Midterm 2 solution and comments

Tuesday, July 10, 2012
1:02 PM

This exam went very poorly. The raw average is 54%. We will adjust that up by 15 points by simply adding 15 points to the grade you received. The grade that shows on your exam paper is your unadjusted grade. What will be recorded in LEARN is your adjusted grade.

	Q1	Q2	Q3	Total			
Out of	35	40	25	100			
				Unadjusted		**Adjusted**	
Mean	14.21	23.91	16.27	54.43	54%	**69.43**	**69%**
Median	13	24	17	54	54%	**69**	**69%**
Decile 1	25	33	24	80	80%	**95**	**95%**
Decile 2	21	31	21	72	72%	**87**	**87%**
Decile 3	18	28	20	64	64%	**79**	**79%**
Decile 4	16	26	18	58	58%	**73**	**73%**
Decile 5	13	24	17	54	54%	**69**	**69%**
Decile 6	11	22	15	49	49%	**64**	**64%**
Decile 7	9	20	13	43	43%	**58**	**58%**
Decile 8	7	17	11	37	37%	**52**	**52%**
Decile 9	5	14	8	31	31%	**46**	**46%**
Decile 10	-	3	-	12	12%	**27**	**27%**
Max	35	40	26	93	93%	**108**	**108%**
Min	-	3	-	12	12%	**27**	**27%**
Std dev	7.62	7.44	5.59	17.86	18%	**17.86**	**18%**

Question 1

Not sure what went wrong here. The question is very much like questions we did in class. Part 1 is a straightforward acquisition of control question:

1. Recognize accrued losses.
2. Add those to the income (loss) for the year.
3. Determine if there are expiring losses.
4. Determine if there are assets with accrued gains that can be elected on to use up expiring losses.
5. Determine which assets to elect on and what Proceeds of Disposition to elect.
6. Calculate the non-capital loss for the year.

The right answer was to elect on both land and building. We provided the numbers for an election on land only so that the graders would have them. Students who elected on land only lost 2 points, but then were eligible for full grades after that.

There were 43 points available. Max for the question was 35. This question was very difficult to grade because so many students did not do steps 4-6 above (where all the points are).

35 | ~~44~~ 43.

16

22

Required 1: Losses available for carryforward

2007	325,000
2008	450,000
2009	455,000
2010	600,000
2011	389,000
	2,219,000

11

11

Required 2: tax costs of assets

	ACB/cost	UCC/CEC	Capital cost
AR	36,000	n/a	
Inventory	120,000	n/a	
Customer lists	244,000	90,000	
Land	1,500,000	n/a	
Building	1,150,000	950,000	950,000
Ovens	400,000	50,000	400,000

8

10

Required 3:

MCI can only deduct the loss carryforwards of GPI if it earns profits in GPI or a similar business AND GPI is carried on with a reasonable expectation of profit. The current plan does not meet the second condition, so the losses would not be deductible.

It appears that Healthy Choice Pizza is a similar business, so the losses of GPI would be able to offset the expected 2012 (and future) income from the business if GPI was carried on with a REOP.

Loss 350,000 Accrued losses

Loss		350,000
DYE losses		186,000
		536,000
ACL reduce TCG or added to net cap		50,000

Accrued losses		
AR		6,000
Inventory		20,000
Ovens		130,000
Customer lists		30,000
		186,000

Taxable income	Land only	Both
TCG	250,000	450,000
less ACL	(50,000)	(50,000)
	200,000	400,000
Property income	7,000	7,000
3(c)	207,000	407,000
Business loss	536,000	536,000
Recapture	-	(130,000)
	536,000	406,000
Div C deduction		
Net cap loss cf	(200,000)	(390,000)
Loss for the year		
Loss	536,000	406,000
Add: Div C deducted	200,000	390,000
	736,000	796,000
Less: 3(c)	(207,000)	(407,000)
Added to pool	529,000	389,000

