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THE UNIVERSITY OF BRITISH COLUMBIA
FACULTY OF LAW

FINAL EXAMINATION

LAW 409/563

DECEMBER 2018

Professor Duff

TOTAL MARKS: 100

TIME ALLOWED: 3 HOURS
Plus 30 minutes reading time

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

Question 1

Millennial Development Corporation (“Millennial”) is a Vancouver-based company that carries on a business developing and selling residential real estate in the Greater Vancouver area. Among its more recent projects is the River Stroll Building (“River Stroll”) in New Westminister, which was completed in the fall of 2015. Sold out before construction even commenced, River Stroll has 120 condominium units, which ranged in price from \$750,000 to \$1 million, resulting in total proceeds of \$100 million (including deposits on pre-sold units which were held in trust until a certificate of occupancy was issued on completion). Because the cost to construct and market the project was \$85 million, net profit was \$15 million.

Soldier & Sailor Stores Inc. (“S&S”), which is also based in Vancouver, owns and operates a chain of discount department stores in Alberta and British Columbia, one of which was located near River Stroll in New Westminister. Although profitable from the 1950s to the mid-2000s, S&S incurred substantial losses in the years after the global financial crisis, forcing it to close a number of stores and sell the properties in which these stores had carried on business in order to finance its remaining operations. By 2015, S&S had accumulated non-capital losses of \$12 million and decided to close its New Westminister store and sell the land and the building in which the store had operated. Acquired by S&S in 1978 for \$500,000, of which \$200,000 was allocated to the land and \$300,000 to the building, S&S had deducted the maximum allowable capital cost allowance on the building, as a result of which its undepreciated capital cost at the beginning of 2015 was \$50,000.

Concluding that the location of this store location was ideal for another condominium development, Millennial decided to offer \$5 million to S&S to purchase the land and the building. After consulting their tax advisors, however, the two companies agreed on an alternative arrangement to a straightforward purchase and sale, involving the creation of a limited partnership. Pursuant to this plan, the two companies carried out the following transactions on October 15, 2015:

- (1) Millennial and S&S entered into an agreement to carry on a business developing and selling residential condominiums in the Vancouver area under the name New West Developments Limited Partnership (“New West”), which they registered with the Province of British Columbia.

According to this agreement, Millennial would be the general partner of New West, S&S would be a limited partner, net proceeds from the sale of all River Stroll units would be distributed exclusively to Millennial, and income and losses of the business would be allocated for tax purposes based on each member’s share of the partnership’s capital at the end of each taxation year.

Question 1 (continued)

The agreement also stipulated that either member could sell its interest or withdraw from the partnership after notifying the other member, but that neither member could sell its interest or withdraw from the partnership during its first fiscal year, which would end on October 15, 2016.

(2) Immediately after entering into this agreement, Millenial sold River Stroll to New West in exchange for an 80% interest in the profits and capital of the business and the assumption by New West of an \$80 million mortgage that Millenial had placed on River Stroll in order to finance its construction.

(3) At the same time, S&S sold the land and the building to New West in exchange for a 20% interest in the profits and capital of the business excluding net proceeds from the sale of River Stroll units.

The next day, New West obtained a certificate of occupancy from the City of New Westminster confirming that construction was completed and River Stroll was safe for occupancy. With this certificate, New West became entitled to pre-sale deposits that had been held in trust, as well as final payments from purchasers of condominium units. With these proceeds, which totaled \$100 million, New West discharged the \$80 million mortgage on the Building and distributed \$15 million to Millenial, leaving \$5 million to commence development of the Property.

Almost a year later, on October 10, 2016, Millenial incorporated a wholly-owned subsidiary called River View Development Corporation (“River View”) to which it contributed \$6.25 million in exchange for common shares. On October 16, 2016, River View purchased S&S’s interest in New West for \$6.25 million.

When Millenial filed its income tax return for its 2015 taxation year, which ended on December 31, it and S&S jointly elected \$85 million as the proceeds of disposition to Millenial from the sale of River Stroll to New West, which was the cost amount of River Stroll on October 15, 2015. When S&S filed its income tax return for its 2015 taxation year, which also ended on December 31, 2015, it and Millenial jointly elected \$200,000 as the proceeds of disposition to S&S of the land and \$50,000 as the proceeds of disposition of the building that it sold to New West.

