



Sample Examination

TAXATION

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Time: Three (3) hours

Instructions

1. This is an open book examination. You may bring into the examination room and freely consult any non-electronic materials with the exception of personal typed or handwritten notes. This is subject only to reasonable space limitations as determined by the invigilator.
2. The duration of the examination is three hours.
3. Absolutely no calculations are expected.
4. There are four (4) questions, each of a different value. Please give full reasons for your answers.
5. Please write legibly on every second line in the answer booklets, in complete sentences rather than in point form. State clearly any factual assumptions necessary to the formulation of your answer(s). Briefly cite relevant case law, statutory or other authority as appropriate.
6. Do not begin the examination until instructed to do so by the invigilator. You must stop writing when told to do so.
7. The examination begins on the next page.

**YOU MUST RETURN THIS EXAM IN THE ENVELOPE PROVIDED WITH YOUR ANSWERS.
FAILURE TO DO SO WILL RESULT IN AN AUTOMATIC EXAM FAILURE.**



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QUESTION 1 (20 MARKS)

Your client, Anita Mavin a successful entrepreneur is the controlling shareholder and the manager of Mavin Inc., a company engaged in website design (60% of total gross receipts) and desk top publishing (40% of gross receipts).

Employee retention of the web-site designers is becoming a problem in this very competitive market and Anita Mavin wants to create an attractive benefit package for the web-designers. However, it would be uneconomical to provide the desk top publishing division which has 15 full time staff with the same benefits as the website designers. Also, there has been talk that the desk-top publishing employees are considering unionizing.

Anita Mavin's son-in-law Ralph suggested the following re-organization.

Ralph advised Anita Mavin that considerable savings could be achieved by contracting out the desk top publishing work to independent contractors. Not only would this remove the potential union problem but there would be a savings of payroll costs from decreased benefit payments and various employment related taxes and withholdings. Mavin Inc. would then be able to offer the website designers a new employee benefits package without creating a perception of inequality between the two divisions.

Ralph recommends giving all desk-top publishers a "One Week Working Notice of Termination" and a \$1,500 "settlement payment" to compensate for the "anguish and humiliation of an abrupt and unfeeling termination". Ralph says the employees would not pay tax on the settlement payment.

As part of the termination package, Mavin Inc. could offer free job counseling and educational seminars, including seminars on how to start a small business. These types of services are valued at \$600 if purchased in the private market.

Former desk-top employees who decide to enter into Independent Contractor Agreements with Mavin Inc. would be offered an opportunity to buy used computers for \$1,500. As independent contractors, the former desk-top employees could set their own hours and could work for other people, however Mavin Inc. would guarantee them 120 hours a month of work for the first year. They would have access to secretarial staff, the office copying machine and an independent contractor's lounge to work in, should the need arise.

The former desk-top publishing employees would benefit as they could easily deduct the expenses related to their home offices, transportation costs going from their home office to Mavin Inc.'s office to pick up their work assignments and for meetings, as well as the cost of their computers and paper supplies.

What are the tax consequences of this proposal for both Mavin Inc. and the desk-top publishing employees?



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QUESTION 2 (25 MARKS)

Your client Charles Allen is the president of a management consultant firm, Allen Financial Services. His only daughter Beth had been studying ecology in the C Islands since 1998. On December 1, 2001, Beth came to Canada with her fiancé Ralph, a Canadian citizen who has been living in the C Islands (a 'tax haven' country with whom Canada does not have a tax treaty) for 10 years.

Ralph has a degree from Harvard in international taxation and is keenly interested in pursuing a career as an international management consultant. Beth and Ralph temporarily moved into a Toronto townhouse owed by Charles Allen.

Ralph has a condo in Cambridge Massachuset, a seaside resort in the C Islands and a flat in London England.

