TAX FOR THE Owner-Manager

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Distribution of Corporate Earnings to the Owner-Manager

When determining the most tax-efficient manner of distributing the active business income of an operating corporation to its owner-manager, tax advisers should consider four possible distribution mechanisms: shareholder benefits, shareholder loans, wages (that is, salary or management bonuses), and dividends.

This article addresses the situation of an Ontario-resident owner-manager who owns all of the shares of an operating corporation. To keep matters relatively simple, I have assumed that other family members do not provide services to the corporation. I do not discuss the income-splitting strategies that might be employed in a family-owned business.

Shareholder benefits. The amount of any shareholder benefit is included in the shareholder's income under subsection 15(1) of the Income Tax Act, and no corresponding deduction is available to the corporation in respect of that amount. Because of this double taxation effect, shareholder benefits are not generally thought of as a tax-effective mechanism to distribute a corporation's earnings. However, advisers should consider whether there are amounts incurred by shareholders that could otherwise legitimately be incurred by a corporation without resulting in a shareholder benefit. One example of such an amount is a premium on a term life insurance policy on the life of the owner-manager. Depending on the specific facts, if ownership of that policy is transferred to a corporation and the corporation is appointed the beneficiary of the policy, the payment of the premiums by the corporation should not result in a shareholder benefit. Thus, corporate earnings can be used to pay for premiums that otherwise would have been paid by the owner-manager with after-tax personal funds. In appropriate cases, the corporation may be entitled to deduct the premiums in computing income: see paragraph 20(1)(e.2).

Shareholder loans. In a fashion similar to shareholder benefits, certain shareholder loans are included in the borrower's income under subsection 15(2), and the corporation making the loan is not entitled to a corresponding deduction. Again, double taxation results because the earnings are taxed in both the corporation's hands and the borrower's hands.

However, the borrower is entitled to a deduction in the taxation year in which a shareholder loan previously included in income is repaid: paragraph 20(1)(j). Therefore, it may be appropriate to loan funds to an owner-manager in a year when his or her income is taxed at a lower marginal rate, if the amounts can be repaid in a subsequent year when the owner-manager is expected to be taxable at a higher marginal rate. The effect is essentially to prepay tax at the lower marginal rate. The same strategy can be employed for individuals connected with the owner-manager. For example, if the owner-manager's spouse is regularly employed but is currently on maternity or paternity leave, it may be appropriate to loan the spouse funds in that year and have the funds repaid in a subsequent year when the paragraph 20(2)(j) deduction can be taken against employment income taxed at a higher marginal rate.

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Change in Quebec's Price Adjustment Clause Policy

Please note: In "Change in Quebec's Price Adjustment Clause Policy" (*Tax for the Owner-Manager*, October 2005), the penultimate sentence should be deleted and replaced with the following copy:

> The CRA has indicated in *Information Circular 01-1*, at paragraph 71, that a letter need not be filed if the "yes" box is checked on form T2057.

Thanks to David Sherman for drawing this point to our attention. The archived issue has been amended.

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Wages and dividends. In most circumstances, the primary issues to be addressed are (1) whether tax can be minimized by distributing corporate earnings to the owner-manager in the form of dividends rather than wages, and (2) whether it is appropriate to distribute the corporate earnings at all.

To the extent that wages are paid to the owner-manager, the corporation should be entitled to a deduction of those wages without undue regard for the reasonableness issue, based on the CRA's administrative position on owner-manager remuneration. (See, for example, TI2001-0064055, March 26, 2001.) To the extent that a corporation's after-tax income is distributed to the owner-manager in the form of a dividend, tax will be payable by the corporation on its income and by the shareholder on the dividend.

The reduction in corporate tax rates in recent years has prompted a re-evaluation of the long-held perception that Canadian-controlled private corporations should bonus down to the small business limit (currently $300,000 federally and $400,000 in Ontario). The accompanying table shows the percentage tax deferral available if active business income is retained in the corporation. The table also outlines the percentage tax savings (or cost) that can result if the after-tax income in the corporation is subsequently distributed to the owner-manager in the form of dividends, in comparison with the corporation paying the owner-manager wages out of its pre-tax income. The table uses Ontario provincial rates and assumes that the individual is taxed at the top marginal rate. The implications of the Ontario health tax and CPP premiums are ignored for the purposes of the table. Because the corporation is wholly owned by the owner-manager, employment insurance premiums are not payable on the wages paid to the owner-manager and are not relevant to the analysis.

The table shows that a potentially significant tax deferral is available for the first $400,000 of active business income retained annually in a corporation. In addition, the table highlights the potential 2.3 percent tax savings if corporate earnings are distributed to owner-managers in the form of dividends, as opposed to wages (although there will be a loss of RRSP contribution room, because dividend income is not earned income for the purposes of the RRSP rules). To the extent that a corporation is retaining active business income on an annual basis in excess of $300,000, advisers should consider how long the retained earnings are intended to be maintained in the corporate form to determine whether the tax cost of distributing those funds at a later time in the form of dividends is offset by the income that may be generated in the meantime on the tax otherwise deferred.

