NOTE: 1. This is an open book examination.

2. THIS EXAMINATION CONSISTS OF 3 QUESTIONS

3. EACH QUESTION IS WORTH 33 MARKS

4. THERE IS ONE BONUS MARK (FOR TAKING CORPORATE TAX)

5. PLEASE ANSWER ALL QUESTIONS
QUESTION 1

Violette Motors Ltd. ("VML") is a Canadian corporation, which owns and operates a Ford automobile dealership called "Violette Motors" in Edmundston, New Brunswick. During the years at issue, all 100 common voting shares of VML were held by Violette Holdings Limited ("VHL"), a Canadian corporation of which Marcel Violette owned all 100 common voting shares and his wife Jeanne owned all 100 non-voting preferred shares (on which dividends could be paid at the discretion of the directors). Marcel Violette is the founder and driving force behind Violette Motors and the sole director of VML and VHL. Jeanne Violette does not work for VML or VHL and acquired her preferred shares from VHL for $1 each.

Although Marcel is the sole director of VML and VHL, Violette Motors operates under a franchise agreement with the Ford Motor Company ("Ford"), under which VHL is subject to strict guidelines regarding new and used vehicles that it is permitted to sell, the display and marketing of these vehicles, as well as pricing of these vehicles. This agreement also required VML to maintain a minimum reserve of $200,000 as a demonstration of its solvency. Ford is a public company that is resident in the United States of America, with shares listed on the New York Stock Exchange.

Although VML derives most of its income from the sale of new and used vehicles, it also earns income from servicing these vehicles, earns interest income from the investment of its minimum reserve, and derives rental income from a building adjacent to the dealership that it owns and rents to a collision repair shop. In 2013, it also realized a gain on the sale of a parcel of vacant land in Grand Falls, New Brunswick (60 kilometres away from Edmundston), which it had acquired with a view to establishing a satellite dealership, which was abandoned when another Ford dealership opened in Grand Falls in 2012.

In computing its income for its 2013 taxation year, which corresponded to the calendar year, VML included a net profit of $500,000 from the sale of new and used vehicles, net income of $100,000 from servicing these vehicles, $5,000 of interest income from its reserve, rental income of $45,000 from the adjacent building, and a taxable capital gain of $150,000 attributable to the sale of the land in Grand Falls. In computing its tax payable for 2013, it included $304,000 under subsection 123(1) of the ITA (38% of $800,000), plus $10,000 under section 123.3 (6²/₃% of $150,000), 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 $19,500 under subsection 123.4(2) (13% of $150,000), resulting in net federal tax payable of $129,500. It also added $150,000 to its capital dividend account (which had been nil before that time), $40,000 (26²/₃% of $150,000) to its refundable dividend tax on hand (RDTOH) (which was nil at the end of its preceding taxation year), and $108,000 (72% of $150,000) to its general rate income pool (GRIP) (which was also nil at the end of its preceding taxation year); paid a capital dividend of $150,000 and a taxable dividend of $108,000, which it designated as an eligible dividend; and claimed a dividend refund of $36,000 under subsection 129(1) of the ITA.
In computing its income for its 2013 taxation year, which also corresponded to the calendar year, VHL included $108,000 as a taxable dividend under subsection 82(1) and deducted the same amount under subsection 112(1). It also added $150,000 to its capital dividend account and $108,000 to its GRIP, and paid a capital dividend of $150,000 on its common shares and an eligible dividend of $108,000 on its preferred shares. In computing their taxes for their 2013 taxation years, Marcel did not include any amount in respect of the capital dividend, while Jeanne included the dividend of $108,000 plus an additional $41,040 (38% of $108,000) under subsection 82(1) and deducted federal and provincial dividend tax credits, resulting in roughly $10,000 of federal and provincial tax payable.

