LEGAL BUSINESS REPORT | ALPERT LAW FIRM
THE TAX LAW PROFESSIONALS
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ASSOCIATED CORPORATIONS

This issue of the Legal Business Report provides current information to the clients of Alpert Law Firm on the rules relating to the tax treatment of associated corporations. Alpert Law Firm is experienced in providing legal services to its clients in tax and estate planning matters, tax dispute resolution, tax litigation, corporate-commercial transactions and estate administration.

A. SMALL BUSINESS DEDUCTION

Pursuant to subsection 125(1) of the *Income Tax Act* (the "Act"), the small business deduction reduces the tax payable by a Canadian Controlled Private Corporation ("CCPC") on the first $500,000 of its taxable active business income earned in Canada. Effective July 1, 2010, the combined federal and Ontario small business tax rate was reduced to 15.5% from 16.5%.

The rules that determine whether two or more corporations are associated are important for determining the entitlement of a CCPC to the small business deduction and certain other tax credits. Where two or more CCPCs are associated with each other in a taxation year, the annual business limit of active business income eligible to be taxed at a lower rate must be allocated between the associated corporations. The general intent of these rules is to restrict the use of multiple small business deductions.

B. BASIC RULES CONCERNING ASSOCIATED CORPORATIONS

At any time in a taxation year, two corporations will be associated if any of the following circumstances apply:

(i) Paragraph 256(1)(a) – one corporation is controlled by the other;

(ii) Paragraph 256(1)(b) – both corporations are controlled by the same person or group of persons, which may be an individual, an estate, or a corporation;

(iii) Paragraph 256(1)(c) – both corporations are controlled by two related persons and one of the related persons owns at least 25% of the issued shares of each corporation (i.e., cross-ownership);

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(iv) Paragraph 256(1)(d) – one corporation is controlled by one person who is related to each member of a group of persons that controls the other corporation, and there is cross-ownership of not less than 25%;

(v) Paragraph 256(1)(e) – both corporations are controlled by two related groups of persons and there is cross-ownership of not less than 25%; or

(vi) Subsection 256(2) – both corporations are associated with the same CCPC under the above rules.

It is important to note that paragraphs 256(1)(c) to (e) of the Act (as well as the deeming provisions of subsection 256(1.2), discussed later) include an exception for shares of a "specified class", which is defined in subsection 256(1.1) of the Act. A class of shares is considered to be a "specified class" if:

(i) the shares are neither convertible nor exchangeable;

(ii) the shares are non-voting;

(iii) dividends payable on the shares are a fixed amount or are calculated as a fixed percentage of an amount equal to the fair market value of the consideration for which the shares were issued;

(iv) the annual dividend rate, calculated as a fixed percentage of the fair market value of the consideration for which the shares were issued, does not exceed the prescribed rate; and

(v) the amount that a shareholder is entitled to receive on the redemption, acquisition or cancellation of these shares by the corporation or a non-arm's length person does not exceed the fair market value of the consideration for which the shares were issued plus any unpaid dividends.

As a result of this exclusion of shares of a specified class, a person who controls a corporation may provide an unlimited amount of share capital financing to another corporation controlled by a related person without the two corporations being deemed to be associated if such share capital financing is in shares of a specified class.

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C. CONCEPT OF CONTROL

The above-mentioned basic rules of the Act that provide the circumstances under which corporations will be held to be associated with one another are based on the concept of control, a term not defined in the Act. For the purposes of the associated corporation rules, there are three situations in which control can occur.

(i) *De Jure* Control

If reference to control of a corporation is not accompanied by the words "directly or indirectly in any manner whatever", then such control means *de jure* control, which is also known as legal control. The general test for *de jure* control was confirmed by the Supreme Court of Canada in ***Duha Printers (Western) Ltd. v. The Queen***, [1998] 1 S.C.R. 795, to be whether the majority shareholder enjoys "effective control" over the affairs of the corporation, as demonstrated by having majority-voting control over the corporation and the ability to elect the directors of the corporation. In determining whether "effective control" exists, the following must be considered:

(a) The corporation's governing statute;

(b) The share register of the corporation; and

(c) Any specific or unique limitation on either the majority shareholder's power to control the election of the board or the board's power to manage the business and affairs of the company, as manifested in either:

(i) The constating documents of the corporation; or

(ii) Any unanimous shareholder agreement.

(ii) *De Facto* Control

The concept of control has been extended to include control "directly or indirectly in any manner whatever", which is defined by the Act to include some forms of factual control in addition to legal control.

Subsection 256(5.1) of the Act specifies that where a corporation, person or group of persons has any direct or indirect influence that, if exercised, would result in control in fact of the corporation, that corporation, person or group of persons controls the corporation. For example, where the voting shares of a corporation are divided

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evenly between two persons, the holding of a "casting vote" may constitute *de facto* control.

However, the rules also extend the meaning of control to circumstances where *de facto* control exists by virtue of a person having any direct or indirect influence, and does not require any share ownership. A potential influence, even if it is not exercised, would be sufficient to result in control in fact. In determining when influence must exist, we must look at the context. However, in certain circumstances, influence does not necessarily translate into control. A person at arm's length may have influence over a corporation because of a legal arrangement such as a franchise, license, or lease agreement. This influence will not be considered to be control pursuant to the Act if: (i) the corporation and the dominant entity are dealing with each other at arm's length; and (ii) the main purpose of the agreement from which influence is derived is to determine the ties between the corporation and the dominant entity regarding the manner in which the business carried on by the corporation is to be conducted.

