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Your Guide to Tax-Saving Strategies

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Tax Traps For Family Owned Businesses

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My December article tends to summarize some end of year tax planning tips. However, since I wrote about some in last month's article, I thought about a different end of year gift for my readers. And it comes in the form of an end-of-year warning. For those of you who happen to own shares in a private corporation, especially a family owned business, then you should be aware of a couple of common tax traps to avoid. Owner-managers are usually so busy running their business, that sometimes it's hard to step back and make sure that the corporate ownership doesn't bring about its own slew of issues. So, before you run

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straight into 2019, take a moment, have a cup of eggnog, and consider your corporate structure to make sure it's all in good order for the start of the new year.

Association Trap

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 ("Opco") carries on an "active business" in Canada, Opco 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%, the small business rate is only 13.5% 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).

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, and 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) (these examples are only a couple in a longer list situations). One sce-

nario of note that would result in companies being associated is where one company ("Company 1") is 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 ownership, including where there are other agreements in place giving a person a contingent or potential right to acquire shares in a company. But for 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 the unwary taxpayer.

A common estate-planning tool for a family-owned business is the estate freeze, which I have written about before. Usually, this would involve the owner freezing his economic interest in Opco and issuing new growth shares to a family trust for the benefit of his 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 each own 100

per cent of their own company, and each company claims the small business deduction (this works because there is no 25 per cent cross ownership by the husband or wife in the other's company.) Husband decides to do an estate freeze Opco (which is originally owned only by him) in favour of his minor children (and excluding his wife) – 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. This means 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, which owns such growth shares. And it does not matter that she is not an actual named beneficiary. So what does this all mean? Well, now you have cross ownership by the wife in both companies (the wife is deemed to own the 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.)

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. For most of 2018, all the talk has been around the TOSI rules (Tax On Split Income) that came into effect in 2018. But we should not forget about the original corporate anti-income splitting rules, which have been in effect for a long time now, and which continue to be applicable (in addition to the TOSI rules). The corporate attribution 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; and

β **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% or 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.

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: The shareholders of the company include the father, mother and a family trust for the benefit of the minor children. Father decides to loan money to Opco on an interest free basis (this is commonly done). By transferring the cash to Opco, 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 Opco) will accrue to the family member shareholders, being the spouse and minor children, thus triggering the corporate attribution rules.

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

→ If a company is 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 the 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. 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.

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 transactions, whether it be an estate plan or simply setting up 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. □