Percentage Tax Deferral if ABI Is Retained in Corporation

	ABI less than $300,000	ABI $300,000-$400,000	ABI $400,000-$1,130,001	ABI greater than $1,130,000*
Corporate tax rate	18.6	27.6	40.8	36.1
Effective tax rate after dividend	4.1	50.3	59.3	56.1
Personal tax rate	46.4	46.4	46.4	46.4
Potential deferral	27.8	18.8	5.6	10.3
Savings (cost)	2.3	(3.9)	(12.9)	(9.7)

* Approximate figure based on the level of income necessary to fully pay the Ontario clawback of the SBD.

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Beware of ABILs: Recent Cases

A capital loss from the disposition of a share or debt that qualifies as a business investment loss (BIL) is attractive because one-half of a BIL—an allowable business investment loss (ABIL)—can be deducted from all sources of income arising in the year and the unused part is treated as a non-capital loss. If a loss is to qualify as a BIL, certain requirements must be satisfied under the Income Tax Act. The CRA regularly challenges taxpayers' claims to deduct ABILs.

In *Chandan v. The Queen* (2005 TCC 685), the taxpayer, along with two others, purchased a gas station and convenience store and operated it through a corporation until the corporation became insolvent. The sole issue was the sufficiency of the documentation to support the nature and amount of the investment. The taxpayer's record keeping was very poor. He did not know the form of his investment. He provided some documents, including an asset purchase agreement, that supported the consideration paid but no documents to support the amount invested.

Notwithstanding these deficiencies, Woods J concluded that the evidence, including the oral testimony, established the prima facie existence of a BIL in respect of common shares. Fortunately for the taxpayer, the Crown did not introduce any evidence to contradict the trial judge's conclusion, and Woods J allowed the appeal.

In *Singh v. The Queen* (2005 TCC 588), the taxpayer had to establish the ACB of common shares sold by him. The only documentation to support the purported

investment in common shares was two pieces of paper—a handwritten loan account and the typed shareholders' ledger, which Woods J seems to have thought may have been prepared after the fact. The taxpayer's oral testimony conflicted with statements in his tax return and the questionnaire he had provided on audit. Woods J found that the taxpayer failed to establish any ACB for the common shares.

Litowitz v. The Queen (2005 TCC 557) dealt with an ABIL in respect of a loan to a corporation controlled by the taxpayer, which had been advanced to another corporation that used the funds to invest in a co-tenancy. The sole issue was whether the debt had become bad, as the taxpayer claimed.

Bowman CJ relied on the decision in *Rich v. The Queen* (2003 DTC 5115 (FCA)), in which Rothstein JA stated that the test an appellant had to meet was whether he had made an honest and reasonable determination that the loan was bad. Bowman CJ reviewed the facts on which the taxpayer, a lawyer experienced and active in the management and development of real estate, made his determination—namely, the corporation's financial statements, which were in a deficit position. The trial judge also referred to other factors considered by the taxpayer in reaching his decision, such as a significant loss in some litigation, the actions of a mortgagee, and the other shareholders' responses to those actions. The appeal was allowed.

In *Toews v. the Queen* (2005 TCC 597), the CRA had disallowed non-capital losses because the BIL was not acquired for the purpose of earning income. The taxpayer and two others formed an operating company, which operated for about three years and then became bankrupt. A discretionary family trust held a significant minority interest in shares of the operating company through a holding company. The BIL related to the taxpayer's interest-free loan to the holding company, which in turn loaned the funds interest-free to the operating company.

The taxpayer, his wife, and two others were trustees of the trust, and the taxpayer, his wife, and their children were the beneficiaries of the trust. Trustee decisions were to be made by majority decision. The taxpayer received no distributions from the trust. He could not receive dividend income directly from either company, but he could have received distributions via the trust. He could not, on his own, compel the trust to make any distributions.

Bowie J held that the principle in *The Queen v. Byram* (99 DTC 5117 (FCA)) did not apply. He relied instead on the decision in *Service v. The Queen* (2005 DTC 5281 (FCA)), where the court found that a loan made by the taxpayer at no interest to a holding company whose shares were all held by the taxpayer's wife had not been made for the purpose of gaining or producing income. Bowie J dismissed the appeal, holding that there was insufficient nexus between the taxpayer and the profits of the operating company.

These cases illustrate the importance of properly structuring taxpayers' investments so that an ABIL may be claimed if the investment fails. It is also vital that proper documentation be prepared and proper records be kept so that there is sufficient evidence to support the claim for an ABIL.

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"Reasonable" Remedies for Anti-Avoidance

Bowman CJ of the Tax Court commented on the scope of the remedies available to the Crown when prosecuting a GAAR-based assessment in *West Topaz Property* (sub nom. *XCo Investments Ltd. v. The Queen*) (2005 TCC 655), which he decided under the specific anti-avoidance provision in subsection 103(1).

