

Practice Examination Solution

Chapter 8 (Capital Gains)

Examination Summary

The marks you have received on each question can be added in the final column.

Question	Type Of Question Or Subject	Total Marks	Your Mark
1	Essay Questions	10	
2 - 7	True Or False Questions	9	
8 - 14	Multiple Choice Questions	21	
15	Capital Gains Reserves	15	
16	Involuntary Dispositions	25	
17	Principal Residence Rules	20	
Total		100	

Solution 1 (10 Marks)

- A. The Glossary to your text defines personal use property as “any property that is owned by the Taxpayer and used primarily for his enjoyment, or for the enjoyment of one or more individuals related to the taxpayer.
- B. Listed personal property is certain specified items of personal use property. The included items are works of art, jewelry, rare books, stamps, and coins (this is not required).
- C. In calculating the capital gain or loss on personal use property, the \$1,000 floor rule is used. The proceeds are deemed to be the greater of \$1,000 and the actual proceeds and the adjusted cost base is deemed to be the greater of \$1,000 and the actual adjusted cost base.
- One-half of any gain, i.e. the taxable capital gain, on personal use property must be included in the individual's Net Income For Tax Purposes. Losses are not deductible.
- The only difference in treatment for listed personal property is that allowable capital losses on listed personal property can be deducted against taxable capital gains on listed personal property.

1 grading point for each highlighted item. Total 22

Your Mark = [(# of grading points ÷ 22)(10%)] = ____%

Solutions 2 Through 7 (9 Marks)

2. **True.** The deficiency will have to be included in income if it occurs at any time during the year, not just at the end of the year.
3. **True.** When shares of stock are sold, their adjusted cost base must be determined on the basis of the average cost of the shares acquired.
4. **False.** While such warranty costs are deducted as a capital loss, they cannot be deducted until the taxation year in which the warranty costs are incurred.
5. **False.** This rule only applies when the transfer is from personal use to business use. If the transfer was from business use to personal use, there would be no CCA deducted.
6. **True.** When a property is converted from a rental property to a principal residence, the taxpayer can elect to have property designated as his principal residence for up to four years prior to the time it stopped being used as a rental property.
7. **True.** If an individual holding an option to acquire a capital property exercises that option, the cost of the option will be added to the adjusted cost base of the acquired asset.

1 grading point for each correct answer. Total 6

Your Mark = [(# of grading points ÷ 6)(9%)] = ____%

Solutions 8 Through 14 (21 Marks)

8. **B.** An allowable capital loss of \$1,500. $[(40\%)(500)(1/2)(\$25 - \$10)]$
9. **B.** If a principal residence is converted to a rental property, an individual can elect not to have a deemed disposition and can continue to designate the property as his principal residence for up to four years after the change in use.
10. **C.** When an individual sells shares in a Canadian small business corporation, any resulting capital gain can be deferred if the proceeds are reinvested in shares of another Canadian small business corporation. Both corporations must be eligible small business corporations.
11. **A.** \$5,450 $[(4\%)(1/2)(\$272,500)]$. The \$272,500 is equal to the cost of the building of \$225,000 $(\$275,000 - \$50,000)$, plus one-half of the difference between its fair market value and its cost $[(1/2)(\$320,000 - \$225,000)]$.
12. **D.** A taxable capital gain of \$12,500 $[(1/2)(\$175,000 - \$150,000)]$. There will be no deemed disposition of the rental property.
13. **D.** \$37,193 $[(\$187,000 - \$122,000)(\$107,000 \div \$187,000)]$ As more than 20 percent of the proceeds is collected in each of the first two years, the reserve will be based on the uncollected proceeds of \$107,000.
14. **B.** If the option expires without being exercised, he will have an allowable capital loss of \$2,500.

1 grading point for each correct answer. Total 7

Your Mark = [(# of grading points ÷ 7)(21%)] = ____%

Solution 15 (15 Marks)

The capital gain that resulted from the 2012 disposition was \$70,000 (\$220,000 - \$150,000). At the end of 2012, the balance owing would be \$150,000. Based on this, the reserve for 2012 is the lesser of:

- $[(\$70,000)(\$150,000 \div \$220,000)]$ \$47,727 Reserve
- $[(\$70,000)(20\%)(4 - 0)]$ \$56,000 Reserve

This means that the Net Income For Tax Purposes inclusion for this year would \$11,136.50 $[(1/2)(\$70,000 - \$47,727)]$.

As no proceeds were collected in 2013, the maximum reserve for this year would be the lesser of:

- $[(\$70,000)(\$150,000 \div \$220,000)]$ \$47,727 Reserve
- $[(\$70,000)(20\%)(4 - 1)]$ \$42,000 Reserve

This means that the Net Income For Tax Purposes inclusion for this year after adding back the prior year's reserve, would be \$2,863.50 $[(1/2)(\$47,727 - \$42,000)]$.