Between December 2001 and December 2002 Ralph's pattern of travel and business was as follows:

- Beth and Ralph spent all of December 2001 (**31 days**) and January 2002 (**31 days**) in Toronto.
- In February 2002 Ralph traveled to the C Islands, where he spent 2 months (**59 days**) looking after the resort.
- He returned to Toronto for the month of April, 2002 (**30 days**)
- On May 1, 2002 he traveled to Boston where he met with former class mates and worked on new business contacts during May and June, 2002 (**61 days**).
- In July and August, 2002 (**62 days**) Beth and Ralph took off for an eco-expedition in Northern BC.
- When they returned, Ralph immediately left for England to spend the early fall (**50 days**) drumming up more business contacts.
- He returned to Toronto on October 20, 2002, for two weeks (**14 days**), at the end of which he plans to leave again for the C Islands where he will remain, until the second week of December.
- He plans to return to Toronto to spend the last 10 days in December, 2002 with Beth and her family.

Beth and Ralph are getting married in the spring of 2003. Charles Allen wants to encourage Ralph to permanently settle in Toronto. He plans to transfer the Toronto condo to the couple as a wedding present and has offered Ralph a job as a financial planner.

Ralph prefers to continue his pattern of traveling internationally to cultivate international business opportunities. He thinks that overall, from an income tax perspective, he would be better off having his permanent home in the C Islands, although he is happy to have the Toronto condo for Beth to live in when he is traveling.

Ralph proposes to incorporate Ralph Co., a Canadian corporation, owned 50% by Beth and 50% by Ralph. Allen Financial Services Inc. would then contract with Ralph Co. for the financial planning and management services Ralph will perform for Allen Financial Services Inc. In this way Ralph can accumulate earnings for investment purposes in the management company. Ralph Co would pay Ralph and Beth modest salaries and hire 6 University students part time to work for this company.

Answer the following questions:

- (i) Is Ralph subject to Canadian income tax in 2001 and 2002? **(10 marks)**
- (ii) Assuming Ralph and Beth marry in the spring of 2003, they receive the condo as a wedding gift and Ralph has the same pattern of travel as in 2002, will Ralph be subject to Canadian income tax in 2003? **(10 marks)**
- (iii) How will Ralph Co. be taxed? **(5 marks)**



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Question 3 (35 Marks)

Carl, an experienced farmer, operates an organic sheep farm at a profit. At the same time, he works part time as a substitute teacher and baseball coach at the local highschool.

Baseball has always been Carl's passion and in 1993 he constructed a baseball diamond and bleachers in a non-productive meadowland on the farm. Carl held highschool baseball practices and exhibition games on the property. The bleachers cost \$50,000 to construct.

In 1997 Carl observed that the senior baseball team in the area, the Majors, consisted largely of players over 30. He conceived the idea of starting a new team, The Meadowland Grazers, which could compete with the Majors. He believed that there was a place for a younger baseball team and that it would be commercially viable. He already had the bleachers, which could now be used in this venture. Further, his wife Doris, was eager to be paid for managing the schedule and keeping the books, which she could do part time while she raised their two pre-school age children. It will take Doris 3 hours a week to perform her employment duties.

Carl did a certain amount of research, determined the attendance levels at the Majors' games and the sort of revenues that could be expected and projected both revenues and expenses for 1998 through 2002. The revenues projected were from a variety of sources including game draws and souvenirs, tickets at the gate, program and advertising, patrons and donations, tournament prizes, player assessments and other revenues. The revenues and expenses projected for 1998 through 2002 are in the chart below.

Year	Revenue	Expenses	Projected P/L
1998	\$10.000	\$40.000	(\$30.000)
1999	\$16.000	\$34.000	(\$ 8.000)
2000	\$34.000	\$35.000	(\$ 1.000)
2001	\$36.000	\$35.000	\$ 1.000
2002	\$37.000	\$35.000	\$ 2.000

From this chart it is clear that Carl expected losses for the first three years and a profit thereafter. Carl showed his calculations to the business law teacher at the local highschool, who said, "Hmm, given the civic mindedness and idealism behind this project it looks like a worthwhile endeavor to me, but don't ask me to invest".