Expiring losses		
Property	=80000	80,000

Net capital		at 1/2
60,000	0.75	40,000
350,000	0.50	350,000

Electable assets	Gain	Recapture	Max TCG triggered
Land	500,000	-	250,000
Building	400,000	130,000	200,000

P of D to elect on Land		cap
2,040,000		1,500,000
P of D to elect on Land and building		
2,790,000		2,650,000

since cap is hit, we elect at FMV for both

The choice to elect on both is clear. First, the expiring gains are far larger than the recapture triggered. Second, they have a clear intention to sell the land and building in 2012, so it is better to recognize the gain this year and use up expiring losses... the recapture will happen either

Question 2
Most of this was straightforward. Here are the commonly incorrect ones:

1. Leasehold improvements have to run through the CCA class. Many people just added by 9/10… forgetting the 1/2-year rule.
2. The severance expense is $69,000 added back instead of $87,000 added back because any amounts paid before end of June of 2012 are deductible in 2011 (like accrued bonuses).
3. The business license is not deductible because it is a prepaid expense… the license was for 2012.
4. The legal fees for articles of incorporation must flow through ECP… if there is no pool existing, we have to start one.
5. You were given the GAIN ($55,000) on the sale of the display equipment. Many people took that as the proceeds.

48 points available. Max was 40.

40 | 48

Net income per fs (or NI + provision)	130,000
Inventory reserve	25,000
Depreciation & amortization	84,000
CCA	-15,000
Life insurance premiums	0
Legal fees - lawsuit	0
Legal fees - bank loan	19,000
Amortization of debt issue costs	-3,800
Legal fees - articles of inc	12,000
CECA	-630
Donations	13,000
Bonuses	0
Golf membership	1,850
Family trip	10,000 or 8,000
Meals & entertainment	6,500
Leasehold improvement	38,000
Business license	24,000

	Class 8	Class 10	Class 10.1	Class 10.1	Class 50	Class 13	Class 10 - sep	
	20%	30%	30%	30%	55%	SL over 10 y	30%	
Open	25,000	42,000	26,200	-	-	-	-	
Add	(31,600)	-	-	30,000	16,000	38,000	5,400	
1/2 out		-	-	(15,000)	(8,000)	(19,000)	(2,700)	
ucc for cca	(6,600)	42,000	26,200	15,000	8,000	19,000	2,700	
cca		-	(3,930)	(4,500)	(4,400)	(1,900)	(270)	(15,000)
1/2 back in	-	-	-	15,000	8,000	19,000	2,700	
ucc	(6,600)	42,000	-	25,500	11,600	36,100	5,130	
remove		(12,000)						
balance	(6,600)	30,000						
tloss/recap	6,600	(30,000)						
end balance	-	-						

ECP	
Open	-
Add	9,000
CEC	9,000

Capital gain	
P of D	85,000
Cost	40,000
Gain	45,000

Family trip	10,000 or 8,000	
Meals & entertainment	6,500 ✓	
Leasehold improvement	38,000 ✓	
Business license	24,000 ✓	
Christmas party	0 ✓	
Gain on sale of equipment	-55,000 ✓	
Recapture	6,600 ✓	
Taxable capital gain	22,500 ✓	
Loss on sale of car	23,000 ✓	
Loss on sale of delivery truck	35,000 ✓	
Terminal loss	-30,000 ✓	
Interest on late municipal taxes	0 ✓	
Interest on late income taxes	2,350 ✓	
Severance expense	69,000 ✓✓	
Dividends from UK	1,000 ✓	288,370
Income for tax		418,370

ECP	
Open	-
Add	9,000
CEC	9,000
CECA	630 ✓✓
Balance	8,370

Capital gain	
P of D	85,000
Cost	40,000
Gain	45,000
TCG	22,500 ✓✓

30

18

Question 3
a. If there was a "trick" question on the exam, this was it. But we told you it was only worth 2 points, so wasting 10 minutes preparing a full CECA schedule should have been avoided.
b. For part 3 of this question, you did NOT have to list was is listed in the answer below; those were provided to give the graders an idea of what possible things they might see.
c. This was the extra point. You could score 4/3 on this question (and several did) if you added the point about Class 10.1.
d. Straightforward replacement property rules question.
e. People made this way more complicated than it needed to be.