The case involved the temporary addition of a new partner to a partnership immediately before it realized a gain and the allocation for tax purposes of most of the resulting income to the new partner. The new partner (Woodwards) had substantial accumulated non-capital losses. XCo and West Topaz had for many years been the only partners of a partnership. In anticipation of the 1992 sale by the partnership of certain apartment buildings, the following preordained series of transactions occurred:

- On March 19, it was agreed that Woodwards would become a partner as to 80 percent, with its partnership interest limited to the apartment buildings. Woodwards agreed to contribute cash (held in escrow pending the apartment buildings' sale) to the partnership equal to 80 percent of the net equity value of the apartment buildings. Its required cash contribution was reduced by a "discount" of $561,000.
- On March 20, an arm's-length purchaser agreed to purchase the apartment buildings. The share of the sale proceeds that Woodwards received covered its capital contribution, plus a profit equivalent to the discount.
- For tax purposes, $5.7 million of income related to the gain on the apartment buildings was allocated to Woodwards. Woodwards sheltered the income with its non-capital losses.
- Woodwards transferred its interest in the partnership to West Topaz for $1 two weeks after the partnership's year-end.

The minister reassessed XCo and West Topaz, reallocating to them Woodwards' $5.7 million share of partnership income. The minister's attack was three-pronged: (1) this was not a valid partnership because Woodwards had no intention of operating a business in common with a view to profit; (2) subsection 103(1) applied; and (3) GAAR applied. The attack on the partnership was not pressed, and the court did not accept it.

On considering section 103, Bowman CJ easily concluded that the principal reason for the partnership's division of profits was the reduction of tax and that the arrangements fell squarely within the provision.

He then turned to the question of remedy. Subsection 103(1) provides that where it applies, the share of each partner in income or loss "is the amount that is reasonable having regard to all the circumstances." He concluded that Woodwards' 80 percent allocation was inherently unreasonable. What would be a reasonable allocation? He rejected the minister's contention that it should be the entire profit ($5.7 million) that had been allocated to Woodwards. Bowman CJ found that in cash terms, Woodwards received about $550,000. This was profit to Woodwards and the cash cost to the appellants to obtain Woodwards' participation. He held that a reasonable treatment under section 103 would be to treat Woodwards' share of the income as the amount it actually received ($550,000) and to reduce the amount allocated to the appellants accordingly. He considered this allocation more in keeping with the "economic reality" of the arrangement. Bowman CJ noted, "I am aware that economic reality is a concept that under recent jurisprudence is not in favour. Nonetheless it is an important ingredient in a determination of what is reasonable."

Bowman CJ said that section 245 did not apply, but he asked whether under section 245 he would have reached the same conclusion on the question of reasonableness of the amount to be allocated to the partners. On balance, he probably would have, but he said that whereas section 103 requires merely an allocation of income or loss that is reasonable in the circumstances, subsection 245(5) is more complex and sets out a variety of actions that are open to the minister "in determining the tax consequences to a person as is reasonable in the circumstances in order to deny a tax benefit . . . from an avoidance transaction." Section 245 "might arguably" justify allocating all the profit to the appellants, he said.

Bowman CJ made several other observations regarding section 245 that will be of interest in determining the scope of the GAAR in other cases. He said, "It may well be that at some point this court will have to consider whether section 245 cases will have to be split into two parts, first whether section 245 applies and second what action is appropriate under subsection 245(5)."

He also observed that while "reasonable" is a relative term and must depend on all the circumstances, its determination "is clearly not a discretionary act on the part of the Minister." Therefore, the court does not need to defer to the minister's view of what is reasonable. Also, anti-avoidance provisions such as sections 103 and 245 are not intended as a means of punishment for offending the minister's "olfactory sense" or "notion of fiscal rectitude."

Section 245 did not apply here, he said, because the more specific provision, section 103, prevails over the general provision, section 245, which is a last resort. Of particular interest was his observation that if a specific anti-avoidance section covers a transaction but does not, in the minister's view, provide a sufficient remedy, section 245 is not there to permit the minister to "top up" the remedy. In effect, he seems to say that if a transaction falls within a specific anti-avoidance rule, the minister must assess under that rule and not rely on the GAAR if doing so would result in more onerous tax consequences.

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Net Worth (and Other Estimated) Assessments

Taxpayers and their advisers should be aware of the audit tools available to the CRA in situations where a taxpayer is believed to have underreported its tax obligations. These tools include the net worth assessment, which is used to estimate tax obligations based on changes to the taxpayer's net worth over time, and the practice of basing GST or PST assessments not only on sales revenue reported but also on total bank deposits or requested input tax credits during the period.

The use of such tools has been widely supported by the courts in the civil assessment context. Now the federal government is attempting to use the same tools to support subsequent criminal action against taxpayers for tax evasion (which often follows the civil-side tax assessment of missing tax, interest, and penalty), usually when the taxpayer is in the throes of personal bankruptcy and may lack the funds to mount a full and proper defence to the charges.

