

FACULTY OF LAW

FINAL EXAMINATION – April 23, 2005

LAW 665:Y5 CORPORATE TAXATION (Sommerfeldt)

Time Allotted: Two (2) Hours Plus Ten (10) Minutes Reading Time

Code Number: **DO NOT ENTER YOUR NAME ON ANY ANSWER SHEETS OR BOOKLETS.** A list will be circulated and your name is to be entered opposite a number on that sheet. That number will be your code number **FOR THIS EXAMINATION ONLY** and should be entered on the examination booklets in the space provided for surname. This will provide for anonymity during marking.

- Special Instructions:**
1. This examination paper contains 5 questions on 7 pages. Check to ensure that the examination paper is complete before starting.
 2. Answer ALL questions.
 3. Questions are NOT of equal value. Apportion your time intelligently. A suggested time allotment (based on a proportionate allocation of the available time among the potential marks) is:

<u>Question</u>	<u>Marks</u>	<u>Time</u>
Reading Time		10 minutes
Q. 1	35	42
Q. 2	35	42
Q. 3	10	12
Q. 4	10	12
Q. 5	<u>10</u>	<u>12</u>
	100 marks	130 minutes

4. This is a **CLOSED BOOK** examination. However, you may use a clean, unmarked copy of the course syllabus (which is provided to you with this examination paper). You may also use *Stikeman Income Tax Act, Annotated* or a comparable edition of the *Income Tax Act (Canada)* (the “ITA”), provided that it complies with the following guidelines:

- (a) portions of the book may be underlined, side-barred, shaded or otherwise highlighted in an unwritten manner;
 - (b) flags, stickies, etc. may be used to mark portions of the book, provided that the flags or stickies do not contain any written annotations other than references to sections or other provisions of the ITA; and
 - (c) no written annotations (other than those of the editor or publisher or those designating section numbers) may be placed in, or attached to, the book.
5. Adhere to the time limitation imposed on this examination strictly. Failure to stop writing at the end of the examination may lead to a deduction of grades or a failure to accept the examination paper.
 6. Cell phones, pagers, beepers and related equipment are strictly forbidden. These items must be turned off and stowed. Except by permission of the instructor, which will not routinely be given, lap top computers are not allowed in examinations.
 7. Since it is very disruptive for those students finishing examinations while others are leaving the examination room and discussing the examination outside the examination door, it is requested that no individual leave the examination room during the last 15 minutes of the examination period.
 8. All monetary amounts referred to in this examination paper are expressed in Canadian currency.
 9. Unless otherwise stated, all individuals referred to in this examination paper are resident in Canada.
 10. Unless otherwise stated, all statutory references in this examination paper are references to the *Income Tax Act* (Canada) (the “ITA”).
 11. Support all answers with references to applicable statutory provisions and jurisprudence.

VALUE QUESTION

- 35 1.** Dr. Dinah Payne is a dentist who carries on the practice of dentistry in Edmonton, Alberta through a professional corporation known as D. P. Payne Professional Corporation (the “PC”), which was incorporated on June 16, 1990 under the *Business Corporations Act* (Alberta) (the “ABCA”). Dr. Payne is the sole officer, director and shareholder of the PC. She owns 100 Class A Shares (which are voting common shares) of the PC.

Ms. Vanna Fudge is an entrepreneur who lives in Edmonton, Alberta, and is a patient of Dr. Payne. Ms. Fudge has considerable business acumen in the area of food, grocery and confection retailing.

In 2003 Dr. Payne and Ms. Fudge decided to embark on a candy-selling retail business venture together. Accordingly, they arranged for the incorporation on December 19, 2003 of Sweet Tooth Un Limited (“STU”) under the ABCA. Dr. Payne subscribed for, and was issued, 50 Class A Shares (which are voting common shares) of STU and Ms. Fudge subscribed for, and was issued, 50 Class A Shares (which are voting common shares) of STU.

