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PETER A. ALLARD SCHOOL OF LAW
UNIVERSITY OF BRITISH COLUMBIA

FINAL EXAMINATION – DECEMBER 2019

LAW 408

Professor Duff

TOTAL MARKS: 100

TIME ALLOWED: 3 HOURS
Plus 30 minutes reading time

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NOTE:

1. This is an <u>open book</u> examination.

2. THIS EXAMINATION CONSISTS OF 2 QUESTIONS

3. PLEASE ANSWER ALL QUESTIONS

4. THE FIRST QUESTION IS WORTH 60 MARKS AND THE SECOND QUESTION IS WORTH 40 MARKS.

5. ALLOCATION OF MARKS WITHIN EACH QUESTION IS INDICATED IN SQUARE BRACKETS AFTER THE QUESTION

QUESTION 1

Grant Dunbar resides in Vancouver, British Columbia, where he carries on a home construction business through a Canadian corporation called Dunbar Construction Limited ("DCL"), of which he is the sole director. Established in 2002, the company grew substantially over the next 15 years as Vancouver's residential real estate market boomed. By 2016, the company had 12 employees, including Grant, who received a salary of $180,000.

When DCL was first incorporated, Grant acquired all 100 voting common shares of the company for $1 each and loaned the company $200,000, which he obtained by taking out a second mortgage on a personal residence that he and his wife Amanda jointly owned. As the business prospered, DCL was able to repay this loan and reinvest its after-tax income in the business. By 2016, the company was worth $4.5 million, of which $300,000 was attributable to deposits under contracts with paying clients, $200,000 to vehicles and equipment uses in the company's business, $1.6 million to two residences that DCL was building on its own account, and $2.4 million to a reserve that DCL had accumulated in order to finance the construction of other new homes on its own account.

In 2016, Grant consulted a corporate lawyer on how best to protect DCL's assets and a tax advisor on how best to minimize his taxes. Acting on the corporate lawyer's advice, Grant incorporated another Canadian corporation called Dunbar Holdings Ltd. ("DHL") to which he transferred his DCL shares on a tax-deferred basis under subsection 85(1) of the *Income Tax Act* in exchange for 100 voting common shares of DHL. Immediately thereafter, DCL declared and paid a dividend of $25,000 on each of its common shares, thereby transferring the $2.5 million reserve to DHL, which invested this amount in interest-bearing securities, and loaned money back to DCL at an arm's length interest rate when DCL required funds to pay for the construction of homes on its own account.

Acting on the tax advisor's recommendation, DHL also authorized the issuance of 100 non-voting preferred shares, which Amanda acquired for $1 each. According to DHL's Articles of Incorporation, the preferred shares are entitled to dividends exclusive of any other share class as well as their paid-up capital and any declared but unpaid dividends on liquidation, while the common shares are entitled to dividends exclusive of any other share class and all assets of the company on liquidation other than amounts payable in respect of the preferred shares. Grant is the sole director of DHL, which has no employees.

As a general contractor, DCL earns income from cost-plus construction contracts under which clients pay an initial deposit computed as 10% of the estimated cost of the project and the company submits regular invoices for labour and materials that it supplies directly as well as payments to sub-contractors, to which it adds a 15% management fee. In addition to income from these contracts, DCL also occasionally builds houses on its own account, buying and demolishing old residences and designing and building new homes for sale.

Question 1 (continued)

In computing its taxable income for its 2017 taxation year, which corresponded with the calendar year, DCL reported a taxable capital gain of $240,000 from the sale of a house that it built on its own account, and active business income of $600,000 of which $550,000 comprised management fees that it received on construction contracts, $10,000 was interest earned on the deposits that it received from clients, and $40,000 was income from the rental of another house that it completed in 2017 but was unable to sell when the Vancouver real estate market declined. In computing its tax payable for this taxation year, DCL claimed the small business deduction on the first $500,000 of the active business income that it reported, paid tax on the remaining $100,000 of this income at the federal and provincial tax rates applicable to "full-rate taxable income", and paid tax on the taxable capital gain that it reported at the federal and provincial tax rates applicable to aggregate investment income.

On this basis, DCL added $72,000 (.72 × $100,000) to its general rate income pool (GRIP), which was nil at the end of its 2016 taxation year, $240,000 to its capital dividend account (CDA), which had been nil, and $73,600 ($30^{2}/_{3}$% × $240,000) to its refundable dividend tax on hand (RDTOH) which had also been nil. It also paid an eligible dividend of $720 on each of its common shares ($72,000 in total), a capital dividend of $2,400 on each of its common shares ($240,000 in total), and a non-eligible dividend of $1,200 on each of its common shares ($120,000 in total), and claimed a dividend refund for the year of $73,600 ($38^{2}/_{3}$% × $72,000 + $38^{2}/_{3}$% × $120,000).

