

CFE CANDIDATE NUMBER:

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**Common Final Examination
September 13, 2017 – Day 1
(Booklet #1 – PRI Version 2)**

Total examination time: 4 hours.

Further details on the examination can be found on the next page.

GENERAL INSTRUCTIONS BEFORE THE EXAMINATION

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CANDIDATE NAME (Please print)

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Examination Details

The examination consists of:

Booklet #1 – Linked Case (240 minutes) (this booklet)

Booklet #2 – Capstone 1 case and rough notes

The case should be answered in Securexam. Securexam has an answer tab and a spreadsheet tab to input your response. The main body of your response should be in the answer tab. Only supporting calculations should appear in the spreadsheet tab, **under Sheet 1**. You are responsible for clearly explaining all your calculations, as outlined in the Securexam tutorial.

Answers or part answers will not be evaluated if they are recorded on anything other than Securexam or the CPA Canada writing paper provided. Rough-note paper is available in the second booklet, which also includes a copy of the Capstone 1 case. Rough notes, and any other notations made in the exam booklet(s) will not be evaluated.

The CPA Canada Handbooks and the Income Tax Act, in the form of searchable PDF files, are available within Securexam throughout the entire examination. Securexam provides the standards in effect and tax laws substantively enacted as at December 31, 2016.

A tax shield formula and other relevant tax information are available at the end of this booklet.

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Common Final Examination, September 2017

Chartered Professional Accountants of Canada
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Toronto, Ontario M5V 3H2

Case**(Suggested time: 240 minutes)**

Phoenix Risen Incorporated (PRI) has gone through a period of significant change, with the passing of ownership to the third generation of the Legault family. You, CPA, have become a trusted member of the management team.

It is now January 14, 2018. As part of the ownership transfer, you helped develop a strategy to meet the needs of both PRI and the former controlling shareholders. The senior family members have retired, and Jennifer and Maggie are no longer actively involved in the business. As Martina continues to modernize the company, your advice remains key. Martina and George continue to head up Phoenix and Cinder, respectively, and Martina also oversees PRI as a whole.

PRI did not acquire Sparky, choosing to focus instead on the Phoenix and Cinder brands. Phoenix is in the process of closing its suburban locations because they are unprofitable and no longer fit with PRI's vision. Accepting that online shopping is a reality it must embrace, PRI created a website for Phoenix and is now making longer-term decisions regarding Phoenix's and Cinder's online presence. To avoid the problems experienced with their venture into suburban stores, the move to online must be well executed. The decision to close stores and reduce Phoenix's size has increased the need to grow PRI through online sales in Canada, and possibly into the U.S. and international markets.

There continues to be increasing pressure on margins in the retail industry. This is partly due to the increased popularity of online shopping and to consumers' ability to use technology to research prices and find deals. High-end U.S. retailers are also opening stores in Canada where customers can still have a face-to-face experience. Specialty box stores are starting to open satellite locations in small centres, where many Cinder stores are located. The economy is stable, but the Canadian dollar has lost value relative to the U.S. dollar.

Phoenix proceeded with the sale and leaseback of its flagship Vancouver store. Phoenix obtained good rates and the option to repurchase the property at the end of the 10-year lease. Having the repurchase option made the decision easier; however, there are still many issues to resolve with respect to Phoenix's real estate holdings.

There is concern about the quick pace of change in the industry and the relationship between the online and storefront aspects of PRI's business. Martina is particularly interested in ensuring that decisions in these two areas are made with long-term success in mind. She asks you to advise her, and the board, on whether they are moving in the right direction and on the decisions to be made. Excerpts from the discussions with Martina are included in Appendix I.

INDEX TO APPENDICES

	<u>Page</u>
I Excerpts from CPA's Discussions with Martina	4
II Online Shopping Website Proposal.....	7
III Online Feedback on Current Phoenix Website	9
IV Online Shopping Survey	10
V Shipping and Return Policies	11
VI Notes from Meeting with George	12
VII Background Information on Phoenix Properties	13

**APPENDIX I
EXCERPTS FROM CPA'S DISCUSSIONS WITH MARTINA**

Online Shopping

The decision not to proceed with Sparky or its online shopping system was a tough one. Ultimately, its corporate culture differed too much from PRI's, and we were concerned about the data breach that had occurred. This seems to be a common concern for online sales, and other large retailers have experienced similar events. Despite this, I am now convinced of the need for an online presence. As a result, we moved into online shopping.

