THE UNIVERSITY OF BRITISH COLUMBIA
FACULTY OF LAW

FINAL EXAMINATION – APRIL 2016

LAW 407.002

Professor Cui

TOTAL MARKS: 100

TIME ALLOWED: 3 HOURS
Plus 30 minutes reading time

NOTE: 1. This is an open book examination.

2. ANSWER ALL QUESTIONS.

THIS EXAMINATION CONSISTS OF 2 QUESTIONS
THE FIRST QUESTION IS WORTH 35 MARKS AND THE SECOND 65 MARKS
(ALLOCATION OF MARKS WITHIN EACH QUESTION INDICATED IN SQUARE BRACKETS AFTER THE QUESTION)
LAW 407, Section 2

QUESTION 1 (35 points)

Jane is a senior technology executive at Google Canada, which has its head office in Kitchener, Ontario. Jane is 35 years old, has been quite focused on her career, and is not yet married. She also does not have a “significant other” at the moment. She is getting concerned that she will not have the opportunity to have children while in her fertile children-bearing years. In part to increase the likelihood of finding a partner, Jane lives in Toronto in an apartment she bought and commutes to Kitchener every workday.

In March 2015, Google announced that the company would pay up to $20,000 for eligible female workers employed in Google’s North American offices to have their eggs frozen for non-medical reasons. Google introduced this program to give female employees the opportunity to delay having children. In summer 2015, Jane visited a clinic approved by Google and arranged to have her eggs frozen. She submitted the clinic’s invoice for $18,000 to Google, which paid off the invoice within weeks.

During a three-week stretch in October 2015, Jane led a team of programmers on an intensive project that kept her at the office very late. Google arranged accommodation at a 4-star hotel in Kitchener for Jane during these weeks. Jane still went back to Toronto for two of the weekends during this October period, but stayed at the hotel during all of the workday nights. The project was successfully completed and Jane is told that she can expect a promotion in light of her performance during the 2015 project.

In 2012, Jane invested in a technology start-up company, Firmament Software, that her friends founded and ran. Her stake in the company is modest but, encouragingly, Firmament has grown and may actually end up becoming a success in the near future. In January 2015, Firmament offered all shareholders the option of purchasing junior debentures (i.e. unsecured loan certificates) from the company. According to the terms of the debentures, the principal amount of debt would be repayable in 5 years, the debt will pay no interest during the 5 years but has favorable terms for converting to stock if Firmament undergoes an initial public offering or is sold to a third party. Each $10,000 of the debenture (in terms of principal amount) would be issued for the price of $6,209, reflecting a compound interest rate of 10% per annum, Jane decided to accept Firmament’s offer and purchased debentures with the aggregate principal amount of $100,000 on January 31, 2015.

Please examine the tax consequences under the Income Tax Act of the above mentioned activities of Jane’s for the 2015 tax year, including:

1. What taxable employment benefits she might have received from Google (15 points); and
2. What income she might have derived from her investment in Firmament Software (20 points).
QUESTION 2 (65 points)

For a number of years, Tim Doohickey has been running an unincorporated business named Doohickey Luggage that sells luggage and offers luggage repairs. In 2014, Tim relocated his shopfront from East 1st Avenue to Aymler Road near the Vancouver International Airport. The relocation of the shop seemed to be a good decision. Many of Tim’s institutional customers are airlines, and the new shop’s proximity to the airport made doing business with them easier. Shipping luggage to fulfill online sales orders similarly became easier to manage. But most importantly, the volume of online sales picked up thanks to expanding Canadian demand and Doohickey Luggage’s growing reputation for sourcing specialty luggage from around the world.

In 2014, Tim also changed the name of the business to Grouse Mountain Luggage, but he did not otherwise have plans for growing the business. In September 2015, the owner of one of his major suppliers in Asia, Mr. Xi, showed up in town. Mr. Xi invited Tim to a lavish dinner, and, over the course of the meal, told Tim that he has moved his family to British Columbia, and was looking to visit Vancouver more often as a result. Indeed, Mr. Xi plans to start a range of businesses in Vancouver, including marketing designer luggage and travel accessories to the ethnically-diverse but affluent population of the city. One idea is to open a new store in the downtown area. Another—if Tim happens to be willing—is to buy over Tim’s business and expanding it!