When Millenial filed its income tax return for its 2016 taxation year, which ended on December 31, it reported partnership income of \$7.5 million from New West. When S&S filed its income tax return for its 2016 year, which also ended on December 31, it reported partnership income of \$7.5 million from New West and a taxable capital gain of \$3 million (capital gain of \$6 million) from the disposition of its interest in New West, and deduced a non-capital loss of \$10.5 million, thereby sheltering this income from tax.

Question 1 (continued)

The Canada Revenue Agency (CRA) has asked you to review these transactions to determine how they should be assessed for tax purposes. In particular, you have been asked to address the following questions:

- (1) Did Millenial and S&S create a valid partnership for the purposes of the *Income Tax Act* (the “ITA”) when they formed New West [9 marks], and, if so, did it continue to exist after River View purchased S&S’s interest [3 marks]?
- (2) Assuming that New West was a valid partnership, could Millenial and S&S elect the amounts that they did as proceeds of disposition of the properties that they sold to New West [6 marks]?
- (3) Assuming that New West was a valid partnership, should Millenial have included any amount in respect of the \$15 million that it received from New West [6 marks]?
- (4) Assuming that New West was a valid partnership, is it possible to challenge the allocation of income to Millenial and S&S from the sale of condominium units in River Stroll either as a sham [4 marks], or under the specific anti-avoidance rules in subsections 103(1) or (1.1) of the ITA [12 marks] or the general anti-avoidance rule in section 245 of the ITA [12 marks]?
- (5) Assuming that New West was a valid partnership, and S&S could elect the amounts that it did when it sold land and property to New West, was S&S correct to characterize the gain from the sale of its interest to River View as a capital gain [4 marks]? If so, did it correctly compute the amount of this gain as \$6 million [4 marks]?

When answering these questions, please refer to relevant statutory provisions and judicial decisions.

END OF QUESTION 1

Question 2

Bennett Williams lives in Kelowna, British Columbia, and owns and operates a chain of hardware stores in the interior of British Columbia through a private corporation called Williams Hardware Limited (WHL). Born in Kelowna in 1948, Bennett is married to his high-school sweetheart Anne, and has two adult children, named Anita and Russell. Anita is a partner in a downtown law firm in Vancouver and has two children, James who was born in 1996, and Bill who was born in 1998. Russell works for WHL in Kelowna and has one child named Elizabeth, who was born in 2004.

Incorporated in 1978 when Bennett opened his first hardware store in Kelowna, WHL grew rapidly in the 1980s and early 1990s as Bennett worked tirelessly to satisfy a growing market in the Okanagan region of central British Columbia. In the late 1990s and 2000s, however, business declined as big box stores moved into the region offering greater variety and lower prices. Nonetheless, by owning its own premises and emphasizing customer service and personal connections, WHL was able to remain profitable throughout the 2000s and was valued at \$8 million at the end of 2014. At this time Bennett owned all 100 voting common shares of WHL, the adjusted cost base of which was only \$10 each (\$1,000 in total) since Bennett had borrowed money to open his first hardware store and had grown the business exclusively by reinvesting profits from the business.

When Bennett turned 65 in 2013, he decided that he would retire from day-to-day involvement in the hardware business, and start transferring ownership of WHL to his children and grandchildren. After speaking with a lawyer in Kelowna, he decided to establish three trusts for this purpose: one trust (“the Preferred Trust”) for himself and Anne, to which he would transfer newly created voting preferred shares of WHL that he would acquire from WHL in exchange for his existing common shares through a tax-deferred “estate freeze”; a second trust (“the Children’s Trust”) for his children Anita and Russell, which would acquire newly-created non-voting common shares of WHL for nominal consideration; and a third trust (“the Grandchildren’s Trust”) for his grandchildren James, Bill and Elizabeth, which would also acquire a newly-created non-voting common shares of WHL for nominal consideration.

The terms of each trust were drawn up by the Kelowna lawyer and included the following provisions for each trust:

The Preferred Trust

To hold and vote the voting preferred shares of WHL and any other investments that the Trust might acquire, to dispose of and acquire investments, to pay all income to Bennett or Anne during their lifetimes as the trustees in their absolute discretion may determine, and to distribute the property of the trust equally to Anita and Russell on the death of the later of Bennett or Anne, with Anita and Russell’s shares distributed equally among their children in the event that they are deceased.

Question 2 (continued)*The Children's Trust*

To hold non-voting common shares of WHL and any other investments that the Trust might acquire, to pay any income or capital to Anita or Russell during their lifetimes as the trustees in their absolute discretion may determine, and to distribute the property of the trust equally to their surviving children on the death of the later of Anita or Russell.

