NOTE:  
1. This is an open book examination.

2. ANSWER ALL QUESTIONS.

THIS EXAMINATION CONSISTS OF 3 QUESTIONS
EACH QUESTION IS WORTH 1/3 OF THE TOTAL GRADE
Question 1 - Taxation of Corporate Income

Atlantic Appliances Limited (“AAL”) is a Canadian corporation, which carries on a business of selling consumer appliances though several retail stores in Nova Scotia, all of which operate out of commercial premises that it owns. During the taxation years at issue, all 100 common voting shares of AAL were owned by Maclean Holdings Limited (“MHL”), a Canadian corporation of which the voting common shares were owned equally by Gavin Maclean, his brother Harrison, and his sister Candice. While Gavin resides in Halifax, Nova Scotia, Harrison is a resident of California and Candice is a resident of Bermuda. According its Articles of Incorporation, however, MHL is governed by a five-person board, comprising nominees of each sibling and two other persons nominated by Gavin. In practice, Gavin manages the business and affairs of AAL and MHL.

Although AAL generally derives most of its income in the form of gross profits from the sale of appliances, it also obtains interest income from the sale of appliances on credit, and rental income from tenants to whom it leases excess retail space in some of the commercial premises that it owns. In 2012, it also sold an underperforming store in Yarmouth, Nova Scotia, resulting in recaptured depreciation on the building and a capital gain on the land.

In computing its income for its 2012 taxation year, which corresponded to the calendar year, AAL included a taxable capital gain of $60,000 from the sale of land in Yarmouth, and business income of $740,000 (comprising $400,000 profits from the sale of appliances, interest payments of $200,000, rental income of $100,000, and recaptured depreciation of $40,000), resulting in total taxable income of $800,000, in respect of which AAL computed federal tax otherwise payable of $304,000 under subsection 123(1) of the ITA (38% of $800,000) plus $4,000 under section 123.3 (6⅔% of $60,000), against which it deducted $80,000 under subsection 124(1) (10% of $800,000), $85,000 under subsection 125(1) (17% of $500,000), and $32,500 under subsection 123.4(2) (13% of $250,000), resulting in net federal tax payable of $110,500. It also added $60,000 to its capital dividend account, $16,000 (26⅔% of $60,000) to its refundable dividend tax on hand (RDTOH), and $180,000 (72% of $250,000) to its general rate income pool (GRIP); paid a capital dividend of $60,000 and a taxable dividend of $600,000, of which it designated $180,000 to be an eligible dividend; and claimed a dividend refund of $16,000 under subsection 129(1) of the ITA.

In computing its income for its 2012 taxation year, which also corresponded to the calendar year, MHL included $600,000 of taxable dividends that it received from AAL as well as $300,000 in dividends from widely held corporations in which it had invested funds, in respect of which it deducted the full amount under subsection 112(1) of the ITA. It also added $60,000 to its capital dividend account and $180,000 to its GRIP, and paid a capital dividend of $60,000 and a taxable dividend of $180,000, which it designated as an eligible dividend.
Question 1 (cont.)

For several years, Maude carried on an unincorporated business selling locally made crafts out of rented premises near the waterfront in Halifax. In 2011, Maude incorporated this business as Halifax Designs Limited ("HDL"), acquiring all 100 voting common shares in exchange for $100. The next year, Gavin contributed $100,000 to HDL to enable it to acquire a long-term lease on premises that Maude was able to customize for the purposes of her business. In exchange for this amount, Gavin acquired 10,000 non-voting preferred shares of HDL, which were non-convertible and non-exchangeable into other shares or debt, redeemable for $10 each, and on which dividends were payable at 1% of the redemption price (the prescribed rate for the year at issue). In computing its income for its 2012 taxation year, which also corresponded to the calendar year, HDL reported business income of $50,000, in respect of which it claimed the small business deduction under subsection 125(1).

The Canada Revenue Agency (CRA) recently audited AAL, MHL and HDL, and has written a letter to each company indicating that it is preparing notices of reassessment against them. With respect to AAL, the letter first questions whether the company qualifies as a Canadian-controlled private corporation (CCPC) on the basis that it was controlled by non-residents. Even if it does qualify as a CCPC, however, the letter also questions the way in which it has characterized different categories of income, suggesting that the sale of the land in Yarmouth may have resulted in business income rather than capital gains and that interest and rental income should be characterized as aggregate investment income which is subject to tax under section 123.3 of the ITA and ineligible for the deductions under subsection 125(1) or 123.4(2). For these reasons, the letter states that AAL may be subject to additional tax under Part III for an excessive capital dividend election and under Part III.1 for an excessive eligible dividend designation. With respect to MHL, the letter states that the company is subject to Part IV tax on all dividends that it received, including dividends from AAL. Finally, the letters state, even if AAL qualifies as a CCPC, it was associated with HDL during the year and must share the business limit of $500,000.

