

**FACULTY OF LAW**

**FINAL EXAMINATION – April 28, 2007**

**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 your multiple-choice answer sheet and on your examination booklets in the space provided for surname. This will provide for anonymity during marking.

- Special Instructions:**
1. This examination paper contains 13 questions on 13 pages. Check to ensure that the examination paper is complete before starting.
  2. Answer ALL questions.
  3. Each of the 10 multiple choice questions is worth 3 marks.
  4. 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 – Q. 10	30 marks	40 minutes
Q. 11	30 marks	40 minutes
Q. 12	25 marks	33 minutes
Q. 13	<u>5 marks</u>	<u>7 minutes</u>
	90 marks	130 minutes

5. This is an **OPEN BOOK** examination.
6. 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.
7. Cell phones, pagers, beepers, computers, calculators, adding machines and similar equipment are strictly forbidden. These items must be turned off and stowed.
8. 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.
9. All monetary amounts referred to in this examination paper are expressed in Canadian currency.
10. Unless otherwise stated, all individuals referred to in this examination paper are resident in Canada.
11. Unless otherwise stated, all statutory references in this examination paper are references to the *Income Tax Act* (Canada) (the “ITA”).
12. Support all written answers with references to applicable statutory provisions and jurisprudence.
13. For each of the multiple choice questions (i.e., questions 1 through 10), select the answer that is the most correct. Select only one answer for each question. Select your answer by circling the corresponding letter (i.e., (a), (b), (c) or (d)) on the accompanying answer sheet.

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**VALUE      QUESTION**

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| <b>3</b> | <b>1.</b> | Acme Enterprises Ltd. (“Acme”) was incorporated under the laws of Alberta on April 1, 1960. Acme was and is a wholly owned subsidiary of Beefeater Pty. Ltd., which is a corporation incorporated under the laws of, and resident in, the United Kingdom. Since April 1, 1960, Acme has had four directors, two of whom have resided in Canada and two of whom have resided in the United Kingdom. Acme carried on business in Canada from April 1, 1960 to mid-1964, whereupon it became apparent that Acme’s business could not be conducted profitably. Accordingly, in the fall of 1964, Acme wound up its business and liquidated most of its assets. However, rather than dissolving, Acme has continued to exist as a rather dormant |
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corporation. Since November 1964, all meetings of the directors of Acme have been held in the United Kingdom and all decisions of the directors of Acme have been made in the United Kingdom. Since November 1964 the only function of Acme has been to hold the shares of a non-Canadian subsidiary.

**For purposes of the ITA, and ignoring the tax treaty between Canada and the United Kingdom, was Acme a resident of Canada during its 2004 taxation year (which coincides with the calendar year)?**

- (a) Yes, because Acme was incorporated in Canada.
- (b) No, because Acme has not been resident (under the common law test) in Canada since November 1964.
- (c) No, because Acme has not carried on business in Canada since November 1964.
- (d) No, because Acme has neither been resident (under the common law test) in Canada nor carried on business in Canada since November 1964.

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VALUE	QUESTION
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3	2. The facts recited above in question 1, together with the facts which follow, apply for purposes of this question. On September 1, 2005, Acme continued under the laws of Nunavut.
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**For purposes of the ITA, and ignoring the tax treaty between Canada and the United Kingdom, was Acme a resident of Canada during its 2006 taxation year?**

- (a) Yes, because Acme continued under the laws of Nunavut on September 1, 2005.
- (b) Yes, because Acme's central mind and management is deemed to be located in Nunavut.
- (c) No, because Nunavut is not a province.
- (d) No, because Acme was not incorporated in Nunavut.