The Grandchildren's Trust

To hold non-voting common shares of WHL and any other investments that it might acquire, to retain and reinvest all income from these shares and other investments in equal shares for the benefit of James, Bill, and Elizabeth, to pay to each beneficiary his or her share of the trust's annual income commencing in the taxation year of the trust in which the beneficiary reaches 21 years of age should he or she survive to this age and to divide this share equally for the benefit of all surviving beneficiaries should this beneficiary not survive to the age of 21, and to distribute all property of the trust in equal shares among surviving beneficiaries when the youngest of these beneficiaries reaches 25 years of age.

The terms of all trusts also stated that the trustees were required to seek Bennett's advice on any investment decisions, while the terms of the Preferred Trust stipulated that the Trust must vote the WHL shares according to Bennett's express directions and could not dispose of the WHL shares without Bennett's consent. For each trust, the relevant trust instrument named as trustee an Alberta-based company called the Olympic Trust Company, which Bennett's lawyer had recommended for this purpose.

The freeze transactions were carried out on January 1, 2015, with Bennett exchanging his 100 voting common shares of WHL for 100 voting preferred shares with an adjusted cost base of \$10 each (\$1,000 in total), each of which was redeemable for \$80,000 (\$8 million in total), and each of the Children's Trust and the Grandchildren's Trust acquiring 500 non-voting common shares for \$1 each (\$1,000 in total) in exchange for promissory notes with interest payable at the then prescribed rate of 1% per annum. Immediately thereafter, Bennett transferred legal title to the 100 voting preferred shares of WHL to the Olympic Trust Company.

WHL had an good year in 2015, and distributed taxable dividends of \$800 on each of its preferred shares (\$80,000 in total which was paid to the Preferred Trust) and \$180 on each of its common shares (\$180,000 in total, \$90,000 of which was paid to each of the Children's Trust and the Grandchildren's Trust). While the Preferred Trust paid the full amount of the dividends that it received to Anne, the Children's and Grandchildren's Trusts did not pay any amount to the beneficiaries of these Trusts, but used the full amount of the dividends that they received to purchase publicly traded shares.

Question 2 (continued)

In computing its income for its 2015 taxation year, the Preferred Trust did not deduct any amount under paragraph 104(6)(b) of the *Income Tax Act* (“ITA”) in respect of the amount that it paid to Anne, but designated this amount not to have been paid or to have become payable to her in the year under subsection 104(13.1). In computing its tax payable, the Preferred Trust included the taxable amount of dividends received from WHL, on which it paid federal tax of 29% and Alberta provincial tax of 11.25%.

In computing its tax payable for its 2015 taxation year, the Children’s Trust also reported the taxable amount of dividends that it received from WHL as well as taxable dividends from publicly traded shares that it acquired with this income, did not claim any deduction under paragraph 104(6)(b) of the ITA, and paid federal tax of 29% and Alberta provincial tax of 11.25% on this income.

In contrast, although the Grandchildren’s Trust did not pay any amount to its beneficiaries, it made a designation under subsection 104(19) of the ITA to deem the taxable dividends that it received from WHL and from publicly traded shares that it acquired with this income to have been received by its beneficiaries in equal amounts, deducted the full amount of these dividends in computing its income for the year under paragraph 104(6)(b), and paid no federal or provincial income tax. Similarly, although James, Bill and Elizabeth, each included the full amount of these taxable dividends in computing their incomes for their 2015 taxation years under paragraphs 104(13)(a) and 12(1)(m) of the ITA, they paid no tax on this income since the tax otherwise payable on these dividends was sheltered by the dividend tax credit and their personal tax credits.

Bennett recently received a notice of reassessment for his 2015 taxation year, including dividend income of \$80,000 on the alternative grounds that: (1) the Preferred Trust was not a valid trust [8 marks], or (2) this income was attributable to Bennett either under subsection 75(2) of the ITA [6 marks] or subsection 74.1(1) of the ITA [6 marks]. In separate notices, all of the Trusts were reassessed on the basis that they were resident in British Columbia for their 2015 taxation years [6 marks] and that their combined incomes were deemed to be those of a single trust under subsection 104(2) of the ITA [6 marks]. As well, each of James, Bill, and Elizabeth were assessed on the basis that amounts that they included as taxable dividends from the Grandchildren’s Trust were subject to tax at the top marginal rate under section 120.4 of the ITA [8 marks].

Please advise Bennett, the Trusts and James, Bill, and Elizabeth on the validity of these reassessments, referring to relevant statutory provisions and judicial decisions.

END OF EXAM