Some general factors that may be used to determine whether *de facto* control exists are as follows:

(i) the percentage of ownership of voting shares (when such ownership is not more than 50 per cent) in relation to the holdings of other shareholders;

(ii) ownership of a large debt of a corporation which may become payable on demand (unless exempted by subsections 256(3) or (6)) or a substantial investment in retractable preferred shares;

(iii) shareholder agreements including the holding of a casting vote;

(iv) commercial or contractual relationships of the corporation, e.g., economic dependence on a single supplier or customer;

(v) possession of a unique expertise that is required to operate the business; and

(vi) the influence that a family member, who is a shareholder, creditor, supplier, etc., of a corporation, may have over another family member who is a shareholder of the corporation.

It is important to note that the factual tests deem control to exist only for the purposes of the associated corporation rules and do not apply for other purposes under the Act.

(iii) Market Value Control

For the purposes of the associated corporation rules, the concept of control is also deemed to include "market value control". Pursuant to paragraph 256(1.2)(c) of the Act, a corporation is deemed to be controlled by another corporation, a person or a group of persons where the corporation, person or group of persons: (i) owns shares representing more than 50% of the fair market value of all the issued and outstanding shares of the corporation; or (ii) owns common shares representing more than 50% of the fair market value of all the issued and outstanding common shares of the corporation. For the purpose of this valuation, voting rights and certain non-voting preferred shares are disregarded. A group of persons is defined as any two or more persons each of whom owns shares of the capital stock of the same corporation.

Pursuant to these various rules, it is possible for a corporation to be controlled or deemed to be controlled by several different persons or groups of persons at the same time.

D. CASE LAW REGARDING CONCEPT OF CONTROL

1. *Silicon Graphics Ltd. v. The Queen*, 2002 FCA 260

This influential Federal Court of Appeal decision set out the accepted test for *de facto* control. The taxpayer, Alias, was a Toronto-based publicly traded corporation in the business of developing and marketing software. Silicon, a US public corporation, advanced a loan to Alias. During the time in which the loan was outstanding, Silicon approved Alias's daily cash forecasts and determined which creditors of Alias would be paid. Silicon also made financial contributions to Alias for software development and marketing. Certain directors and officers of the taxpayer were formerly associated with Silicon, and Alias software only operated on hardware made by Silicon. The Minister claimed that Alias and Silicon were associated and had to share the small business tax credit.

The Tax Court of Canada dismissed the taxpayer's appeal on the ground that the non-residents of Canada had *de jure* control of Alias; therefore, the corporation did not fall within the definition of CCPC.

The Federal Court of Appeal set aside the Tax Court decision and allowed the taxpayer's appeal. The Federal Court held that *de jure* control required that: (i) a

sufficient common link or interest exist among the shareholders; or (ii) the shareholders act together to exert control over the corporations. Because Alias was widely held, there was no evidence to prove that the shareholders were acting together and *de jure* control could be not established.

The Federal Court then considered whether Alias was controlled directly or indirectly by Silicon, resulting in Alias not fulfilling the criteria of a CCPC as defined in subsection 125(7) of the Act. The Federal Court found that Silicon was not in *de facto* control of Alias and outlined the accepted test for *de facto* control. The Federal Court stated that in order for there to be a finding of *de facto* control, a person or group of persons must have a clear right and ability to effect a significant change in the board of directors or the powers of the board of directors or to influence in a very direct way the shareholders who would otherwise have the ability to elect the board or directors. It does not refer to one's ability to influence the day-to-day management and operation of the business. The Federal Court found no such control based on the evidence and held that Alias was a CCPC.

2. ***Taber Solids Control (1998) Ltd. et al. v. The Queen*, 2009 TCC 527**

In this Tax Court of Canada decision, a corporation ("Old Taber") was jointly owned by a husband and wife. After a corporate reorganization, the wife became the sole shareholder of Old Taber and the husband became the majority shareholder of a new corporation ("Taber 1998"). Taber 1998 began to operate Old Taber's equipment rental business, using rented equipment owned by Old Taber. Taber 1998 was Old Taber's only customer. The Minister claimed that the two corporations were associated and had to share the small business tax credit.

The Minister argued that the main reason for the reorganization was for tax purposes; therefore, pursuant to subsection 256(2.1) of the Act, the corporations were associated. Alternatively, the Minister claimed that the corporations were associated because Old Taber was controlled in fact by Taber 1998, pursuant to subsection 256(5.1) of the Act.

The Tax Court decided against the taxpayer, and accepted the Minister's alternative argument. In dismissing the Minister's first argument, the Tax Court held that the tax consequences were not the main reason for the reorganization, but rather an incidental benefit derived therefrom. There were legitimate business reasons for the reorganization, namely to protect the valuable assets from possible lawsuits arising from operations and to allow growth in those assets to accrue separately from operations.