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VALUE	QUESTION
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3	3. Zenith Enterprises Ltd. ("ZEL") is a Canadian-controlled private corporation which has only one class of issued shares, namely, voting common shares. ZEL has issued a total of 100 shares, 50 of which
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are owned by Tom Black (“Black”) and 50 of which are owned by Bob Green (“Green”). Black and Green have entered into a unanimous shareholder agreement (the “Agreement”), which contains a rather unusual buy-sell provision (the “Buy-Sell Provision”). Under the Agreement, either shareholder has the right to purchase all the shares owned by the other shareholder if that other shareholder dies, divorces or becomes temporarily disabled. Both Black and Green are married; however, Black has been married for only three years and his marriage has proven to be quite unstable. Last year Black and his wife had a short period of separation but subsequently reconciled and are currently cohabiting, although the relationship continues to be unstable. Green is an outdoor adventurer, who is not only a fearless risk taker, but is also careless and accident-prone. Both Black and Green are in excellent health and each has a long life expectancy.

**For purposes of the ITA, who controls ZEL?**

- (a) Neither Black nor Green, because the exercise of the Buy-Sell Provision is contingent on the death of either shareholder.
- (b) Only Black, because Green is more likely than Black to become temporarily disabled.
- (c) Only Green, because Black is more likely than Green to divorce.
- (d) Each of Black and Green, because the Buy-Sell Provision is contingent on the divorce or temporary disability of either shareholder.

**VALUE QUESTION**

**3**                      **4.** Oil Slick Holdings Ltd. (“Oil”) is a Canadian-controlled private corporation which has only one class of issued shares, namely, Class A Shares, which are voting common shares. Duane Rollerstun (“Duane”), who is the sole shareholder of Oil, owns 100 Class A Shares of Oil. Flame Retardant Inc. (“Flame”) is a Canadian-controlled private corporation which has two classes of issued shares, namely, Class A Shares, which are voting common shares, and Class B Shares, which are non-voting common shares. Michael Kippersoft (“Michael”) owns 99 Class A Shares of Flame and Duane owns 101 Class B Shares of Flame. Other than the difference in the voting rights attaching to the Class A Shares and the Class B Shares of Flame, both classes of shares of Flame have identical rights, privileges, restrictions and conditions. In particular, both the Class A Shares and the Class B Shares of Flame have an unlimited right to receive dividends and an unlimited right to participate in the remaining property of Flame on dissolution. Duane and Michael are

not related to one another. Duane and Michael deal with each other at arm's length.

**For purposes of the ITA, are Oil and Flame associated with each other?**

- (a) No, because the Class B Shares of Flame do not have voting rights.
- (b) No, because the Class B Shares of Flame are shares of a specified class.
- (c) Yes, because the number of issued Class B Shares of Flame is greater than the number of issued Class A Shares of Flame.
- (d) Yes, because Duane owns more than 25% of the Class B Shares of Flame.

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VALUE	QUESTION
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3	5.	The facts recited above in question 4, together with the facts which follow, apply for purposes of this question. Canuckle Equities Corp. ("Canuckle") is a Canadian-controlled private corporation which has only one class of issued shares, namely, Class A Shares, which are voting common shares. Flame, which is the only shareholder of Canuckle, owns 200 Class A Shares of Canuckle.
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**For purposes of the ITA, are Oil and Canuckle associated with each other?**

- (a) No, because of subsection 256(3) of the ITA.
- (b) Yes, because of paragraph 256(1.2)(d) of the ITA.
- (c) Yes, because of subsection 256(2) of the ITA.
- (d) Yes, because of both paragraph 256(1.2)(d) of the ITA and subsection 256(2) of the ITA.

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VALUE	QUESTION
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3	6.	Torry Ventures Inc. ("TVI") is a Canadian-controlled private corporation which has only one class of issued shares, namely, voting common shares. TVI has issued a total of 100 shares, 75 of which are owned by Ed Staleback ("Ed") and 25 of which are owned by Lyle Snowberg ("Lyle"). Both Ed and Lyle are employees and officers of TVI. In particular, Ed is the president of TVI and Lyle is the treasurer of TVI. Ed and Lyle are not related to one another. Ed and Lyle deal with each other at arm's length. On October 1, 2005, each
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share of TVI had a fair market value of \$10,000. On October 1, 2005, pursuant to a financial assistance program made available by TVI to all of its employees, TVI loaned \$100,000 to Lyle, which he used to purchase 10 shares of TVI from Ed. At the time that the loan was advanced by TVI to Lyle, TVI and Lyle executed a loan agreement, which required that the loan be repaid within two years. As well, Lyle signed a promissory note to evidence the loan and pledged the 10 purchased shares to TVI as security for the loan. On December 15, 2006, Lyle repaid the loan in full. TVI's fiscal year commences on November 1 of a particular calendar year and ends on October 31 of the following calendar year.

