Spring 2012	**AFM 361: Taxation I**	**All Sections**
Friday, July 6, 2012, 1:30 pm	**Midterm Examination 2**	**120 minutes**

Q1:	/35	Q2:	/40	Q3:	/25	Total:	/100

Instructions:

1. **You may not ask questions during the exam**. If you think you require more information in a fact situation, outline the exact information you need, specify how it would affect your decision, and then make an assumption. Do not contradict the given facts or assume the abnormal.
2. You are permitted to have one 8.5X11 page with notes on both sides. You must submit this page with your exam. **Failure to submit this page will result in a 3-point penalty**.
3. You are permitted to use a calculator (with no other functionality); no other electronic devices are permitted.
4. Time allotments are provided for each question as a guide to ensure that you spend the appropriate amount of time on each question.
5. Clearly annotate all calculations you wish to have included in the grading.
6. Round all answers to the nearest dollar.
7. There are 3 questions in this examination. The exam is out of 100 points and counts for 25% of your grade in the course.
8. Answer all questions in the booklets provided.
9. A schedule of CCA rates is provided on the last page of the exam.

Question 1 **(35 *points [41 available]*, 42 *minutes*)**

Greasy Pizza Inc. (GPI), a purveyor of large and greasy pizza in the Greater Toronto Area, was incorporated in 1995. GPI grew rapidly in the late 1990s and early 2000s and was quite successful.

However, in the last few years, the Company has lost significant numbers of customers due to the increased focus on healthy living by Canadians which is making its uniquely greasy (and fattening) pizza less appealing.

After running out of money due to continuing business losses, the sole owner of GPI agreed to sell his shares to MegaCorp Inc. (MCI) on January 1, 2012, the day after GPI's normal 2011 fiscal year-end. MCI runs several businesses, including Healthy Choice Pizza, a successful chain of restaurants in Toronto.

MCI wanted to purchase GPI to eliminate a competitor and to access GPI's customer lists and its significant loss carryforwards. MCI plans to sell GPI's land and building in 2012 and close down the remaining GPI restaurants at the end of their leases that expire in 2012. MCI will transfer the Healthy Choices Pizza business into GPI early in 2012.

It is early 2012 and you are the tax manager at MCI working on the GPI tax returns. You have **correctly** prepared the preliminary tax numbers for GPI's year ended December 31, 2011 **before the effects of the acquisition of control** and determined the following:

Normal Operating Business Loss for Fiscal 2011	$350,000
Allowable Capital Loss in 2011	$50,000
Interest Income Earned on Cash Deposits	$7,000

You have also noted the following:

GPI Assets	Cost/ACB	UCC/CEC	FMV@12/31/11
Accounts Receivable	$42,000	n/a	$36,000
Inventory	$140,000	n/a	$120,000
Customer Lists	$244,000	$120,000	$120,000
Land	$1,000,000	n/a	$1,500,000
Building	$750,000	$620,000	$1,150,000
Pizza Ovens	$400,000	$180,000	$50,000

Taxation Year	Non-Capital Losses	Net Capital Losses
1999	0	$60,000
2007	$325,000	0
2008	$450,000	0
2009	$535,000*	$350,000
2010	$600,000	0

** the 2009 non-capital loss includes $80,000 of property losses incurred when GPI sold a building that it rented out.*

It is anticipated that the operating net income from the Pizza businesses of GPI in 2012 will be as follows:

Greasy Pizza Business	($125,000)
Healthy Choice Pizza Business	$2,250,000
	$2,125,000

Required:

1. Provide to the CFO of MCI a summary of the losses that GPI will have available for carryforward into 2012, assuming all necessary actions are taken to maximize the non-capital loss carryforwards for 2012.

2. Provide a summary of relevant tax costs of the assets of GPI at the beginning of its 2012 tax year.

3. Discuss any issues related to the plans MCI has for the Greasy Pizza business closure in 2012.

Question 2 **(40 *points [48 available], 50 minutes*)**

NKQ Inc., a seller of exclusive Harry Potter merchandise, is located in Ontario and is an HST registrant.

The summarized income statement for the 2011 fiscal year is as follows:

NKQ Inc.
Income Statement
For the Year Ended December 31, 2011

Sales		$1,750,000
Cost of Sales	$800,000	
Administrative Expenses	680,000	(1,480,000)
		270,000
Other Income and Expenses		(140,000)
		130,000
Provision for Income Taxes		(39,000)
Net Income		$91,000