The fact that the taxpayers may have, on the advice of their accountant, ended up with a corporate structure that was tax effective is not sufficient to conclude that it must have been the primary reason for the separate existence of the corporations. Circumstances surrounding the reorganization had to be taken into consideration. The Tax Court found that the taxpayers would have proceeded with the reorganization, regardless of the benefits of the small business deduction.

Although subsection 256(2.1) of the Act did not apply, the Tax Court held that the husband and Taber 1998 had *de facto* control over Old Taber, pursuant to subsection 256(5.1), as the husband, and consequently Taber 1998, had direct or indirect influence over the decision-making of Old Taber's board of directors. The Tax Court clarified the scope of the ***Silicon Graphics*** test for *de facto* control, changing it from a person who simply controls the composition of the board, to one who has the potential to make board decisions. The Tax Court held that Taber 1998 had: (i) actual influence over the major operational decision for Taber 1998 to be Old Taber's sole customer; (ii) actual influence over Old Taber's board decisions regarding the disposition of the equipment; and (iii) potential influence, based on Old Taber's complete economic dependence on Taber 1998, to control decisions regarding the acquisition of equipment, notwithstanding that the reality of the situation was the husband and wife jointly made such decisions.

3. *Lenester Sales Ltd. v. The Queen*, 2004 FCA 217

In this Federal Court of Appeal decision, the Court considered the issue of whether a franchisor has sufficient control over its franchisee to be an associated corporation. The two corporate taxpayers were two of 80 or 90 franchisees, and the pattern was essentially the same for all of them: the franchisor selected a person to operate the franchise, the operator underwent a training period, and then the franchisor sold 51 percent of the shares in an existing company to the operator and retained ownership of the remaining 49 percent. The operator then became the full-time employee of the company. The company had two directors, one appointed by the franchisor and the other appointed by the operator. The bank accounts of the franchisees were pooled with those of the franchisor and the franchisor also performed the purchasing function for all the franchisees.

The Minister argued that the corporate taxpayers did not qualify for the small business deduction because they were associated with their franchisor who exercised *de facto* control over both of them. The Tax Court of Canada dismissed the Minister's appeal, finding no evidence of *de jure* or *de facto* control. The Federal Court of Appeal affirmed the Tax Court decision and held that the two franchisees were entitled to the full small business deduction provided to CCPCs. The Federal Court followed the test

set out in ***Silicon Graphics*** and found that the franchisor did not have the "clear right and ability to effect a significant change in the board of directors or the powers of the board of directors or to influence in a very direct way the shareholders who would otherwise have the ability to elect the board of directors." Therefore, the corporations were not associated.

4. *9044-2807 Quebec Inc. v. The Queen*, 2004 FCA 23

In this Federal Court of Appeal decision, two corporate taxpayers ("ML1" and "ML2") were found to be associated with a third corporation ("TC"), rendering the corporate taxpayers ineligible for the full amount of the small business deduction. The shares of TC were held by another holding corporation, 1864 Quebec, and each of the taxpayer's five sons owned 20% of the shares in 1864 Quebec. The husband was the sole shareholder of ML1 and the wife owned 90% of the shares in ML2. TC was ML1 and ML2's sole client.

The Tax Court of Canada dismissed the taxpayers' appeal and concluded that the three corporations were associated with each other because the two corporations, ML1 and ML2, were controlled *de facto* by TC. The Federal Court of Appeal affirmed the Tax Court decision. The Federal Court once again employed the ***Silicon Graphics*** test and found that TC had *de facto* control over the two corporate taxpayers. In coming to this conclusion, the Federal Court was influenced by the existence of family relationships between the shareholders of all three corporations. Furthermore, TC was the sole client of the two corporate taxpayers and provided management services to them. The Federal Court held that the economic dependence of the two corporate taxpayers on TC was such that TC had the decision-making power over those who had *de jure* control of the two corporate taxpayers.

5. *Plomberie JC Langlois Inc. v. The Queen*, 2006 FCA 113

In this Federal Court of Appeal decision, an individual who was the sole director and a 50% shareholder of the corporate taxpayer was found to have *de facto* control of the corporation. The Minister found that the small business deductions claimed by the corporate taxpayer had to be shared with other companies under the control of this individual. The individual argued that he shared control with another shareholder, who owned 50% of the shares of the corporation and took care of the day-to-day operations.

The Tax Court of Canada dismissed the taxpayer's appeal and held that although the individual did not have *de jure* control over the corporate taxpayer based on the

division of shares, he did have *de facto* control, since, as the sole director, he had ultimate control over any decisions made by the corporation. The Federal Court of Appeal affirmed the decision of the Tax Court.

6. ***Ekamant Canada Inc. v. The Queen*, 2009 TCC 408**

In this Tax Court of Canada decision, the common shares of the corporate taxpayer were held by four individuals equally (three non-residents and one Canadian resident). Two of the non-residents appointed their father (the third non-resident), to be president of the corporation, giving him the right to vote at shareholders' meetings to elect directors. Subsequently, in a document entitled "Proxy", the president appointed the Canadian resident to attend shareholder meetings and to vote to elect directors. Finally, in 2006 a shareholders' agreement was entered into that stated that the Canadian resident would be designated as director and as president of the corporation. The Minister disallowed the small business deductions in its 2000 to 2003 assessments of the corporation on the basis that it did not qualify as a CCPC, as it was controlled by the three non-resident shareholders. The corporate taxpayer appealed.

