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THE UNIVERSITY OF BRITISH COLUMBIA
FACULTY OF LAW

FINAL EXAMINATION – APRIL 2019

LAW 407

Section 1
Professor Duff

TOTAL MARKS: 100

TIME ALLOWED: 3 HOURS
Plus 30 minutes reading time

- NOTE:
1. This is an open book examination.
 2. ANSWER ALL QUESTIONS.

THIS EXAMINATION CONSISTS OF 2 QUESTIONS

EACH QUESTION IS WORTH 50 MARKS

(ALLOCATION OF MARKS WITHIN EACH QUESTION INDICATED IN
SQUARE BRACKETS AFTER THE QUESTION)

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QUESTION 1

Denise Seguin is a digital marketing expert and avid rock climber, who completed a Masters in Business Administration at the *hautes études commerciales* (HEC) in Montreal in the spring of 2015. Despite several job offers from digital media companies in Montreal, Denise decided to move to Squamish B.C. after graduating, in the expectation that she could find work in Vancouver's growing digital media industry while also pursuing her passion for rock climbing. In June 2015, Denise moved to Squamish, where she purchased a used car for \$8,000 and rented a two-bedroom apartment from July 1, 2015 to June 30 2016. The next month, she began looking for work in Vancouver.

Despite stellar grades and excellent references, Denise found it challenging to find a full-time job in Vancouver. In mid-July, however, Denise obtained a part-time position as a digital marketing consultant with Tout Suite Ltd. ("Tout Suite"), a Canadian-controlled private company (CCPC) that had developed a social media management platform to organize multiple social media accounts and networks. According to the terms of her agreement with Tout Suite, Denise would be paid \$50 per hour, was expected to work 20 hours per week, and was to report to the company's Senior Marketing Manager at Tout Suite's Vancouver office on a weekly basis. The agreement also stated that Denise would be regarded as an independent contractor, who was responsible for paying her own income taxes and pension contributions, and was expected to perform most of her duties either at home or at the offices of Tout Suite clients in the Vancouver area.

In her tax return for her 2015 taxation year, Denise reported payments from Tout Suite as income from a business, against which she deducted a portion of the rent and utilities that she paid on her Squamish apartment based on the square feet of the bedroom that she used as a home office compared to the square feet of the apartment as a whole. She also deducted the cost of office furniture and a computer that she acquired for the purpose of her home office, and a portion of the capital cost of her car based on its use to visit Tout Suite clients and Tout Suite's Vancouver office for weekly meetings with the company's Senior Marketing Manager.

During the summer and fall of 2015, Denise worked diligently in the hope that she might secure a permanent position at Tout Suite. In order to supplement her income, she also advertised her services as a rock-climbing instructor by posting notices in Squamish sports stores and coffee shops. In computing her income for her 2015 taxation year, Denise reported revenue of \$1,800 from this activity, against which she deducted the cost of new rock-climbing equipment gear and trips to check out rock-climbing locations in the B.C. interior, resulting in a net loss of \$3,200, which she deducted against the net income that she reported from Tout Suite. At the end of 2015, Denise decided to stop offering rock-climbing lessons and took down all the notices that she had put up in Squamish advertising her services.

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Question 1 (continued)

In November 2015, Tout Suite offered Denise a permanent position as a digital marketing specialist commencing on January 1, 2016, which she accepted. Under the terms of this agreement, Denise received an annual salary of \$100,000 and the right to acquire 20,000 non-redeemable Tout Suite common shares for \$10 per share (which was their fair market value at the time). The agreement also stipulated that she was expected to perform most of her duties at Tout Suite's Vancouver office and the offices of Tout Suite clients, would be reimbursed for the use of a motor vehicle to travel from the company's Vancouver office to the offices of Tout Suite clients at 54 cents per kilometre (the authorized CRA rate for the year), and could work at home one day a week to identify and prepare presentations to potential clients. Thrilled with the permanent position, Denise sold her used car for \$6,000 on January 2, 2016, and bought a new Jeep Compass SUV the same day for \$28,000.