As you know, Phoenix is one of the few online retailers that serves the Canadian market exclusively. This strategy allows us to fulfill our original mission of "being a hallmark retailer in the Canadian market, with strong traditions and values" while becoming more accessible to a wider market. Our mission statement now reflects the online addition: "Our mission is to serve our customers through our stores by providing a high-quality retail experience. The experience is tailored to meet the needs of Canadians by providing value, quality, choice, and service they can trust. *From in-store to online, we make it easy for Canadians to shop with us.*"

In an effort to be online quickly, we rather impulsively entered into an 18-month contract with a service provider, Express Site (Express). With Express, we have put approximately 25% of Phoenix's product line on our website, and we should have the remainder up before the end of the contract. We also want to develop an online presence for Cinder. Once Phoenix's site is fully operational, we will begin bringing Cinder online. We are considering creating "sister sites" and linking the websites so that when a customer visits one site, there is a link to the other, and orders can be combined in one virtual shopping basket and processed with one checkout.

The Express contract expires on June 30, 2018, unless we renew it. We need to decide whether to continue with Express. We have another proposal, from Alpha Shop (Alpha). Both proposals are outlined in Appendix II. While we have been happy with many aspects of Express's service, there have also been issues (Appendix III).

We want to be personal with our customers, even online. There is a lot of opportunity to use technology to target our customers. We think marketing campaigns that cater to our customers' individual needs directly would engage them and benefit our sales. A recent survey of both Phoenix and Cinder customers might help with your analysis (Appendix IV).

The reality is that we need a strategy for e-commerce across PRI. For both Phoenix and Cinder, we must decide how to best approach our clientele.

APPENDIX I (continued)
EXCERPTS FROM CPA'S DISCUSSIONS WITH MARTINA

Warehousing and Distribution – Online Sales

We started closing Phoenix's suburban locations a few months ago and, in order to quickly start online sales for Phoenix, began using our Winnipeg location as a temporary warehousing and distribution centre. Putting staff out of their jobs is not something we like to do. Using this location enabled us to reduce the number of layoffs. If feasible, I would like to continue to use the Winnipeg location for our online orders, but I recognize that its physical layout is not conducive to stocking products so they can be efficiently located, packaged, and readied for customer delivery.

Orders are processed at the Winnipeg warehouse in one to two days, and shipping times range from one to seven days, depending on the customer's location. Shipping from Winnipeg to locations such as Newfoundland is proving to be slower than we thought. I expect that modifications can be made to increase the efficiency and speed up the processing time but am not sure.

Our stores could perhaps be used for online distribution, but they would require renovations in order to accommodate the additional inventory and processing functions. Customer orders would be sent from the closest store with available inventory, so there would be no regional differences to contend with. Processing time from the stores is expected to be three days, since they are not dedicated to this service exclusively, and shipping times would likely range from one to three days, depending on the location of the inventory and the customer's location.

As we get the remaining Phoenix inventory on the website and establish Cinder's website, we anticipate that online sales will continue to grow. We also need to consider any impact from offering free shipping or other options (Appendix V), and any potential expansion to the U.S. market.

APPENDIX I (continued)
EXCERPTS FROM CPA'S DISCUSSIONS WITH MARTINA

Other

Maggie's son Jeff recently graduated with a MBA in international business, and I hired him as the VP of e-commerce, a new position. The VPs of marketing are not happy because they think I am interfering with their area of expertise and giving preference to family members again.

Jeff's vision is to make PRI a global e-commerce retailer. He believes that we need to expand our online presence and let go of our emotional attachment to storefronts, and that we can do this while remaining true to our core beliefs. He sees us promoting Canadian products to the world, starting with the U.S., and supplying Canadians living around the globe through our online presence. He sees us developing an "app" for mobile devices and using social media for promotion and actual purchases. His ideas include shipping directly from suppliers to customers, teaming up with other businesses to reach new customers, creating an interactive web magazine, and possibly adding entertainment to our websites. According to Jeff, we are behind, catering to Generation X when we should be looking ahead to the Millennials!