The Tax Court dismissed the corporate taxpayer's appeal, and held that the corporation was controlled by the non-residents at all relevant times because together they owned enough shares to elect the directors. Additionally, the family relationship between them, together with the fact that the two non-residents appointed their father as president, strongly suggested that the three were acting in concert.

As a general rule, corporations are controlled by the board of directors. In this case, there was no unanimous shareholders' agreement in existence to suspend this rule. The 2006 shareholders' agreement was not relevant to the years at issue, and thus was of no assistance to the corporate taxpayer. In addition, the Tax Court did not consider the "Proxy" document to be a unanimous shareholders' agreement, as: (i) only the three non-residents signed the document; and (ii) "[it was] not aimed at restricting the powers of the directors to manage, or supervise the management of, the business activities and internal affairs of the corporation." Therefore, the corporate taxpayer was not a CCPC, as it was controlled by the non-residents.

7. ***Lyrtech RD v. Canada*, 2013 TCC 12**

In this Tax Court of Canada case, the corporate taxpayer, Lyrtech, appealed the Minister's assessments denying refundable investment tax credits Lyrtech had claimed,

on the ground that it was not a CCPC. The Minister determined that Lyrtech was under the *de facto* and *de jure* control of a public corporation, L Ltd., and was therefore not a CCPC under the definition in subsection 125(7) of the Act.

The Tax Court dismissed the taxpayer's appeal. The Court held that *de facto* and *de jure* control coexist simultaneously in the Act, without the necessity for specific references to *de facto* and *de jure* control. Therefore, the Crown was entitled to argue that the taxpayer was under both the *de facto* and *de jure* control of L Ltd. The Court first addressed whether L Ltd. had *de facto* control of the taxpayer, and listed the following factors included in the CRA's Interpretation Bulletin IT-64R4: (i) the percentage ownership of voting shares in relation to the holdings of other shareholders; (ii) ownership of a large debt of the corporation which may become payable on demand; (iii) shareholder agreements including the holding of a casting vote; (iv) commercial or contractual relationships of the corporation; (v) possession of a unique expertise that is required to operate the business; and (vi) the influence that one family member involved in the corporation may have over another family member who is a shareholder.

The Court held that L Ltd. exercised significant influence over Lyrtech, and that Lyrtech was economically dependent on L Ltd. The following facts were considered: (i) the same people were directors of both corporations; (ii) expenses were allocated unreasonably between the two corporations; (iii) Lyrtech was dependent on L Ltd. for financing; (iv) L Ltd. stood as surety with respect to Lyrtech's credit facilities; and (v) the two corporations' financial statements were consolidated. In light of this economic dependence and influence, the Court found that L Ltd. controlled Lyrtech "directly or indirectly in any manner whatever" within the meaning of subsections 125(7) and 256(5.1) of the Act, and was therefore not a CCPC.

The Court also considered the Crown's argument that L Ltd. had indirect *de jure* control of the taxpayer pursuant to subparagraph 251(5)(b)(i) and subsection 248(25) of the Act. Subparagraph 251(5)(b)(i) provides that, for the purposes of the definition of a CCPC, where a person has a right under a contract, in equity or otherwise, either immediately or in the future, and either absolutely or contingently, to shares of a corporation or to acquire such shares or to control the voting rights of such shares, the person shall be deemed to have the same position in relation to the control of the corporation as if the person owned the shares. Paragraph 248(25)(a) provides that a person beneficially interested in a trust includes any person who has any right as a beneficiary in a trust, either directly or indirectly through trusts or partnerships. The Crown argued that L Ltd.'s subsidiaries had a future and conditional right to all the shares of Lyrtech because they were the beneficiaries of a trust, FFL, which owned all of Lyrtech's shares.

The Court held that L Ltd.'s subsidiaries did not exercise *de jure* control of Lyrtech because their rights to acquire Lyrtech's shares were contingent on the discretion of the trustees of FFL. According to the Court, "the nature of the beneficial interest of each beneficiary of FFL's capital is too uncertain or indirect to be a right to the [taxpayer's] shares under paragraph 251(5)(b)". The subsidiaries' beneficial interests did not confer any right to acquire the shares of Lyrtech. Therefore, L Ltd. did not exercise indirect *de jure* control of Lyrtech. However, since L Ltd. exercised *de facto* control, Lyrtech was not a CCPC and therefore could not claim the refundable investment tax credits.

8. ***The Queen v. Price Waterhouse Coopers Inc., as Trustee in Bankruptcy for Bioartificial Gel Technologies (Bagtech) Inc.*, 2013 FCA 164**

In this Federal Court of Appeal decision, the Court considered the concept of control and the investment tax credit rate applicable to CCPCs. The Minister concluded that the corporate taxpayer, Bagtech, was not a CCPC, and Bagtech's trustee in bankruptcy objected to the Minister's notices of determination. The majority of Bagtech's shareholders were non-residents; however, there was a unanimous shareholders' agreement ("USA") that gave Bagtech's Canadian resident shareholders the right to elect the majority of its directors.

