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THE UNIVERSITY OF BRITISH COLUMBIA
FACULTY OF LAW

FINAL EXAMINATION

LAW 408.001/562.001

DECEMBER 2018

Professor Duff

TOTAL MARKS: 100

TIME ALLOWED: 3 HOURS
Plus 30 minutes reading time

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NOTES:

1. This is an <u>open book</u> examination.
2. THIS EXAMINATION CONSISTS OF 2 QUESTIONS
3. THE FIRST QUESTION IS WORTH 40 MARKS.
4. THE SECOND QUESTION IS WORTH 60 MARKS
5. ALLOCATION OF MARKS WITHIN EACH QUESTION IS INDICATED IN SQUARE BRACKETS AFTER THE QUESTION
6. PLEASE ANSWER ALL QUESTIONS

Question 1

Doug and Eva Dufresne are residents of Winnipeg, Manitoba, from where they and their twin children, Lisa and Andy, carry on business selling furniture and appliances through a number of taxable Canadian corporations known as The Dufresne Group Beginning with one store in Winnipeg, which Doug and Eva opened in 2005, the business grew steadily over the following decade, as the Dufresnes opened two more stores in Manitoba, one store in Saskatchewan, and another store in Alberta.

Until 2015, these stores were owned by a single taxable Canadian corporation called Dufresne Furniture and Appliance Limited ("DFA"), of which Doug and Eva each owned 50 of the 100 issued and outstanding common shares. Since Doug and Eva had financed this corporation mainly through loans secured by a mortgage on their residence, the paid-up capital and adjusted cost base to Doug and Eva of these shares was \$100 (\$1 per share). At the beginning of 2015, the fair market value of these shares was \$2 million, of which \$750,000 was attributable to the premises in which the stores were located (which DFA had purchased as it expanded), \$600,000 was attributable to inventory, \$400,000 was attributable to receivables, and \$250,000 to term deposits that the company had accumulated in order to finance future expansion.

Born in 1994, Lisa and Andy both began working part-time in the family business when they became 16 years of age, learning important "back office" skills like book-keeping and inventory management as well as "showroom" skills like sales and floor management. By 2015, each had completed a college degree in business administration and both expressed a desire to play a larger role in the management and ownership of the family business. Always intending that they would eventually transfer the business to their children, Doug and Eva contacted DFA's lawyer to advise them on how they might best accommodate their children's wishes without fully relinquishing control over the business. Based on the lawyer's advice, as well as that of a tax advisor with whom the lawyer conferred, the Dufresnes engaged in the following transactions on January 1, 2015:

> (1) Doug and Eva incorporated a company under the Manitoba *Corporation Act* called Dufresne Holdings Limited ("DHL") to which they each transferred their 50 voting common shares of DFA in exchange for 50 voting common shares of DHL (100 in total) each of which had a paid-up capital of \$1 (\$100 in total);
>
> (2) Lisa incorporated a company under the Saskatchewan Business Corporations Act called Dufresne Saskatchewan Limited ("DSL"), to which she contributed \$100 in exchange for 100 common shares;
>
> (3) Andy incorporated a company under the Alberta Business Corporations Act called Dufresne Alberta Limited ("DAL"), to which he contributed \$100 in exchange for 100 common shares;

Question 1 (continued)

(4) DFA transferred all the assets of the Saskatchewan store to DSL in exchange for non-voting preferred shares of DSL that were redeemable for an amount equal to the fair market value of the assets transferred, ($300,000), not convertible or exchangeable into other shares or debt, and paid an annual dividend equal to the product of the prescribed rate (1%) and the fair market value of assets transferred;

(5) DFA transferred all the assets of the Alberta store to DAL in exchange for non-voting preferred shares of DAL that were redeemable for an amount equal the fair market value of the assets transferred ($300,000), not convertible or exchangeable into other shares or debt, and paid an annual dividend equal to the product of the prescribed rate (1%) and the fair market value of assets transferred; and

(6) DHL entered into management agreements with DFA, DSL, and DAL according to which DHL would provide management services to each of these companies with respect to the manner in which the furniture and appliance business carried out by these companies would be conducted and would negotiate all purchase orders on behalf of DFA, DSL and DAL in exchange for a royalty based on a percentage of each company's sale revenue.

In computing their incomes for their 2015 taxation years (which corresponded with the calendar year), DSL and DAL each reported active business income of $250,000, of which $150,000 was attributable to sales of furniture and appliances and $100,000 was attributable to interest from sales on credit. Each company also paid royalties of $25,000 to DHL under the management agreements and dividends of $3,000 on the preferred shares of each company that were held by DFA.