For 2014, all of the proceeds have been collected so that **no reserve** can be deducted. With the 2013 reserve added back, the Net Income For Tax Purposes inclusion for this year would be \$21,000 $[(1/2)(\$42,000)]$.

*As a check, the total taxable capital gain of \$35,000 $[(1/2)(\$70,000)]$ has been collected over the 3 years $(\$11,136.50 + \$2,863.50 + \$21,000)$.

1 grading point for each highlighted item. Total 23

Your Mark = $[(\# \text{ of grading points} \div 23)(15\%)] = ___\%$

Solution 16 (25 Marks)**Part A**

The 2012 tax consequences of the involuntary disposition would include both a taxable capital gain and recapture. The amounts would be calculated as follows:

Proceeds Of Disposition (Insurance Proceeds)	\$300,000
Less: Capital Cost	(250,000)
Capital Gain	\$ 50,000
Inclusion Rate	1/2
Taxable Capital Gain	\$ 25,000
UCC Balance	\$175,000
Lesser Of:	
• Cost = \$250,000	
• Proceeds Of Disposition = \$300,000	(250,000)
Negative Closing UCC Balance = Recapture	(\$ 75,000)
Recapture	75,000
January 1, 2013 UCC	Nil

For 2012, there is no CCA claim. Instead, there is \$75,000 in recaptured CCA that must be taken into income. As a result, there is a total of \$100,000 $(\$75,000 + \$25,000)$ that will be added to Leblanc Ltd.'s 2012 Net Income For Tax Purposes.

Part B

After the asset is replaced in 2013, an election can be made under ITA 44(1), and an amended return can be filed for 2012. In the amended return, the taxable capital gain will be nil, the lesser of the amount calculated in Part A (\$50,000) and the following:

Proceeds Of Disposition (Insurance Proceeds)	\$300,000
Less: Cost Of Replacement Property	(500,000)
Excess, If Any	Nil

Using the ITA 13(4) election, a new recapture figure can be calculated as follows:

January 1, 2012 UCC Balance	\$175,000
Deduction:	
Lesser Of:	
• Proceeds Of Disposition = \$300,000	
• Capital Cost = \$250,000	\$250,000
Reduced By The Lesser Of:	
• Normal Recapture = \$75,000	
• Replacement Cost = \$500,000	(75,000) (175,000)
Recapture Of 2012 CCA (Amended)	Nil

Part C

Assuming that Leblanc Ltd. makes the appropriate tax minimizing elections under ITA 13(4) and 44(1), the CCA claim for 2013 would be calculated as follows:

January 1, 2013 UCC	Nil
Add: Cost Of Replacement Property	\$500,000
Less: Reduction For Gain Reversed Under ITA 44(1)	(50,000)
Deemed Cost	\$450,000
Less: Recapture Reversed Under ITA 13(4)	(75,000)
UCC*	\$375,000
One-Half Net Additions	(187,500)
CCA Base	\$187,500
CCA Rate - Class 8	20%
CCA Claim	\$ 37,500

*As a check, the UCC for the new building is equal to the UCC of the old building (\$175,000), plus the additional \$200,000 (\$500,000 - \$300,000) in funds paid by Leblanc in excess of the insurance proceeds.

1 grading point for each highlighted item. Total 29

Your Mark = [(# of grading points ÷ 29)(25%)] = ____%

Solution 17 (15 Marks)

The capital gains on the two properties would be calculated as follows:

	City Home	Cottage
Proceeds Of Disposition	\$528,000	\$330,000
Adjusted Cost Base	(264,000)	(36,000)
Real Estate Commissions	(32,000)	(16,000)
Capital Gain	\$232,000	\$278,000

During the period 1997 through 2013 (17 years), the cottage experienced the larger capital gain as shown in the preceding table. To minimize the total capital gain, it should be designated the principal residence for 16 years. This will completely eliminate the capital gain as the exemption formula adds an additional year. This will leave one year for the city home to be designated his principal residence.

Given this approach, the exemptions would be as follows:

	City Home	Cottage
Capital Gains Before Exemptions	\$232,000	\$278,000
Exemption:		
City Home [$\$232,000 \times [(1 + 1) \div 17]$]	(27,294)	
Cottage [$\$278,000 \times [(16 + 1) \div 17]$]		(278,000)
Capital Gain	\$204,706	Nil

This gives a total capital gain of \$204,706 on the two properties and a taxable capital gain of \$102,353 [$(1/2) \times (\$204,706)$].

1 grading point for each highlighted item. Total 17

Your Mark = $[(\# \text{ of grading points} \div 17)(15\%)] = __\%$