achieve that objective." Her intention for the property purchases was to develop a group of properties that would generate a stream of rental income to supplement her real estate sales activities. Over the years, she purchased a number of properties as described below. More recently, in late 2008, she decided to 'go out on her own' in her real estate sales activities. She left her previous real estate agency and on January 1, 2009, she opened her own agency using Earl Grey Realty, Ltd.

Rental Properties

All of the rental properties owned by Earl Grey Realty have had some potential as commercial rental properties. However, most of the tenants have been small businesses and would not sign long-term leases. Between 2001 and 2009, Rose purchased eight different properties. At the end of 2009, she still owned four properties, but sold the property at 1429 Green Street during 2010.

Following is a summary of the **correctly prepared** income for tax purposes from the rental activities

	#1 Oolong Ave.	#2 Chai Blvd.	#3 Herbal Street	#4 Green Street	Total
Gross rents received	$ 20,000	$ 12,000	$ 35,000	$ 20,000	$ 87,000
Expenses to earning rental income:					
Advertising (for tenants)	500	–	1,750	250	2,500
Property taxes and interest	20,400	11,500	33,667	19,333	84,900
Income for tax purposes	(900)	500	(417)	417	(400)

Details of the Green Street property are as follows. On January 31, 2009, Rose purchased the Green Street property for $250,000 with the value of the land being 60% of the total. The property was located in downtown Vancouver (in one of the rougher neigbourhoods). The property was acquired with $30,000 cash plus a loan of $220,000 at an interest rate of 10%. The loan was a short-term line of credit.

At the time of the purchase, the building required extensive renovation; however, she only spent $25,000 to renovate the common areas, so the building would look a little better inside. This way better tenants could be attracted over time.

As tenants would move out, she would substantially renovate the vacated store or office, using the least expensive, but nicest looking alternatives. She would then raise the rent considerably to the new tenant. The total cost of these renovations was $100,000. The improvements caused property taxes to increase from $2,500 in 2008 to their present level of $4,500 per year. Between May 2009 and August 2010, the Green Street property was rented on a continuous basis.

The Green Street area followed the pattern of her other locations. They were quite run down when she acquired the building. She and other local property owners would then work hard to improve the look of the neighbourhood. These changes would attract better tenants who pay more rent. They also increased the property values.

In June 2010, Rose undertook a significant improvement on the exterior of the building to aid the redevelopment of the Green Street area, making the building much more modern looking. Again, emphasis was on short-term improvement to appearance, with little regard for durability. These renovations totaled $300,000. Like previous renovations, these were financed entirely with debt at an interest rate of 15%.

On August 15, 2010, Rose was admitted to the hospital with some heart troubles; coincidentally, she received an unsolicited offer on the Green Street property. On August 31, 2010, the property was sold for $1,200,000. Rose negotiated a reasonable split of the price to $400,000 for the land and $800,000 for the building. Rose's previous real estate transactions seem to have followed a similar pattern with respect to the type of property, location, financing, income stream and length of ownership.

In your discussion with Rose, she indicated that she had sold the property due to health concerns that existed at that time of sale and due to the significant management issues related to the property. There were constant complaints by the tenants about the type of people that frequented the neighbourhood, and she had recently heard a rumour that a safe drug injection site might locate next door.

Brokerage Activities

Rose runs the small real estate agency that is part of Earl Grey Realty. She has several junior associates who also assist clients to buy or sell real estate.

Projected, internally prepared financial statements for the year ending December 31, 2010 are as follows.

Earl Grey Realty, Ltd.
Projected Income Statement
Year ending December 31, 2010

Commission income		$ 900,000
Distribution to other agents		300,000
		600,000
Expenses		
Compensation to Rose[1]	342,000	
General and administrative[2]	100,000	
Depreciation and amortization[3]	20,000	462,000
		480,000
Rental building operations (as above)		(400)
Gain on disposal of rental building		530,000
		1,009,600
Income taxes		170,000
Net income		$ 839,600

Additional information

1. Rose' compensation includes the following items

Salary	300,000
Bonus	35,000
Extended group health	4,000
RPP	3,000

   Consistent with all prior years, the bonus was declared December 10, 2010 and is expected to be paid July 2, 2011. The company contributes 1% of salary to a money-purchase RPP and Rose contributes a further 5%. Last year's bonus was $45,000 and was paid on July 2, 2010.

