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**THIS EXAMINATION CONSISTS OF -5- PAGES, INCLUDING THIS PAGE
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**THE UNIVERSITY OF BRITISH COLUMBIA
FACULTY OF LAW**

FINAL EXAMINATION – DECEMBER 2018

**LAW 407
TAXATION 1**

**Section 2
Professor Sheppard**

TOTAL MARKS: 100

TIME ALLOWED: 3 HOURS

- NOTE:**
- 1. This is an open book examination. You may bring into the examination room and use during the examination your casebook, *Income Tax Act*, class handouts, notes and summaries. Do not use library books, textbooks, or materials prepared by someone other than you.**
 - 2. All questions are to be answered, except for your choice of answering question 3.1, 3.2 or 3.3. If, in answering a question, alternative legal arguments are reasonably possible, state and discuss them. Please explain each answer.**
 - 3. Suggested times are allocated to each of the questions. The examination is 3 hours or 180 minutes long, and the allocated times total 168 minutes, leaving 12 minutes unallocated for such purposes as reading or review.**

THIS EXAMINATION CONSISTS OF 3 QUESTIONS.

MARKS

1. Lionel Hutz graduated from the Faculty of Law at Springfield A&M University with a Juris Doctor (JD) degree. Hutz articulated in 2000 with Ms. Constance Harms, a solo practitioner of law in Springfield, British Columbia and was admitted to the Law Society of British Columbia in 2001. Hutz worked with Ms. Harms' firm as an associate until September 30, 2018, when Ms. Harms was elevated to the Bench and became a Judge.

10**(a) (Suggested time: 17 minutes)**

At the start of October 2018, Judge Harms offered to sell her law practice to Hutz for \$100,000, since after her appointment as a judge, she could not practice law any longer. Hutz wanted to buy the firm from her and become a self-employed lawyer but wondered how to pay for it. Hutz has savings of around \$100,000, which are invested in publicly traded corporate stock in the Itchy and Scratchy Studios Inc., a Canadian company whose stock trades on the Toronto Stock Exchange, and which cost him only \$20,000. Hutz has a choice: he could either sell shares to pay Ms. Harms out of the proceeds or he could finance the purchase of her firm by holding onto the stock and borrowing the \$100,000, using the stock as collateral security for the loan. Due to the surprising popularity of Itchy and Scratchy cartoons, the stock price has risen greatly but the stock has never paid any dividends. Further increases in the value of the stock are expected. The proposed lender, The First Bank of Springfield, would charge interest at the rate of 5% (being \$5,000 per year) on a loan, secured by the stock as collateral. Advise Hutz of the income tax implications to him of the two alternatives, either selling the stock or borrowing against it.

10**(b) (Suggested time: 17 minutes)**

Lionel Hutz was impressed by your tax advice in part (a) immediately above. He bought Ms. Harms' firm in November, 2018 and wants to hire you to begin working for him as an associate in the firm. To overcome your reluctance to leave your current position with a national law firm where you currently work, Hutz offers to pay you \$25,000 for surrendering your future partnership and income prospects and go to work for him as an associate. Hutz is unsure about the tax implications of this proposed transaction. Advise Hutz of the tax consequences to you.

10**(c) (Suggested time: 17 minutes)**

You accepted Hutz's offer in (b) immediately above and are now working as an associate for Hutz's law firm. Hutz needs your advice on an aspect of his purchase of the practice from Ms. Harms. Hutz and Ms. Harms cannot agree on the terms of sale of the only laptop computer used in the law office, because they do not understand the tax consequences. Ms. Harms originally purchased the computer for a price of \$5,000, to be used exclusively for the law practice. Over the years of Ms. Harms' ownership of the computer she has

written it down by claiming capital cost allowance (CCA) at the maximum rate of 30% (Class 10, declining balance) from \$5,000 to \$2,500. Ms. Harms' accountant advises her that for income tax reasons, she should sell the computer to Hutz for not more than \$1,000. Hutz's business consultant has researched the fair market value of laptops and thinks its fair market value is closer to \$3,000. Hutz offers to pay \$3,000 for the laptop computer and cannot understand why Ms. Harm refuses the \$3,000. Advise Hutz of the tax consequences to Ms. Harm and him of the sale.

