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UNIVERSITY OF BRITISH COLUMBIA
PETER A. ALLARD SCHOOL OF LAW

FINAL EXAMINATION – DECEMBER 2019

LAW 407.001
Taxation

Section 1
Professor Duff

TOTAL MARKS: 100

TIME ALLOWED: 3 HOURS
Plus 30 minutes reading time

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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)

QUESTION 1

Alissa Anand is a computer software engineer, who completed a master in computer science degree from the University of British Columbia in 2008. After graduating from this program, Alissa worked at Microsoft Corporation's Vancouver office for six years, gaining valuable industry experience and rising to the level of senior software specialist. During this period, she rented an apartment near her parents' home in South Surrey and commuted by car to Microsoft's Vancouver office.

In October 2015, Alissa was approached by a professional recruiter to apply for a position as vice-president of software development at a Vancouver-based Canadian-controlled private corporation called Klever Inc. ("Klever"), which was in the process of developing "competitive intelligence software" to assist clients in their business decisions by providing market information on their competitors. According to the recruiter, the position would pay a salary similar to what she was earning at Microsoft, and would also include the right to acquire common shares of Klever. Attracted by the opportunity, Alissa applied for and was offered the position, left Microsoft on good terms at the end of 2015, and commenced the new position with Klever on January 1, 2016.

Under the terms of her employment agreement with the company, Alissa received an annual salary of $75,000, a dedicated parking space in the building where Klever's office was located, and the right to acquire 10,000 common shares each year for $1 per share (an amount equal to their fair market value on January 1, 2016). In order to enable Alissa to acquire these shares, Klever also offered her an interest-free loan, the principal amount of which would be repayable on the earliest of the dates that she sold the shares or left the company. In computing her income for her 2016 taxation year, Alissa included her salary of $75,000 and a taxable benefit of $3,000 based on the fair market value of the parking space for the year, but did not include any amount in respect of 10,000 common shares that she acquired on July 1, 2016 (when their fair market value was $4 per share) nor a $10,000 interest-free loan that she obtained from Klever on that date in order to acquire these shares.

Although Alissa continued to live in South Surrey after changing jobs, the commute to Vancouver became increasingly difficult in 2016 as traffic to and from the City of Vancouver became more congested. In February 2016, Alissa discovered a different route that added five kilometres to the driving distance but reduced average commuting time by fifteen minutes each way. When this alternative route also became congested, Alissa purchased a condominium in Vancouver's Gastown District (the "Gastown condo"), to which she moved in December 2016. Only two blocks from Klever's office, the distance between the condo and her South Surry apartment was 37 kilometres by her original driving route and 42 kilometers by her most recent route. In computing her income for her 2016 taxation year, Alissa deducted as moving expenses the cost of transporting household effects from her South Surrey apartment to the Gastown condo as well as legal fees and property transfer taxes to purchase the Gastown condo.

Question 1 (continued)

After moving to Vancouver, Alissa realized that she no longer needed a parking space at Klever's office, since she had a parking spot in her condo and was able to walk to work in less time that it would take to drive. When she asked if she could give up the space and receive additional salary instead, however, she was told that this was not possible since the parking space had already been paid for as part of the rent that Klever paid for office space in the building. Since she neither needed nor wanted the parking space in 2017, and never used it during the year, Alissa did not include any amount in respect of the parking space in computing her income for her 2017 taxation year.

Notwithstanding her disappointment about the parking space, Alissa enjoyed working at Klever, where she had considerable success perfecting the company's competitive intelligence software. In June 2017, Klever secured a lucrative contract for its software, causing its share value to increase as rumors circulated that the company might be sold to a larger software company. On July 1, 2017, when the fair market value of Klever's common shares was $16 per share, Alissa exercised her option to acquire another 10,000 shares at a cost of $1 per share, obtaining another $10,000 interest-free loan in order to finance this acquisition. In computing her income for her 2017 taxation year, Alissa did not include any amount in respect of the acquisition of these shares nor the interest-free loan that she obtained from Klever to acquire these shares, nor the outstanding loan to the company that she obtained to acquire shares on July 1, 2016.

In the summer of 2017, a former professor at the University of British Columbia (UBC) Department of Computer Science invited Alissa to teach an advanced course on software development in the fall of 2017. Flattered by the offer, she accepted the invitation, teaching a 2-hour evening course once a week over the 13-week term, for which she spent 10 hours a week preparing and grading assignments in a study in her condo. In computing her income for her 2017 taxation year, Alissa included a $3,000 honorarium that she received for teaching the course as business income, against which she deducted a portion of her mortgage interest on the condominium, condo fees and utility expenses from September to December 2017 based on the size of the study to that of the condo as a whole, resulting in a net loss, which she deducted in computing her income from all sources.