In her tax return for her 2016 taxation year, to which she attached a signed form from Tout Suite that she was required to maintain a home office and to use her motor vehicle for work, Denise reported her salary as employment income and did not include any amount in respect of the right to acquire Tout Suite shares nor the motor vehicle allowance that she received for travel from Tout Suite's Vancouver office to the offices of Tout Suite clients. She also deducted a portion of the rent and utilities that she paid on her Squamish apartment (again based on the square feet of the bedroom that she used as a home office compared to the square feet of the apartment as a whole) and a portion of the capital cost of her new SUV based on its use to travel from her home in Squamish to the offices of Tout Suite clients to which she frequently travelled directly at the beginning of the day and from which she often returned directly at the end of the day.

In January 2017, Denise was offered a managerial position at Tout Suite, which would require her to perform most of her duties at Tout Suite's Vancouver office. By this time, the value of Tout Suite's shares had increased to \$110 per share as rumours circulated that the company might issue shares on the Toronto Stock Exchange. For these reasons, Denise decided to exercise some options and sell shares in order to purchase a condo in Vancouver so that she would not have to commute the 65 kilometres to Vancouver from her Squamish apartment (which she had rented for another year from July 1, 2016 to June 30, 2017).

On January 31, 2017, Denise exercised the right to acquire 10,000 Tout Suite shares for \$100,000, after which she immediately sold the shares to an arm's length purchaser for \$1.1 million (using the proceeds from the sale to pay for the options). Later that day, Denise paid \$750,000 to purchase a condominium in Vancouver's Yaletown District and deposited the remaining \$250,000 in an interest-bearing savings account. A month later, on February 28, 2017, Denise moved from Squamish to Yaletown. Although Denise tried to cancel the lease on the Squamish apartment, the landlord refused and she was required to pay rent on the apartment for another four months until the end of June 2017, during which time she used the apartment to store her rock-climbing gear.

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Question 1 (continued)

In her tax return for her 2017 taxation year, Denise reported her annual salary from Tout Suite, interest income from her savings account, and a taxable benefit of \$1 million in respect of the options that she exercised on 10,000 Tout Suite shares in respect of which she claimed a deduction of \$500,000 in computing her taxable income. She also deducted a portion of the rent and utilities that she paid on her Squamish apartment for January and February (again based on the square feet of the bedroom that she used as a home office compared to the square feet of the apartment as a whole) as well as a terminal loss on her SUV on the basis that she was no longer using it for the purpose of earning income after she moved to Vancouver. She also deducted the cost of transporting household effects from Squamish to Vancouver, legal fees and property transfer taxes on the purchase of the Yaletown condominium, and rent on the Squamish apartment from March to June 2017.

Denise recently received a notice of reassessment from the Canada Revenue Agency (CRA) for her 2015, 2016 and 2017 taxation years which

- (1) disallowed the deduction of home office and motor vehicle expenses in her 2015 taxation year on the grounds that she was employed by Tout Suite and had not filed the form required under subsection 8(10) of the *Income Tax Act* (ITA) [12 marks];
- (2) disallowed the loss from her rock-climbing enterprise in her 2015 taxation year on the grounds that this activity was not a business with a reasonable expectation of profit or that the expenses were unreasonable under section 67 of the ITA [10 marks];
- (3) disallowed the deduction of home office expenses in her 2016 and 2017 taxation year on the grounds that her use of the work space office did not satisfy the requirements of subsection 8(13) of the ITA [4 marks];
- (4) disallowed the deduction of motor vehicle expenses in her 2016 taxation year and the terminal loss on her SUV in her 2017 taxation year on the grounds that she had received a motor vehicle allowance that was exempt from tax [6 marks];
- (5) disallowed a deduction in respect of options that she exercised in 2017 on the basis that she disposed of the shares within two years of their acquisition [6 marks]; and
- (6) disallowed the deduction of moving expenses in her 2017 taxation year on the basis that the move did not enable her to be employed at a new work location [12 marks].