Although Dr. Payne and Ms. Fudge are friends as well as business colleagues, they determined that it would be advisable for them to enter into a Unanimous Shareholder Agreement (the “USA”), effective as of December 19, 2003. The USA provides that STU is to have three directors, two of whom may be elected by Dr. Payne and one of whom may be elected by Ms. Fudge. In accordance with the USA, Dr. Payne elected herself and her husband, Ian, as directors of STU, and Ms. Fudge elected herself as a director of STU.

The USA contains a provision commonly referred to as a right of first refusal, which provides that, if either shareholder desires to sell her shares of STU on specified terms to a third party, that shareholder must first offer to sell her shares of STU on the same terms to the other shareholder. Only if the other shareholder declines the offer, may the first shareholder proceed with the sale to the third party.

The PC pays monthly remuneration (which includes both salary and the cost of various benefits) of \$5,000 to Dr. Payne. Thus, the annual cost to the PC of Dr. Payne’s monthly remuneration is \$60,000.

The PC has a taxation year of January 1 to December 31. It is expected that, in the 2005 taxation year, the PC will have preliminary net income (i.e., after all expenses except remuneration paid or payable to Dr. Payne, but before the payment of income tax) from its dental practice of \$560,000. Thus, after deducting the \$60,000 of periodic remuneration paid to Dr. Payne, the preliminary net income of the PC for 2005 from its dental practice is expected to be \$500,000.

Given that STU is engaged in a start-up business, Dr. Payne and Ms. Fudge have decided not to draw a monthly salary or other monthly remuneration from STU. Rather, they have decided that they will first determine the profitability, if any, of STU on an annual basis before determining whether any remuneration will be paid by STU to them for a particular year.

STU has a taxation year of January 1 to December 31. In its 2004 taxation year STU barely broke even, such that it had no net income. It

is expected that, in the 2005 taxation year, STU will have preliminary net income (i.e., after all expenses except any remuneration that might become payable to Dr. Payne and Ms. Fudge, but before the payment of income tax) from its candy-selling retail business of \$400,000.

It is anticipated, but not yet known with certainty, that the PC and STU will have financial results for 2006 comparable to those expected for 2005.

Dr. Payne and Ms. Fudge have come to you for tax advice concerning the 2005 and 2006 taxation years of both the PC and STU.

Identify and discuss the Canadian federal income tax issues and considerations that are applicable to the PC and STU in the context of their 2005 and 2006 taxation years. What steps would you recommend to ensure that the PC and STU do not have any income for 2005 taxed at the high general corporate tax rate?

What is the low rate of federal corporate income tax available in circumstances where the small business deduction is available? Explain the statutory basis for the calculation of this rate and any restrictions or limitations that pertain to the small business deduction. (You need not discuss provincial income tax considerations.)

What advice would you give to Dr. Payne, Ms. Fudge, the PC and STU to improve their Canadian federal income tax situation for 2006?

VALUE	QUESTION
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| 35 | 2. | John Brole is an advertising agent and publicist, who carries on his business in northern Alberta through a corporation known as Ads R Us Ltd. ("ARU"), which was incorporated in 1996 under the <i>Business Corporations Act</i> (Alberta) (the "ABCA"). John is the sole officer, director and shareholder of ARU. Until December 31, 2004, John owned 100 Class A Shares (which are voting common shares) of ARU. ARU has a taxation year of January 1 to December 31. |
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On December 31, 2004, the 100 Class A Shares of ARU had an adjusted cost base to John of \$100 (i.e., \$1 per share) and a fair market value of \$120,100 (i.e., \$1,201 per share). The stated capital (for corporate law purposes) and the paid-up capital (for tax law purposes) in respect of the Class A Shares of ARU were each \$100 (i.e., \$1 per share). John held, and continues to hold, his Class A Shares of ARU as capital property.

On December 31, 2004, ARU purchased for cancellation, pursuant to section 34 of the ABCA, 10 of the Class A Shares of ARU then held by John, for a price of \$12,010 (i.e., \$1,201 per share).