The Tax Court of Canada held that Bagtech was a CCPC on the basis of paragraph 125(7)(b) of the Act. Paragraph 125(7)(b) provides that a corporation will not be a CCPC if all of its shares that are owned by a non-resident person or by a public corporation were owned by a particular person, the corporation would be controlled by that person. The Tax Court, following ***Duha Printers***, concluded that the analysis of *de jure* control required that the USA be taken into account. Since the power to elect the majority of a corporation's directors confers effective control, and the "particular person" in section 125(7)(b) could not appoint the majority of Bagtech's directors due to the USA, Bagtech was controlled by Canadian residents and was therefore a CCPC. The Federal Court of Appeal upheld the Tax Court's conclusion that Bagtech was a CCPC, and dismissed the Crown's appeal.

E. INDIRECT OWNERSHIP AND LOOK-THROUGH PROVISIONS

The meaning of "owned" is important for the associated corporation rules. For example, the cross-ownership rules apply when shares are owned by a related person. Thus, the Act provides for "look-through" rules that deem a person to own shares.

Pursuant to paragraph 256(1.2)(d) of the Act, where shares of an operating corporation are held by a holding corporation, the shareholder of the holding corporation is treated as owning shares in the operating corporation in proportion to the value of its holdings in the holding corporation. The Act also contains "look-through" provisions for partnerships in paragraph 256(1.2)(e), where each partner is deemed to own shares in proportion to his or her share of the partnership's income or loss.

The "look-through" rule for trusts is found in paragraph 256(1.2)(f), and where a trust owns shares in a corporation, there is a distinction made between different types of trusts. In a testamentary trust, where some beneficiaries are entitled to all income of the trust prior to the death of one or all of them, and no other person is entitled to any capital of the trust before that time, the shares are deemed to be owned by these income beneficiaries before that time. In a discretionary trust, all discretionary beneficiaries are deemed to own the shares. In any other case, each beneficiary is deemed to own a proportion of the shares based on the fair market value of his interest in the trust. In addition, for certain reversionary trusts, the person from whom property of the trust was directly or indirectly received is deemed to own the shares in the corporation.

These provisions greatly extend the previous rules regarding associated corporations and results in many more corporations being deemed to be associated. For all these look-through provisions, the fair market valuations are made without regard to the voting rights of the shares in the corporation.

Furthermore, there is a deeming rule in subsection 256(1.3) of the Act, whereby shares of a corporation owned by a child under 18 years of age are deemed to be owned by a parent of the child. This rule applies only for the purposes of determining whether the corporation is associated with any other corporation controlled by that parent or controlled by a group of persons of which that parent is a member. An exception to this rule is where the child manages the business and affairs of the corporation without a significant degree of influence by the parent.

1. ***The Queen v. Propep Inc.*, 2009 FCA 274**

In this Federal Court of Appeal decision, the issue was whether the corporate taxpayer ("Propep") was associated with two other corporations ("C1" and "C2"), and thus required to share the small business deduction. The voting shares of Propep were owned by 9059-3179 Quebec Inc. ("9059"). All of 9059's voting shares were owned were owned by a trust, and 9059 was the primary beneficiary of the trust. The trustees were two unrelated parties, P and C. The minor son of P ("PM") was the secondary beneficiary of the trust. The two corporations allegedly associated with Propep were controlled by P and his father. Therefore, in determining whether Propep and the two corporations were associated, the Court needed to decide whether PM was a "beneficiary" of the trust. If PM was a beneficiary, then the look-through rules would apply.

The Tax Court of Canada held that PM was not a beneficiary because his interest as the secondary beneficiary did not exist, as 9059 was still in existence at that time and not wound up. Therefore, PM's right as a beneficiary was conditional.

However, the Federal Court of Appeal overturned this decision and held that PM was deemed to own the 9059 shares, as the trustees could have wound up 9059 at any time. In addition, the Federal Court stated that PM was a beneficiary because he had the right to receive the income, even if the right was conditional. Therefore, because P was deemed to own the shares of 9059, as PM was his minor son, Propep (controlled by 9059) and the two corporations controlled by P were associated.

F. OPTIONS OR RIGHTS

Subsection 256(1.4) of the Act applies to rights under contract (e.g., buy-sell agreements), and expands the notion of control for the purposes of the association rules. A person who has a right to acquire shares of a corporation or to control the voting rights of shares of a corporation is treated as being in the same position in relation to the control of the corporation as if the person actually owned the shares. In addition, where a person has a right to cause a corporation to redeem, acquire or cancel any shares of its capital stock owned by other shareholders of the corporation, that person is deemed to be in the same position in relation to the control of the corporation as if the shares were redeemed, acquired or cancelled by the corporation. These deeming provisions apply to any rights under a contract, in equity or otherwise, immediate or in the future, absolute or contingent.

However, there are exceptions for rights contingent on death, bankruptcy or permanent disability of an individual. Also, in terms of buy-sell agreements, while subsection 256(1.4) of the Act may be broad enough to include almost any buy-sell agreement, the CRA has indicated that it will not normally apply the provision solely because of a right of first refusal or a shotgun arrangement contained in a shareholder agreement.

Because of subsection 256(1.4), where a shareholders' agreement provides for a mandatory sale (other than by death, bankruptcy, or permanent disability), one must consider how the association rules may affect other corporations owned by the shareholders.

