

Canadian Income Taxation: Planning and Decision Making- 2013-2014 Edition

Chapter Two

Multiple Choice

1. The manager 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 has the manager used?

- A) Transferring income to another entity.
- B) Converting the nature of income from one type to another.
- C) Shifting income from one time period to another.
- D) This is a form of tax evasion and is not allowed.

Ans: C

Difficulty: Comprehension

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2. Which of the following scenarios illustrates a potential tax avoidance scheme?

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

Ans: D

Difficulty: Comprehension

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3. The manager 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 manager is engaging in

- A) tax evasion.
- B) tax planning.
- C) GAAR.
- D) a Section 18 restriction.

Ans: B

Difficulty: Knowledge

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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 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%.

C) 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%.

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 compounded after-tax value of the investment will be \$1,077.

Ans: C ($12\% \times [1 - .4] = 7.2\%$ after-tax return)

Difficulty: Comprehension, Application

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5. Which of the following statements regarding GAAR is false?

A) When an avoidance transaction takes place, the anti-avoidance rule is automatically applied.

B) A transaction is not seen as an avoidance transaction if it is undertaken primarily for bona-fide business purposes.

C) A transaction is not seen as an avoidance transaction if it is undertaken primarily for investment purposes.

D) A transaction is not seen as an avoidance transaction if it is undertaken primarily for family purposes.

Ans: A

Difficulty: Comprehension

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Problems

6. Steven James earned \$150,000 this year in profits from his proprietorship, which placed him in a 45% tax 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 \$43,000	24%
On the next \$44,000	32%
On the next \$48,000	40%
On income over \$135,000	45%

(All rates are assumed for this question.)

Steven requires \$3,000 of after-tax withdrawals per month for his personal living expenses. All remaining profits are used to pay taxes and to expand the business. Steve expects the same profits before living expenses 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.

Ans:

A)

Excess cash as a proprietorship:

Profits	\$150,000
Tax: 24% x 43,000 \$10,320 32% x 44,000 14,080 40% x 48,000 19,200 45% x 15,000 6,750 (Assumed federal plus provincial rates)	<u>(50,350)</u>
	\$ 99,650
Living expenses	<u>(36,000)</u>
Available for expansion	<u>\$ 63,650</u>

Excess cash as a corporation:

Profits	\$150,000
Salary	<u>(48,000)</u>
Corporate business profits	102,000
Tax: 15% x 100,424	<u>(15,300)</u>
Available for expansion	<u>\$86,700</u>
Excess cash (\$86,700 - \$63,650)	<u>\$23,050</u>

B) Transferring income to another entity

Difficulty: Application/Comprehension

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7. List the three key factors of cash flow and three factors that require speculation for decision making in tax planning.

Ans:

Three key factors of cash flow

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

Three factors requiring speculation

(Several examples are provided here, and students may list other relevant factors, also.)

1. Appropriate discount rate
2. Future tax rates
3. Available cash on hand
4. Predicted rates of growth
5. Future environmental conditions
6. Future business plans

Difficulty: Knowledge

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8. Andrew has \$10,000 to invest. He can put his money into an investment earning an annual rate of 12% interest, which is paid at the end of the year. His annual tax rate is 42%.

Required:

- a) Calculate the 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.

Ans:

- a) $(\$10,000 \times .12) \times (1-.42) = \696 $\$696 + \$10,000 = \$10,696$
- b) $\$10,000 \times .12 \times .42 = \504

Difficulty: Application

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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 business to the company with losses.

Ans:

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 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**

Difficulty: Comprehension

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10. For each of the examples listed below, state which of the three categories of tax planning (shifting income from one time period to another; shifting income from one entity to another; shifting income from one type of income to another) has been applied.

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

Ans:

A. Shifting income to another entity

B. Converting income from one type to another

C. Shifting income from one time period to another

Difficulty: Comprehension

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