

MULTIPLE CHOICE. Choose the one alternative that best completes the statement or answers the question.

- 1) The CEO at Big Company Corporation has decided to sell a piece of capital equipment after the company's year-end in order to avoid paying capital gains tax this year. Which tax planning method will the CEO be using?
- A) Transferring income to another entity.
 - B) This is a form of tax evasion and is not allowed.
 - C) Shifting income from one time period to another.
 - D) Converting the nature of income from one type to another.

Answer: C

- 2) Which of the following scenarios illustrates a potential tax avoidance scheme?
- A) Dividends received from shares transferred from a wife to her husband are taxed in the hands of the wife.
 - B) Property transferred between arm's-length parties is valued at fair market value.
 - C) A man transfers property to his child at a value less than fair market value.
 - D) A shareholder owns two corporations and undertakes legal steps in order to permit loss utilization between the two companies.

Answer: C

- 3) The controller of Little Company Ltd. has decided to sell a piece of capital equipment after the company's year-end in order to avoid paying tax on capital gains this year. The controller is engaging in
- A) tax evasion.
 - B) tax avoidance.
 - C) tax planning.
 - D) GAAR.

Answer: C

- 4) Certain skills are necessary for successful tax planning. One of these skills is applying the time value of money. Which of the following is FALSE regarding this skill?
- A) Applying the time value of money is a tool used for wealth accumulation.
 - B) If a taxpayer earns an annual return of 12% and is subject to a 40% tax rate, the annual after-tax return is 4.8%.
 - C) If a taxpayer invests \$1,000 at 8% and subsequently earns \$48 in after-tax income on the investment at the end of the first year, the taxpayer's tax rate is 40%.
 - D) If a taxpayer invests \$1,000 for one year at a rate of return of 14% and is subject to a 45% tax rate, the after-tax value of the investment will be \$1,077.

Answer: B

- 5) Which of the following statements regarding GAAR is true?
- A) Individuals who organize their affairs in order to pay as little tax as possible will automatically be subject to GAAR.
 - B) The purpose of GAAR is to catch tax evaders.
 - C) When an avoidance transaction takes place, the anti-avoidance rule is automatically applied in all circumstances.
 - D) The Canada Revenue Agency states that "A transaction will not be an avoidance transaction if the taxpayer establishes that it is undertaken primarily for bona fide business, investment or family purposes."

Answer: D

ESSAY. Write your answer in the space provided or on a separate sheet of paper.

- 6) Steven James earned \$150,000 this year in profits from his proprietorship, which placed him in a 45% bracket. The rate of tax for Canadian-controlled private corporations in his province is 15% on the first \$500,000 of income. Personal tax rates (federal plus provincial) in James' province are:

| | |
|--------------------------|-----|
| On the first \$46,000 | 24% |
| On the next \$46,000 | 32% |
| On the next \$50,000 | 40% |
| On the next \$61,000 | 45% |
| On income over \$203,000 | 50% |

(All rates are assumed for this question.)

Steven withdraws \$3,000 per month for his personal living expenses. All remaining profits are used to pay taxes and to expand the business. Steven expects the same business after-tax profits next year.

Steven is considering incorporating his business next year. If he incorporates, he will pay himself a gross salary of \$48,000.

Required:

- A. Determine the increase in Steven's cash flow if he incorporates his company? Show all calculations.
- B. Name the type of tax planning that Steve would be engaging in if he incorporated his company.

Answer: A) Excess cash as a proprietorship:

| | |
|--|-----------------|
| Pre-tax Profits | \$150,000 |
| Tax: | |
| 24% 46,000 | \$11,040 |
| 32% 46,000 | 14,720 |
| 40% 50,000 | 20,000 |
| 45% 8,000 | 3,600 |
| (Assume federal plus provincial rates) | <u>(49,360)</u> |
| After-tax profits | \$100,640 |

| | |
|---------------------------|-----------------|
| Living expenses withdrawn | <u>(36,000)</u> |
| Available for expansion | <u>\$64,640</u> |

Excess cash as a corporation:

| | |
|--|-----------------|
| Profits before salary | \$150,000 |
| Salary | <u>(48,000)</u> |
| Corporate pre-tax profits | 102,000 |
| Tax: 15% x 102,000 | <u>(15,300)</u> |
| After-tax profits (Available for expansion) | <u>\$86,700</u> |
| Excess cash available for expansion (\$86,700 - \$64,640) | \$22,060 |

C) Transferring income from one entity to another (individual to corporation)

7) Part A: List the three key factors of cash flow.

