

BUSINESS FINANCE TAXATION BMT644 CASE ASSIGNMENT (JOHN MONALILO & RR BUSINESS)

You have just been hired by John Monalilo as a part time tax specialist for his new business located in province of Ontario, Keswick. In 2011, John graduated from McMaster University with a bachelor degree in mechanical engineering and immediately got a permanent full-time job with QR Ltd. Three years later, John started his own sole proprietorship "RR Business" along with his full-time job. RR Business designs and produces sports tools for competitive athletes. Over the past few years, it has built a strong reputation for itself by producing effective products. It is now February 15, 2018, and it's your first day working for John. He calls you into his office to explain what he needs your help with.

John: "Welcome aboard! I'm so glad to have your help. As you know, I currently have a small growing business, and up to now my accountant Eva has been doing all my record keeping using an accounting software". Could you also highlight any tax issues related to 2017 taxation year that I should be aware of?"

You: "I can take a look at that."

John: "Also, I've got a private loan several years ago when I was having some cash flow issues, and the bank insists that I submit financial statements that are compliant with ASPE, and that have been done properly by Eva. However, I have been told that the accounting income should be adjusted to be in accordance with Canadian *Income Tax Act*, whatever that means. I was wondering if you could help by explaining the tax implications and issues. I read an article about "Section 3 of the *Income Tax Act*" the other day, it sounded very relevant but was all Greek to me. By the way, I'll email me the latest financial statements of my business (Exhibit I)."

You: "No worries John, I would love to help and explain that for you."

John: "Oh ... one other thing. I would like your assistance in filing my 2017 personal income tax return. Here are my records (Exhibit II). Believe me or not, I am not familiar with the Canadian tax rules and for this reason I have not filed a return yet. Lastly, my own sole proprietorship "RR Business" is not currently incorporated. The article said that any good business owner should be thinking about the tax advantages of incorporating. They are including an article on this topic in next month's issue, but I thought you might be able to tell me more. Incorporating never made sense to me and just sounds like a big administrative nightmare. How does incorporating differ from just including the income on my personal tax return? Do I really get tax advantages? Does the tax filing, assessment, instalment, payment deadline defer, how? Could you give me estimates of due amounts and when? What are the ways to minimize my tax payable?"

You: "Sure, once I have completed my analysis of your tax information, I'll write a memo explaining all tax implications and issues you have mentioned and determine your income for tax purposes in accordance with section 3 of the *Income Tax Act* including RR's net income from business for tax purposes for 2017. Furthermore, I'll recommend you a new strategy to minimize your tax payable."

EXHIBIT I
TAX INFORMATION OF JOHN'S SOLE PROPRIETORSHIP RR BUSINESS

RR BUSINESS - SOLE PROPRIETORSHIP
INCOME STATEMENT
For the Year ended December 31, 2017

Sales Revenue		\$ 1,872,152
Less: Cost of Goods Sold		(1,104,123)
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Gross Margin		768,029
Operating Expenses		
Payroll expenses		\$ 198,741
Advertising and promotion expenses	Note 1	113,000
General and administrative expenses		98,741
Management bonus	Note 2	60,000
Rent expenses		45,871
Amortization		41,000
Legal fees expenses	Note 3	25,000
Architect's fee for design of new warehouse building		25,000
Internet access fees		18,201
Accounting expenses		7,859
Transaction fees		6,548
Insurance expenses		6,541
Travel, vehicle, and repairs		6,541
Charitable donations		6,000
Interest and bank charges		5,484
Website hosting and maintenance		5,412
Maintenance		<hr/> 1,451
Total Operating Expenses		<hr/> (472,649)
Net Income Before Capital Gains		295,380
Capital gains		33,000
Net Income Before Tax		<hr/> \$ 328,380

RR BUSINESS - SOLE PROPRIETORSHIP
BALANCE SHEET
As at December 31, 2017

ASSETS

Current assets

Cash		\$ 55,613
Accounts receivable		14,521
Inventory		12,541
Prepaid expenses		1,445
Total current assets		\$ 84,120

Non-current assets

Property and equipment and intangibles, net	Note 4	950,000
Investment		42,000
Total non-current assets		\$ 992,000

Total Assets

\$ 1,076,120

LIABILITIES

Accounts payable		\$ 87,510
Long-term debt		155,000
Total liabilities		\$ 242,510

OWNER'S EQUITY

Contributed capital		300,000
Retained earnings		533,610
Total owner's equity		\$ 833,610