Audit tools. In the civil assessment context, the federal government has considerable power to audit for tax compliance.

For example, the minister is empowered to enter premises, ask proper questions, or demand any information or document: see, for example, ITA subsections

231.1(1) and 231.2(1) and ETA subsections 288(1) and 289(1). Provinces have similar powers: see, for example, section 31(1) of the Ontario Retail Sales Tax Act (RSTA). Specific powers allowing governmental authorities to estimate assessments based on a change in net worth are found in ITA subsection 152(7), ETA subsection 299(1), and RSTA section 18(7).

Under these rules, the governmental authority is not bound to accept the taxpayer's tax returns, and may consequently make an assessment using whatever method it thinks is appropriate in the circumstances. If the taxpayer fails to file a tax return, files a return that is grossly inaccurate, or fails to provide any documentation confirming the information reported on the return, an assessment based on the net worth method is usually issued, although other tools may be used, including (in GST and RST contexts) reliance on bank deposits to substantiate true revenues.

What is a net worth assessment? A net worth assessment is an indirect method of estimating the net income a taxpayer should have declared on his or her tax return based on a review of his or her financial circumstances. The assessment is usually based on the assumption that a taxpayer's income for a period is the increase in the taxpayer's net worth between the beginning and end of the period, plus any expenditures during that period.

Generally, a taxpayer's net worth is determined by calculating the excess of his or her total assets, business and personal, over his or her total liabilities, business and personal, at a specified date, and then adding known or estimated expenditures to capture the total increase in revenues over the period under review. That number is then assumed by the tax authorities to be the real inflow of taxable income or taxable supplies for taxing purposes.

Consequently, in doing a net worth analysis, the CRA will review all bank accounts, brokerage and mutual fund accounts, real properties, credit card accounts, and anything else that may be relevant to a taxpayer's financial position to determine the change in the taxpayer's assets, liabilities, and expenditures.

Other methods often used in the GST and RST contexts. In *Hsu v. The Queen* (2001 DTC 5459), the FCA ruled that the CRA was not bound by traditional net worth estimates and could use a number of different methods to estimate tax liability. In that case, rather than issue an assessment based on the increase in the taxpayer's net worth during the period, the CRA used a 10 percent rate of return on the taxpayer's net worth at the beginning of the relevant period, employing effectively a property income method of assessment—all done in the absence of documentary information provided by the taxpayer. The court upheld the approach and ruled that the legislation allowed the issuance of arbitrary assessments using any method that is appropriate in the circumstances.

In a more recent case, *2868-2656 Québec Inc. c. La Reine* (2003 TCC 277), the appellant corporation was assessed GST by the CRA on the assumption that deposits made to its sole shareholder's personal bank account were for taxable supplies that it had made in the course of operating its business. Because the sole shareholder could not provide adequate evidence of the source of these mysterious deposits, the Tax Court held that the appellant did not rebut the burden of proof on the taxpayer, and dismissed its appeal.

In *2760-3125 Québec Inc. c. La Reine* (2004 TCC 183), the Tax Court upheld a GST assessment that was based on a percentage markup on the taxable sales for which the appellant requested income tax credits (ITCs); the taxpayer had no records or documents to permit an assessment to correctly determine its amount of taxable sales for GST purposes.

Taxpayer required to disprove a net worth assessment. As these cases demonstrate, once the government makes the assumption that a taxpayer's true tax position is based on something other than its tax returns (on net worth or on bank deposits), the burden of disproving that assumption falls on the taxpayer.

The courts will require the taxpayer to lead evidence to demolish the assumptions made by the government. If cogent evidence cannot be brought to attack the validity of the assumption underlying the net worth or bank deposit assessments, the taxpayer will invariably lose its case.

Know your rights. Although a taxpayer is required, on a balance of probabilities, to demonstrate that its version of the facts is correct and that an estimated assessment is incorrect, the government is not relieved of all obligations, nor is the government permitted to assign an arbitrary figure to the taxpayer's net worth or ultimate tax liability. The government is still required to disclose the precise basis upon which its assessment has been formulated, and the courts have held that audits must be performed to meet a minimum standard of reliability.

Estimated assessments not supported in the criminal context. Taxpayers will be happy to note that the use of estimated assessments has not been supported in the context of a criminal prosecution for tax evasion. The courts have now clarified that the Crown cannot simply assume guilt through use of a net worth assessment or any other estimated assessment.

To prove criminal tax evasion, the Crown must establish that the accused (1) did something or engaged in a course of conduct that avoided or attempted to avoid the payment of tax; (2) knew that tax was imposed by statute; and (3) engaged in the conduct for

the purpose of avoiding or attempting to avoid the payment of the tax owing, or knowing that avoiding the payment of the tax owing was a virtual consequence of the accused's actions.