At the same time, we have to decide what to do with our real estate holdings. We have deferred much needed capital expenditures because we are evaluating whether we should maintain ownership of some or all of our properties. George insists we should be expanding our real estate interests (Appendices VI and VII).

I know we need to continue to evolve, but George and Jeff have such different views about the direction PRI should be heading.

Please consider all this in your analysis of our e-commerce strategy and overall management approach.

APPENDIX II ONLINE SHOPPING WEBSITE PROPOSAL

Express Site (Express)

Express provided Phoenix with an efficient means of getting its online site operational. Express is an American company that traditionally works with small businesses that want to establish online shopping without the level of sophistication of larger retailers.

Express set up a website, designed in collaboration with Phoenix. The basics of the website image are pre-set and unchangeable, but the store logo and brand colours can be used to customize the look.

The site's categories are organized to match the departments in Phoenix so that Phoenix's customers can easily navigate the layout to find specific items. Inventory items must be individually entered in Express's system by Phoenix, allowing Phoenix to control which items are available to customers online.

When customers find an item to purchase, they add it to their shopping cart and continue shopping until ready to check out.

There is no customer profile or login on the Express site. Customers simply enter a shipping address. Express's checkout system relies on a partnership with FriendlyPay, an online payment service that provides security over payments and a customer guarantee. When customers check out, they are directed to FriendlyPay to submit their payment and are then redirected back to the main site. The FriendlyPay system provides additional controls over the customer's payment information.

Once their order has been submitted, the customer receives an email confirming the order and the amount charged to their credit card. Because the Express platform is unable to synchronize with Phoenix's inventory system, customers receive a second email within 24 hours, confirming that the product is available and providing the anticipated delivery date. If not available immediately, the item's anticipated delivery date is provided based on when it will be restocked.

Phoenix paid \$1.25 million upfront to Express for the establishment of the site, which commenced operation on January 1, 2017. An additional \$250,000 was paid for the inclusion of the first 25% of inventory items, with the remaining 75% still to be included at an additional cost of \$750,000. After 18 months, an ongoing annual maintenance fee of \$175,000 is required, and the contract is renewable on a yearly basis at Phoenix's discretion. If Cinder were to use Express, it would incur an additional set of fees, including the upfront payment, the fee for adding inventory, and the ongoing maintenance fees.

Express is capable of adding U.S. versions of its sites. This would require the creation of a separate site, and it would incur an additional set of the fees listed above for each U.S. site.

APPENDIX II (continued)
ONLINE SHOPPING WEBSITE PROPOSAL

Alpha Shop (Alpha)

Alpha is a Canadian IT company specializing in online shopping platforms, mobile applications, and social media. Known as a leader in the industry, Alpha has built its reputation by gaining shoppers' trust and by providing retailers with an easy-to-use system. Each site is customized to reflect the image of Alpha's client company. Alpha aims to reflect online the in-store experience that shoppers are accustomed to. Alpha can customize separate sites for Phoenix and Cinder or, at a reduced rate, can use the same format for both. It can also link the two sites, allowing customers to create one profile and combine orders from both stores.

When a customer enters an Alpha-created site, they are provided with an overview of the store's departments, easy access to the weekly promotions, and a handy search function at the top of the page. The search function allows customers to customize the search and to limit results within specific parameters.

The Alpha system would be synchronized with PRI's inventory so that items are automatically included on the site and customers are aware of inventory levels when shopping. PRI can also choose not to sell certain items online, in which case store inventory details will be provided, but customers will be unable to order the product from the website.

Customers can further improve their individual shopping experience by setting up a profile. The profile includes the customer's billing address and phone number, as well as an option to add additional mailing addresses. Customers can choose to enter their payment information and have it stored in their profile. Alpha's system will track all shopping history and use the information to predict other products that customers may like. PRI could use this information to target customers through direct marketing. For example, a customer who has viewed jewellery and accessories one day may receive an email the next day about similar products.