G. EXCEPTIONS TO ASSOCIATED CORPORATIONS

Subsections 256(3) to (6) of the Act provide for exceptions to the general associated corporations rules.

(i) Subsections 256(3) and 256(6): situations involving an indebtedness or redeemable shares

This is a saving provision that treats associated corporations as not being associated if control is present for the purpose of protecting the interests of the corporation that controls the other corporation in respect of: (i) any indebtedness owing to the controller; or (ii) any redeemable shares owned by the controlled corporation. Additionally, there must be an enforceable agreement that provides for the passing of control, upon the happening of an event that is likely to occur, to a person or group with whom the controller was dealing at arm's length. For example, corporation A makes a loan to corporation B and retains control of corporation B until the loan is recovered.

Subsection 256(6) is similar to 256(3), except that the controlled corporation is deemed not to be controlled by the person who controls the corporation.

(ii) Subsection 256(4): corporations controlled by the same executor, liquidator of a succession or trustee

This saving provision relieves two or more corporations from the association rules if they are controlled by an executor, liquidator, or trustee. However, this does not apply where an individual executor, liquidator or trustee controls one or more

corporations other than as an executor (e.g., if he or she is the owner-manager of a corporation).

(iii) Subsection 256(5): corporation controlled by corporate trustee

Under this provision, if a corporate trustee controls another corporation through a trust, the two corporations are deemed not be associated. However, if a settlor of the trust controls the corporate trustee, then this provision does not apply.

H. ANTI-AVOIDANCE RULE

Previously, the anti-avoidance rule provided the Minister of National Revenue with a discretion to direct that two or more corporations be deemed to be associated where he was satisfied that the separate existence of the corporations was not solely for the purpose of carrying out their business in the most effective manner and that one of the main reasons for their separate existence was to reduce the amount of taxes that would otherwise be payable under the Act.

The associated corporation rules have removed this Ministerial discretion from the anti-avoidance rule. Pursuant to subsection 256(2.1) of the Act, the rules now deem two or more corporations to be associated with each other where it may reasonably be considered that one of the main reasons for their separate existence is to reduce the amount of taxes that would otherwise be payable under the Act or to increase their refundable investment tax credits. For example, the anti-avoidance rule now applies where one of the main reasons for the separate existence of two or more corporations may reasonably be considered to be to duplicate the small business deduction.

In an article by Maureen Donnelly and Allister Young, (1992) CTJ 363, the authors analyzed the case law in this area and concluded that there are three significant factors that will encourage a court to vacate the Minister's decision deeming two corporations to be associated. "Taxpayers who can satisfy the court (i) that they were unaware of the tax advantages of non-association; (ii) that the stated objectives (for example, estate planning, or limitation of liability) were best achieved by the corporate structure in use, and that no alternative structure would work as well; and (iii) that the controlling shareholder of the original corporation did not continue to be the directing mind of the second corporation; will significantly increase their chances for success."

I. CASE LAW REGARDING ANTI-AVOIDANCE RULE

1. *The Queen v. Covertite Ltd.*, 81 DTC 5353

In this Federal Court Trial Division case, the first corporation, which carried on a roofing business, was substantially owned by an individual whose wife was a major shareholder of a second corporation incorporated in another province to carry on the same business. The major source of financing for the second corporation was through the first corporation, which also sold equipment, advanced funds, paid for supplies, executed contracts and supplied a valued employee to the second corporation. The records of both corporations established a significant tax advantage accruing to the first corporation through the existence of the second corporation. The Minister determined that the two corporations were associated and assessed the first corporation on the basis that the second corporation was an extension of the first corporation's operation with the main reason for its existence being to reduce taxes that would otherwise have been payable by the first corporation alone.

The Federal Court held that the evidence given by the individual and his wife, that the second corporation was set up to facilitate the wife's business intentions and change of residence, was not sufficiently convincing to disprove the Minister's contention that the second corporation was established for the main reason of reducing taxes. Without credible facts to substantiate their claim, the statements by the taxpayers amounted to a mere denial of the Minister's conclusion, which was insufficient to allow the Federal Court to vacate Minister's direction.

2. *McAllister v. The Queen*, [1994] F.C.J. No. 788

In this Federal Court Trial Division decision, the Minister disallowed a small business deduction deeming three corporations owned by members of the same family to be associated with each other.

The appeals by the taxpayers to the Tax Court of Canada were dismissed; however, their appeals to the Federal Court were allowed. The Federal Court held that none of the corporations were established for fraudulent purposes. Each corporation was a *bona fide* corporation that invoiced its own customers on its own stationery, paid its own employees from its own bank account and handled its own hiring, firing and accounts receivable. The Federal Court found that the business of the three corporations had started to change after their incorporations, giving the new directing mind of each corporation the ability to make separate management decisions taking

their respective operations in new directions. The main purpose for the separate incorporations was to provide for the succession and independence of the next generation of members of the family. The Federal Court found no evidence that tax planning advantages had been discussed when the separate incorporations were being considered. Therefore, the Federal Court was unable to find that tax considerations were a main purpose behind the incorporations and held that the corporations were not associated.

