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*TAX*PLANNING

Putting any corporate transaction in place can have consequences. Here are some...

Tax traps to avoid

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I thought I would start the new year off right by offering up some tips for *Taxletter* readers who wish to avoid tax traps when putting certain corporate structures in place.

Association Trap

You may be aware that carrying on a business through a corporation offers up certain tax advantages, most notably access to the small business deduction for Canadian corporations.

If a Canadian controlled corporation carries on an "active business" in Canada (referred to as an operating company, or Opco), it will be entitled to get the small business deduction tax rate on its first $500,000 of income.

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The regular corporation tax rate (in Ontario) is averaged out at 26.25 per cent for 2012. However, the small business rate is only 15.5 per cent on the first $500,000 of income.

This means that the small business deduction can be a very important tool for many corporate taxpayers.

And 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 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 deduction.

There is a long list of rules under the Tax Act which determines when two or more companies are associated. As a high-level summary, 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, this summary is by no means exhaustive).

For example, one scenario 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 2 (or vice versa).

If that sounds confusing, wait until I get to the next part.

On top of the long list of rules for association, the Tax Act also includes certain deeming rules that apply to ownership of shares – for example, where there is an agreement 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 in the course of general estate planning, and how these rules can trip the unwary taxpayer.

The Estate Freeze – An Example

A common estate planning tool for family-owned businesses is the estate freeze.

Usually an owner freezes his interest in Opco and issues new growth shares to a family trust for the benefit of his children.

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 a husband and wife wholly own respective corporations and 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. He changes his common shares into freeze shares, with new growth shares now being held by a discretionary family trust for the benefit of his minor children.

A number of other tax benefits are restricted based on the association rules

Under the Tax Act, each beneficiary of a discretionary trust is deemed to own all of the shares owned by the trust, with ownership of shares by a child under 18 years of age normally attributed to each of the parents.

Accordingly, in this example, the wife will be deemed to own all of the growth shares of the husband's company since her minor children are beneficiaries of the discretionary trust.

What does this mean? Since the husband controls Opco, and all of the common shares are deemed to be owned by the wife, then both Opco and the wife's company ("Wifeco") will be associated. Consequently, these two companies must now share the small business deduction.

Now let's take this example one step further. Assume that the child beneficiaries include two minors and a child over the age of 18. The adult child 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 Opco common shares through her other minor children, Wifeco and Opco continue to be associated. So the end result is that the $500,000 small business deduction now has to be shared among Opco, Childco and Wifeco.

There are ways to plan around this unintended result. However, this requires some tax planning prior to any implementation of an estate freeze to ensure that the association rules are not tripped over.

It's important to note that a number of other tax benefits are restricted based on the association rules. One example is the enriched investment tax credit regarding scientific research and experimental development expenditures available to a Canadian controlled private corporation.

Corporate Attribution Rules

Another tax trap for family owned corporations involves 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 the main purposes of the transfer or loan is to reduce the income and benefit of a "designated person" in respect of Mr. X (Note: a "designated person" is someone's spouse, or child, niece, nephew or other non-arm's length person who will not reach the age of 18 in that year.); and;

✓ the designated person is a "specified shareholder" of the company; that is, one who owns directly or indirectly 10 per cent of more of the issued shares of any class at any time; then such income (in this particular case) will be attributed to Mr. X for tax purposes rather than being taxed in the hands of the lower tax bracket person.

Although it may seem simple enough to steer clear of these rules by not making any transfers or loans as noted above, it is still quite easy to trip into these rules by implementing a common estate plan. How? Well, keep in mind that a corporate reorganization can be classified as a transfer, which is where shares are transferred to a holding company, or exchanged for other shares of the company, which is a required transaction in any 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 in the corporation itself.

But more important, these rules can be tripped over during any simple transaction with a family business corporation.

Here's an example: a company's ("Opco") shareholders are a father, mother and a family trust for the benefit of the minor children. The father decides to transfer cash to Opco by way of an interest-free loan. By transferring the cash to Opco, the father has reduced his investment income (income he would have earned if he kept the cash in his own hands).

And as that income (now earned by Opco) accrues to the family member shareholders, the transfer of that cash will benefit the family members, being the spouse and minor children, thus triggering the corporate attribution rules.

Additionally, the "derivative transfer" rules may extend the application of the corporate attribution rules.

These rules potentially apply when an individual has, first, transferred or lent property to his corporation and that property (or substituted property) is in turn transferred by the corporation to another corporation in which family members who are "designated persons" are significant shareholders.

As long as the property in the first corporation (or substituted property) ends up in the transferee corporation, these rules can potentially be applicable – even if the second transfer takes place years after the first transfer and is completely independent thereof.

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.

This means it is Canadian controlled, with all or substantially all (equal to 90 per cent or more) of the fair market value of its assets being used principally (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 used in investment rather than business activities, the small business corporation exception may no longer apply, until such time as that status is restored. (Note: 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 designated persons.

However, this would then prevent access to certain other tax advantages, like the capital gains exemptions for minors. Moreover, it does not protect against a spouse who owns shares directly in the company.

✓ Loan for value strategy. I've discussed this in previous articles, whereby the parent makes a loan to the company with interest at the prescribed rate as fixed by CanRev.

In order for this strategy to work, however, interest must be paid each year by the company before January 31.

However, before relying on any of these exceptions, I recommend 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 own situation.

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 the new year off on the wrong foot. ❑