THE UNIVERSITY OF BRITISH COLUMBIA
PETER A. ALLARD SCHOOL OF LAW

FINAL EXAMINATION – APRIL 2021

LAW 506.002
Taxation

Professor Taylor

EXAM PASSWORD: 4Et7L6
RESUME CODE: B1517C

TOTAL MARKS: 100

(8:50 AM PDT) **PREPARATION TIME ALLOWED:** 10 MINUTES
(9:00 AM PDT) **WRITING (INCLUSIVE OF READING) TIME ALLOWED:** 3 HOURS, 15 MINUTES

8:50-9:00 AM Preparation Time (Exam writing not permitted) – This time is given to students to download/print your exam questions once the exam has been made available online on Canvas, to read the Exam Password on this exam coversheet, to enter the Exam Password for the exam in Examplify, and to progress in Examplify until you see the **STOP SIGN,** where you will **WAIT until 9:00 AM**. **DO NOT proceed past the STOP SIGN**. **DO NOT begin typing your exam answers in Examplify until 9:00 AM!**

9:00 AM Exam Writing Time – At 9:00 AM, you may proceed past the STOP SIGN in Examplify and begin typing your exam answers. Students are required to calculate and monitor their own time for writing exams. All exam answer uploads will be monitored to ensure that typing of answers only occurred during the allotted Exam Writing Time.

This is an open book examination, meaning that you can refer to the *Income Tax Act,* the course textbook, lecture slide decks, and your own notes.

If you think you have discovered an error or potential error in a question on this exam, please make a realistic assumption, set out that assumption clearly in writing for your professor, and continue answering the question. Do not email your professor or anyone else about this while the exam is in progress.

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Assumptions:

In this exam, you should assume that Homer and Marge Simpson are legally married, and have three children: Bart (born Jan 1, 2000), Lisa (born Jan 1, 2002), and Maggie (born Jan 1, 2009). You should also assume that all individuals mentioned are residents of Canada and all geographic places mentioned are located in Canada.

All answers should be supported with references to relevant provisions of the *Income Tax Act* and to case law that we have studied, where applicable.

Part I – Short answer questions (25 marks/45 mins) – ANSWER **ALL** QUESTIONS

MARKS

3 1. Is it possible for Homer to deal at arm's length with the following persons for purposes of the *Income Tax Act?* Why or why not?

a) Maggie

b) Marge's mother

c) A child adopted by Marge's sister Patty

4 2. In 2018, Homer was employed at the local nuclear power plant and Marge carried on a business as a sole proprietor. Marge selected the period that runs from January 2 to the next January 1 for preparing her business's financial statements. With reference to applicable provisions of the *Income Tax Act,* please advise:

a) On what date was Marge's tax return for the 2018 taxation year due?

b) When was Homer's 2018 tax return due?

c) In which year's income tax return is Marge required to report income from her business that was earned in February 2018, and when is that return required to be filed?

2 3. The CRA reassessed Marge for her 2018 taxation year to increase her tax payable on the basis that she under-reported her income. Marge did fail to report income, but she serves a notice of objection anyway. On Marge's behalf, Homer's friend Moe tells the CRA officer reviewing the objection that if the CRA reduces the reassessment by half, Marge will put a cheque in the mail today. If not, Moe says Marge will go bankrupt and the CRA "won't see a cent". Moe tells the CRA officer to "take it or leave it". Can the CRA officer accept?

2 4. Marge learns that the CRA based the reassessment on information from a confidential informant. However, the CRA refuses to reveal the informant's identity. Moe advises Marge to apply to the Federal Court for a declaration that the CRA has deprived Marge of her right to the enjoyment of property without due process of law, contrary to the *Canadian Bill of Rights,* SC 1960, c 44. Moe says the reassessment can then be quashed as unlawful. Do you agree with Moe's advice?

4 5. For many years, Homer was employed by the Springfield Nuclear Co. (SNC). SNC is a public company listed on the Springfield stock exchange. When he was hired, Homer purchased 1,000 SNC stock options for $2 each through an employee stock option program. The options had an exercise price of $10 per share. In 2019, SNC shares were trading at $100 per share, and Homer exercised 500 options. In 2020, the share price declined to $10. Disappointed, Homer sold his remaining 500 options to his friend Moe for $12 per option. What are Homer's tax consequences in the 2019 and 2020 taxation years?