3. ***Hughes Homes Inc. and Lopa Enterprises Ltd. v. The Queen,* [1997] T.C.J. No. 1003**

In this Tax Court of Canada decision, the corporate taxpayer, H Inc., was a management company incorporated in 1986. A husband and wife each owned 50 per cent of its outstanding shares. H Inc. was carrying on a building business through five other corporations, of which the husband was the directing mind. In September 1989, a separate corporation, L Ltd., was incorporated by the wife, who owned all of its shares to provide design and decorating services to H Inc. On August 24, 1990, the wife reduced her equity in H Inc. from 50 per cent to 10 per cent. The Minister deemed H Inc. and L Ltd. to be associated under the anti-avoidance provisions of subsection 256(2.1) of the Act.

The Tax Court allowed the taxpayer's appeal and vacated the Minister's assessments, holding that none of the principal reasons for the separate existence of H Inc. and L Ltd. was the reduction of tax. The main reasons for L Ltd.'s separate incorporation were to accomplish asset protection and to provide the wife with a separate business entity for the purposes of her own business. Although the wife's share reduction in H Inc. accomplished tax savings, this reduction was merely incidental to the reasons for L Ltd.'s separate existence.

4. ***431543 B.C. Ltd. v. The Queen*, [1999] T.C.J. No. 734**

In this Tax Court of Canada case, three corporations, A, E, and J&N, were denied the full small business deduction because they were found to be associated corporations. A husband and wife were the sole shareholders of E. The wife was the sole shareholder of J&N, until its shares were later transferred to E. In September 1992, the three corporations entered into a reorganization. On August 31, 1992, the husband's mother established a fully discretionary *inter vivos* family trust whose beneficiaries were the minor children of the husband and wife. Following the reorganization, all of A's shares were owned by the husband and by the trust, all of E's shares were owned by

the husband and wife, and all of J&N's shares were owned by E. The Minister denied the full small business deduction for A because it was associated with E and J&N. In addition, the corporations had admitted that they were associated in their 1993 returns and had allocated a portion of their annual business limit to E.

The Tax Court of Canada dismissed the taxpayer's appeal. The Tax Court found that after the reorganization, the husband owned all of the Class A common voting shares of A and the trust owned its Class B common non-voting shares. Since the trust was found to be fully discretionary, the Class B common non-voting shares were deemed by subparagraph 256(1.2)(f)(ii) of the Act to be owned by the beneficiaries. Pursuant to subsection 256(1.3) of the Act, the Class B common non-voting shares were deemed to be owned by the wife, since there was no evidence that either of their children managed the business and affairs of A. As a result, the wife was deemed to own 100% of the issued Class B common non-voting shares of A, and the husband owned 100% of its Class A common voting shares. Therefore, the three corporations were associated pursuant to the provisions of paragraph 256(1)(c) of the Act.

5. ***LJP Sales Agency Inc. v. The Queen*, 2003 TCC 851**

In this Tax Court of Canada decision, the corporate taxpayer, LJP, was wholly owned by a single individual, who also owned 9% of JV Inc.; the other 91% of JV Inc. was owned by the individual's wife. The Minister reassessed LJP's return and deemed the two corporations to be associated because the main reason that the two companies existed as separate entities was to reduce the amount of taxes payable under the Act. The corporate taxpayer appealed the assessment.

The Tax Court allowed the appeal. The Tax Court held that the main reason for the separation of the corporations was to resolve the serious family issues between the husband and wife and not for the benefit of gaining access to a tax advantage. The husband wanted to disinherit their children, and the wife wanted to leave her estate to them. In order to save their marriage, they needed to equally split their accretion of wealth, so they could leave their estates separately as they intended. The Tax Court found that the arrangement would have been implemented even if there had been no tax advantage. The Minister was ordered to reassess on the basis that LJP and JV Inc. were not associated.

6. ***LJP Sales Agency Inc. v. MNR*, 2007 FCA 114**

As discussed above, the corporate taxpayer, LJP, was successful in establishing its entitlement to the small business deduction for 1995 to 1997. While the Minister previously reassessed the taxpayer in accordance to the Tax Court's decision (2004 DTC 2007), it refused to reassess the taxpayer on a similar basis for the 1998 and 1999 taxation years. The time for filing the notice of objection or waiver had expired for LJP, and thus, it applied under subsection 152(4.3) of the Act for an order of mandamus requiring the Minister to reassess for 1998 and 1999 to allow the small business deduction. A prothonotary of the Federal Court dismissed the application, and the taxpayer appealed to the Federal Court of Appeal.

In dismissing the taxpayer's appeal, the Federal Court of Appeal followed ***Sherway Centre Inc. v. Canada***, 2003 DTC 5082, stating that,

> "the Minister has a duty or power under subsection 152(4.3) to reassess beyond the normal limitation period only when the reassessment is reasonably related to a change in the taxpayer's numerical balance in a previous taxation year as a result of a decision on appeal, not to a change in the principles on which the computation was based."

In this case, LJP based its request for reassessment on a Tax Court's decision that allowed the small business deduction for 1995 to 1997. Thus, the Federal Court of Appeal found that the prothonotary appropriately dismissed the application.

7. ***Corpor-Air Inc v. The Queen*, 2006 TCC 75**

In this Tax Court of Canada decision, the sole director and shareholder of the corporate taxpayer was Mrs. P. Mrs. P's husband controlled a group of corporations that had already used up the available small business deduction limit. The Minister disallowed the small business deduction for the corporate taxpayer because he considered the corporate taxpayer to be associated with the group of corporations and found that Mr. P had *de facto* control over the corporate taxpayer. The corporate taxpayer appealed to the Tax Court.