**Is the amount of the \$100,000 loan from TVI to Lyle to be included in computing Lyle's income for his 2005 taxation year?**

- (a) No, because *bona fide* arrangements were made on October 1, 2005 for repayment of the loan within two years.
- (b) No, because the loan was repaid in less than two years.
- (c) Yes, because the loan proceeds were used to buy shares of TVI from Ed.
- (d) Yes, because Lyle is a specified employee of TVI.

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VALUE	QUESTION
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| 3 | <p>7. Belinda Strongax ("Belinda"), who is a resident of Canada, owns a particular property (the "Property"), which is an eligible property (as defined in subsection 85(1.1) of the ITA), which she holds as capital property and which is not a depreciable property. On April 15, 2006, the adjusted cost base (which constitutes the cost amount) to Belinda of the Property was \$500 and the fair market value of the Property was \$20,000. Magnum Tricycle Parts Inc. ("MTP") is a taxable Canadian corporation, all the shares of which are owned by Belinda. On April 15, 2006, Belinda transferred the Property to MTP, in consideration for which (i) MTP made and delivered to Belinda a promissory note (payable on demand) in the amount of \$1,000, and (ii) MTP issued to Belinda 19,000 preferred shares having an aggregate redemption price and an aggregate fair market value of \$19,000. As contemplated by subsection 85(1) of the ITA, Belinda and MTP made a joint election in prescribed form (i.e., Form T2057), in which Belinda and MTP agreed that they would treat the Property as having been disposed of by Belinda to MTP for \$300 (i.e., the agreed amount was \$300). Belinda and MTP filed the election with the Canada Revenue Agency in a timely manner before the deadline stipulated by subsection 85(6) of the ITA.</p> |
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**For purposes of the ITA, what was the amount of Belinda's proceeds of disposition of the Property?**

- (a) \$300, by reason of paragraph 85(1)(a) of the ITA.
- (b) \$1,000, by reason of paragraphs 85(1)(b) and (e.3) of the ITA.
- (c) \$500, by reason of paragraphs 85(1)(c.1) and (e.3) of the ITA.
- (d) \$20,000, by reason of paragraphs 85(1)(a) and (e.2) of the ITA.

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**VALUE      QUESTION**

**3            8.** Alec Baldtwin (“Alec”) and Kim Basezinger (“Kim”) are both resident in Canada for purposes of the ITA. Alec and Kim are not related to one another. Alec and Kim deal with each other at arm’s length.

Before April 1, 2007, Triangle Holdings Corp. (“Triangle”) was a taxable Canadian corporation which had only one class of issued shares, namely, voting common shares. Triangle had issued a total of 80 shares, 40 of which were owned by Alec and 40 of which were owned by Kim.

Before April 1, 2007, Geothermal Voicemail Ltd. (“Geothermal”) was a taxable Canadian corporation which had only one class of issued shares, namely, voting common shares. Geothermal had issued a total of 100 shares, 60 of which were owned by Alec and 40 of which were owned by Triangle.

Before April 1, 2007, Geometric Equities Inc. (“Geometric”) was a taxable Canadian corporation which had only one class of issued shares, namely, voting common shares. Geometric had issued a total of 100 shares, 60 of which were owned by Kim and 40 of which were owned by Triangle.