Although Klever managed to secure several more contracts in the first three months of 2018, its share value declined sharply to $6 per share on May 1, 2018, after Microsoft released an improved version of its cloud-based "business analytics software", several aspects of which were similar to the software that Klever had developed. In a tense meeting with senior managers that day, the company's president and co-founder suggested that a Klever employee might have shared information with Microsoft, pointing the finger at Alissa as a former employee who had left Microsoft on good terms. Outraged, Alissa resigned and sued Klever for constructive dismissal and defamation.

Question 1 (continued)

After lengthy negotiations, during which time the company's common shares continued to decrease in value, Alissa and Klever settled the claim under an agreement dated August 2, 2018. Pursuant to this agreement, Klever apologized for any damage to Alissa's reputation, repurchased her 20,000 common shares for $6 per share (their fair market value when she resigned on May 1, 2018), and forgave the two loans that Alissa had obtained from the company in order to acquire these shares. In computing her income for her 2018 taxation year, Alissa reported a taxable capital gain of $50,000 on the sale of her shares (computed as $^1/_2 \times 20{,}000 \times (\$6 - \$1)$) but did not include any amount in respect of the forgiven loans.

The Canada Revenue Agency ("CRA") has asked you to review these events in order to determine how Alissa should be assessed for her 2016, 2017 and 2018 taxation years. In particular, the CRA would like to know the following:

(1) what amounts, if any, should Alissa have included in computing her income for her 2016, 2017 and/or 2018 taxation year [4 marks], and what amounts, if any, could she have deducted in computing her taxable income for her 2016, 2017 and/or 2018 taxation years [5 marks] in respect of the exercise of her right to acquire common shares of Klever on July 1, 2016 and July 1, 2017?

(2) what amount, if any, should Alissa have reported in respect of the sale of her Klever shares on August 2, 2018? [6 marks]

(3) what amount, if any, should Alissa have included in computing her income for her 2016, 2017 and 2018 taxation years, in respect of the interest-free loans that she obtained from Klever on July 1, 2016 and July 1, 2017 [4 marks], and in respect of the forgiveness of these loans on August 2, 2018? [4 marks]

(4) could Alissa deduct the moving expenses that she claimed in computing her income for her 2016 taxation year? [8 marks]

(5) in computing her income for her 2017 taxation year, what amount, if any, should Alissa have included in respect of the parking space that she was provided at Klever's office? [5 marks]

(6) should the payment that Alissa received from UBC be characterized as business income or employment income [6 marks], could Alissa deduct mortgage interest, condo fees and utility expenses in computing this income [6 marks], and, if so, could she deduct a net loss from this source in computing her income from all sources for her 2017 taxation year? [2 marks]

In addressing these questions, please refer to relevant statutory provisions and cases.

END OF QUESTION 1

QUESTION 2

Frederic Magrit resides in Montreal, where he carries on a commercial real estate business, earning income by renting retail and office space in low-rise commercial buildings that he buys from other developers or constructs on vacant land that he acquires for this purpose. In addition to this income, Frederic also derives income from a portfolio of publicly-traded shares from which he earns dividends and capital gains. By January 2018, the adjusted cost base of these shares was $400,000 and their fair market value was $1 million.

Frederic is married to Sophie Deschamps, a visual artist who teaches art history at the Université du Québec à Montréal (UQAM) and operates an art gallery in the trendy Plateau District of Montréal, which she established in 2011 in order to display and sell works by various Québec artists, including herself. Although Sophie receives an annual salary of $60,000 from UQAM, the gallery has never made a profit and reported losses of $20,000 in 2016, $30,000 in 2017, and $40,000 in 2018, which Sophie deducted in computing her income from all sources in these taxation years.

In 2016, Frederic decided to expand his commercial real estate business in order to capitalize on Montreal's growing economy and rising real estate market. After looking for suitable properties, he eventually decided to purchase the following two properties: (1) a recently-completed commercial building that another developer had constructed in order to sell ("the Developed Property"), and (2) a parcel of vacant land that had been used as a parking lot for several years ("the Vacant Land"). The asking price for the Developed Property was $1.2 million and the asking price for the Vacant Land was $500,000.

Although Frederic paid $500,000 for the Vacant Land, he was unwilling to pay $1.2 million for the Developed Property without a clear agreement on how the purchase price would be allocated between the land (the "Land") and the building (the "Building"). Since the Land was assessed at $800,000 for municipal tax purposes and the cost to construct the Building was $400,000, the vendor initially proposed that the allocation should correspond to these amounts. When Frederic refused to accept this allocation, the vendor accepted his demand to allocate $200,000 to the Land and $1 million to the Building.

After finalizing the agreement to purchase the Developed Property, Frederic sought to attract tenants, offering inducement payments to tenants who signed leases and structural improvements to the building to accommodate tenants' specific requirements. In computing his business income for his 2016 taxation year, Frederic deducted the full amount of these inducement payments and the full cost of these structural improvements.