Please advise these companies on the tax law issues raised by these reassessments, referring to relevant statutory provisions and judicial decisions. In addition to any other tax law issues that you consider relevant, please explain: (1) whether or not AAL qualifies as a CCPC and why, (2) which of AAL, MHL and HDL, if any, are associated for corporate tax purposes, (3) how AAL’s income should be characterized for tax purposes, and the implications of this characterization for the taxation of this income as well as the dividends that it paid to MHL, (4) whether MHL is subject to Part IV tax on the dividends that it received from AAL and other corporations and in what amounts, and (5) what, if any, other tax consequences might apply to MHL face if it is subject to Part IV tax?

END OF QUESTION 1
Question 2 - Taxation of Shareholders

Maude Lebowski is a graphic artist who lives in Toronto, where she operates a successful graphic design business under the name Lebowski Design Limited ("LDL"). Maude incorporated the company in 2001, at which time she contributed $50,000 to the company in exchange for 10,000 voting common shares with a paid-up capital of $5 per share.

After LDL was incorporated, the graphic design business grew quickly, as Maude invested the company’s profits by hiring new personnel and purchasing sophisticated computer design equipment. By the end of 2007, LDL employed twelve people and the company’s assets were valued at $1.2 million, of which $800,000 was attributable to computer equipment, $300,000 to office furniture, and $100,000 to cash reserves. After the global financial crisis in 2008, however, opportunities for further growth stagnated, though LDL continued to earn income from its graphic design business.

Unwilling to distribute these earnings in the form of dividends that would attract personal tax, Maude decided to invest the company’s after-tax earnings in short-term securities which could be sold to finance future expansion of the business once conditions improved. By the end of 2011, the company’s assets were valued at more $1.62 million, of which $600,000 was attributable to computer equipment, $220,000 to office furniture, and $800,000 to short-term securities.

In 2012, LDL was reassessed on the basis that its income from these short-term securities was aggregate investment income and subject to tax at a very high rate. After speaking with a tax lawyer, Maude was advised that LDL should no longer accumulate surplus funds but should distribute these to her in the most tax-effective manner possible, taking advantage among other things of the capital gains deduction on the sale of qualified small business corporation shares. In order to facilitate these transactions, the tax lawyer contacted various clients to find someone who would purchase and resell the shares of LDL. After one client offered to do so for no less than $50,000, the tax lawyer found another client (the “Client”) who was prepared to accept $20,000. Acting on the tax lawyer’s advice, Maude and the Client carried out the following transactions on June 20, 2012:

(1) At 10:00 a.m., LDL declared and paid a stock dividend on each of its 10,000 common shares of one non-voting redeemable preferred share, each of which had a paid-up capital of $1 ($10,000 in total) and a redemption amount of $80 ($800,000 in total).

(2) At 10:01 a.m., Maude incorporated a private company called Lebowski Holdings Limited (“LHL”), to which she paid $20,000 in exchange for 200 voting common shares with a paid-up capital of $100 each.
(3) At 10:02 a.m., Maude sold to LHL the 10,000 preferred shares that she had received from LDL in exchange for 10,000 non-voting redeemable preferred shares of LHL, each of which had a paid-up capital of $1 ($10,000 in total) and a redemption amount of $80 ($800,000 in total).

(4) At 10:03 a.m., LDL redeemed the 10,000 preferred shares held by LHL for $80 per share ($800,000 in total), which it paid in cash after selling its short-term securities.

(5) At 10:04 a.m., Maude sold her 10,000 voting common shares of LDL to the Client for $800,000, which was paid in the form of a promissory note.

(6) At 10:05 a.m., the Client sold these 10,000 voting common shares of LDL to LHL for $820,000 in cash.

(7) At 10:06 a.m., the Client paid $800,000 to Maude, who cancelled the promissory note.

In computing her income for her 2012 taxation year, Maude reported a taxable dividend of $10,000 on account of the stock dividend that she received from LDL, and a taxable capital gain of $750,000 on the disposition of her 10,000 voting common shares of LDL to the Client, in respect of which she claimed the capital gains deduction under subsection 110.6(2.1) of the ITA. In computing its income for its 2012 taxation year, LHL reported a deemed dividend of $790,000 on the redemption the non-voting preferred shares of LDL, in respect of which it claimed a deduction under subsection 112(1) of the ITA.

The Canada Revenue Agency (CRA) recently audited Maude and LHL and has indicated in a letter to Maude that her sale of 10,000 LDL shares to the Client either may not qualify for the capital gains deduction or may result in a deemed dividend under subsection 84(2) of the ITA, section 84.1 of the ITA, or section 245 of the ITA (the GAAR). In a separate letter to LHL, the CRA has indicated that it is considering whether to reassess the $790,000 deemed dividend that it reported as a capital gain under subsection 55(2) of the ITA.