When a product is selected, customers add it to their shopping cart. Once the customer is ready to check out, the system prompts the customer to either log in using their profile or continue as a guest. Customers review the order before confirming the purchase. PRI has the option to store the credit card information for future use. The system compares the billing address to the address for the credit card entered, which verifies that the card belongs to the user ordering the product. Upon completion of the order, a confirmation email is sent, including an anticipated delivery date. Customers can also log into their account for up-to-date tracking information.

Alpha requires a five-year contract and provides the option of a five-year renewal term. Development of sites for both Phoenix and Cinder would cost \$2.6 million in total, with a \$1-million annual fee.

Alpha's website is easily convertible to U.S. currency, handles different tax rates, and any shipping options.

APPENDIX III
ONLINE FEEDBACK ON CURRENT PHOENIX WEBSITE

Glad you finally have online shopping available! I like to purchase items in your store, but it was nice to be able to research it online. I was surprised by the selection, though – it seems that you have more available in the store. The site itself seemed rather amateurish in comparison to the quality I expect and associate with Phoenix.

– Shop-a-holic

I ordered a product online for a gift, only to find out a few days later that you don't have it in stock. Now my sister's gift will be late! I didn't even have the option to cancel the order when I discovered this. Unacceptable.

– Mad Sis

I ordered a sweater, which arrived on schedule. I am nervous shopping online, but I trust FriendlyPay, and this made the experience feel secure. Thanks!

– Secure Spender

I loved the free shipping! I will definitely use Phoenix for all future online purchases. It's a great way to send gifts to relatives across the country without additional costs. I also love that you are exclusively Canadian. I am happy to support you!

– Family Afar

The FriendlyPay steps were cumbersome. I disliked having to set up another account! Why can't I just pay you directly? It would be faster.

– Speedy Shopper

I was excited about the site, but the process was quite slow and not comparable to other retailers. I expected more from Phoenix. Not knowing if goods are in stock means I won't be ordering from you.

– High Expectations

Your products are great! I am moving to the U.S. shortly. With online shopping, there is no reason not to expand outside of Canada! My American family had never heard of Phoenix, but I know they would love you.

– Loyal and Hopeful

**APPENDIX IV
ONLINE SHOPPING SURVEY**

The following survey was provided to both Phoenix and Cinder shoppers. Shoppers were asked to provide an answer on a scale of (1) to (5), with (1) being “strongly disagree” and (5) being “strongly agree.”

The average results were as follows:

	Phoenix	Cinder
You regularly use a computer with online access.	4.0	4.9
You frequently (more than six times a year) purchase items online.	2.1	4.0
Before purchasing an item in a store, you research it online.	1.9	3.1
You are comfortable providing information online.	1.9	3.5
Technology invading your privacy is a concern to you.	4.2	3.0
You prefer a website that remembers your information.	1.5	4.1

In addition, customers were asked to provide feedback on what the most important aspects of an online shopping website are to them.

The most common replies were as follows:

Phoenix	Cinder
<ul style="list-style-type: none"> ▪ Same experience as in the store 	<ul style="list-style-type: none"> ▪ Product information on what is in stock and pricing by store
<ul style="list-style-type: none"> ▪ Ease of purchase 	<ul style="list-style-type: none"> ▪ Personalized shopping
<ul style="list-style-type: none"> ▪ Ease of returns 	<ul style="list-style-type: none"> ▪ Ease of returns
<ul style="list-style-type: none"> ▪ Security 	<ul style="list-style-type: none"> ▪ Navigability

APPENDIX V
SHIPPING AND RETURN POLICIES

Believing in customer service and wanting to maintain a high-end feel, Martina felt that charging for shipping would not meet the expectations of Phoenix's customers. In the current year, all orders were shipped for free. Goods could be returned within thirty days, and customers either returned the goods free of charge to a store or paid for any shipping incurred. Phoenix experienced a quick online ordering uptake, since it allowed customers to purchase goods with little risk.

Approximately 25% of total online orders are currently being returned. This has been frustrating, as Phoenix has historically experienced much lower return rates. The cost of shipping goods is high, particularly when shipping out of Winnipeg. When goods are returned, Phoenix loses the sale and incurs shipping and restocking costs, which is negatively impacting its margins.