Other Information

1. NKQ had a number of inventory items which did not sell well this year. The accountant has recorded a general reserve for inventory obsolescence for these items of $25,000 and included it in Cost of Sales.
2. Included in Administrative Expenses are the following Items:
   a. Depreciation and amortization expenses of $84,000.
   b. NKQ expensed a premium of $3,500 on a $3,000,000 life insurance policy for the Company's president. The president has a personal relationship with the author of the Harry Potter books and the Company would likely lose its exclusive merchandise rights if the president were no longer with the Company. This policy is required by the Company's bank as collateral for the Company's new bank loan.
   c. $10,000 paid to lawyers to sue a party selling "knock-off" Harry Potter wands in Ontario.
   d. $19,000 paid to lawyers for new bank loan agreement negotiated in the year.

e. $12,000 paid to lawyers for legal fees related to amending the Company's articles of incorporation.
f. Donations expensed for various charities of $13,000.
g. Accrual for manager bonuses earned in the year of $42,500. The bonuses were paid on May 31, 2012.
h. President's golf membership dues of $1,850.
i. Travel expenses include a trip to England to see Harry Potter World for the President and her family at the invitation of the author of the Harry Potter books. The total trip cost was $10,000 for the 5 members of the President's family (the President, her husband and 3 children).
j. Meals and Entertainment expenses of $13,000.
k. Amount expensed on costs incurred to improve the "Hogwarts Look" of the Leased Offices were $38,000. The lease for the office expires on December 31, 2016, and the Company has 2 options to extend the lease for 4 years on each extension date.
l. 2012 business license fees of $24,000 paid in December 2011.
m. $3,000 was expensed for a Christmas party open to all staff and their families.

3. Included in Other Income and Expenses are the following Items:
    a. Gain on the sale of specialty Harry Potter display equipment of $55,000 (Class 8-see capital asset information below). The cost of the equipment was $40,000 and net book value ([cost – accumulated depreciation] for financial accounting) at disposal date was $30,000.
    b. Loss on the sale of BMW car (driven by the president) of $23,000 (see capital asset information below). Proceeds equaled $28,000. Original cost was $60,000, excluding taxes. This is the only car the company owned at the beginning of the 2011 year.
    c. Loss on the sale of old delivery truck of $35,000 (see capital asset information below). Original cost was $58,000 and proceeds were $12,000.This was the only asset in the Class 10 pool.
    d. Interest expensed on late municipal taxes of $1,200.
    e. Interest expensed on late income tax installments of $2,350.
    f. Severance expense of $96,000 for long-time employee dismissed in 2011. The employee is being paid out at rate of $3,000 per month over 32 months with the first payment made in October 2011 (3 payments were made in 2011, so $87,000 was owing at the end of 2011).
    g. Dividends received and recorded as income from Harry Potter World Investment in the UK of $9,000 (net of $1,000 withheld by UK payer).

4. Relevant capital asset information is as follows:
   a. The UCC balances at December 31, 2010 were as follows:
      i. Class 8 $25,000
      ii. Class 10 $42,000
      iii. Class 10.1 $26,200

5. During the year, the Company made the following purchases which were capitalized for accounting:
   a. A new computer operating system was purchased for $16,000 on February 25, 2011**.
   b. A new Canon printer was purchased for $5,400 on September 19, 2011**.
   c. A new Harry Potter-themed Porsche (a passenger vehicle) was purchased for $83,000 plus taxes on December 31, 2011.
   d. New office furniture was purchased for $8,400 on May 23, 2011.

   ** Note that the previous computer system and printer were leased by the Company.

<u>Required:</u>

Prepare a schedule reconciling the accounting net income to income for tax purposes. You do not need to follow the ordering rules of section 3 of the Income Tax Act in preparing this schedule. Identify all items omitted from the calculation.

Question 3 **(25 *points [25 available], 28 minutes*)**

There are 5 sub-questions in this question. Treat each of the sub-questions independently. You may use any style (e.g., bullets, full sentences, etc.) that you feel conveys your answer clearly.

A. ***[2 points]*** Buylo Ltd. (which has a December 31 year-end) made the following purchases and sales throughout the period 2003 to 2011:
   1. 2003: Purchased goodwill for $40,000.
   2. 2005: Purchased a government licence with an indefinite life for $50,000.
   3. 2007: Purchased a trademark for $20,000.
   4. 2009: Sold goodwill for $100,000.
   5. 2011: Sold the licence for $150,000.

   Required: Determine the amount of Cumulative Eligible Capital that Buylo Ltd. has as at January 1, 2012.

B. ***[6 points]*** A Inc. and B Inc. each sold a building during their 2011 tax year. Both companies received more for their building than they originally paid for it in 2003 and have claimed as much Capital Cost Allowance as they are allowed under The Act each year. A Inc. is treating the sale of its building as a capital transaction. B Inc. is treating the sale of its building as an income transaction.

   Required:
   1. What type(s) of income will A Inc. include in taxable income for 2011 related to the sale of the building?
   2. What type(s) of income will B Inc. include in taxable income for 2011 related to the sale of the building?
   3. What differences must exist between the business models of A Inc. and B Inc. if both of them are doing their tax reporting correctly?