In computing its taxable income for its 2017 taxation year, which also corresponded with the calendar year, DCL included active business income of $50,000, of which $30,000 comprised interest on loans to DCL (which DCL deducted in computing its active business income), and $20,000 was interest from other sources. It also included eligible dividends of $72,000 and non-eligible dividends of $120,000, in respect of which it claimed the inter-corporate dividend deduction under subsection 112(1) of the ITA. In computing its tax payable, DCL paid tax on the $50,000 interest income that it received at the federal and provincial rates applicable to "full rate taxable income". It also added $108,000 ($72,000 + .72 × $50,000) to its GRIP which was nil at the end of its 2016 taxation year and $240,000 to its CDA which had been nil, and paid an eligible dividend of $1,080 on each non-voting preferred share ($108,000 in total) and a capital dividend of $2,400 on each voting common share ($240,000 in total)

In their tax returns for their 2016 taxation years, Grant included no amount in respect of the capital dividend that he received, while Amanda included $108,000 as an eligible dividend plus a gross-up of $41,040 (38% × $108,000) under subparagraph 82(1)(b)(ii) of the ITA, and deducted the applicable federal and provincial dividend tax credits in computing her tax payable.

Question 1 (continued)

Grant and Amanda have two children: Scott who was born in 1997 and Lisa who was born in 2001. Although Lisa has never worked for DCL, the company employed Scott as an apprentice electrician from 2013 to 2016. In 2016, however, Scott incorporated a wholly owned Canadian company called Scott Electric Limited ("SEL"), of which he is the sole employee and through which he provides services exclusively to DCL. In computing its income for its 2017 taxation year, which ended on March 31, SEL reported active business income of $50,000 (after deducting Scott's salary and other expenses) in respect of which it claimed the small business deduction.

In addition to the preferred shares of DHL, Amanda also owns 50% of the non-voting common shares of Spice Jar Furniture Limited ("SJFL"), a Canadian company that Amanda's parents incorporated in 1979 in order to carry on a furniture retail business in North Vancouver. Amanda and her brother Vincent acquired these shares for nominal consideration in 2015 as part of an estate planning arrangement in which their parents exchanged their voting common shares on a tax-deferred basis for voting preferred shares. Amanda's parents reside in North Vancouver and continue to control SJFL through their voting preferred shares and manage the business as the company's sole directors.

As part of this estate planning arrangement, Amanda's parents also decided that they would pay $25,000 each year to each of their grandchildren. Instead of making these gifts themselves, however, they caused SJFL to pay these amounts to their grandchildren at the end of its 2017 taxation year, which corresponded with the calendar year. In computing their incomes for their 2017 taxation year, Scott and Lisa did not include any amount in respect of these gifts.

The Canada Revenue Agency (CRA) has asked you to review these facts in order to determine how each of these taxpayers should be assessed. In particular, the CRA would like to know:

(1) which, if any, of DCL, DHL, SEL, and SJFL were associated in their 2017 taxation years and the implications of association for the taxes payable by these companies in their 2017 taxation years? [12 marks]

(2) how the different kinds of income that DCL and DHL received in their 2017 taxation years should be characterized for income tax purposes [12 marks], and the implications of this characterization for the income taxes payable by these companies for their 2017 taxation years under Part I of the ITA [6 marks] and the computation of their GRIP, CDA and RDTOH accounts? [6 marks]

(3) whether any taxes in the ITA other than the income tax in Part I might be applied in computing taxes payable by DCL and DHL in their 2017 taxation years? [8 marks]

Question 1 (continued)

(4) whether subsection 74.1(1) or subsection 56(2) could apply to attribute any of the dividends that Amanda received in 2017 to Grant? [8 marks]

(5) whether the cash gifts received by Scott and Lisa might be included in computing their incomes (and/or those of their grandparents) for their 2017 taxation years and/or and whether these gifts might be subject to tax under section 120.4? [8 marks]

In your answers, please refer to relevant statutory provisions and judicial decisions.