Martina has had the marketing department analyze the impact of various shipping options on the volume of sales. She is considering three options: maintaining the free shipping on all orders, providing free shipping on orders of \$50 and over, or charging all shipping costs directly to the customer. Ignoring the returns, the estimated 12-month projections for each option are as follows:

	<u>Free Shipping</u>	<u>Free Shipping on Orders of \$50 and Over</u>	<u>Shipping Billed to Customer</u>
Number of orders of \$50 and over	50,890	75,200	48,362
Number of orders under \$50	60,765	13,564	12,975
Total expected revenues*	\$ 13,081,000	\$ 16,376,000	\$ 11,117,000
Total expected COGS*	<u>7,848,000</u>	<u>9,825,400</u>	<u>6,670,200</u>
Margin on orders	<u>\$ 5,233,000</u>	<u>\$ 6,550,600</u>	<u>\$ 4,446,800</u>

*On average, shipping costs are \$20 for orders of \$50 and over, and \$9 for orders under \$50. Shipping costs are expected to decrease if shipped from locations closer to the destination, rather than from Winnipeg. In the above table, revenues and cost of goods sold exclude the shipping.

Approximately 75% of orders are from customers residing less than 100 kilometres from a Phoenix store.

Martina would like your assessment of these alternatives. Additionally, she wonders if Cinder should follow the same approach or consider a different policy. If U.S. sales proceed, the preference is to use the same policy for both countries.

APPENDIX VI
NOTES FROM MEETING WITH GEORGE

Just because we decided not to pursue the REIT idea does not mean we should ignore our real estate holdings entirely. Most of our returns have been generated through our real estate. For example, our Toronto retail centre had a \$400 million fair market value five years ago, and it is now valued at \$700 million (Appendix VII).

The increase in real estate values makes it tempting to sell all our properties. But PRI would then be strictly a retail operation, which, in my opinion, results in us being less diversified and exposed to higher business risk. While Jeff is all about e-commerce, I think real estate and e-commerce can and should support each other.

While we have started closing Phoenix's suburban stores, the downtown stores are part of our history, so upgrading them is important. I think we should also upgrade the two malls we own and use the rental income as a stable revenue source. Converting the retail space in our Winnipeg mall to a warehouse means there is no longer an anchor tenant, which may reduce the mall's attractiveness to other retailers.

PRI should acquire additional commercial rental property in the downtown cores of cities where we currently have stores, and it should look at buying suitable buildings for a store in Halifax and St. John's, so we have stores from coast to coast.

I have updated the information on our Phoenix properties, including their fair values, mortgages, and capital expenditures (Appendix VII). I am convinced that real estate is the only thing guaranteed to provide a good rate of return and increase in value over time. In the past few years, the Toronto retail centre has increased in value by almost 20%. We should have no problem getting mortgages to fund the capital expenditures required and to acquire more properties. We have \$1,400 million in equity from our properties that should be easily convertible to cash. If we use the properties as security for a mortgage, the interest rate should be low and we can choose a long amortization period. I plan to get the capital expenditures underway as soon as possible.

In the past, we bought properties for the purpose of opening stores and did not focus on managing the properties as a stand-alone business. I propose that we change that — we should be increasing the number of properties we own, not divesting.

APPENDIX VII
BACKGROUND INFORMATION ON PHOENIX PROPERTIES
(in millions of dollars)

		FMV	Historical Cost	Mortgage	Capital Expenditure Estimates	
					Year	Amount
Toronto	Retail centre	\$700	\$120	\$0	2018	\$28
Calgary	Retail centre	\$490	\$300	\$104	2018	\$13
Montreal	Building	\$4	\$1	\$0	2018	\$1
Edmonton	Suburban mall	\$300	\$375	\$90	2019	\$20
Winnipeg	Suburban mall	\$90	\$125	\$0	2019	\$30
Total		\$1,584	\$921	\$194		\$92

The mortgages mature in the following years:

Montreal 2018
Edmonton 2029
Calgary 2033

End of Exam

CPA COMMON FINAL EXAMINATION REFERENCE SCHEDULE

1. PRESENT VALUE OF TAX SHIELD FOR AMORTIZABLE ASSETS

Present Value of Total Tax Shield from CCA for a New Asset

$$= \frac{CTd}{(d+k)} \left(\frac{2+k}{2(1+k)} \right) = \frac{CdT}{(d+k)} \left(\frac{1+0.5k}{1+k} \right)$$