Please advise Denise on the merits of this notice of reassessment, explaining which of these amounts should could deduct for each of these taxation years, referring to relevant statutory provisions and judicial decisions.

END OF QUESTION 1

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QUESTION 2

John Beverley is a Toronto lawyer, who practices in the area commercial real estate at a firm called Beverley McLachin LLP. Married to another lawyer named Lisa Gregory, John and Lisa reside in a home in Toronto's affluent Rosedale neighbourhood (the "Rosedale Home"), which they purchased in 2016. They also own a recreational property in Caledon (the "Caledon Home") northwest of Toronto, which John inherited from his father when he passed away in 2008.

The Caledon Home was originally part of a fifteen-acre farm (the "Caledon Property") that John's father purchased in 1979, when Caledon's zoning by-law required a minimum lot size of 15 acres for land that was zoned for agricultural purposes. In the early 1980s, John's father spent \$250,000 to renovate an old farmhouse on the property, where John spent weekends and holidays while growing up, and where he and Lisa have spent weekends and holidays since he inherited the property in 2008. Although zoned for agricultural purposes, neither John's father nor John used the property for this purpose, though they rented 12 of the 15 acres to a local farmer who used this land to grow corn. When John inherited the Caledon Property in 2008, its fair market value (which became its adjusted cost base to John) was \$1.25 million, of which \$250,000 was attributable to the renovated farmhouse, \$400,000 to the 3 acres subjacent to and immediately contiguous to the farmhouse, and \$600,000 (\$50,000 per acre) to the 12 acres that were rented out to the local farmer.

In June 2014, the Town of Caledon adopted a new zoning by-law which allowed certain agricultural land, including the Caledon Property, to be rezoned for development purposes and subdivided into one-acre parcels. Since John and Lisa considered 15 acres unnecessary to their use and enjoyment of the farmhouse residence as a recreational property, they decided to rezone the Caledon Property so that it could be subdivided into a 3-acre property on which the farmhouse was situated, which they would retain for personal use, and 12 one-acre lots that they would sell for residential development. When John submitted an application to rezone and subdivide the Caledon Property later that summer, its fair market value was \$2.25 million, of which \$250,000 was attributable to the farmhouse, \$800,000 to the 3 acres subjacent and immediately contiguous to the farmhouse, and \$1.2 million (\$100,000 per acre) to the remaining 12 acres.

Although it took several months before the application was finally approved in March 2015, John was able to sell the lots (the "Caledon Lots") by the end of June for \$250,000 each, realizing net proceeds of \$2.9 million after accounting for legal expenses and application fees to rezone and subdivide the Caledon Property and real estate commissions to sell the lots. In computing his income for his 2015 taxation year, John assumed that the gain was eligible for the principal residence exemption and did not include any amount in respect of these proceeds. Nor did he deduct \$25,000 in legal expenses and application that he incurred in 2014 to rezone and subdivide the Caledon Property, nor \$75,000 in real estate commissions that he paid in 2015 in order to sell the lots.

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Question 2 (continued)

Around the time that John's application to rezone and subdivide the Caledon Property was approved, he learned that a client (the "Vendor") was planning to sell a 20-unit three-storey apartment building in Toronto's Parkdale District (the "Parkdale Property") near a rapidly gentrifying area of the city. Convinced that the building would be a good long-term investment as Toronto's population increased and young professionals moved into the neighbourhood, John decided to offer the client \$1.8 million – basing this amount on assessed values for municipal tax purposes of \$1 million for the land and \$600,000 for the building, and an estimated value of \$200,000 for the appliances and other tangible property. After consulting his tax advisor, however, John's offer allocated \$500,000 to the land, \$1 million to the building, and \$300,000 to the appliances and other tangible property.

