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Your Guide to Tax-Saving Strategies

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***For shareholders of family owned businesses,
it's important to avoid ...***

Tax traps

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Those of you who happen to own shares in a private corporation, especially a family owned business should be aware of a couple common tax traps to avoid. Owner managers are usually extremely busy running their business. Sometimes it's hard to step back and make sure the corporate ownership doesn't bring about its own slew of issues.

As you may be aware, carrying on a business through a corporation offers up certain tax advantages, notably access to the small business deduction for Canadian corporations. If a Canadian controlled corporation (let's call it "Opco") carries on an "active business" in Canada, it will be entitled to get the small business deduction tax rate on its first \$500,000 of income. While the

regular corporation tax rate (in Ontario) is currently 26.5 per cent, the small business rate is only 15.5 per cent on the first \$500,000 of income. This means that access to the small business deduction can be a very important tool for many corporate taxpayers.

What constitutes an "active business"? Under the Income Tax Act (Canada), an active business is essentially any business that is not a "specified investment business" (i.e., a company that earns passive / investment income from property) or is not a "personal services business" (i.e., if an employee-employer relationship would exist in respect of services provided by the shareholder to a third party, but for the existence of the company).

Association trap

One limitation on accessing the small business deduction is that you cannot incorporate multiple companies with

the same ownership group in order to multiply the small business deduction. In fact, the Tax Act provides that if two or more companies are "associated," then these companies must share the \$500,000 threshold for claiming the small business deduction.

There is a long list of rules under the Tax Act which determines when two or more companies will be associated. As a high level summary, without getting into all the complexities and variations, some of these rules state that two or more companies will be associated if one is controlled by another or if they are controlled by the same person or group of persons (directly or indirectly). Note: These examples are only a couple in a longer list of situations.

One scenario of note that would result in companies being associated would be where one company ("Company 1") was controlled by one person ("A") and A was related to another person ("B") who controlled a second company ("Company 2") AND A owned at least a 25 per cent interest in any class of shares of Company B (or if B owned at least a 25 per cent interest in any class of shares of Company A).

If that sounds a bit confusing, wait till we get to the next part. On top of the long list of rules for association, the Tax Act also includes certain deeming rules when it comes to own-

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ership, including where there are other agreements in place giving a person a contingent or potential right to acquire shares in a company. But for the purposes of this article, I'm going to focus on a specific set of rules that deem ownership in the context of trusts and among family members and how these rules can trip up the unwary taxpayer.

How an 'estate freeze' can trigger an association trap ...

A common estate planning tool for family owned business is the estate freeze. Usually, this would involve the owner freezing his or her economic interest in Opco and issuing new growth shares to a family trust for the benefit of his or her children (therefore limiting the owner's eventual death tax and passing on tax on any future growth in the company to the next generation). However, such a common estate plan can inadvertently result in association between corporations that might otherwise be entitled to claim a separate small business deduction from one another.

Assume, for example, that husband and wife wholly own respective corporations that are each claiming a small business deduction (this works because there is no 25 per cent cross ownership by the husband or wife in the other's company). The husband decides to do a freeze of Opco in favour of his minor children—this results in new growth shares held by a discretionary family trust for the benefit of his minor children. For such a trust, under the Tax Act, each beneficiary of a trust is deemed to own all of the shares owned by the trust, with

ownership of shares owned by a child under 18 years of age normally deemed to be owned by the parents. Accordingly, the wife will be deemed to own all of the new growth shares of the husband's company by virtue of the fact that her minor children are beneficiaries of the trust that owns such growth shares.

... with good intentions leading to cross ownership

What does this mean? Well, now you have cross ownership (the wife is deemed to own shares in Opco through the trust). Therefore both Opco and the wife's company will be associated such that the two companies are now going to have to share the small business deduction (or share the \$500,000 threshold of income).

Further complications to be aware of

Let's then take this example one step further. Assume that of the child beneficiaries, two are minors and one is an adult. The adult child then forms his own corporation ("Childco"), which would be entitled to the small business deduction. Since the adult child is deemed to own all of the common shares of Opco through the trust, but also owns all of the shares of Childco, Opco will also be associated with Childco. Moreover, since the wife is still deemed to own all of the common shares of Opco because of the two other minor children, the wife's company, Opco and Childco will all be associated and will all have to share the \$500,000 small business deduction.

There are ways to plan around this unintended result;

however, this requires some tax planning prior to any implementation of the estate freeze to ensure that the association rules are not tripped over.

Note: A number of other tax benefits are restricted based on the association rules, one example being the enriched investment tax credit in respect of scientific research and experimental development expenditures available to a Canadian controlled private corporation.

Corporate attribution rules

Another tax trap for family owned corporations revolves around the corporation attribution rules. These rules provide that where an individual ("Mr. X") has transferred or loaned property to a corporation either directly or indirectly by means of a trust or any other means ...

- and where one of main purposes of the transfer or loan was to reduce income and benefit a "designated person" in respect of Mr. X (note: a "designated person" is someone's spouse, or minor child, minor niece or nephew or a minor grandchild); and

- that designated person is a "specified shareholder" of the company (i.e., who owns directly or indirectly 10 per cent of more of the issued shares of any class at any time);

... then Mr. X will be subject to a tax based on a deemed interest component based on the amount of the transferred / loaned property.

Another potential trap: corporate reorganization and an estate freeze

Although it may seem simple enough to steer clear of these

rules by not making any transfer or loan as noted above, it is still quite easy to trip into these rules by implementing a common estate freeze. How? Well, you should keep in mind that a corporate reorganization can be classified as a transfer; e.g., where shares are transferred to a holding company, or exchanged for other shares of the company, which is a common way to implement an estate freeze. Therefore, the corporate attribution rules can apply both to estate freezes which involve transfers to holding companies as well as those involving a direct reorganization of the capital of the corporation itself.

Another example of these rules kicking in is as follows: A company (call it "Smallco") has for its shareholders father, mother and a family trust for the benefit of the minor children. The father decides to loan money to Smallco on an interest-free basis (this is commonly done). By transferring the cash to Smallco, the father has reduced his potential investment income (i.e., income he would have earned had he kept

the cash in his own hands), and that potential income (now earned by Smallco) will accrue to the family member shareholders, being the spouse and minor children, thus triggering the corporate attribution rules.

Corporate attribution rules: two exceptions and the traps these may lead to

But like any tax rule, there are certain exceptions to the application of the corporate attribution rules:

- A company must be deemed a "small business corporation" throughout the taxation year, at all times (meaning: Canadian controlled, with 90 per cent or more of the fair market value of its assets being used more than 50 per cent in an active business in Canada). The trouble is that if a significant portion of the corporation's asset base is in the form of investments rather than in respect of business activities, the small business corporation exception may no longer apply, until such time as small business corporation status is restored. (Strategies can be devised to continually jettison non-qualifying assets on a

tax-efficient basis.)

- Including an anti-attribution clause in the family trust that would prevent distributions to the spouse or minor children may seem a good idea. However, this would then prevent access to certain other tax advantages, such as the capital gains exemptions for minors. Moreover, it does not protect against a spouse who owns shares directly in the company.

Consult your tax advisor

However, before relying on any of these exceptions, I would caution you to get the appropriate tax advice from your advisor to ensure that the particular exception is one that will apply, and is practical in light of your fact scenario.

The above are just a couple of tax traps to be aware of when implementing any corporate transaction, whether it be an estate plan or simply the setting up of a family business as a start-up. At the end of the day, the best tip I can give you is to speak to your tax advisor to ensure you don't start your new venture off on the wrong note. □