Triangle, Geothermal and Geometric were all incorporated in Alberta in 1996 and continued thereafter to be governed by the *Business Corporations Act* (Alberta) (the “ABCA”). Before April 1, 2007, the only assets of Triangle were the 40 shares of Geothermal and the 40 shares of Geometric referred to above. Coincidentally, on March 31, 2007, the fair market value of Geothermal was the same as the fair market value of Geometric. Before April 1, 2007, Triangle, Geothermal and Geometric did not have any liabilities.

On April 1, 2007, Triangle, Geothermal and Geometric amalgamated under section 181 of the ABCA to become an amalgamated

corporation known as Ireland Controls Corporation (“Amalco”), which has only one class of authorized shares, namely voting common shares. On the amalgamation, the 40 shares of Triangle previously owned by Alec were converted into 40 shares of Amalco, the 40 shares of Triangle previously owned by Kim were converted into 40 shares of Amalco, the 60 shares of Geothermal previously owned by Alec were converted into 60 shares of Amalco, the 60 shares of Geometric previously owned by Kim were converted into 60 shares of Amalco, the 40 shares of Geothermal previously owned by Triangle were cancelled and the 40 shares of Geometric previously owned by Triangle were cancelled. By reason of the amalgamation, all of the property of Triangle, Geothermal and Geometric (other than the 40 shares of Geothermal owned by Triangle and the 40 shares of Geometric owned by Triangle) became property of Amalco.

**Which provision in section 87 of the ITA describes and applies to the amalgamation of Triangle, Geothermal and Geometric?**

- (a) Subsection 87(1) of the ITA.
- (b) Paragraph 87(1.1)(a) of the ITA.
- (c) Paragraph 87(1.1)(b) of the ITA.
- (d) Subsection 87(9) of the ITA.

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VALUE	QUESTION
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3	<p>9. Dividends ‘R’ Us Corp. (“DRU”) is a Canadian-controlled private corporation, which carries on an active business in Canada and which does not have any other source of income. DRU’s taxation year coincides with the calendar year. In 2006 DRU’s income from its active business was \$1,000,000, of which \$300,000 qualified for the small business deduction and \$700,000 was taxed at the high corporate income tax rate.</p>
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DRU would like to pay a dividend of \$200,000 on April 28, 2007, out of the after-tax portion of its 2006 high-rate income, so as to enable its shareholders to take advantage of the enhanced dividend tax credit under paragraph 121(b) of the ITA.

**DRU should do which of the following:**

- (a) Make a designation under paragraph 55(5)(f) of the ITA.
- (b) Make an election under subsection 83(2) of the ITA.
- (c) Make a designation under subsection 89(14) of the ITA.

- (d) File an agreement under subsection 125(3) of the ITA.

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VALUE	QUESTION
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3	<p>10. Pink Sheep Incorporated (“PSI”) is a private corporation and a Canadian corporation that was incorporated in Alberta in 1999 and that has not continued into any other jurisdiction. PSI has 120 shareholders, a majority of whom are resident in Canada for purposes of the ITA. PSI has only one class of issued shares, namely, voting common shares, of which 80% are owned by persons resident in Canada and 20% are owned by persons who are not resident in Canada. None of PSI’s shareholders is a public corporation, nor is PSI a public corporation. The shares of PSI are quoted on the OTC Bulletin Board operated by NASDAQ Stock Market Inc.</p>
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**Is PSI a Canadian-controlled private corporation?**

- (a) Yes, because PSI fails to comply with prescribed conditions relating to the number of its shareholders, the dispersal of ownership of its shares and the public trading of its shares.
- (b) Yes, because the OTC Bulletin Board operated by NASDAQ Stock Market Inc. is not a prescribed stock exchange.
- (c) No, because the National Association of Securities Dealers Automated Quotation System is a prescribed stock exchange.
- (d) No, because all of the shares of PSI which are owned by non-resident persons are treated as being owned by a single person.