END OF QUESTION 1

QUESTION 2

Andrew Hoyle lives in Courtney, British Columbia, where he carries on a logging business through a private corporation called Hoyle Logging Limited ("HLL"). Established by Andrew's father Jack in 1984, the business expanded in the late 1990s and early 2000s as the U.S. housing market soared and demand for Canadian softwood lumber followed. By 2006, the company was worth $2 million, most of the value of which was attributable to logging trucks and other specialized equipment for harvesting and processing logs. Since the company was initially capitalized mostly with debt, and its growth was financed by the reinvestment of retained earnings, the paid-up capital (PUC) of HLL's 100 common shares at this time (all of which were owned by Jack) as well as their and adjusted cost base (ACB) to Jack was only $1 each ($100 in total).

In October 2006, Jack died in a tragic boating accident and Andrew, who had worked in the business for many years, inherited all 100 common shares of HLL. Under subsection 70(5) of the ITA, Jack was deemed to have disposed of these shares for proceeds equal to fair market value immediately before his death, and Andrew was deemed to have acquired the shares at a cost equal to this fair market value. As a result, although the PUC of these shares remained $1 per share ($100 in total), their adjusted cost base to Andrew became $20,000 each ($2 million in total). Fortunately for Andrew and the business, HLL had purchased life insurance to cover income taxes resulting from a deemed disposition on Jack's death, and Jack's estate was able to reduce the amount of tax payable on the deemed disposition by claiming the lifetime capital gains, which sheltered $500,000 of the nearly $2 million capital gain from tax.

Despite a serious downturn in 2007 and 2008, when U.S. housing starts plunged and demand for Canadian softwood lumber collapsed, the business continued to prosper under Andrew's management. Having had to lay off employees and sell some of its equipment in order to weather the downturn, however, Andrew was reluctant to reinvest the company's after-tax income in order to expand the business until he felt confident that the U.S. housing market had fully recovered. As a result, as the company's profits increased from 2010 to 2014, it did not acquire new trucks or equipment but accumulated a substantial reserve in order to finance potential future expansion. By December 2014, the company was worth $3.6 million, of which $1.6 million was attributable to trucks and equipment and $2 million was attributable to investments in marketable securities.

In January 2015, however, HLL bought three new logging trucks, increasing the value of its trucks and equipment to $2 million and reducing the value of its reserve to $1.6 million. Over the next two years, HLL continued to buy new trucks and equipment, as a result of which the ratio of the reserve to HLL's total assets continued to decrease. By December 2016, HHL was worth $4 million, of which $2.5 million was attributable to trucks and equipment and $1.5 million to its reserve.

Question 2 (continued)

In February 2017, Andrew decided that the business was large enough and sufficiently profitable that it no longer required a substantial reserve. As a result, after consulting a tax advisor on how best to distribute these funds, he and HLL carried out the following transactions in sequence on April 1, 2017:

(1) Andrew incorporated two new companies called Hoyle Holdings Ltd. ("HHL") and Courtney Holdings Ltd. ("CHL"), acquiring one common share of each company for $1;

(2) HLL declared and paid a stock dividend on each of its common shares of 15 preferred shares (1,500 in total) each of which had a PUC of $0.01 ($15 in total) and a redemption amount of $1,000 each ($1.5 million in total);

(3) Andrew sold these HLL preferred shares to HHL in exchange for 1,500 preferred shares, each of which had a PUC of $0.01 ($15 in total) and a redemption amount of $1,000 each ($1.5 million in total);

(4) Andrew sold these HHL preferred shares to CHL in exchange for 1,500 preferred shares, each of which also had a PUC of $0.01 ($15 in total) and a redemption amount of $1,000 ($1.5 million in total);

(5) HHL redeemed its preferred shares of HLL for $1.5 million, which HLL paid with the proceeds from the disposition of the marketable securities comprising its reserve;

(6) CHL redeemed its preferred shares of HHL for $1.5 million;

(7) Andrew sold his 100 HLL common shares to CHL for $2.5 million, $1.5 million of which was paid in cash and $1 million in the form of 10,000 preferred shares, each of which had a PUC of $50 ($500,000 in total) and a redemption amount of $100 ($1 million in total).

In his tax return for his 2017 taxation year, Andrew reported a stock dividend of $15 and a taxable capital gain of $250,000 on the disposition of his HLL shares to CHL, in respect of which he claimed the lifetime capital gains deduction under subsection 110.6(2.1) of the ITA. He recently received a notice of reassessment disallowing the capital gains deduction on the grounds that the HLL shares were not qualified small business corporation shares [10 marks], reducing the PUC of his CHL preferred shares to nil under section 84.1 of the ITA [10 marks], and deeming the $1.5 million that he received from CHL to be a dividend either under subsection 84(2) [10 marks] or section 245 of the ITA [10 marks]. Please advise Andrew on the merits of this notice of reassessment, referring to relevant statutory provisions and judicial decisions.

END OF EXAMINATION