In computing its income for its 2015 taxation year (which corresponded with the calendar year), DFA reported dividends of $3,000 from each of DSL and DAL in respect of which it claimed a deduction under subsection 112(1) of the ITA, as well as active business income of $625,000, of which $400,000 was attributable to sales of furniture and appliances, $220,000 was to interest from sales on credit, and $5,000 was attributable to interest on its term deposits. It also added $125,000 to its general rate income pool (GRIP) which was nil at the end of its preceding taxation year, paid a dividend of $125,000 to DHL which it designated as an eligible dividend, and also paid royalties of $70,000 to DHL under the supply and management agreements.

In computing its income for its 2015 taxation year (which corresponded with the calendar year), DHL – which had four full-time employees – reported active business income of $120,000 comprising royalties from DSL, DAL and DFA, as well as dividend income of $125,000 from DFA in respect of which it claimed a deduction under subsection 112(1) of the ITA. It also added $125,000 to its GRIP and paid a dividend of $1,250 on each of its common shares ($125,000 in total), which it designated as an eligible dividend.

Question 1 (continued)

When filing their tax returns for their 2015 taxation years, Doug and Eva each jointly elected with DHL to transfer their DFA shares to DHL for proceeds of disposition equal to $813,650, realizing a capital gain of $813,600 in respect of which they each claimed the lifetime capital gains deduction under subsection 110.6(2.1) of the *Income Tax Act* ("ITA"). They also each reported dividend income of $62,500 in respect of which they added the gross-up for eligible dividends under subparagraph 82(1)(b)(ii) of the ITA and claimed a dividend tax credit under paragraph 121(b) of the ITA.

Doug and Eva, as well as each of DFA, DSL, DAL and DHL, recently received notices of reassessment for their 2015 taxation years which:

(1) characterized all interest income received by DFA, DSL and DAL as aggregate investment income [6 marks];

(2) characterized the royalties that DHL received from DFA, DSL and DAL as income from a specified investment business [4 marks];

(3) denied the deduction under subsection 125(1) to each of DFA, DSL, DAL and DHL on the basis that they were associated corporations and had not filed a prescribed form with the Minister to assign a percentage of the $500,000 business limit amongst them as required by subsection 125(3) of the ITA [16 marks];

(4) levied Part III.1 tax of $7,000 on DFA in respect of an excessive eligible dividend designation on the dividend that it paid to DHL [4 marks];

(5) levied Part IV tax of $2,000 (at the then applicable rate) on DFA on the dividends that it received from DSL and DAL on the basis that these companies were not connected with DFA within the meaning of subsection 186(4) of the ITA [4 marks]; and

(6) disallowed the lifetime capital gains exemptions claimed by Doug and Eva on the basis that the shares of DFA that they transferred to DHL were not qualified small business corporation (QSBC) [6 marks].

Please advise DFA, DSL, DAL and DHL as well as Doug and Eva on the merits of these notices of reassessment, referring to relevant statutory provisions and judicial decisions.

END OF QUESTION 1

Question 2

John and Lynn Mowbray reside in Victoria. British Columbia, where they carry on a business developing and renting commercial real estate through a taxable Canadian corporation called Mowbray Investments Limited ("MIL"), of which they each own 500 of the 1,000 issued and outstanding voting common shares. At the beginning of 2016, the fair market value of these shares was $6.8 million, while their paid-up capital was $10,000 ($10 per share) and the adjusted cost base to John and Lynn of their shares was $760,000 each ($760 per share) as a result of a share exchange in a prior taxation year in respect of which they claimed the lifetime capital gains exemption to shelter $750,000 of realized gains.

For many years, Lynn's father, Robert Wilson, who resided in Vancouver until his death in 2016, carried on a business in Vancouver acquiring and selling residential properties through a taxable Canadian corporation called Wilson Residential Properties Limited ("WRPL") of which he owned all 1,000 issued and outstanding common voting shares. At the beginning of 2016, the fair market value of these shares was $3 million, while their paid-up capital was $100,000 ($100 per share) and their adjusted cost base to Robert was $850,000 ($850 per share) as a result of a share exchange in a prior taxation year in respect of which he claimed the lifetime capital gains exemption to shelter $750,000 of realized gains.

In February 2016, WPRL sold two residences in Point Grey, realizing a net profit of $1.2 million. With the proceeds from these sales, the company acquired a parcel of vacant land in West Vancouver (the "West Vancouver property") for $3 million, which Robert intended to subdivide and sell for residential development. By July 2016, however, Vancouver real estate market had weakened significantly and the Province of British Columbia introduced a tax on foreign buyers of residential property, as a result of which the value of the West Vancouver property decreased to $2.4 million. Shortly thereafter, on August 3, 2016, Robert and his wife Louise both died in a tragic boating accident in Hawaii.