6 6. In 2019, Homer's father Abe gifted an antique car to Bart. Abe purchased the car many years ago for $10,000 and he spent $5,000 restoring it. By 2019, the car was worth $25,000. In January 2021, Bart sold the car for $35,000. Unbeknownst to Bart, however, Abe has outstanding tax debts of $5,000 per year for each of the 2018, 2019, and 2020 taxation years. What are the tax consequences of these transactions to Abe and Bart?

2 7. In 2019, Homer deposited $50,000 worth of GICs and savings bonds to an account for Lisa. The account is intended to be Lisa's college fund. The bonds and GICs generated $5,000 of interest income in each of 2019 and 2020. Whose income is that for tax purposes in each of those years?

2 8. The CRA has commenced a new audit of Homer. Homer shows you a document sent by the CRA entitled "Requirement to Report for Interview". The document says that it was issued under the authority of sections 231.1 and 231.2 of the *Income Tax Act,* and it directs Homer to attend at the local CRA office for an oral interview. The document threatens criminal prosecution for failure to comply. Is this document within the scope of the CRA's legal authority?

Part 2 – Fact Patterns (60 marks/108 mins) – ANSWER **BOTH** QUESTIONS

25 9. The town of Springfield decided to build a monorail. The monorail would
(45 mins) connect Springfield with important towns like Brockway, Ogdenville, and North Haverbrook, which are located outside the Springfield metropolitan area. The town hoped that a monorail would attract tourists and put Springfield on the map. A local billionaire, Mr. Burns, funded the monorail's construction and operation through his company, Springfield Monorail Co. The monorail began operations on January 1, 2019.

Mr. Burns offered Homer, a former safety inspector at the Springfield nuclear plant, a position as a monorail safety inspector. The terms of employment included:

a) Homer's employment would commence on January 1, 2019.

b) Homer's salary would be $100,000 per year.

c) Homer would also receive a $25,000 signing bonus.

d) Homer would report for work at one of the four monorail stations on a rotating basis, spending three months at a time at each location.

e) Springfield Monorail Co. would provide Homer with a company car (cost $50,000) to commute back and forth from his home in Springfield to the other monorail stations. The car would be

(Question 9, continued)

available to Homer year-round, and for unlimited use. The company would pay for all operating costs, except for a $250 per month "vehicle fee" that was deducted from Homer's salary.

f) Homer would be responsible for all non-vehicle costs, if any, associated with travelling between Springfield and the other monorail stations.

g) Homer would receive $10,000 per year to purchase uniforms, although receipts would be required for any such expenses.

h) Homer would be eligible for an employer-paid group accident insurance plan that would pay him $5,000 per month if he was unable to work due to illness or injury.

In addition, Mr. Burns offered $10,000 to any employee who successfully completed the Monorail Inspector's Course, offered online through Springfield University, before the end of 2019.

Homer accepted the position and began work on January 1, 2019.
In 2019:

a) Homer received a salary of $100,000 per year.

b) Homer received the $25,000 signing bonus, which was paid by another of Mr. Burns' companies, Springfield Uranium Co.

c) Homer drove the company car a total of 50,000 km – 30,000 km of personal use in and around Springfield and 20,000 km to go back and forth between Springfield and other monorail stations.

d) Homer paid $5,000 for uniforms and submitted his receipts, but he received the full $10,000 clothing amount anyway.

e) Homer paid $5,000 to be a member of the Transportation Employees' Union. Membership in the union was not mandatory in order to work as a monorail inspector, but Homer felt that it would be beneficial to his career.

f) Homer paid $5,000 to enroll in the Monorail Inspector's Course.