The Canadian courts have generally rejected the use of the estimated assessment by concluding that (1) increases in net worth, standing alone, cannot be assumed to be attributable to taxable income; (2) the government may not disregard explanations of the accused reasonably susceptible of being checked, but if relevant leads are not forthcoming then the government is not required to negate every possible source of non-taxable income, a matter peculiarly within the knowledge of the accused; and (3) proof of a likely source of the net worth increases is not essential if the evidence negates all possible sources of non-taxable income.

This approach was recently confirmed in *R v. Zuk* (2005 ONCJ 428). The accused was a self-employed stock promoter, and the Crown argued that the accused enjoyed an increase in wealth attributable to a taxable source (namely, his business of stock promotion), which he did not report on his tax return. Accordingly, the CRA used the estimated net worth assessment to estimate the accused's income during the relevant period. The accused cited several non-taxable sources of income to account for his increase in wealth, most of which were not properly investigated by the Crown.

The court concluded that in tax evasion cases where the Crown seeks a conviction based on the evidence of a net worth assessment, the Crown bears the burden of proof, including the burden to investigate any explanations reasonably susceptible of being checked, and to prove beyond a reasonable doubt that its assumed amount of taxable income is correct. Since the Crown had put into evidence documents that raised questions on their face, and since there were means available for further investigation, the Crown could not assume that the income was taxable and expect that assumption to be sufficient to meet the burden of proof beyond a reasonable doubt. Consequently, the accused was acquitted of tax evasion and misrepresentation of income.

Commentary. The net worth assessment and the bank deposit assessment remain important tools for government auditors, and small business owners and managers should be aware of them and understand their implications. For now, the use of these audit tools will not likely extend into criminal proceedings, but they do pose a significant exposure problem for taxpayers with possible underreporting issues on the civil tax assessment side.

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SR & ED ITCs: Tax Preparation Software Note

Different jurisdictions in Canada have different taxation regimes with respect to SR & ED investment tax credits (ITCs). Two cases with slightly varying facts illustrate the significant differences in the taxation of SR & ED ITCs among various jurisdictions. These differences may not be reflected in the corporate tax preparation software currently available, and tax advisers should be especially careful when using the software if SR & ED ITCs are involved.

Case 1: A corporation carries on business exclusively in Ontario and engages in eligible SR & ED activities. What are the federal and Ontario income tax considerations that must be taken into account when computing the corporation's federal and Ontario SR & ED ITCs?

Solution: The federal ITC is taxed federally because it reduces the SR & ED expenditure pool in the taxation year following the year in which the ITC is claimed (paragraph 37(1)(e) of the Income Tax Act (ITA)). The federal ITC is not taxable in Ontario because the Ontario SR & ED pool is increased by the amount of the federal ITC claimed in the preceding taxation year pursuant to section 11.2(3) of the Ontario Corporations Tax Act.

The Ontario ITC is taxed federally because it is considered "government assistance," which reduces the SR & ED pool pursuant to ITA paragraph 37(1)(d) and subsection 127(9) (definition of "government assistance"). The Corporations Tax Act imports the aforementioned federal provisions to tax the Ontario ITC in Ontario.

Case 2: A corporation carries on business through permanent establishments in Quebec and Ontario. The corporation carries on eligible SR & ED activities in Quebec only. What are the federal, Quebec, and Ontario income tax considerations that must be taken into account when computing the corporation's federal and Quebec SR & ED ITCs?

Solution: The Quebec ITC is taxed federally for the same reason as the Ontario ITC previously discussed. The Quebec ITC is not taxed for Quebec income tax purposes because it is not one of the items listed in section 225 of the Quebec Taxation Act that reduce the eligible Quebec SR & ED pool.

The federal ITC is taxed federally in the subsequent taxation year for the same reason as previously discussed. The federal ITC is taxed in Quebec in the subsequent taxation year because it reduces the Quebec SR & ED pool by virtue of section 225(a) of the Taxation Act and paragraph 225R1(a) of the Regulation Respecting the Taxation Act.

In this case, Ontario taxes the federal ITC because, in contrast to the previous example, the Ontario SR & ED pool is not increased by the amount of the federal ITC claimed in the preceding taxation year. This is the case because only SR & ED expenditures incurred in Ontario qualify for the enhanced Ontario SR & ED deduction (section 12(1) of the Corporations Tax Act, definition of "qualified expenditure"). The federal ITC is taxed in Ontario because the Corporations Tax Act imports ITA paragraph 37(1)(e) into its legislation; the ITC therefore reduces the Ontario SR & ED pool in the subsequent taxation year.

Ontario taxes the Quebec ITC because the Corporations Tax Act imports the federal definition of "government assistance" found in ITA paragraph 37(1)(e) into the Ontario SR & ED pool. This result is counterintuitive because the underlying SR & ED expenditures are incurred in Quebec.

Most corporate tax software programs will not recognize the subtlety of the taxation of the federal ITC in Ontario if the underlying SR & ED expenditure was incurred in another province. Presumably, the software programs automatically pick up the SR & ED expenditures from federal form T661 in Ontario schedule 161, which calculates the enhanced Ontario SR & ED pool that eliminates the taxation of the federal ITC in Ontario. Until the corporate software programs are corrected, manual overrides must be carefully implemented to ensure that the correct result for all taxing jurisdictions involved is achieved.