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(d) (Suggested time: 34 minutes)

Charles Montgomery Burns is Hutz's most lucrative client. Mr. Burns owns the Springfield Nuclear Power Plant, but has not spent the money necessary to maintain the plant adequately. The core of the reactor is a Fissionator 1952 Slow-Fission Reactor, which has nearly melted down frequently, because of poor maintenance and safety director Homer Simpson's incompetence. The nuclear power regulators successfully prosecute Mr. Burns for the plant's many violations of environmental protection laws. Mr. Burns secretly paid Mayor Diamond Joe Quimby \$50,000 to "keep the regulators off my back" but even Joe could not prevent their investigation of the environmental hazards caused by the plant's deficiencies.

Following a criminal trial by judge alone on numerous environmental offences, presided over by Judge Constance Harms, she convicts Mr. Burns and imposes fines on him of \$3 million for the violations. For future public safety, the regulators conclude that the plant's two cracked cooling towers must be fixed by filling their cracks (cost \$5 million) and that three more cooling towers must be constructed (cost \$45 million). Under the relevant capital cost allowance system, if applicable, you can assume the towers' rate of CCA would be 50% on a declining-balance basis. Due to Mr. Burns' habitual stinginess the annual maintenance bill for the plant is usually less than \$100,000. Hutz represented Mr. Burns at the trial, and despite losing the case, charged him \$250,000 for his legal services. Mr. Burns wants your advice on the tax consequences to him of these outlays.

2. Muscular weightlifter Rainier Wolfcastle has given up on his failed acting career and has started work as a freelance physical education instructor carrying on his own business as a contractor to various public and private schools in Springfield, British Columbia. Wolfcastle works under separate contracts with each school.

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(a) Suggested time: 25 minutes)

In August 2018, Wolfcastle made a contract with Principal Skinner, on behalf of the Springfield Elementary School to teach physical fitness to that school's students starting in September, 2018. However, School Superintendent Gary Chalmers arbitrarily

cancelled the contract in mid-August. Wolfcastle consulted Hutz, who negotiated a settlement of the claim for breach of contract, whereby the school paid Wolfcastle \$10,000 as compensation for its breach. Hutz received from Wolfcastle payment of \$2,000 in late August for his legal services. Advise Wolfcastle of the tax consequences to him.

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(b) (Suggested time: 17 minutes)

Ordinarily, a school that hires Wolfcastle agrees to pay him remuneration for his services as a fitness instructor, but his contract with the exclusive private school, Cloisters Academy, allows his daughter, Greta, to attend the school for free without charging him the usual annual tuition of \$24,000. Wolfcastle pays a housekeeper to look after 6-year old Greta during each working day. Advise Wolfcastle of the tax consequences to him.

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(c) (Suggested time: 17 minutes)

Wolfcastle owns a 10-room house in Springfield, where he lives with his spouse, Maria, and their daughter, Greta. One of the rooms contains a fully-equipped gym, where Wolfcastle does his own daily workouts and holds keep-fit classes for adults for which he charges them fees. Maria and Greta also make personal use of the gym. To travel from his home to the schools and between schools where he works, Wolfcastle bears the costs of driving his car used exclusively for the purpose. Advise Wolfcastle of his tax consequences.

ANSWER 3.1, 3.2 OR 3.3. DO NOT ANSWER MORE THAN ONE.

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3.1 (Suggested time: 25 minutes)

An Iranian company, located in its capital city, Tehran, manufactures and exports rugs around the world and proposes to sell them into Canada. The company is incorporated in Iran and its directors meet there. There is no tax treaty between Canada and Iran. What, if any, are the Canadian income tax consequences to the company of each of the following alternative methods of entering the Canadian market?

(a) Canadian Importer

The company would sell the rugs in Tehran to a Canadian importer that would bring them into Canada and resell them in its chain of retail stores for its own profit.

(b) Canadian sales representative

The company would hire an independent contractor with an office and warehouse somewhere in Canada as a sales representative to find Canadian purchasers of the rugs; the representative would transmit purchase orders to the company, which in response would ship the rugs to the representative pursuant to the orders.

(c) British Columbia subsidiary

The company would incorporate a wholly owned BC subsidiary to market the rugs in Canada, and the subsidiary would pay out its earnings as dividends to the Iranian company.

Under each of the three alternatives, does Canada impose income tax on the Iranian company? If so, on what basis? Discuss.

OR

3.2 Under the Canadian income tax system, the following contrasting terms:

“received,” and “receivable;” and

“operating expense” and “capital outlay”

are not defined by the statute. With reference to the cases and appropriate accounting concepts in the course, briefly define each of the four terms. Discuss.

OR

3.3 Describe the Canadian withholding system of collecting income tax and its applications to the various circumstances of individual taxpayers (ignore companies).

END OF EXAMINATION