Please advise Maude and LHL on the legal issues raised by these letters, referring to relevant statutory provisions and judicial decisions.

END OF QUESTION 2
Question 3 – Corporate Reorganizations

Jennie Lynch is resident of Vancouver, who carries on a business of investing in commercial real estate through a private company called Lynch Realty Limited (“LRL”). Although LRL derives most of its income from the development and rental of commercial properties, it occasionally disposes of these properties when Jennie determines that market conditions are suitable. LRL consistently characterizes these properties as capital property for tax purposes, and has never been challenged in this characterization by the CRA.

For several years, Jennie’s daughter Michelle worked for LRL, obtaining first-hand experience about the commercial real estate business. In the fall of 2011, she decided to invest on her own, obtaining bank financing to acquire for $3 million a parcel of vacant land in Richmond (the “Richmond Property”), on which she planned to construct a mixed retail and residential building for rental purposes. Shortly after taking possession of the property, however, discovered that a substantial portion of the land was contaminated from undocumented use as a gas station in the 1930s. Since environmental remediation would take a lengthy period of time and render the land useless for any other purpose during this period, the value of the land dropped substantially, to $1 million by early 2012.

Around the same time, Jennie decided that it might be a good time for LRL to sell a property in Vancouver (the “Vancouver Property”) that it had acquired in 2009 for $3 million ($2 million for the land, $1 million for the building). By early 2012, the estimated value of the property was $5 million — of which $3.5 million represented the value of the land and $1.5 million the value of the building. Since LRL had deducted the maximum allowable capital cost allowance on the building (a Class 1 property with an annual CCA rate of 4%), its undepreciated capital cost at the time was $903,168.1

After speaking with Jennie tax lawyer, LRL and Michelle carried out the following transactions in January and February 2012:

1. On January 15, LRL incorporated Vancouver Properties Limited (“VPL”), contributing $100 in exchange for 100 voting common shares with a paid-up capital of $1 each.

2. Immediately thereafter, also on January 15, LRL sold the Vancouver Property to VPL in exchange for 50,000 non-voting Class A preferred shares of VPL with a paid-up capital of $60 per share and a redemption amount of $100 per share.

3. Later on January 15, LRL sold its 100 voting common shares of VPL to Michelle for $100.

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1 This amount reflects CCA deductions as follows: $20,000 for 2009 (taking into account the half-year rule), $39,200 in 2010, and $37,632 in 2011.
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Question 3 (continued)

(4) Also on January 15, immediately after acquiring the common shares of VPL, Michelle sold the Richmond Property to VPL in exchange for 10,000 Class B preferred shares of VPL, with a paid-up capital of $100 each and redeemable for $100 each.

(5) On January 16, VPL sold the Vancouver Property to an arm’s length purchaser for $5 million.

(6) Immediately thereafter, also on January 16, VPL redeemed the Class A preferred shares held by LRL for $5 million.

(7) On February 16, LPL sold the Richmond Property to an arm’s length purchaser for $1 million.

(8) Immediately thereafter, also on February 16, VPL redeemed the Class B preferred shares held by Michelle for $10,000.

When filing their tax returns for their 2012 taxation years, LRL and VPL jointly elected $2 million as the agreed amount for the land and $1 million as the agreed amount for the building in respect of the disposition of the Vancouver Property, while Michelle and VPL jointly elected $1 million as the agreed amount for the disposition of Richmond Property. In computing its income for its 2012 taxation year, VPL reported taxable capital gains of $750,000 on the land and $250,000 on the building in respect of the disposition of the Vancouver Property, and a $1 million allowable capital loss from the disposition of the Richmond Property. In computing its income for its 2012 taxation year, LRL included recaptured depreciation of $96,832 on the disposition of the building to VPL, and a deemed dividend of $2 million on the redemption of its Class A shares of VPL in respect of which it deducted the same amount under subsection 112(1) of the ITA. In computing her income for her 2012 taxation year, Michelle reported no income or loss resulting from these transactions.

The Canada Revenue Agency has asked you to review these transactions and advise on their tax treatment. Among any other issues that you identify, please address whether LRL and VPL could elect the amounts they did on the sale of the Vancouver Property to VPL, whether Michelle and VPL could elect the amount they did on the sale of the Richmond Property to VPL, whether VPL realized a taxable capital gain on the arm’s length disposition of the Vancouver Property and an allowable capital loss on the arm’s length disposition of the Richmond Property, and whether Part IV tax and/or the anti-avoidance rule in subsection 55(2) might apply to the redemption of the Class A shares of VPL held by LRL. In providing your answers, please refer to relevant statutory provisions and judicial decisions.

END OF EXAMINATION