By the end of 2016, the Building was fully occupied with tenants who provided a steady flow of rental income, which Frederic included in computing his income from the commercial real estate business for his 2016 taxation year. This income, however, was greatly exceeded by the inducement payments and the cost of the structural improvements

Question 2 (continued)

that Frederic had incurred in order to attract tenants. In addition, Frederic also deducted property taxes in respect of the Developed Property, interest payments on the hypothec, and the maximum allowable capital cost allowance (CCA) on the Building (based on a capital cost of $1 million), resulting in substantial net deductions that exceeded Frederic's net income from his other commercial properties, resulting in a net loss from the business that he deducted in computing his income from all sources in his 2016 taxation year.

Frederic took possession of the Vacant Land on January 1, 2017, financing the purchase with a bank loan at a rate of 5% per year. Later that month he engaged an architect to develop plans for a building on the site. When these plans were completed, Frederic applied to the City of Montreal for a development permit which was approved in October 2017, at which time Frederic engaged a general contractor to prepare the Vacant Land for construction. Shortly after starting work on the site, however, the contractor discovered that the soil was contaminated by a buried oil tank that had not previously been identified.

Knowing that the City of Montreal would require lengthy and costly remediation before it would allow any construction to continue, Frederic decided to sell the property in order to cut his losses. After reducing the price several times, Frederic eventually sold the property for $300,000 on December 31, 2017, realizing a loss of $200,000, which he reported as a business loss from an adventure or concern in the nature of trade. In computing the income from his commercial real estate business for his 2017 taxation year, however, Frederic included net income from the continued operation of a parking lot on the Vacant Land, and deducted architect fees, the cost of the development application, interest on the bank loan, and property taxes in respect of the Vacant Land.

After selling the Vacant Land, Frederic and Sophie flew to Southern Florida, where they had rented the same condominium for several years in January in order to escape Montreal's cold winter weather. Learning that the condo was for sale, they decided to submit an offer, which was immediately accepted. Since the Canadian dollar price of the condo was $1.3 million and the proceeds from the sale of the Vacant Land were only $300,000, it was clear that they would either have to sell assets or borrow $1 million in order to complete the purchase. After speaking with a tax advisor, Frederic and Sophie carried out the following transactions in sequence on January 15, 2018:

(1) Sophie borrowed $1 million from the Bank of Montreal (the "Bank"), which she used to purchase Frederic's portfolio of publicly-traded shares (the "Shares");

(2) Frederic used the proceeds from the sale of the Vacant Land and the sale of the Shares to Sophie to purchase the condominium;

(3) Frederic borrowed $1 million secured by a mortgage on the condominium (the "Mortgage"), which he used to repurchase the Shares from Sophie; and

(4) Sophie used the $1 million that she received from Frederic to repay the Bank.

Question 2 (continued)

In their 2018 tax returns, neither Frederic nor Sophie elected out of the spousal rollover in subsection 73(1) of the *Income Tax Act*. On this basis, in computing her income for her 2018 taxation year, Sophie reported net income from the Shares (computed by including dividends that Frederic received from the Shares less the interest paid on the Mortgage) as well as a taxable capital gain (computed by adding all taxable capital gains and subtracting all allowable capital losses from the disposition of Shares by Frederic in the year).

Frederic and Sophie recently received notices of reassessment which:

(1) disallowed the deduction of losses in computing Sophie's income for her 2016, 2017 and 2018 taxation years on the basis that the art gallery was not a business carried on with a reasonable expectation of profit [5 marks];

(2) reduced the capital cost of the Building to $400,000 on the basis that it was reasonable to regard $800,000 as consideration for the Land [5 marks];

(3) disallowed the deduction of CCA on the Building in computing Frederic's income for his 2016 taxation year on the basis that he could not deduct CCA in excess of net income from his other commercial properties [4 marks];

(4) disallowed the deduction of inducement payments and the cost of structural improvements in computing Frederic's income for his 2016 taxation year on the basis that these were capital expenses [6 marks];

(5) disallowed the deduction of architect fees, the cost of the development application, and interest and property taxes in respect of the Vacant Land in computing Frederic's income for his 2017 taxation year on the basis that these were also capital expenses [8 marks];

(6) characterized Frederic's loss on the disposition of the Vacant Land as an allowable capital loss [4 marks];

(7) disallowed the deduction of interest on the Mortgage on the alternative grounds that the borrowed money was not used to earn income from a business or property, or that the use of this money to repurchase the Shares from Sophie was subject to the general anti-avoidance rule (GAAR) in section 245 of the ITA [9 marks]; and

(8) attributed to Frederic both dividends on the Shares as well as taxable capital gains and allowable capital losses from the disposition of Shares on the grounds that Frederic's repurchase of the Shares from Sophie was subject to the specific anti-avoidance rule in subsection 74.5(11) of the ITA or to the GAAR [9 marks].

Please advise Frederic and Sophie, citing relevant statutory provisions and cases.

END OF EXAMINATION