(Question 9, continued)

g) Homer converted one bedroom (200 square feet) in the Simpson House (total 2,000 square feet) to a home office, which he used only to complete the online Monorail Inspector's Course. In 2019, Homer incurred $10,000 of total expenses for things such as hydro, gas, internet, insurance, light bulbs and other supplies related to the house.

h) Homer paid $10,000 for meals in other towns on the monorail line. Since Homer was typically away from Springfield for 14 hours per day when stationed at another location, he often chose to stay overnight and he incurred $25,000 of hotel costs.

i) Homer completed the Monorail Inspector's Course and received $10,000 from Springfield Monorail Co.

j) Homer received parking and speeding tickets totaling $5,000 while driving between Springfield and other towns on the monorail line.

On January 1, 2020, Homer was injured when a monorail car that he had forgotten to inspect jumped the track. After that time, he was unable to work and received no salary. Homer applied for accident insurance benefits but his claim was denied because his doctor, Dr. Nick Riviera, turned out not to have a valid medical degree.

Bad publicity due to the accident caused the monorail to cease operations on March 31, 2020. Homer was laid off and did not receive severance.

Shortly afterward, Homer accepted an offer to work for the Springfield Kwik-E Mart for $50,000 per year. However, before Homer started work the Kwik-E Mart cancelled the contract. Kwik-E Mart paid Homer compensation of $25,000, for "losses including lost income, mental distress, and humiliation". Finally, in April 2020, Homer obtained an updated disability report from a new doctor, Dr. Hibbert. The Springfield Monorail's accident insurance plan then paid Homer a lump sum of $15,000 for past benefits up to March 31, 2020 when he had been laid off.

Discuss Homer's income from employment for purposes of section 3 of the *Income Tax Act* for the 2019 and 2020 taxation years. In your answer, you should identify Homer's source(s) of income, each amount that must be included or deducted, and each amount that is not to be included or

(Question 9, continued)

deducted. Give reasons for your position including references to relevant provisions of the *Act* and case law that we have studied.

In your answer, you should assume the following:

a) Springfield and all locations on the monorail line are located in British Columbia, and speeding and parking tickets are issued under provincial statues and/or municipal bylaws;

b) the Transportation Employees' Union is a trade union within the meaning of the *Canada Labour Code;* and

c) the prescribed amount for purposes of paragraph 6(1)(k) of the *Income Tax Act* is 50 cents per kilometre.

35 10. When Springfield announced its plans to build a monorail, Marge saw the
(63 mins) opportunity to start a new business. She decided to open a bed and breakfast to cater to all of the tourists Springfield expected. She borrowed $500,000, secured by a mortgage on the Simpsons' house, where Marge and Homer had lived for the past 30 years. The interest rate on her mortgage was 10% per year, payable monthly. She spent the mortgage proceeds as follows:

a) $300,000 to purchase a 3-bedroom cottage at Lake Springfield;

b) $150,000 to renovate the cottage; and

c) $50,000 to outfit the cottage with furniture, kitchenware, linens, and towels.

Marge also moved a number of paintings (cost $10,000, fair market value $60,000) from the Simpsons' house to the cottage.

The cottage could not be used while it was being renovated. The renovations were completed on July 1, 2019 and Marge opened for business as "Bed and Breakfast with Marge". Demand was strong and Marge's 2019 cash receipts totaled $300,000. Her 2019 expenses included $50,000 of interest, $50,000 for food and drinks served to her guests, and $25,000 for cleaning expenses. Marge also participated in a

(Question 10, continued)

program offered by the town of Springfield which guaranteed a property tax freeze for 2020 if those taxes were paid in 2019. Marge paid for her 2019 and 2020 property taxes with a combined payment of $40,000.

In mid-2019, the Krustylu Studios booked Marge's cottage for use in a new live action Itchy and Scratchy movie, starring the voice of Troy McClure. Marge invoiced the studio for $50,000, but by the end of 2019 the studio still had not paid this invoice (this amount is not included in the $300,000 of cash receipts). In addition, in 2019 the Flanders' family booked Marge's cottage for a family reunion to be held in 2020. Marge charged $25,000, which the Flanders family paid in 2019 (also not included in the $300,000 of cash receipts).

