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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. The amount of active business income which is eligible to be taxed at a lower rate is reduced for corporations which have taxable capital in excess of ten million dollars in the previous taxation year. As of 2016, the combined federal and Ontario small business tax rate was 14.7863% on the first $500,000 of active business income.

Where two or more CCPCs are associated with each other in a taxation year, for the purposes of the Act, the $500,000 annual limit of active business income eligible to be taxed at a lower rate must be allocated between the associated corporations. As such, the rules outlining when two or more corporations are considered associated are important for determining the entitlement of a CCPC to the small business deduction and certain other tax credits. The general intent of these rules is to restrict taxpayers from splitting a corporation for the purpose of gaining access to multiple small business deductions.

## B. BASIC RULES CONCERNING ASSOCIATED CORPORATIONS

One corporation is considered associated with another in a taxation year if at any point during that year any of the following circumstances apply:

(i) one corporation is controlled by the other, directly or indirectly in any manner whatever (Paragraph 256(1)(a) of the Act);

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

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(iii) 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) (Paragraph 256(1)(c) of the Act);

(iv) 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% (Paragraph 256(1)(d) of the Act);

(v) both corporations are controlled by two related groups of persons, where each of the members of one group is related to every member of the other group, and there is cross-ownership of not less than 25% (Paragraph 256(1)(e) of the Act); or

(vi) both corporations are associated with the same CCPC under the above rules and the CCPC with which they are both associated has not filed an election to not receive the small business deduction (Subsection 256(2) of the Act).

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 provide the circumstances under which corporations will be held to be associated with one another. These 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 types of control which may apply.

### (i) *De Jure* Control

If reference to control of a corporation in the Act is not accompanied by the words "directly or indirectly in any manner whatever", then "control" means *de jure* control, which is also known as legal control. De jure control exists where 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. This test was confirmed by the Supreme Court of Canada in ***Duha Printers (Western) Ltd. v. The Queen***, [1998] 1 S.C.R. 795.

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

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 a corporation, (i.e. "de facto control") they are deemed to control that corporation. References in the Act to a corporation being controlled "directly or indirectly in any manner whatever," extend the concept of control to as defined in the Act to forms of de facto or factual control.

The CRA has provided insight into some general factors that may be used to determine whether *de facto* control exists in CRA IT-64R4. These factors include:

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(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.

In exceptional circumstances, laid out in the Act, influence does not necessarily translate into control. For example, pursuant to subsection 256(5.1), a person may have influence over a corporation because of a legal arrangement such as a franchise, license, or lease agreement but will not be considered to control that corporation 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.

Subsection 256(5.1) of the Act was amended by the 2017 Federal Budget, effective for taxation years that begin on or after March 22, 2017, to include that the determination of such control must consider all factors that are relevant in the circumstances and will not be limited to whether the controlling person has a legally enforceable right or ability to effect a change in the board of directors or the board's powers. In fact, such a legal ability is not required at all for de facto control. A potential influence, even if it is not exercised, may be sufficient to result in de facto control.

This amendment effectively overturns the recent 2016 Federal Court of Appeal decision in ***McGillivray Restaurant Ltd v. R,* 2016 FCA 99.** In that case, the Federal Court of Appeal held that de facto control is found where the controlling party has the right or ability to exert substantial control over the board of directors or the powers they possess. The Court also held that this analysis was concerned only with control of the

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board of directors, not the day to day operation of the corporation. Under the 2017 Budget amendment, such a narrow definition of de facto control no longer exists.

**(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. 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

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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.

## E. <u>OPTIONS OR RIGHTS</u>

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) of the Act, 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.

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## F. 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.

## G. 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.

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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."

## H. 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.

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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-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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