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VALUE	QUESTION
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30	<p>11. Mismanagement Abnormal Development Corp. (“MAD”) is a Canadian-controlled private corporation and a taxable Canadian corporation, incorporated under and governed by the laws of Alberta. MAD’s taxation year coincides with the calendar year. Throughout 2005, MAD had only one class of authorized shares, namely, voting common shares, of which 100 were owned by Simon Towel (“Simon”). Simon is the sole shareholder, the sole director and the sole officer of MAD. Simon is a resident of Canada for purposes of the ITA.</p>
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MAD carries on an active business in Canada. In particular, MAD operates a talent agency. MAD’s head office and Simon’s principal residence are both located in Edmonton, Alberta.

At the beginning of 2005, MAD owned all the shares of Rand Jaxsen Ltd. (“RJL”), which operated a vocal academy. In mid-January 2005, MAD sold the shares of RJL and realized a capital gain of \$400,000. Prior to the sale of the shares of RJL, MAD had a nil balance in its capital dividend account. Needing money for post-Christmas bills and other purposes, Simon caused MAD to pay a capital dividend in the amount of \$250,000 to him (as the sole shareholder of MAD) on January 20, 2005. MAD filed an election under subsection 83(2) of the ITA with the Canada Revenue Agency (“CRA”), using Form T2054, in respect of the capital dividend, when MAD filed its 2005 income tax return in June 2006. Apart from Form T2054, MAD did not file any other documents with CRA in respect of the capital dividend election.

Since Simon makes regular trips to Toronto, Ontario in his ongoing search for talent, he determined that it would be advisable to have accommodation readily available in Ontario. Accordingly, Simon arranged for MAD to use \$1,000,000 of its funds to purchase an upscale lake-front cottage in Niagara-on-the-Lake, near the place where the Niagara River flows into Lake Ontario. When Simon is looking for talented singers in Ontario, he stays at the cottage and commutes from Niagara-on-the-Lake to Toronto and other cities on a daily basis. As well, during the summer of 2005, Simon spent the month of July at the cottage while on vacation. During his vacation, he did not attend to any business on behalf of MAD. Whenever Simon stayed at the cottage while he was in Ontario in respect of MAD’s business, he did not pay any rent to MAD for the cottage. However, in respect of his vacation, he paid rent in the amount of \$1,000 to MAD for his personal use of the cottage during the month of July 2005. He picked this amount because he had heard that many elderly residents of Niagara-on-the-Lake, while vacationing in Florida each winter, rent out their homes in Niagara-on-the-Lake to tourists for \$1,000 per month. Simon felt that \$1,000 per month would be a reasonable amount for him to pay to MAD as rent for the cottage.

Before September 2005, Simon owned a parcel of land (the “Land”) which he held as capital property. On September 1, 2005, the Land had an adjusted cost base to Simon of \$200,000 and a fair market value of \$500,000. On September 1, 2005, pursuant to an agreement between Simon (as vendor) and MAD (as purchaser), Simon transferred the land to MAD in exchange for a promissory note in the amount of \$200,000 and a share certificate representing 1,000 preferred shares having an aggregate redemption price of \$300,000 (although the preferred shares were not then authorized). On February 12, 2006, MAD’s solicitor, Ian Waite, of the firm Waite & Delay, filed Articles of Amendment at Alberta Corporate Registry, so as to amend the articles of MAD in order to create and authorize the preferred shares issued on the rollover of the Land. On September

15, 2006, Simon and MAD filed a joint election under subsection 85(1) of the ITA with CRA, using Form T2057, in respect of the transfer of the Land, in which they agreed on the amount of \$225,000.

In October 2005, MAD had a cash-flow shortage. Rather than borrow money from a commercial lender (which would have resulted in financing costs), to meet ongoing business expenses, MAD used the income tax source deductions (approximately \$5,000) in respect of the remuneration paid to its employees for that month. MAD's obligation to remit the source deductions for October 2005 to CRA is still outstanding. MAD does not have any intention to remit those source deductions in the near future.