For many personal reasons not worth elaborating here, Tim was interested in Mr. Xi’s proposal, and told the latter that it would be good to discuss further. The two thus met again in October to discuss the terms of the sale of Grouse Mountain Luggage. To Tim’s surprise, Mr. Xi did not offer to make the purchase in cash. Instead, he outlined the following two options:

1. Option 1: The total purchase price of the deal would be $450,000, but only $150,000 would be paid at the time of completion. The remaining amount of $300,000 would be paid over the course of the next 6 years—$50,000 at the end of each year. A 2% interest would be payable annually on the outstanding balance of the purchase price.

2. The purchase price would have a fixed component of $200,000 payable at completion, but Tim would in addition be entitled to a 50% share of the net profit for the business for the next 6 years. In addition, Tim would be paid $15,000 a year as a consultant to the business during the same period for a maximum of 30 hours of his time per year.

Knowing how successful Mr. Xi is with his businesses in Asia, Tim could see that the business, as run by Mr. Xi, could generate $120,000 of net profit a year on a conservative estimate. Thus his payoff from agreeing to the second option would be getting up to $75,000 a year ($15,000 from consultancy and $60,000 of profit share), for 6 years. While this is somewhat risky, Tim secretly believes that both offers are in fact very generous, in light of his own expectations of what he could achieve with the business. In fact, he did not
think that he could get more than $200,000 in a cash sale of the business to anyone else. Therefore, he was inclined to accept the second (contingent purchase price) option, since the $200,000 up-front payment in that option implies that he will have no downside, but only upside, from the deal.

Tim consulted his regular accountant about the deal. The accountant told Tim that the main valuable assets in his business was (i) the business’ existing contracts with various airlines and its online sales portal, and (ii) the 15-year fixed-rent lease of the physical space on Aymler Road that houses his business (whereas Tim previously owned the physical premises of the East 1st Avenue shop, in the new location he is simply a tenant). The remaining assets of the business (e.g. the current inventory of luggage, repair tools, etc) were worth only about $90,000. Upon thinking over the deal, Tim concluded that there was only one way in which the deal could be improved. Tim’s 17-year-old daughter Celeste is an honors student in high school. Tim wants her to be able to go to the university she prefers (including outside Canada), and travel around the world as part of her education. Tim wants to be prepared for financing that education.

In the end, Tim arranged for the free transfer of all tangible and intangible business assets of Grouse Mountain Luggage to Celeste on November 1, 2015. On November 2, Celeste entered into a binding contract to transfer the same assets to Mr. Xi, on terms that essentially comprise those described under Option 2 above. The completion of the sale to Mr. Xi is conditional on due diligence on the various assets of Grouse Mountain Luggage and the satisfactory modifications of the various contracts with third parties, which are expected to be completed by December 15, 2015. The contract between Celeste and Mr. Xi further provides that the first payment of purchase price, of $200,000, would be put into escrow on December 15, 2015. Celeste could demand the release of the escrowed amount on the earlier of (i) January 15, 2016, and (ii) the date on which Celeste receives confirmation from Mr. Xi that the buyer’s conditions precedent have been completed and satisfied.

On December 15, 2015, Mr. Xi funded the escrow account pursuant to the contract. He sent his confirmation that all conditions precedent were satisfied on Tuesday, December 29. The escrowed amount was released to Celeste on January 5, 2016 upon her request.

Assume that Tim’s aggregate capital cost in all assets of Grouse Mountain Luggage (that are transferred to Celeste and subsequently sold to Mr. Xi) was $100,000. Please examine, among other possible legal issues under the Income Tax Act, the following issues for Tim and Celeste:

1. How would Tim have had to compute capital gain on the sale of his business if he had made the sale directly to Mr. Xi in 2015 under the first option offered by Mr. Xi? (17 points)
2. What are the tax consequences of the gratuitous transfer of assets from Tim to Celeste in 2015? (20 points)
3. What are the tax consequences, for Celeste (and/or Tim), of the release of the $200,000 escrowed amount on January 5, 2016? (8 points)
4. What will be the tax consequences, to Celeste (and/or Tim), of ongoing payments from Mr. Xi to Celeste under the contract of sale (20 points)?

END OF EXAMINATION