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# Vern Krishna: Family businesses should heed the rules on associated corporations

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Tax incentives for small business are an important part of the Canadian tax system, and the April 2015 federal budget will enhance their attraction even further in the next four years.

But you have to be careful. There are some swamps that can capture family businesses, such as the rules on associated corporations.

Of course, commercial lawyers can arrange business corporate structures to minimize taxes, facilitate income splitting, defer taxes, and prepare for tax-free capital gains. The tax rules might be generous, but the anti-avoidance provisions dealing with the reality of corporate management need to be carefully watched.

Let’s look at those associated corporation rules.

The low business tax rate of 11 per cent is confined to “Canadian-controlled private corporations” that earn “active business income” in Canada. The rate is available on a maximum of $500,000 per year. Assuming a provincial tax rate of approximately 4 per cent, the total rate of tax is 15 per cent. The federal government is planning to drop the rate by a further two percentage points over the next four years.

Given the upper limit of $500,000, lawyers may be tempted to create several corporations in order to multiply the value of the small business deduction. But the tax rules are a step ahead. The Income Tax Act limits “associated corporations” to $500,000 in total in any year. Associated corporations are corporations that are controlled by the same person or group of persons. The trap is that “control” means both legal (de jure) and factual (de facto) control.

We generally determine de jure control by shareholder voting rights — “ownership of such a number of shares as carries with it the right to a majority of the votes in the election of the board of directors.” In the simplest case, this would require the ability to control 50 per cent plus one of shareholder voting rights. We can also have corporate control by virtue of special voting rights, such as shareholder power to wind up a corporation and appropriate most of its assets.

Directors might legally manage a corporation, but shareholders with majority votes have indirect control through their ability to elect a company’s board of directors. Thus, in tax law, the majority shareholders, not the directors per se, effectively control the corporation.

The Income Tax Act expands the definition of effective control to include direct or indirect influence over critical decisions. Where a person or group of persons has the ability to affect significant corporate changes, they have factual or de facto control.

There is no exhaustive list of factors that determine the existence of de facto control. Each case must proceed on its own facts. That said, it’s possible to see which way the law might tip. The determinative principle is whether a person or group of persons has the clear right and ability to change the board of directors of the corporation, or influence in a very direct way the shareholders who would otherwise have the ability to elect the board of directors. Thus, we need to examine external agreements, shareholder resolutions, power to change the board of directors and shareholders’ agreements that enable influence over the composition of the board of directors.

A recent decision of the Tax Court called McGillivray Restaurant Ltd. v. The Queen illustrates some of the corporate association factors that the courts will examine.

A husband and wife owned a Keg franchise in Winnipeg. The wife, Ruth, owned 76 per cent of the shares. Her husband, Gordon, owned the remaining 24 per cent, and was president and secretary of the corporation. Gordon also owned two other franchised restaurants. One of these other restaurants was landlord for the corporate taxpayer in the case. The other provided the taxpayer with financing and management services. Gordon was also operations director and general manager for all three restaurants.

In determining that the three corporations were associated, the court went beyond the shareholdings to see who, in fact, controlled the restaurants. Here are just a few of the things the court considered:

- Gordon was the sole director, president, secretary, operations director and general manager of all three restaurants, including the corporate taxpayer
- Ruth and Gordon were not at arm’s length
- The general manager of the corporate taxpayer reported to Gordon, who did not need his wife’s approval to make any decisions
- Gordon alone had experience running the restaurants

In these circumstances, the court held the three corporations to be factually associated and, collectively, entitled to only one small business deduction in each year.

Small business corporations offer substantial tax advantages for tax planning. The small business tax rate is generous and, in the next four years, will become even more so.

Commercial lawyers, however, must avoid quixotic illusions that the anti-avoidance rules can look through. The devil is in the details of how family corporations are actually managed.

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