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Personal Services Business: (More) Lessons from the Jurisprudence

In the previous issue, Tom McDonnell discussed the *Dynamic Industries* case and its implications in the personal services business context (see "Practice Notes: Personal Services Businesses," *Tax for the Owner-Manager*, October 2005). This article looks at a number of other cases on the topic.

By virtue of subsection 125(7), a corporation is considered to be carrying on a "personal services business" if

- an individual performs services through the corporation,
- the individual or a related person owns at least 10 percent of the shares of the corporation, and
- if the corporation did not exist, the individual would be considered to be an officer or employee of the recipient of the services.

A number of adverse income tax implications arise if a corporation earns income from a personal services business:

- The income is active business income and thus is not eligible for the small business deduction.
- Certain expenses that are ordinarily deductible will not be deductible (paragraph 18(1)(p)).
- Remuneration is deductible only when it is paid, not when it is accrued (paragraph 18(1)(p)).

If the service corporation has only one client, it is generally more likely to be carrying on a personal services business than if it has a number of clients. In *Dynamic Industries* (2005 FCA 211), the fact that a corporation had only one client in a particular taxation year was not considered fatal because the corporation had more than one client in years before and after the particular year.

An Ontario court has recently held that the substance of a relationship can override its form in appropriate circumstances. In *Spie* (2005 GTC 1460 (Ont. SCJ)), a corporation wished to hire an individual to perform services for it. It was intended that the individual would operate his own equipment in the performance of such services. However, the collective bargaining agreement of the union to which the individual belonged required that the corporation hire the individual as an employee; the corporation did so, and rented the equipment from him. The court held that the substance of the relationship was that the corporation had hired an independent contractor with his own equipment rather than enter into two separate arrangements, one of employer-employee and the other of lessor-lessee. This was critical for Ontario retail sales tax purposes: equipment lessees pay Ontario RST, whereas persons that hire the owner of the equipment to operate it do not.

If a corporation employs more than five full-time employees throughout a year in the business of providing the services in question, by virtue of the definition in subsection 125(7) the service income will be deemed not to be personal services business income. The definitions of "more than five" and "full-time" have recently received a significant amount of judicial attention.

In *Lerric* (2001 DTC 5169 (FCA)), the court held that corporate members of a joint venture are not considered to employ any of the employees employed by the joint venture. Conversely, *Interpretation Bulletin* IT-73R6 indicates that each corporate partner is considered to employ all (not merely its proportionate share) of the employees of the partnership.

Lerric also left open the possibility that, contrary to *Hughes* (94 DTC 6511 (FCA)) and IT-73R6, five full-time employees plus one part-time employee might satisfy the "more than five full-time employees" requirement.

In *Baker* (2005 FCA 185), employees who regularly worked 20 hours per week were considered not to be

full-time employees. This case overrode *Ben Raedarc Holdings* (98 DTC 1218 (TCC)), which reached the opposite conclusion in similar circumstances.

The second statutory exemption to the personal services business rules found in the definition in subsection 125(7) is that fees earned from an associated corporation do not constitute personal services business income. Ordinarily, it is not advantageous to associate corporations because they must share the small business deduction. However, as the following example illustrates, there is at least one instance in which an advantage can be gained from associating corporations.

Assume that a corporation (Investco) earns specified investment business income. If an associated corporation is formed to manage Investco in return for a fee, the fee will not constitute personal services business income. In this fashion, passive income can be converted into active business income so that the small business deduction can be accessed. Of course, the quantum of the fee will have to be justifiable.

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Section 84.1 Again: Brouillette v. The Queen

Section 84.1 of the Income Tax Act has been the cause of many sleepless nights for tax lawyers and accountants. This anti-avoidance rule can be a minefield for the uninitiated, and tax practitioners must always be aware of its potential application in any sale of shares to a purchaser corporation. The Tax Court of Canada's decision in *Brouillette* (2005 TCC 203) sets out a sensible approach for applying section 84.1—or, more correctly, for not applying it—in the context of a shareholder "cashing out" an interest in a qualifying small business corporation.

Section 84.1 applies when an individual taxpayer disposes of shares of a "subject corporation" to a "purchaser corporation" that does not deal at arm's length with the taxpayer and, immediately after the disposition, the subject corporation is connected with the purchaser corporation.

Paragraph 84.1(1)(a) provides for a "PUC grind" that limits the paid-up capital of shares of the purchaser corporation received by the taxpayer as consideration for the subject shares. Paragraph 84.1(1)(b) may result in an immediate deemed dividend to the taxpayer. The deemed dividend is the amount by which the non-share consideration received from the purchaser corporation exceeds the greater of (1) the paid-up capital of the subject corporation shares and (2) the "hard" adjusted cost base of the subject corporation shares. If the non-share consideration is in the form of a promissory note, the full principal amount of the note is counted in determining the amount of the dividend, even though a portion of the principal may not be payable until a future date.