26 points available. Max was 26 (even though question was out of 25).

2~~8~~6/25

AFM361
Midterm #2
Question 3 Responses

2 a The total ECE amounts is $110,000
The total ECA amounts is $250,000

1 for ∅
... I know.

2 a

The total ECE amounts is $110,000
The total ECA amounts is $250,000
As the total of ECA amounts exceeds the total ECE by the end of 2011, the CEC balance at the beginning of the next tax year is 0 because all prior CECA amounts deducted and ECE amounts put in the pool will be recaptured

1 for ∅
1 for how I know.

6 b

1 A will report recapture income for the amount of capital cost less the UCC at the time of sale
A will report a taxable capital gain for the amount = 1/2 * (P of D - ACB) of the building

2 B will report business income = proceeds - cost

3 For A to report the transaction as a capital gain, A should be able to show:
i)it is generating income regularly from the building (ie., rent, etc)
ii)it has other properties that it generates income from
iii)it has sold prior properties infrequently and reported them as capital transactions
iv)it held the asset for more than a short period of time
v)it arranged long term financing when it purchased the property to match with expected holding period of the asset

For B to report the transaction as an income gain, B should be able to show:
i)it held the property for a relatively short period of time
ii)it arranged for a short term financing facility when it purchased the property
iii)neglible income was earned on the property
iv)work was done on the property to prepare the property for sale
v)B has bought and sold properties frequently in the past

3(4) c

Conditions that must be present to claim a terminal loss:
1)cannot be a class of depreciable property where terminal losses are expressly denied (i.e., Class 10.1)
2)there is a positive balance in the UCC pool at the end of a tax year
3)there are no assets owned by the taxpayer previously in that pool at the end of the tax year

4 d

involuntary replacement property rules apply here because the widget making machine was expropriated
thus, machine is eligible for use of replacement property rules

recapture deferred =	lower of	cost	100	
		proceeds	200	100
	less	ucc		60
		recapture deferred		40

taxable capital gain deferred=
gain reported = lesser of:
1)capital gain

p of d	200
acb	100
capital gain	100

2)p of d	200
cost of replacement property	150
excess proceeds	50
lesser of 1 and 2	50

gain deferred		50
summary of taxable income deferred		
recapture deferred		40

gain deferred at	0.50	25
total income deferred		65
taxes deferred at	20%	13

6 e

1 taxable income before sred expenses			$	2,000,000
sred expenses deducted			$	(2,000,000) see 2 below
taxable income			$	-
2011 taxes thereon @		20%	$	-
2 SRED S.37 pool				
open 2010			$	-
eligible expenses for 2010			$	1,200,000
less deducted for 2010			$	-
end 2010 and open 2011			$	1,200,000
eligible expenses for 2011			$	900,000
less deducted for 2011				
lesser of	i)pool balance to date	$ 2,100,000		
	ii)taxable income for year	$ 2,000,000	$	(2,000,000)
end 2011 and open 2012			$	100,000
3 ITC pool				
open 2010			$	-
add for 2010			$	360,000
less deducted for 2010			$	-
end 2010 and open 2011			$	360,000
add for 2011			$	270,000
less used 2011				

	end 2010 and open 2011					$ 360,000
	add for 2011					$ 270,000
	less used 2011					
		lesser of	i)pool balance to date	$ 630,000		
			ii)fed tax pay b4 itc	$ -		$ -
	end 2011 and open 2012					$ 630,000 ✓✓
1200000	elig exp	@		30%	rate	
900000	elig exp	@		30%	rate	