C. ***[3 points]*** What conditions must be present in order for a terminal loss to be recorded?

D. ***[8 points]*** Due to a national shortage of widgets, the Canadian government expropriated the widget-making machine of AFM Inc. in 2011. The government paid AFM Inc. $200,000 for the machine, which had cost AFM Inc. $100,000 in 2004 and had remaining UCC of $60,000. Assuming that AFM purchases another widget-making machine for $150,000 and has a 20% tax rate, what amount of tax do the replacement property rules (S. 44) allow AFM Inc. to defer in 2011?

E. ***[6 points]*** The following information pertains to ShanRob Inc., which began operations on January 1, 2010:

	Year ended Dec 31, 2010	Year ended Dec 31, 2011
Taxable income before SR&ED deductions	$0	$2,000,000
Eligible SR&ED expenditures	$1,200,000	$900,000
Tax rate	20%	20%
Specified rate for SR&ED credits	30%	30%

ShanRob Inc. always takes deductions and claims credits as early as it can.

<u>Required</u>:

1. What amount of tax will ShanRob Inc. pay in 2011?
2. What amount is in ShanRob Inc.'s SR&ED pool on January 1, 2012?
3. What amount of SR&ED investment tax credits (ITCs) will ShanRob Inc. carry forward into 2012?

Class	Rate (%)	Description
1	4	Most buildings you bought after 1987 and the cost of certain additions or alterations made after 1987. The rate for eligible non residential buildings acquired after March 18, 2007, used for the manufacturing and processing in Canada of goods for sale or lease includes an additional allowance of 6% (total 10%). For all other eligible non residential buildings in this class, the rate includes an additional allowance of 2% (total 6%). To be eligible for the additional allowances, elections have to be filed.
3	5	Most buildings acquired before 1988 (or 1990, subject to certain conditions). Also include the cost of additions or alterations made after 1987.
6	10	Frame, log, stucco on frame, galvanized iron, or corrugated metal buildings that meet certain conditions. Class 6 also includes certain fences and greenhouses.
8	20	Property that you use in your business that is not included in another class. Also included is data network infrastructure equipment and systems software for that equipment acquired before March 23, 2004.
10	30	General-purpose electronic data-processing equipment (commonly called computer hardware) and systems software for that equipment acquired before March 23, 2004, or after March 22, 2004, and before 2005 if you made an election. Motor vehicles, automobiles, and some passenger vehicles.
10.1	30	A passenger vehicle not included in Class 10.
12	100	Under proposed changes, the cost limit for access to Class 12 (100 %) treatment will increase to $500 from $200 for tools acquired on or after May 2, 2006, and medical and dental instruments and kitchen utensils acquired on or after May 2, 2006.
13		Leasehold interest - You can claim CCA on a leasehold interest, but the maximum rate depends on the type of leasehold interest and the terms of the lease.
14		Patents, franchises, concessions, or licences for a limited period. Your CCA is whichever of the following amounts is less: - the total of the capital cost of each property spread out over the life of the property; or - the undepreciated capital cost to the taxpayer as of the end of the tax year of property of that class.
16	40	Taxis, vehicles you use in a daily car-rental business, coin-operated video games or pinball machines acquired after February 15, 1984, and freight trucks acquired after December 6, 1991, that are rated higher than 11,788 kilograms.
17	8	Roads, parking lots, sidewalks, airplane runways, storage areas, or similar surface construction.
29		Eligible machinery and equipment used for the manufacturing and processing (M&P) in Canada of goods for sale or lease, acquired after March 18, 2007, and before 2012 that would otherwise be included in Class 43. To make an election, attach a letter to your income tax return for the tax year you bought the property indicating you are electing to put the property in Class 29. General-purpose electronic data- processing equipment (commonly called computer hardware) and systems software for that equipment, including associated data processing equipment, if acquired after March 18, 2007, and before January 28, 2009, and used in qualifying M&P activities, that otherwise would be in Class 50.
43	30	Eligible machinery and equipment, used for the manufacturing and processing (M&P) in Canada of goods for sale or lease that are not included in Class 29.
45	45	General-purpose electronic data processing equipment (commonly called computer hardware) and systems software for that equipment acquired after March 22, 2004, and before March 19, 2007.
46	30	Data network infrastructure equipment and systems software for that equipment acquired after March 22, 2004, (if acquired before March 23, 2004, include in Class 8 (20%)).
50	55	General-purpose electronic data-processing equipment (commonly called computer hardware) and systems software for that equipment, including ancillary data- processing equipment acquired after March 18, 2007, and not included in Class 29 or Class 52.
52	100	General-purpose electronic data processing equipment (commonly called computer hardware) and systems software for that equipment, including ancillary data- processing equipment acquired after January 27, 2009, and before February 2011.