After lengthy negotiations, John and the Vendor agreed to an aggregate price of \$2 million, of which \$500,000 was allocated to the land, \$1.2 million to the building, and \$300,000 to the appliances and other tangible property. The sale of the Parkdale Property closed on September 1, 2015, by which time John had received all the proceeds from the sale of the Caledon Lots, which he used to pay the Vendor. In computing his income for his 2015 taxation year, John included gross rental income of \$80,000 for the months of September to December, against which he deducted \$16,000 in management fees and operating expenses, \$4,000 in property taxes, and capital cost allowance of $\frac{1}{2} \times (4\% \times \$1.2 \text{ million}) = \$24,000$ on the building (Class 1 property) and $\frac{1}{2} \times (20\% \times \$300,000) = \$30,000$ on the appliances and other tangible property (Class 8 property), resulting in net rental income of \$6,000.

With \$900,000 remaining from the sale of the Caledon lots, John and Lisa decided to move from Toronto's Leaside neighbourhood, where they had lived since 2005 when they bought a house for \$800,000 (the "Leaside Home"), to a more affluent neighbourhood like Rosedale. In December 2015, they entered into agreement to purchase the Rosedale Home for \$3.2 million, conditional on selling the Leaside Home, which they then listed for sale. When the Leaside Home sold for \$2.4 million on December 30, 2015, John and Lisa waived the condition on their agreement to purchase the Rosedale Home and looked forward to moving there on the closing date of May 1, 2016. Assuming that the gain on their Leaside Home was eligible for the principal residence exemption, neither John nor Lisa included any amount in respect of the \$1.6 million gain in their 2016 tax returns.

Two days after John and Lisa sold their Leaside Home, a pipe burst in the Parkdale Property, resulting in major flooding to several apartments. When John hired a contractor to repair the damage, it became apparent that leaky plumbing over many years had caused serious mould problems and structural damage to the building. As a result, John had to spend \$300,000 to have the mould removed, the defective plumbing replaced and the structural damage repaired – which took three months to complete and required several tenants to vacate their apartments. In computing his income for his 2016 taxation year,

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Question 2 (continued)

John included gross rental income of \$200,000 for the year, against which he deducted \$48,000 in management fees and operating expenses, \$12,000 in property taxes, \$300,000 in repair costs, and capital cost allowance of $4\% \times (\$1.2 \text{ million} - \$24,000) = \$47,040$ on the building and $20\% \times (\$300,000 - \$30,000) = \$54,000$ on the appliances and other tangible property, resulting in a net rental loss of \$261,040, which he deducted against his income from his legal practice.

Having spent \$300,000 to repair the Parkdale Property, John had less money to pay for Rosedale Home on the closing date of May 1, 2016. In order to obtain these funds, John withdrew \$300,000 from his capital account in Beverly McLachlin, which he refinanced by taking out a \$300,000 mortgage on the Rosedale Home. In computing his income for his 2016 taxation year, John deducted interest expenses on this mortgage.

The CRA has asked you to review these transactions in order to determine how John should be assessed for tax purposes. In particular, the CRA would like to know:

- (1) whether some or all of the proceeds from the sale of the Caledon Lots were subject to tax, either as a taxable capital gain or business income, or both? [12 marks]
- (2) if so, whether John could deduct legal expenses and application fees to rezone and subdivide the Caledon Property and real estate commissions to sell the lots, and in which taxation year these amounts were deductible? [2 marks]
- (3) whether the CRA could reallocate the consideration that John paid for the Parkdale Property, and the implications of any such reallocation for the capital cost allowance that John deducted in 2015 and 2016? [8 marks]
- (4) whether the expenses that John incurred to remove mould, replace plumbing and repair structural damage to the Parkdale Property were deductible in 2016? [8 marks]
- (5) if these expenses were deductible in 2016, whether the deduction of property taxes and capital cost allowance that John claimed in 2016 might be disallowed? [8 marks]
- (6) whether some or all of the gain that John and Lisa realized on the sale of the Leaside Home was subject to tax? [4 marks] and
- (7) whether John could deduct interest expenses incurred in respect of the mortgage on the Rosedale Home? [10 marks]

In addressing these questions, please refer to relevant statutory provisions and judicial decisions, including section 245 of the ITA.

END OF EXAMINATION