Part B: List the six skills required for tax planning as suggested in the textbook.

Answer: Part A:

Three key factors of cash flow

1. Amount of money coming in
2. Amount of money going out
3. Timing

Part B:

Six skills required for tax planning

1. Anticipation
2. Flexibility
3. Speculation
4. Applying the 8th Wonder of the World
5. Perspective
6. Global approach

- 8) Andrew has \$10,000 to invest. He wants to put his money in a one-year investment earning an annual rate of 12%. Andrew is in a 42% tax bracket.

Required:

- a) Calculate the total value of Andrew's investment, after-tax, at the end of the year.
b) Calculate the amount of taxes Andrew will have to pay on his investment.

Answer: a) $(\$10,000 \times 1.12) \times (1 - .42) = \$10,696$

b) $\$10,000 \times .12 \times .42 = \504

- 9) Match each of the following terms with the most accurate example. Use each example only once.

TERMS:

Tax evasion

Tax planning

Tax avoidance

EXAMPLES:

A. An individual is seeking a beneficial outcome, and therefore, applies an application that is not specifically prohibited by law.

B. A business is seeking a beneficial outcome, and therefore, does not report a portion of revenue earned during the year.

C. Two unrelated companies take steps to become related in order to shift income from the profitable to the company with losses.

Answer: An individual is seeking a beneficial outcome, and therefore, applies an application that is not specifically prohibited by law. **Tax planning**

A business is seeking a beneficial outcome, and therefore, does not report a portion of revenue during the year. **Tax evasion**

Two unrelated companies take steps to become related in order to shift income from the profitable business to the company with losses. **Tax avoidance**

10) For each of the examples listed below, state which of the following three categories of tax planning has been applied:

Shifting income from one time period to another

Shifting income from one entity to another

Shifting income from one type of income to another.

A. Jack has run a successful proprietorship for the past four years, and has now decided to incorporate a company.

B. Karen has decided not to pay herself a dividend from her corporation, (of which she is the sole shareholder) but has chosen to sell a portion of her shares to an associate instead.

C. XYZ Corporation has chosen to delay the recognition of a discretionary reserve until the following year.

Answer: A. Shifting income from one entity to another

B. Shifting income from one type of income to another

C. Shifting income from one time period to another

Answer Key

Testname: UNTITLED2

- 1) C
- 2) C
- 3) C
- 4) B
- 5) D
- 6) A) Excess cash as a proprietorship:

| | |
|--|-----------------|
| Pre-tax Profits | \$150,000 |
| Tax: | |
| 24% 46,000 \$11,040 | |
| 32% 46,000 14,720 | |
| 40% 50,000 20,000 | |
| 45% 8,000 3,600 | <u>(49,360)</u> |
| (Assume federal plus provincial rates) | |
| After-tax profits | \$100,640 |
| Living expenses withdrawn | <u>(36,000)</u> |
| Available for expansion | <u>\$64,640</u> |

Excess cash as a corporation:

| | |
|---|-----------------|
| Profits before salary | \$150,000 |
| Salary | <u>(48,000)</u> |
| Corporate pre-tax profits | 102,000 |
| Tax: 15% x 102,000 | <u>(15,300)</u> |
| After-tax profits (Available for expansion) | <u>\$86,700</u> |
| Excess cash available for expansion (\$86,700 - \$64,640) | \$22,060 |

C) Transferring income from one entity to another (individual to corporation)

Answer Key

Testname: UNTITLED2

7) Part A:

Three key factors of cash flow

1. Amount of money coming in
2. Amount of money going out
3. Timing

Part B:

Six skills required for tax planning

1. Anticipation
 2. Flexibility
 3. Speculation
 4. Applying the 8th Wonder of the World
 5. Perspective
 6. Global approach
- 8) a) $(\$10,000 \times 1.12) \times (1 - .42) = \$10,696$
b) $\$10,000 \times .12 \times .42 = \504
- 9) An individual is seeking a beneficial outcome, and therefore, applies an application that is not specifically prohibited by law. **Tax planning**
A business is seeking a beneficial outcome, and therefore, does not report a portion of revenue earned during
Tax evasion
Two unrelated companies take steps to become related in order to shift income from the profitable business company with losses. **Tax avoidance**
- 10) A. Shifting income from one entity to another
B. Shifting income from one type of income to another
C. Shifting income from one time period to another

Exam Case Two

It is February 1st, 20x8 and Chloe and Bart have come to ask you some questions regarding their 20x7 tax returns. The couple lives in a common-law relationship. Bart is a chef at a luxury hotel and Chloe is an electrician in a nearby city.