Brouillette involved a relatively straightforward leveraged buyout. Mr. Brouillette wished to sell his 50 percent interest in Autoco, a qualifying small business corporation, and utilize his full $500,000 capital gains exemption. The buyers wished to finance the purchase price with the earnings of Autoco. The following transactions were entered into to effect the sale:

1) 9016-4476 Quebec Inc. ("9016") was incorporated. Mr. Brouillette owned 51 percent of the voting shares.
2) 9017-4481 Quebec Inc. ("9017") was incorporated by the buyers, two individuals unrelated to Mr. Brouillette. Each of them subscribed for 50 percent of the issued and outstanding shares.
3) On June 13, 1995, Mr. Brouillette transferred all of the shares of Autoco to 9016 in exchange for $500,000 worth of its class E preferred shares on a tax-deferred basis under subsection 85(1).
4) In October 1995, Mr. Brouillette sold his class E shares in 9016 to 9017 in exchange for a demand promissory note in the principal amount of $500,000. The note provided for annual payments of $50,000, with the full amount to be paid no later than October 1, 2000. Mr. Brouillette retained 51 percent voting control of 9016.
5) A unanimous shareholders' agreement provided that 9017 was not to receive any dividends from 9016 until the promissory note was fully paid or that, if dividends were paid to 9017, those dividends were to be used only to make payments on the promissory note.

The CRA reassessed Mr. Brouillette on the basis that, inter alia, paragraph 84.1(1)(b) deemed him to have received a dividend on the sale of the class E shares. The main thrust of the CRA's argument was that there was a single "controlling mind" that orchestrated the series of transactions involved in the sale and that Mr. Brouillette and 9017 were therefore not dealing at arm's length with each other. (Note that Mr. Brouillette owned no shares in 9017; the arm's-length issue was solely a factual one.)

Lamarre Proulx J allowed Mr. Brouillette's appeal. Readers are encouraged to read the decision for her excellent analysis of the arm's-length and de facto control issues. At least two passages are of particular

interest to practitioners. At paragraph 46, Lamarre Proulx J stated:

> Parliament could have provided that any disposition of shares to a corporation would result in a deemed dividend equal to the amount by which the paid-up capital was exceeded. However, Parliament did not do so. It must therefore be assumed that Parliament intended to sanction transactions made with one's self, that is to say, complex transactions in which the shareholder ultimately retains substantially the same property. When the buyer corporation and the seller have separate economic interests, and they carry out the transaction in accordance with those separate interests, section 84.1 does not apply.

The judge cited literature which argued that section 84.1 should apply only when a shareholder retains control of the subject corporation. In particular, section 84.1 should not apply when a shareholder is "cashing out" an ownership interest in the subject corporation. The court's approval of this approach should provide tax advisers with a significant level of comfort when they recommend creative tax plans to a selling shareholder. The following comments (at paragraph 51) further support the position that tax planning in the context of an arm's-length sale should not of itself bring section 84.1 into play:

> Financial advisors are not the directing minds of the corporations that they advise. They advise. They do not make the decisions. It cannot be determined that parties have acted in concert simply because they have used the same financial advisors. The interests of each party to an agreement must be analysed to determine whether they have acted in concert.

This decision is strong authority for the proposition that implementing an arm's-length share sale in a manner that provides the seller with security for payment of a deferred purchase price will not of itself support a finding that the seller and buyer are not acting at arm's length. In the context of the capital gains exemption and section 84.1, the case legitimizes the use of a new acquisition corporation by the buyer to permit tax-free access to the earnings of the subject corporation to fund the purchase price. The certainty provided to this aspect of owner-manager tax planning is welcome. (For a discussion of a very recent case that considers the possible application of section 245 to section 84.1 planning, see "The Evans Case," below.)

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The Evans Case: GAAR in a Post-Canada-Trustco World

It is too soon to speculate about how far the decisions of the Supreme Court of Canada in *Canada Trustco* (2005 SCC 54) and *Mathew* (2005 SCC 55) will go in changing the approach to the general anti-avoidance rule (GAAR) set out in the *OSFC* decision (2001 FCA 260). Certainly, the tests adopted by the SCC to determine what is embraced by the phrase "abusive tax avoidance" are ostensibly different from the one previously enunciated by the FCA. Practitioners will now focus on the GAAR cases in the Tax Court of Canada to see how the new tests will be applied in particular fact situations. *Evans* (2005 TCC 684) is the first of these to deal with the GAAR in a substantive way, and the decision is provocative for a number of reasons.

The taxpayer in *Evans* owned all of the shares of a qualifying small business corporation. Had he chosen to sell the shares to an arm's-length purchaser, he would have qualified for the full capital gains exemption and received $500,000 free of tax. Alternatively, had he chosen not to sell the shares but to pay himself $500,000 in the form of dividends, he would have incurred a significant tax liability. Instead, he adopted a plan that had the effect of paying him $500,000 as proceeds of a sale of shares in his company (sheltered from tax by the capital gains exemption) while leaving him as the sole equity shareholder in the company.