In 2014, Marcel decided that his son, Philippe, who had managed the service department since graduating from university in 2011, should acquire an ownership interest in the business. Although Marcel's initial idea was that VML or VHL would issue shares to Philippe, his plans changed after he discussed the matter with his tax advisor. Instead, Philippe incorporated a new company called Violette Auto Services Ltd. ("VAS"), acquiring 100 common shares for $100, to which VML transferred all the assets of the service department (other than the premises) on a tax-deferred basis under subsection 85(1) in exchange for non-voting preferred shares of VAS that were redeemable for an amount equal the fair market value of the assets transferred, not convertible or exchangeable into other shares or debt, and paid an annual dividend equal to the product of the prescribed rate and the fair market value of assets transferred. Thereafter, VAS serviced all vehicles sold by VML, in the same premises as it had previously occupied, which it leased from VML.

The Canada Revenue Agency (CRA) has asked you to advise it on how VML, VHL, VAS and Michel Violette should be assessed, referring to relevant statutory provisions and judicial decisions. In addition to any other issues that you may identify, please consider:

(1) whether VML was a Canadian-controlled private corporation [5 marks];

(2) how the different kinds of income that VML received in 2012 should be characterized for tax purposes [8 marks], and the implications of this characterization for the dividends that it paid to VHL and that VHL paid to Marcel and Jeanne Violette [4 marks];

(3) whether VML should have paid any tax on the dividends that it paid to VHL, and/or and whether VHL should have paid any tax on the dividends that it received from VML [4 marks];

(4) whether the dividend that Jeanne Violette received from VHL could be attributed to Marcel Violette [6 marks]; and

(5) whether VML and VAS were associated in 2014 [6 marks].

END OF QUESTION 1
QUESTION 2

Irwin Simons lives in Edmonton, Alberta, where he owns and operates a successful trucking business through a Canadian-controlled private corporation called Lloydminster Transport Ltd. ("LTL"). Established by Irwin in 1997 with a capital investment of $25,000, which LTL used to purchase a single truck that hauled equipment between Edmonton and the heavy oil refinery in Lloydminster, Saskatchewan, the business grew rapidly in the 2000s as oil and gas prices soared and the oil and gas industry boomed in northern Alberta and Saskatchewan. By the summer of 2008, LTL had over a hundred employees and owned a fleet of 65 trucks, which it had acquired by reinvesting the profits from its trucking business.

Although LTL’s trucking business suffered when oil and gas prices collapsed after the global financial crisis in 2008, the business recovered strongly in 2011 as oil and gas prices recovered. After the severe downturn in 2009 and 2010, however, Irwin decided that LTL should wait before purchasing any more trucks and should instead accumulate a reserve in order to finance the acquisition of more trucks at a later date. By September 30, 2014, LTL was worth approximately $10 million, of which $6.5 million was attributable to its trucks, $1.5 million to an office and service facility in Edmonton, and $2 million to cash and marketable securities. At this time, Irwin held all 1,000 common voting shares of LTL, which had a paid-up capital and adjusted cost base of $25 per share.

In the summer of 2014, oil and gas prices began to fall again, and Irwin concluded that it no longer made economic sense to maintain a reserve for potential expansion of LTL’s trucking business. As a result, LTL disposed of it marketable securities and Irwin contacted his tax advisor to determine how LTL might best distribute the proceeds to him in the most tax-efficient manner possible. After learning the Irwin had not previously claimed the lifetime capital gains deduction, the tax advisor suggested a series of transactions whereby Irwin would incorporate a holding company to which LDL would distribute most of its reserve, which would allow Irwin to claim the lifetime capital gains deduction on the sale of LTL shares to a third party.