Under the terms of Robert's will, his WPRL shares were bequeathed equally to John and Lynn (250 shares each) and to Lynn's brother Alex and his wife Heather (250 shares each), both of whom live in Portland, Oregon. Under subsection 70(5) of the ITA, Robert was deemed to have disposed of these shares immediately before his death for proceeds of disposition equal to their fair market value ($2.4 million), and each beneficiary under his will was deemed to have acquired these shares at a cost equal to this fair market value. As a result, while the paid-up capital of each WPRL share remained $100 ($100,000 in total) the adjusted cost base of these shares to each beneficiary became $2,400 ($2.4 million in total).

After mourning the death of Robert and Louise, John and Lynn and Alex and Heather decided that the West Vancouver property should be sold and WPRL wound up. Before proceeding with these transactions, however they consulted a tax advisor who

Question 2 (continued)

suggested that Alex and Heather should sell their WPRL shares to John and Lynn, who should then sell all the WPRL shares to MIL, following which WPRL and MIL could amalgamate, and the amalgamated company could then sell the West Vancouver property, using the proceeds from this sale to finance the acquisition of WPRL by MIL.

Acting on this advice, John and Lynn, Alex and Heather, and WPRL and MIL carried out the following transactions on October 15, 2016:

(1) John purchased 250 WPRL shares from Alex in exchange for a $600,000 promissory note and Lynn purchased 250 WPRL shares from Heather in exchange for a $600,000 promissory note;

(2) John and Lynn each sold 500 WPRL shares to MIL in exchange for $1.2 million promissory notes;

(3) MIL and WPRL carried out a vertical amalgamation, retaining the name Mowbray Investments Limited ("MIL II");

(4) MIL II sold the West Vancouver property for $2.4 million;

(5) MIL redeemed the John and Lynn's promissory notes for $1.2 million each; and

(6) John redeemed Alex's promissory note for $600,000, and Lynn redeemed Heather's promissory note for $600,000.

Shortly thereafter, MIL II distributed $50,000 to each of John and Lynn as a reduction of paid-up capital.

In computing their incomes for their 2016 taxation years, Alex and Heather reported no amount in respect of the sale of WPRL shares to John and Lynn, nor any amount in respect of the redemption of the promissory notes that they received in exchange for these shares. Likewise, in computing their incomes for their 2016 taxation years, John and Lynn reported no amount in respect of the sale of WPRL shares to MIL, nor any amount in respect of the redemption of the promissory notes that they received in exchange for these shares. Nor did John and Lynn include any amount in respect of the $50,000 that they each received from MIL II as a reduction of its paid-up capital.

In computing its income for its 2016 taxation year, which it reported as ending immediately before its amalgamation with MIL on October 15, 2016, WRPL reported active business income of $1.2 million from the sale of the two Point Grey residences and claimed the small business deduction under subsection 125(1) of the ITA in respect of

$500,000 of this income. In computing its income for its 2017 taxation year which ended on October 15,2017, MIL II reported a business loss of $600,000 from the sale of the West Vancouver property, which it deducted against rental income from its commercial real estate business, resulting in a non-capital loss of $250,000 which it deducted in computing its taxable income for its 2016 taxation year, which it reported as ending immediately before its amalgamation with WRPL on October 15, 2016.

The Canada Revenue Agency (CRA) has asked you to review these events in order to determine how Alex and Heather, John and Lynn, and WPRL and MLI II should be assessed for tax purposes. Specifically, the CRA would like to know:

(1) whether subsection 84(2), section 84.1 or the GAAR might apply to characterize some or all of the proceeds that Alex and Heather received on the sale of WRPL shares to John and Lynn as dividends that would be subject to non-resident withholding tax [10 marks];

(2) whether subsection 84(2), section 84.1 or the GAAR might apply to characterize some or all of the proceeds that John and Lynn received on the sale of WRPL shares to MIL as dividends that would be subject to the dividend gross-up and tax credit [12 marks];

(3) whether the 2016 taxation years of WPRL and MIL ended immediately before these corporations were amalgamated on October 15, 2016 [2 marks], and, if so, whether WRPL was a Canadian-controlled private corporation throughout this taxation year [4 marks] and whether it and MIL were associated in their 2016 taxation years [6 marks];

(4) whether MIL could deduct a business loss from the sale of the West Vancouver property in computing its income for its 2017 taxation year [16 marks];

(5) assuming that MIL could deduct a business loss from the sale of the West Vancouver property in computing its income for its 2017 taxation year, whether it could carry back a non-capital loss which it could deduct in computing its taxable income for its 2016 taxation year [4 marks]; and

(6) whether John and Lynn should have been subject to tax on some or all of the $50,000 that they received from MIL as a reduction of paid-up capital (6 marks).

Please advise the CRA, referring to relevant statutory provisions and judicial decisions.

END OF EXAM