**Identify and discuss the Canadian federal income tax issues and considerations that are applicable to Simon and MAD in the context of their 2005 and subsequent taxation years.**

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VALUE	QUESTION
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12.

Assume that you are a member in good standing of the Law Society of Alberta, with an office on the top floor of Commerce Place in downtown Edmonton, overlooking Telus Field and the river valley. Your practice focuses on Canadian income tax law.

You have just met with Albert Wilson ("Albert") and Sonja Wilson ("Sonja"), who reside in Edmonton, Alberta and who are married to each other. In the course of your meeting with Albert and Sonja, you learned a few details, as set out below, about their corporations, Modern Modular Homes Ltd. ("MMH") and Barkona Realty Inc. ("BRI").

MMH is a Canadian-controlled private corporation and a taxable Canadian corporation which has only one class of issued shares, namely, voting common shares. MMH has issued a total of 100 shares, 60 of which are owned by Albert and 40 of which are owned by Sonja. Albert and Sonja are the directors of MMH. Albert is the president of MMH and Sonja is the vice-president and secretary-treasurer of MMH. MMH carries on an active business in Canada, namely, the manufacture and sale of modular homes.

BRI is a Canadian-controlled private corporation and a taxable Canadian corporation which has only one class of issued shares, namely, voting common shares. BRI has issued a total of 100 shares, all of which are owned by Sonja. Sonja is the sole director of BRI. Sonja is the president and secretary-treasurer of BRI. Sonja is a licensed real estate agent. BRI carries on an active business in Canada, namely, the sale of commercial real estate.

Both MMH and BRI are profitable. Each corporation has a fiscal year that commences on July 1 of a particular year and ends on June 30 of the following year. Based on the earnings of MMH and BRI over the past several years and the current year, it is anticipated that in the fiscal year beginning on July 1, 2007 and ending on June 30, 2008, MMH will have taxable income of \$600,000 and BRI will have taxable income of \$500,000.

For the past several years, MMH and BRI have filed an agreement with the Canada Revenue Agency so as to divide the business limit in respect of the small business deduction between the two corporations. Each corporation has annually paid a bonus to its shareholder or shareholders so as to reduce its income to an amount equal to its share of the business limit for the particular year.

Albert and Sonja have requested that you analyze the current situation pertaining to MMH and BRI, explain any income tax concerns and advise as to whether there is a means whereby more of the income of MMH and BRI could qualify for the small business deduction. Assuming that a planning opportunity is available, Albert and Sonja have requested that you advise as to how the current structure could be reorganized. Neither Albert nor Sonja is willing to sell, give or otherwise transfer any of his or her shares of either corporation to the other individual. Albert and Sonja are unwilling to consider any reorganization unless it can be implemented on a tax-deferred (or rollover) basis. They would like you to describe in detail the steps of any reorganization that you might recommend.

Albert and Sonja both have significant business experience and are sophisticated in their approach to tax planning. Accordingly, they have requested that you provide them with specific references to the statutory provisions that pertain to your analysis, your advice and your description of any reorganization that you might propose.

**Please write the analysis, advice and proposal that you would provide to Albert and Sonja.**

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VALUE	QUESTION
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5	13. Edmonton Idol Corporation (“EIC”) is a Canadian-controlled private corporation and a taxable Canadian corporation, whose sole shareholder is Paula Amdul (“Paula”), who is an individual resident in Canada. In March 2007, EIC paid a taxable dividend of \$120,000 to Paula. The dividend was not an eligible dividend and was not paid under a dividend rental arrangement.
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**What amount is Paula required, by reason of having received the above dividend, to include in computing her income for 2007 for Canadian federal income tax purposes?**

**What is the amount of the federal dividend tax credit that she may deduct from the tax otherwise payable by her under Part I of the ITA in respect of the above dividend?**

**Explain your answer in detail. Include references to the relevant statutory provisions. Show your calculations.** (You need not calculate the amount of tax payable by Paula. You may ignore provincial income tax considerations.)

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**TOTAL MARKS: 90**

**End of Examination**

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