Notation for above formula:

C = net initial investment

T = corporate tax rate

k = discount rate or time value of money

d = maximum rate of capital cost allowance

2. SELECTED PRESCRIBED AUTOMOBILE AMOUNTS

	2016	2017
Maximum depreciable cost — Class 10.1	\$30,000 + sales tax	\$30,000 + sales tax
Maximum monthly deductible lease cost	\$800 + sales tax	\$800 + sales tax
Maximum monthly deductible interest cost	\$300	\$300
Operating cost benefit — employee	26¢ per km of personal use	25¢ per km of personal use
Non-taxable automobile allowance rates		
— first 5,000 kilometres	54¢ per km	54¢ per km
— balance	48¢ per km	48¢ per km

3. INDIVIDUAL FEDERAL INCOME TAX RATES

For 2016

<u>If taxable income is between</u>	<u>Tax on base amount</u>	<u>Tax on excess</u>
\$0 and \$45,282	\$0	15%
\$45,283 and \$90,563	\$6,792	20.5%
\$90,564 and \$140,388	\$16,075	26%
\$140,389 and \$200,000	\$29,029	29%
\$200,001 and any amount	\$46,316	33%

For 2017

<u>If taxable income is between</u>	<u>Tax on base amount</u>	<u>Tax on excess</u>
\$0 and \$45,916	\$0	15%
\$45,917 and \$91,831	\$6,887	20.5%
\$91,832 and \$142,353	\$16,300	26%
\$142,354 and \$202,800	\$29,436	29%
\$202,801 and any amount	\$46,965	33%

4. SELECTED INDEXED AMOUNTS FOR PURPOSES OF COMPUTING INCOME TAX

Personal tax credits are a maximum of 15% of the following amounts:

	2016	2017
Basic personal amount	\$11,474	\$11,635
Spouse, common-law partner, or eligible dependant amount	11,474	11,635
Age amount if 65 or over in the year	7,125	7,225
Net income threshold for age amount	35,927	36,430
Canada employment amount	1,161	1,178
Disability amount	8,001	8,113
Infirm dependants 18 & over	6,788	6,883
Net income threshold for infirm dependants 18 & over	6,807	6,902
Adoption expense credit limit	15,453	15,670

Other indexed amounts are as follows:

	2016	2017
Medical expense tax credit — 3% of net income ceiling	\$2,237	\$2,268
Annual TFSA dollar limit	5,500	5,500
RRSP dollar limit	25,370	26,010
Lifetime capital gains exemption on qualified small business corporation shares	824,176	835,716

5. PRESCRIBED INTEREST RATES (base rates)

<u>Year</u>	<u>Jan. 1 – Mar. 31</u>	<u>Apr. 1 – June 30</u>	<u>July 1 – Sep. 30</u>	<u>Oct. 1 – Dec. 31</u>
2017	1	1	1	
2016	1	1	1	1
2015	1	1	1	1

This is the rate used for taxable benefits for employees and shareholders, low-interest loans, and other related-party transactions. The rate is 4 percentage points higher for late or deficient income tax payments and unremitted withholdings. The rate is 2 percentage points higher for tax refunds to taxpayers, with the exception of corporations, for which the base rate is used.

6. MAXIMUM CAPITAL COST ALLOWANCE RATES FOR SELECTED CLASSES

Class 1.....	4% for all buildings except those below
Class 1.....	6% for non-residential buildings acquired for first use after March 18, 2007
Class 1.....	10% for manufacturing and processing buildings acquired for first use after March 18, 2007
Class 8.....	20%
Class 10.....	30%
Class 10.1.....	30%
Class 12.....	100%
Class 13.....	Original lease period plus one renewal period (minimum 5 years and maximum 40 years)
Class 14.....	Length of life of property
Class 14.1	5% For property acquired after December 31, 2016
Class 17.....	8%
Class 29.....	50% Straight-line
Class 43.....	30%
Class 44.....	25%
Class 45.....	45%
Class 50.....	55%
Class 53.....	50%