The actual steps taken to achieve this result were complicated and are summarized in some detail in the reasons for judgment. Boiled down to its essence, the plan involved the creation of a new series of high-low preferred shares with a redemption amount of $500,000 and a paid-up capital of $100. (The amounts described here have been rounded up from the actual amounts in the case.) These shares were paid to the taxpayer by way of a stock dividend. His wife and three of his children formed a partnership which purchased the preferred shares from him for $500,000, the fair market value. The price was satisfied with a promissory note payable over five years with interest at the prescribed rate for section 74.5 purposes. Over the next three years, dividends were paid to the partnership and some of the preferred shares were redeemed. All of the amounts received were paid to the taxpayer as interest or instalments of principal on the note. The dividends were allocated to the children (they were entitled to 99 percent of the partnership income), but they paid very little tax because of their low marginal rates and the dividend tax credit.

The plan therefore envisioned the taxpayer receiving tax-free payments of $500,000 of principal on the note,

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an annual interest amount taxable in his hands (and deductible in computing partnership income), and very low tax on the dividends allocated to the members of the partnership. In the CRA's view, this was a classic dividend strip; the CRA applied the GAAR to treat all payments on the note as dividends taxable in the taxpayer's hands.

Bowman CJ allowed the taxpayer's appeal, saying that this was not an appropriate case for the application of the GAAR. The economic purpose of the series of transactions was to put corporate funds in the taxpayer's hands (paragraph 19). This, he said (at paragraphs 20 and 22), was a non-tax purpose, although he agreed that the method chosen to achieve the result was tax-motivated. Notwithstanding the motive, he concluded that the transaction was not an "avoidance transaction" within the meaning of subsection 245(3). He cited the explanatory notes to the GAAR, which state that the GAAR "does not permit a transaction to be considered to be an avoidance transaction because some alternative transaction that might have achieved an equivalent result would have resulted in higher taxes."

Some tax practitioners are likely to be surprised by the finding of no avoidance transaction on these facts. The principal purpose for the stock dividend steps was tax-motivated and, one would have thought, grounds for tainting the series as a whole. Bowman CJ's decision seems to restrict the scope of the purpose test in subsection 245(3) to the overriding purpose of the series as a whole, to the exclusion of any of the individual steps. In this respect the decision is, to say the least, surprising in view of the very specific wording of paragraph 245(3)(b).

Perhaps anticipating some controversy regarding his finding of no avoidance transaction, Bowman CJ went on to consider whether the planning was acceptable under the misuse/abuse test in subsection 245(4). He concluded that the planning here was neither a misuse of a section of the Act nor an abuse of the provisions of the Act read as a whole. It is in this connection that his remarks are likely to be cited in subsequent cases.

He listed the provisions relevant to the overall plan: section 85, section 110.6, subsection 84(3), section 112, subsection 52(3), and section 74.5. In each case, he said, the provisions were used for the very purpose for which they are in the Act (paragraph 28). He concluded that there cannot be an "abuse of the provisions of the Act where each section operates exactly the way it is supposed to" (paragraph 29). He then said that the only basis on which he could support the application of the GAAR would be to find "that there is some overarching principle of Canadian tax law that requires that corporate distributions to shareholders must be taxed as dividends, and where they are not the Minister is permitted to ignore half a dozen specific sections of the *Act*" (paragraph 30). He was not prepared to find any such principle. Further, he questioned whether the decisions in *McNichol* (97 DTC 111 (TCC)) and *RMM Canadian Enterprises* (97 DTC 302 (TCC)) were correct. Here, the business of the taxpayer's company was not discontinued, and in fact taxable dividends were paid to the partnership. The fact that the children paid very little tax was attributable to their low marginal rates, not to dividend stripping.

Bowman CJ did not mention section 84.1 in the course of his abuse analysis. That section would have defeated the scheme if the wife and minor children had formed a corporation to act as the purchaser of the stock dividend shares. One might ask whether the careful avoidance of section 84.1 through the use of a partnership rather than a corporation is an abuse of the scheme of which that section might be said to be a part. One can read Bowman CJ's remarks as a finding that it is not an abuse but rather a legitimate planning step taken to capitalize on the fact that there is no provision comparable to section 84.1 in the partnership rules.

If the decision stands, it opens the door to owner-managers utilizing the capital gains exemption to extract $500,000 in after-tax corporate profits without selling the corporation to an arm's-length party. (At the time of writing, the Liberal government has proposed an increase in the capital gains exemption to $750,000.) Although the kiddie tax (section 120.4) would likely block the use of a partnership of minor children for plans executed after 1999, the structure used in this case would probably work if the stock dividend shares were purchased by a spouse or by a partnership made up of the spouse and adult children. Other refinements might be added, depending on individual circumstances. Cautious tax planners may want to wait to see whether the decision is appealed before implementing a similar arrangement.

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