Bart's remuneration (salary) in 20x7 was \$84,000. The following information is available from Bart's 20x7 T4 slip:

Deductions from pay:

| | |
|--------------------------------------|--------|
| CPP and EI | 3,400 |
| Registered Pension Plan Contribution | 2,000 |
| Income tax deducted | 25,000 |

Bart's employer contributes an equal portion to Bart's RPP. Bart is also provided with a company car for use during the entire year. The car is leased by the hotel. Lease payments are \$550 per month. The hotel pays \$400 per month for the operating costs of 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 20x7 from the restaurant's tip pool. His employer did not report the tips on Bart's T4.

Bart withdrew \$10,000 from his RRSP in 20x7. Both Bart and Chloe contribute to their TFSAs each year. They each have a balance of \$8,000 in their TFSAs, bearing 3% annual interest.

Chloe earns \$65,000. She is waiting for her T4 from the electrical company to arrive in the mail, so will address some other issues at this point in time which she believes might affect her 20x7 taxes.

- 1) She sold a small piece of land in 20x7 (which is capital in nature) for \$68,000. The land originally cost \$50,000. Selling costs were \$800. She received \$35,000 of the proceeds in 20x7 and will receive the remainder of the funds this year (20x8).
- 2) Chloe began a small farming operation on the couple's acreage in 20x7. Her farm revenue totaled \$5,000 in 20x7 and her expenses 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 minimum net income for tax purposes, and taxable income, for 20x7. Show your work using the aggregating formula from Section 3 of the Income Tax Act.
- b) Calculate Bart's federal tax liability for 20x7.
- c) Calculate the 20x7 tax consequences from Chloe's two issues.

(Use 2017 tax rules.)

Solution:

a)

| | |
|--|-----------------|
| ITA 3(a) | |
| Employment income: | |
| Remuneration | \$84,000 |
| Gratuities | 3,000 |
| Standby charge | 1,980 |
| [($\$550 \times \frac{2}{3} \times 12$) \times 9,000/20,004] | |
| Operating benefit | |
| Lessor of \$2,250 ($\$9,000 \times .25$) | |
| and \$990 ($\$1,980 \times .5$) | 990 |
| RPP contribution | <u>(2,000)</u> |
| Employment income | <u>\$87,970</u> |
| | |
| ITA 3(c) | |
| Other income: | |
| RRSP withdrawal | <u>\$10,000</u> |
| | |
| Net income for tax purposes | <u>\$97,970</u> |
| | |
| Taxable income | <u>\$97,970</u> |
| (Amounts are rounded) | |

b) Federal tax liability

| | | | |
|----------------------------|-------|------------------|------------------|
| \$ 97,970.00 | | | |
| | | | |
| \$ 45,916.00 | 0.15 | | \$ 6,887 |
| \$ 45,915.00 | 0.205 | | \$ 9,413 |
| \$ 6,139.00 | 0.26 | | \$ 1,596 |
| <u>\$ 97,970.00</u> | | | <u>\$ 17,896</u> |
| NON-REFUNDABLE TAX CREDITS | | | |
| BASIC | | \$ 11,635 | |
| CPP/EI | | \$ 3,400 | |
| EMPLOYMENT | | \$ 1,178 | |
| | 0.15 | <u>\$ 16,213</u> | \$ 2,432 |
| FEDERAL TAX LIABILITY | | | <u>\$ 15,464</u> |
| | | | |
| | | | |

c) 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 |
| 68,000 | | | | |
| | | | | |
| 0.8 | x | 17200 | \$ | 13,760 |
| | | | | \$ 8,347 |
| Capital gain | | | | <u>\$8,853</u> |
| Taxable capital gain | | | | <u>\$4,426</u> |

Chloe will have a taxable capital gain this year of \$4,426 due to the deferral of a portion of the proceeds.

2. Farming income loss

| | |
|---------------------------|-------------------|
| Revenue | \$ 5,000 |
| Expenses | <u>(\$17,000)</u> |
| Net loss for tax purposes | <u>(\$12,000)</u> |

Since farming is not Chloe's chief source of income, the amount of her losses will be restricted. She will be allowed to deduct \$7,250*:

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

*(Restricted farm loss cannot exceed \$17,500)

The \$4,750 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 Chloe's farming income. (Since she did not farm prior to 20x7, the loss will be carried forward.)