Although Irwin initially rejected this plan on the grounds that he did not wish to sell the company or wind-up its business, his advisor assured him that the transactions could be accomplished without him having to relinquish control of the company and without any impact on its business — adding that he knew several clients with private companies which could purchase some of Irwin’s LTL shares and sell them back to LTL in exchange for a fee. Satisfied by his advisor’s assurance, Irwin accepted the plan, and his advisor contacted several clients to determine who would carry out the necessary transactions for the least amount. Although several clients insisted on a fee of no less than $8,000, another client agreed to a lower rate of $5,475. After negotiating this agreement with this client (the “Most Accommodating Client”) and his company Surplus Accommodation Limited (“SAL”), Irwin’s advisor arranged for the following transactions to be carried out in order on October 1, 2014:
Question 2 (continued)

(1) LTL declared and paid a stock dividend on each of its common shares of 10 preferred shares (10,000 in total), each of which had a paid-up capital of $1 ($10,000 in total) and a redemption amount of $200 ($2 million in total);

(2) Irwin incorporated a company called Simons Holdings Ltd. (“SHL”) to which he sold all 10,000 preferred shares that he had received from LTL in exchange for 100 common shares, each of which had a paid-up capital of $100 ($10,000 in total);

(3) SHL redeemed the 10,000 LTL preferred shares that it had acquired from Irwin for $2 million, which LTL paid out of the proceeds from the disposition of its marketable securities;

(4) Irwin sold 101 common shares of LTL to SAL for $808,000, payable in the form of a promissory note (the “SAL Note”);

(5) SAL redeemed the 101 LTL shares for $808,000, payable in the form of a cheque for $5,475 and a promissory note for $802,525 (the “LTL Note”);

(6) SAL and Irwin exchanged the SAL Note for the LTL Note, and Irwin sold the LTL Note to SHL for $802,525.

Immediately after these transactions, SHL invested its remaining cash in marketable securities, using the same investment advisor that LTL had used. Not distinguishing between SHL and LTL, the investment advisor sent a bill for its services to LTL, which inadvertently paid the bill and deducted the amount in computing its income.

In their tax returns for their 2014 taxation years, Irwin and SHL jointly elected $10,000 as Irwin’s proceeds of disposition of the 10,000 preferred shares to SHL. In computing his income for his 2014 taxation year, Irwin included $10,000 in respect of the stock dividend, and a taxable capital gain of \( \frac{1}{2} \times \left( [808,000 - (101 \times 25)] = 402,737.50 \right) \) on the sale of 101 LTL shares to SAL, and deducted an allowable capital loss of and \( \frac{1}{2} \times \left( [808,000 - 802,525] = 2,737.50 \right) \) on the exchange of the SAS Note for the LTL Note. In computing his taxable income, Irwin claimed a lifetime capital gains deduction of $400,000 in respect of the sale of the LTL shares to SAS.

Irwin recently received a notice of reassessment disallowing the capital gains deduction on the grounds that the LTL shares were not qualified small business corporation shares when he sold them to SAS [8 marks], or that the transactions resulted in a deemed dividend under subsection 84(2) [6 marks], section 84.1 [6 marks] or section 245 of the ITA [8 marks]. SHL also received a notice assessing a shareholder benefit in respect of the bill paid by LTL [5 marks]. Please advise Irwin and SHL on the merits of these notices, referring to relevant statutory provisions and judicial decisions.

END OF QUESTION 2
QUESTION 3

Leanne Feldman is a digital media designer who lives in Vancouver, British Columbia, where she owns a digital media design business called “Blast Zone Media” through a Canadian-controlled private corporation called BZM Limited (“BZM”). Established in 2001, after the so-called “dotcom bubble” burst in 2000, the business thrived over the following decade as digital marketing took off with the spread of the internet and the rise of social media. By the end of 2011, BZM had 80 employees, annual revenues of $2.5 million, and was worth $10 million — of which $1 million was attributable to computers and office furniture which it had acquired with after-tax income, $4 million was attributable to the premises in which it carried on its business (which it had purchased out of after-tax income several years earlier for $1 million), and the remainder was attributable to proprietary software (the “Software”) that it had developed in the course of its business which had an adjusted cost base for tax purposes of $1.