As it turned out the actual results were quite different from the projections. While the projected and actual expenses were relatively close, the revenues in all of the years fell significantly short of the projections. Carl has claimed a loss each year from 1998-2001 and does not expect a profit in 2002. The chart below shows a breakdown of some of the major deductions Carl took for purposes of determining his profit and loss for each year. The chart includes his projected expenses for 2002.



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Carl elaborates on some of the items in the chart. He tells you that Doris works 4 hours a week during the baseball season and 1-2 hour a week during the rest of the year on baseball team matters. The team launch party was a great success. It was held on Carl's birthday and the entire community attended. The name recognition campaign was the business law teacher's idea and he thinks that in the long run, it did increase attendance at games.

Year	Salary to Doris Bates	CCA deducted on bleachers	Advertising	Entertainment
1998	\$15,000	\$10,000	\$10,000 5 yr name recognition campaign	\$5,000 Team launch party
1999	\$16,500	\$ 8,000	\$ 1,000	\$ 500
2000	\$18,150	\$ 6,400	\$ 1,000	\$ 500
2001	\$19,965	\$ 5,120	\$ 1,000	\$ 500
2002	\$21,961	\$ 4,096	\$ 1,000	\$ 500

Faced with these facts Carl is considering closing down the team. He has learned that he can dismantle the bleachers and sell them to another baseball team for \$70,000.

Doris wants him to continue the baseball team because she has been investing her salary in interest bearing certificates of deposit and enjoys the extra income.

It is now December 2002. Carl has come to you for advice on the following matters.

- A. Carl received a notice of assessment concerning the Meadowland Grazer baseball team operation. Provide Carl with your reasoned opinion of each of the following points raised in the notice of assessment.
1. The losses sustained on the operation of the Meadow Grazers Baseball Team are non-deductible personal expenses. **(10 marks)**
 2. Carl is not entitled to deduct the entertainment expense in 1998 because the gala launch was a non-deductible personal expense. **(5 marks)**
 3. The interest earned by Doris on the certificate of deposits should be attributed to Carl. **(5 marks)**
 4. The \$10,000 campaign paid for name recognition is a non-deductible capital expense. **(5 marks)**
- B. Describe the tax consequences from the proposed sale of the bleachers. **(10 marks)**



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QUESTION 4 (20 MARKS)

In 1990, Alice and Bob Carter inherited 200 acres of property near a popular ski resort from their Aunt Dale. Aunt Dale paid \$100,000 for the property which was appraised at \$200,000 at the time of her death. (The appraisal included \$50,000 for an old house on the property). Alice, a national cross country ski team member, was delighted. The property is near the ski hills where she trains and the old house had great personal value to her. She could use the house to stash her equipment, take warm-up breaks in between training runs and if she got caught in a snow storm, she could stay the night.

Bob, who lived in another Province, was content to do nothing with the property for the time being. Instead, he used his half interest in the property to secure a loan for \$80,000 which he then invested in dividend producing high tech shares. The shares paid \$80 a year in dividend income. Bob deducted his \$5,000 interest payments as an expense related to the dividend income he received.

Bob, has recently contacted Alice with a proposal for selling the property. He is willing to gift Alice his share of the old house and some acres surrounding it, if they sell the balance of the property to a developer. Bob thinks that the house with a few acres has a current market value of \$70,000.

Because the property is so near the ski resort area, Bob thinks that a sale to a developer would yield at least \$300,000 for the land alone, without the house. Alternatively, Bob says that his friend Edward, a real estate broker, is interested in working with them to file a subdivision plan, and sell individual house lots to ski enthusiasts. Edward suggests that with this alternative plan Bob and Alice could earn in excess of \$400,000.

(A) Advise Alice on:

- The tax consequences of Bob's proposed plan to gift her his half interest in the old house **(5 marks)**
- Compare the tax consequences of the proposal to sell the land directly to the developer with the alternative plan to sell individual lots. **(10 marks)**

(B) Bob received a notice of assessment denying him a deduction for the interest he has been paying on the \$80,000 loan. Bob tells you that he is planning on selling the high tech shares for a significant capital gain. Provide Bob with your opinion on the tax issues raised in the notice of assessment. **(5 marks)**

END OF THE EXAMINATION