The Tax Court dismissed the taxpayer's appeal and affirmed the Minister's decision. The Tax Court found that Mr. P exercised *de facto* control over the corporate taxpayer within the meaning of subsection 256(5.1) of the Act, even though his wife exercised *de jure* control of the corporation. The Tax Court held that the transactions between the corporate taxpayer and the group of corporations owned by Mr. P were

artificial and carried out with the intention of transferring income to the corporate taxpayer to allow him to take advantage of the small business deduction. Therefore, the corporate taxpayer and the group of corporations were associated.

8. ***Maintenance Euréka Ltée v. Canada*. 2011 TCC 307**

In this Tax Court of Canada case, the two corporate taxpayers, Maintenance Euréka Ltée ("Euréka") and Frontenac Ltée ("Frontenac"), were separately owned by two spouses, Gratien Veilleux ("Veilleux") and Lauréanne Pomerleau ("Pomerleau"), respectively. Their son owned 24% of the common shares of each corporation. The corporations were reassessed on the basis that they were related corporations, and appealed the reassessments. The corporations provided housekeeping and security guard services for institutional and commercial buildings in the same Quebec regions. At times, the corporations provided the same services to the same customers on an alternating basis. The corporations also had the same phone numbers and email addresses, and occupied the same premises. The corporations' employees worked for both corporations and were paid on an alternating basis by the corporations.

Veilleux testified that prior to the incorporation of Frontenac, Pomerleau asked him for a stake in Euréka, which he refused because he wanted to control his business. This caused marital difficulties, and Pomerleau decided to incorporate Frontenac in order to have business assets of her own. Veilleux also claimed that there were commercial reasons for the corporations to be separate entities, stating that one corporation could bid on the other's abandoned contracts, and since the employees performing the work on the new contract would then be entitled to lesser benefits, this increased the corporations' profit margins. The CRA auditor doubted that there was a genuine commercial advantage, as Veilleux did not make any references to such an advantage at the meetings between the parties or in any written representations. On this basis, the CRA auditor determined that the corporations functioned as a single business, and that the main reason for their separate existence was to reduce the income tax otherwise payable by enabling both to claim the small business deduction.

The Tax Court dismissed the taxpayers' appeal. The Court noted that under subsection 256(2.1) of the Act, the reasons for the separate existence of corporations during the taxation year, and not the reasons for which the corporations were initially created, determine whether or not the corporations are associated during the year. The Court found that there were contradictions between Veilleux's testimony and statements he had made prior to trial. While he had stated to the CRA auditor that Pomerleau had merely observed him while he carried out Euréka's business, he stated in court that she had provided him with administrative services that enabled her to acquire the

experience necessary to start her own business. In addition, there were no independent witnesses, such as the corporations' accountant, called by the corporations to corroborate Veilleux's account of Pomerleau's role in Frontenac. The Court held that the alleged commercial reasons were also dubious. In addition, the Court held that the corporations' shareholders must have been aware of the rules regarding associated corporations, as this would explain the fact that the couple's son owned 24% of the shares of each corporation rather than 25%. In general, the Court found that Veilleux and his son were not credible witnesses. Therefore, the Court held that Euréka and Frontenac were associated corporations and dismissed the appeal.

J. CORPORATE PARTNERSHIPS

The anti-avoidance provision in the Act is designed to prevent multiple access by a corporation to the small business deduction through the use of two or more partnerships. The anti-avoidance provision reduces the amount of partnership income that qualifies for the small business deduction in the hands of a corporate partner.

Where a corporation is a member of a partnership and the corporation or an associated corporation is a member of one or more other partnerships, for the purpose of calculating the specified partnership income of the corporation subject to the small business deduction, only the greatest amount of active business income from any single partnership is to be included and the active business income of all other partnerships is deemed to be nil. This limiting provision only applies where it may reasonably be considered that one of the main reasons for the separate existence of the partnerships is to increase the amount of the small business deduction of any corporation.

In addition, there are three provisions dealing with corporate partnerships. Firstly, where a corporation is a member of a partnership, which in turn is a member of another partnership, the corporation is deemed to be a member of the second partnership, and its share of income from the second partnership is deemed to be the amount to which it is directly or indirectly entitled through the chain of partnerships of which it is a member. This provision looks through various levels of partnerships for the purpose of these rules.

Secondly, income of a partnership that is controlled, directly or indirectly in any manner whatever, by any combination of non-resident persons or public corporations at any time in its fiscal year will not qualify for the small business deduction. This provision is designed to treat the income of the partnership the same as if the business were carried on by a corporation, in which case the corporation would not be a Canadian-

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controlled private corporation and its income would therefore not qualify for the small business deduction.

Thirdly, a partnership is deemed to be controlled by non-resident persons or public corporations if their share of the income of the partnership from any source exceeds 50% of the income of the partnership from that source for the fiscal period.

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Please contact Howard Alpert directly at (416) 923-0809 if you require assistance with tax and estate planning matters, tax dispute resolution, tax litigation, corporate-commercial transactions or estate administration.