In January 2012, a representative of Microsoft Corporation (“Microsoft”) contacted BMZ, offering to purchase the Software for $5 million. Although tempted by the offer, Leanne rejected it on the grounds that the Software was essential to BMZ’s business and could increase in value as BMZ’s business expanded. Later that year, however, Leanne began to reconsider the wisdom of this decision when BMZ received a letter from another media design company alleging that the Software was very similar to its own software, and threatening to sue BMZ for an interest in the Software.

After consulting its lawyers, BMZ carried out the following transactions in the fall of 2012, the primary purpose of which were to transfer the Software to a separate legal entity in order to insulate BMZ from the threat of a possible lawsuit:

1. on September 25, 2012, BMZ incorporated a subsidiary called Digital Media Software Limited (“DMS”), to which it sold the Software for $5 million, payable in the form of 1 common share with a paid-up capital of $1;

2. immediately thereafter, DMS entered into an agreement with BMZ to lease the Software at an arm’s length rate for a period of five years to BMZ and any subsidiary corporation that it might incorporate or acquire;

3. on September 26, 2012, DMS declared and paid a dividend of $4,999,999 on the common share held by BMZ, payable in the form of a promissory note; and

4. on September 27, BMZ loaned $4,999,999 to DMS in the form of the promissory note, which was secured by an interest in the Software.

Later that fall, Microsoft Corporation contacted Leanne once again, repeating its offer to acquire the Software for $5 million. Leanne agreed on the condition that Microsoft would honour the lease entered into between DMS and BMZ, Microsoft loaned DMS $4,999,999 which it used to discharge its debt to BMZ, and BMZ sold its common share of DMS to Microsoft for $1.
Question 3 (continued)

With the $5 million that BMZ received from Microsoft and DMS, Leanne decided that the company was in an excellent position to expand its business geographically by opening up a separate office in another part of the country. After investigating opportunities in the competitive Toronto market, BMZ acquired all the shares of an unrelated digital media company called Hooplah Digital Media Limited ("HDM"), which had incurred substantial business losses between 2008 and 2011 and had yet to return to profitability. Under Leanne's capable management and with the benefit of the Software that BMZ had developed, HDM returned to profitability in 2013, after which it was continued into British Columbia for corporate law purposes and amalgamated into BMZ through a short-form vertical amalgamation under section 273 of the Business Corporations Act of British Columbia.

In their income tax returns for their 2012 taxation years, both of which coincided with the calendar year, BMZ and DMS jointly elected $1 as the proceeds of disposition of the Software under subsection 85(1) of the ITA. In computing its income for its 2012 taxation year, BMZ included a dividend of $4,999,999 under subsection 82(1) and deducted the full amount of this dividend under subsection 112(1). In computing its taxable income for 2012, BMZ also deducted a non-capital loss under paragraph 111(1)(a), which it carried back from its 2014 taxation year after the amalgamation with HDM. [Note: see subsection 87(2.1), which deems a new corporation resulting from an amalgamation under subsection 87(1) to be "the same corporation as, and a continuation of each predecessor corporation" for the purpose of determining the new corporation's non-capital loss.]

You have been retained by the CRA to advise it on how BMZ should be assessed in respect of these transactions. Among any other issues that you may consider relevant, please consider the following three questions, referring to relevant statutory provisions and judicial decisions:

(1) could BMZ and DMS elect $1 as the proceeds of disposition of the Software under subsection 85(1) of the ITA, and (related to this question) might the $4,999,999 promissory note that BMZ received from DMS be characterized as non-share consideration received in exchange for the Software? [6 marks]

(2) assuming that the promissory note was not non-share consideration, might the $4,999,999 note that BMZ received from DMS be characterized as proceeds of disposition of the DMS common share to Microsoft under subsection 55(2) of the ITA? [15 marks]

(3) could BMZ deduct a non-capital loss attributable to HDM's business losses in computing its taxable income for its 2012 taxation year? [12 marks]

END OF EXAMINATION