After Homer caused a serious monorail accident in early 2020, tourism dried up. On June 30, 2020, Marge closed the bed and breakfast. Concerned about making ends meet now that Homer was also unemployed, Marge decided to move the Simpson family to the cottage. She sold the Simpsons' house (cost $100,000) to an arm's length purchaser for $1,000,000. Marge paid her realtor, Cookie Kwan, a commission of $50,000 for brokering the sale. Marge used the sale proceeds to repay the $500,000 bank loan, and then invested the remaining proceeds ($450,000) in the stock market to provide income for herself and Homer. Her stocks generated dividends of $50,000 in 2020.

The Simpson family moved into the cottage on July 1, 2020. As of that date, the cottage had a fair market value of $750,000; however, the fair market value of the furnishings, kitchenware, and household linens had declined to $10,000. In addition, after moving to Lake Springfield, Marge decided that she needed a new vehicle. She purchased a new model 4-wheel drive called the Canyonero for $50,000. However, she did not enjoy driving a large vehicle and a month later she decided to sell it. She sold it (fair market value now $30,000) to her sister Selma for $15,000.

In the fall of 2020, there was a heavy rainstorm which flooded the cottage. Marge paid $200,000 for restoration work. Her only source of funds was her investment portfolio. Rather than cash in those assets, Marge borrowed $200,000 from the bank, secured by her investments. Marge wanted to keep those investments so they could generate income in the future. Marge paid $5,000 of interest on this loan in 2020.

(Question 10, continued)

While the cottage was being repaired, a burglar stole Marge's paintings. When Marge made an insurance claim, the insurance adjuster determined that the paintings were forgeries and the insurance company only paid $1,000 in compensation.

For 2020, Marge's gross business revenues from the bed and breakfast were only $50,000 (not including the Krustylu Studios and Flanders family amounts). Her business expenses included $25,000 of interest for six months, $10,000 for food and drink supplies, and $5,000 of cleaning expenses. Marge made several attempts to collect the $50,000 owed by Krustylu Studios, but without success. In December 2020, Krusty the Clown was busted for tax evasion and the Krustylu Studios went bankrupt. Marge realized that she would never collect that amount.

What is Marge's income from business, property, and taxable capital gains for purposes of section 3 of the *Income Tax Act* in the 2019 and 2020 taxation years? In your answer, you should identify each source of income and discuss each amount that must or must not be included and/or deducted (including capital cost allowance). Give reasons for your position including references to relevant provisions of the *Act* and case law that we have studied.

In your answer, you should make the following assumptions:

a) Marge is the sole owner of the Simpsons' house;

b) you may ignore subsections 45(2) and (3) of the *Income Tax Act;*

c) all depreciable property is in the same class, except for buildings, which are in a separate class;

d) Marge will claim the maximum CCA whenever possible;

e) all depreciable property qualifies for CCA at a rate of 10%; and

f) you may ignore the half-year rule in Regulation 1100(2) of the *Income Tax Regulations.*

<u>Part 3 – Short Essay Question (15 marks/27 mins) –</u> <u>ANSWER **ONE** QUESTION</u>

15 **(27 mins)**

11. The Canadian income tax system has been criticized as unnecessarily complex. Some critics suggest a flat tax system without graduated tax rates. Others suggest that different forms of income should be treated the same. Others suggest that the tax system should have fewer deductions and credits. Drawing on our study of tax policy as well as the *Income Tax Act* and the case law that we have studied, do you think Canadian tax law is more complicated than it needs to be? If so, what is one structural change that you would make to our tax laws and why?

12. In order to be deductible under paragraph 20(1)(c) of the *Income Tax Act,* interest must relate to borrowed money that a taxpayer has used "for the purpose of" gaining or producing income from a business or property. Over time, the Supreme Court of Canada's approach to interpreting the "for the purpose of" requirement has shifted. With reference to the decisions in *Bronfman Trust v Canada, Singleton v Canada,* and *Lipson v Canada,* comment on the Supreme Court of Canada's interpretation of this requirement. Do you agree or disagree with the evolution of the Court's jurisprudence? Why or why not?

13. The House of Lords decision in *Commissioners of Inland Revenue v Duke of Westminster* has been the subject of debate and criticism for 85 years. In your view, is the decision compatible with the modern approach to statutory interpretation, including considerations of legislative context and legislative purpose? Do you believe that special interpretive rules should be necessary to deal with tax avoidance?

END OF EXAMINATION