2. According to company records, general and administrative expenses consist of the following.

Office costs (utilities etc.)	30,000
Salaries	45,000
Charitable contributions	10,500
Dine and entertaining clients	6,000
Golf membership for Rose	4,000
Health club membership	1,000
Spa treatments	1,500
Corporate reorganization costs	2,000

   The dining, entertainment and golf membership are used exclusively to attract and retain key clients. Because Rose feels that real estate sales is a "relationship" business, she must look her best to attract new clients; thus, she regularly exercises at the health club and keeps in top appearance through spa treatments. The reorganization costs were incurred in 2009 when she reorganized the company's equity structure and articles of incorporation to permit its use as an operating real estate agency. The $6,000 cost has been amortized straight line over 3 years for accounting purposes.

3. Depreciation is for furniture and fixtures acquired for 75,000, and a computer system acquired for $20,000; all assets were acquired on January 1, 2009. For tax purposes, the computer system is a class 50 asset (55% rate) with a UCC at January 1, 2010 of $14,500.

Required:

(A) Determine the most appropriate treatment for the sale of the Green Street property. (30 minutes)

(B) Calculate the corporation's minimum taxable income for the year ended December 31, 2010. (30 minutes)

Question Two (50 marks, 60 minutes)

The accountant for Flourish and Blotts, a bookstore that is **not** a CCPC, has provided you with the following income statement and financial information for the year ended December 31, 2010.

Flourish and Blotts, Ltd.
Income Statement
Year ended December 31, 2010

Sales		$8,300,000
Cost of goods sold		6,800,000
Gross profit[1]		1,500,000
Expenses		
General and administrative[2]	500,000	
Depreciation and amortization	80,000	
Interest	190,000	770,000
		730,000
Dividends from a Canadian company[3]		5,000
Gain on disposal of fixed assets[4]		308,000
		1,043,000
Income taxes[7]		281,000
Net income		$ 762,000

Additional information

1. During the year, the corporation operated stores in Ontario and in the U.K. Included in sales are $2 million relating to the U.K. operation. Cost of goods sold includes $1.7 million in wages of employees; 30% of which are in the U.K.

2. Salaries of $190,000 are included in general and administrative expenses; $20,000 of this amount arose in the U.K.

3. The company invested in stock of a taxable Canadian company, a company that is not connected. Flourish and Blotts received dividends of $5,000 in 2010.

4. The gain on disposal of fixed assets arose from the sale of one of the corporation's warehouses and related land. The sale took place on May 30, 2010. The building was the last class 3 asset held by the corporation. The total proceeds of disposition on the land and building was $400,000, of which 70% was allocated to the land. The land and building were purchased in 1985 at a total cost of $120,000, of which 60% was allocated to the land at the time.

5. The undepreciated capital cost balances at January 1, 2010 were as follows:

Class 1 (4% rate)	$1,600,000	Class 8 (photocopier)	11,750
Class 3 (5% rate)	26,600	Class 10.1	7,550
Class 8	115,000	Class 13	300,000

6. Asset transactions undertaken during 2010 were as follows:
   a. A new warehouse was purchased on August 1, 2010 for $350,000. The cost of the land was $230,000 and the balance was allocated to the building.
   b. The company replaced its only photocopier with two new models, one that included a facsimile machine. The new photocopier machines cost $24,000 and $18,000 respectively. The old photocopier was sold for proceeds of $3,500.

c. Improvements on its leased store were made at a cost of $224,000 on Jan. 1, 2010. The lease on the premises was most recently renewed in 2008 for 4 years with two successive options to renew for 5 years each. On Jan. 1, 2008, improvements of $360,000 were made.
d. A 20-year license to exclusively distribute certain lines of books was purchased on July 1, 2010 for $160,000;
e. A company car to be available for transporting out-of-town clients was purchased for $60,000. This car replaced the only other existing company car, which was purchased in 2006 for $44,000. The old car was sold for $12,000.
f. The company's warehouse was vandalized on October 31, 2010. Some of the inventory and equipment was seriously damaged. The company's insurer decided that the equipment could not be repaired and awarded the company $560,000: $300,000 to replace the inventory, and $260,000 to replace the equipment. The company decided to upgrade its equipment and ended up investing $340,000 in replacement equipment. Replacement inventory cost $300,000.

7. Tax expense includes $52,000 paid to the U.K. government on $175,000 U.K. profits. The expense also includes the estimated tax effect of the company's net capital loss carry forward from 2002 of $100,000.

Required:

(A) (i) Compute the minimum Division B income, following the ordering found in section 3 and making any necessary election, for the year ended December 31, 2010 under the provisions of the *Act*. Do not consider HST.

(ii) Calculate the corporation's minimum taxable income for the year ended December 31, 2010. (40 minutes)

(B) Calculate the corporation's minimum federal tax payable (Part I tax) for the year. (20 minutes)