Total Liability and Owner's Equity

\$ 1,076,120

NOTES

1. Advertising and promotion includes \$20,000 for airing a TV commercial, \$30,000 for production of the TV commercial, \$5,000 for club memberships in a sports-related facility to enhance business contacts and \$12,000 for acquiring a permanent mailing list for seeking new customers.
2. A management bonus of \$60,000 was announced and accrued in September 2017. The bonus was paid in two equal installments on January 31 and April 30 of the following year.
3. Legal expenses include \$2,000 for drafting the mortgage document for the new warehouse, \$1,000 to investigate a zoning limitation on the new warehouse site, and \$5,000 for the audit fee.
4. During 2017, RR completed construction of a new warehouse building and its cost of \$620,000 was added to the balance sheet. The cost consists of the following:

Building construction	\$500,000
Heating and cooling systems	100,000
Landscaping of grounds	20,000
Total	\$620,000

5. The undepreciated capital cost of CCA classes at the end of the previous taxation year 2016 was as follows:

Manufacturing equipment	\$50,000
Furniture	190,000
Computer equipment	76,000

6. The manufacturing equipment was sold in 2017 for \$65,000 (original cost—\$57,500).
7. During 2017, the company purchased office furniture for \$14,000, and expanded into the manufacturing business by purchasing the following assets:

Equipment (manufacturing)	\$30,000
Product license for an indefinite period	10,000

EXHIBIT II

JOHN PERSONAL TAX INFORMATION FOR 2017

The following information represents John's employment and taxation facts:

1. John Monalilo is a senior mechanical engineer in the logging industry, QR Ltd., a Canadian public corporation and dealing with QR Ltd. at arm's length.
2. John's 2017 gross salary was \$90,000, from which QR Ltd. deducted the following amounts:

Income tax	\$ 30,000
CPP and EI premiums	3,400
Private health insurance premiums	600
Group sickness and accident insurance premiums	400

In addition to his salary, QR Ltd. paid \$2,000 to a deferred profit-sharing plan, \$600 of private health insurance premiums, and \$400 of group sickness and accident insurance premiums on John's behalf.

3. From January 1, 2017 to May 31, 2017 John was entitled to a company car that was purchased for \$58,000, including tax. During this period, John drove this car 12,000 km for employment purposes and 8,000 km for personal use. From June 1, 2017 to September 31, 2017, John was entitled to another company car that was leased for monthly fee \$1050, including tax. John drove the second car 2,200 km per month of which 900 km were for employment purposes. In either case, A Ltd. will pay all of the operating costs for the car which are expected to be \$2,700 annually.
4. John was required to use his own personal automobile (not belong to his RR Business) for QR Ltd. business from October 1, 2017 to the end of the year. For this, QR Ltd. pays him an annual allowance of \$3,600. In 2017, John incurred automobile operating costs of \$5,200. Also, in 2017, he purchased a new automobile (for personal use) for \$34,000 plus HST (13%), and received \$18,000 as a trade on his old car. At the end of the previous year 2016, the old car had an undepreciated capital cost allowance balance of \$15,000 (class 10.1). Of the 20,000 kilometers driven in 2017 using his own car, 12,000 were for employment purposes.
5. Back in 2013, QR Ltd. granted John an option to purchase 1,000 common shares of the QR Ltd. for \$10 per share. The fair market value of the shares at the date the option was granted was \$8 per share. No other stock options were granted to this employee during 2013. In 2014, when the shares were worth \$16 per share John exercised the option and purchased all 1,000 shares. In the current year 2017, John sold the 1,000 shares for \$38 per share. The shares do not have any special dividend rights or restrictions.

6. During 2017, John launched his dream in property investment by purchasing a warehouse property and leased it to QR Ltd. to store construction equipment. The property cost \$250,000 (land 30,000, building 220,000). The building was constructed after March 18, 2007. The price for the land includes \$2,000 of permanent landscaping completed just this year. The 2017 rental income is summarized below:

Rent received		\$20,000
Expenses:		
Insurance	\$ 1,200	
Property taxes	4,000	
Interest	10,000	
Repairs:		
General maintenance	\$ 800	
Storage shed addition to the building	3,000	(19,000)
Income		\$ 1,000

7. On July 1, 2016, John purchased a three-year guaranteed investment certificate for \$20,000 with interest at 10%. The interest compounds annually but is not payable until July 1, 20X9.

8. On September 3, 2017, John sold the following shares he had before:

Shares of a public corporation:	
Selling price	\$ 87,000
Original cost	145,000
Shares of a small business corporation:	
Selling price	\$ 16,000
Original cost	33,500

9. John received (made) the following additional receipts (disbursements) in 2017:

Receipts:	
Dividends (Eligible) from Canadian public corporations	\$ 2,000
Dividends (Non-eligible) from CW Ltd.	3,000
Dividends from foreign corporations (net of 10% foreign tax)	900
Disbursements:	
Contribution to RRSP (within allowable limits)	10,000
Safety deposit box	100

***** THE END *****