In January 2003, ARU loaned \$25,000 to John to provide him with the funds necessary to make a down payment on a new home. The loan was documented by means of a director's resolution signed by John as the sole director of ARU, and by a demand promissory note in the amount of \$25,000 made and delivered by John to ARU. John is a regular buyer of lottery tickets. His intention was and is to repay the \$25,000 loan out of his hoped-for lottery winnings. John has not yet won a lottery, with the result that he has not yet repaid the loan.

Identify and discuss fully the Canadian federal income tax issues and considerations that arise from the above facts.

VALUE	QUESTION
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10	3. Raphael Kline ("Kline") is the sole officer, director and shareholder of Opco Incorporated ("Opco"), which was incorporated on February 27, 2001 under the <i>Business Corporations Act</i> (Alberta) (the "ABCA"). Before December 31, 2003, Kline owned 100 Class A Shares (which are voting common shares) of Opco. Kline held his Class A Shares of Opco as capital property.
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On December 31, 2003, Kline transferred his 100 Class A Shares of Opco to 123456 Alberta Ltd. ("Newco"), which was a generic shelf company that Kline's solicitor had recently incorporated under the ABCA. Shortly before this transfer, Kline had become the sole shareholder, director and officer of Newco. On December 31, 2003, the articles of Newco authorized the issuance of only one class of shares, which were designated as Class A Shares and which were voting common shares. Newco's first taxation year ended on December 31, 2003.

The Share Purchase Agreement (the "Agreement") between Kline and Newco provided that the consideration payable by Newco to Kline for the 100 Class A Shares of Opco was to be 1,000 Class B Shares of Newco. It was intended that the Class B Shares would be non-voting redeemable retractable fixed-value preferred shares having an aggregate redemption price equal to the fair market value on December 31, 2003 of the 100 Class A Shares of Opco. The Agreement also provided that Kline and Newco were to jointly elect under subsection 85(1) of the *Income Tax Act* (Canada) (the "ITA") in respect of the disposition of the 100 Class A Shares of Opco by Kline to Newco.

On December 31, 2003, Kline, Newco and Opco executed most of the documents pertaining to the transfer of the 100 Class A Shares of Opco by Kline to Newco, including the Agreement and the requisite director's resolutions. However, since the Class B Shares of Newco were not yet authorized by Newco's articles, on December 31, 2003 Newco did not issue a share certificate for the 1,000 Class B Shares which were to be delivered by Newco to Kline as consideration for the transfer of the 100 Class A Shares of Opco.

On April 25, 2004, Kline and Newco jointly completed and signed an election (the "Election") in prescribed form (i.e., Form T2057) under subsection 85(1) of the ITA. The Election described the consideration payable by Newco to Kline for the transfer of the 100 Class A Shares of Opco as being 1,000 Class B Shares of Newco. You may assume that the Election was properly completed in all respects. The Election was duly filed by Kline and Newco with the Canada Revenue Agency on April 26, 2004.

On May 5, 2004, Newco filed articles of amendment with the Alberta Registrar of Corporations to authorize the creation of the Class B Shares of Newco. On May 5, 2004, Newco issued to Kline a share certificate representing 1,000 Class B Shares of Newco. You may assume that the articles of amendment and the share certificate were properly completed and filed or issued, as the case may be.

On the basis of the above facts, was there a valid election under subsection 85(1) of the ITA in respect of the transfer of the 100 Class A Shares of Opco by Kline to Newco? Explain your answer.

VALUE	QUESTION
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10	4. Briefly summarize the respective holdings of the Federal Court of Appeal in <i>The Queen v. Guaranty Properties Limited</i> , [1990] 2 CTC 94, 90 DTC 6363 (FCA), and <i>The Queen v. Pan Ocean Oil Limited</i> , [1994] 2 CTC 143, 94 DTC 6412 (FCA), and reconcile any apparent inconsistency between the two holdings.
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VALUE	QUESTION
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- 10** **5.** In the context of section 227.1 of the *Income Tax Act* (Canada), briefly discuss the difference between an inside director of a corporation and an outside director of a corporation. Focus on the distinction between the functions of an inside director and an outside director and the differences, if any, in the standard of care applicable to an inside director and an outside director.
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TOTAL MARKS: 100

End of Examination

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