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Introduction: The Corporation as a Person in Tax Law

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I. Introduction

A. What Is a Corporation and What Is a Shareholder?

The term "corporation" is sometimes used loosely and in different ways by lawyers, accountants, and business people, so a short history lesson may be useful. The modern corporation arose out of a form of organization in England called a "joint-stock company," which had "members" and was recognized as a partnership rather than as a corporation.

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Even now in some Canadian jurisdictions, the term “members” is used to refer to shareholders. By the late 1800s, through a series of statutory changes, companies were given the status of separate legal entities with limited liability for their members. The separate-entity principle also became well established in Canadian law during that period. There are many implications that follow from a corporation being a separate legal entity, including the right of the corporation to enter into contracts, the right to sue and be sued, and the transferability of interests in the corporation. In addition, “[i]t is a basic rule of company law that shareholders do not own the assets of the company,”[1] although express lookthrough rules set out in the Income Tax Act may apply,[2] and in some circumstances the “corporate veil” may be pierced, as discussed elsewhere in this chapter and book.

Since this book is about the taxation of corporations and their shareholders, it seems appropriate to begin with definitions of both of these terms. Unfortunately, the statutory definitions in the Act are unhelpful. Subsection 248(1) defines a “corporation” as including an incorporated company, but “company” is not defined, and the use of the word “includes” indicates that the definition is not exhaustive. The Act largely leaves the question to the general law. In light of the historical development of corporate law, the term “corporation” generally refers to an artificial person existing in the eyes of the law, which in Canada is usually created by way of incorporation under a federal, provincial, or territorial statute.

For an entity organized in a foreign jurisdiction, where the rules may be significantly different from Canada’s, the entity may be classified as a corporation for Canadian income tax purposes[3] depending on its characteristics, taking into account foreign law and the entity’s constating documents, then comparing those characteristics with those of entities recognized as corporations in Canadian law.[4] While this may sound straightforward in theory, difficulties often arise in attempting to classify a particular foreign entity, especially where there is a mixture of elements that we associate with corporations, partnerships, trusts, and other business vehicles. Some of the challenges in classifying a foreign entity as a corporation are discussed in more detail later in this chapter.

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1 *Envision Credit Union v. Canada*, 2013 SCC 48, at paragraph 57. This is not a new concept, by any means. See, for example, the concurring reasons of Cartwright J in *Army & Navy Department Stores Ltd. v. Minister of National Revenue*, [1953] 2 SCR 496, at 511.

2 *Envision*, supra note 1, at paragraph 57: “see, e.g., the s. 256(1.2) look-through rules that deem shares (property) owned by a corporation to be controlled by the shareholders of the corporation.” Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as “the Act”). Unless otherwise stated, statutory references in this chapter are to the Act.

3 The Canada Revenue Agency’s (CRA’s) historical and somewhat rigid views were set out in *Interpretation Bulletin* IT-343R (Archived), “Meaning of the Term Corporation,” September 26, 1977. For further reading on entity classification, see Ian Crosbie, “Entity Classification: Some Common Sense” (2011) 17:3 *Corporate Finance* 1-20; Marc Darmo, “Characterization of Foreign Business Associations,” International Tax Planning feature (2005) 53:2 *Canadian Tax Journal* 481-505; and Michael N. Kandev and Sandra Slaats, “Recent Developments in the Foreign Affiliate Area,” in *Report of Proceedings of the Sixty-Seventh Tax Conference*, 2015 Conference Report (Toronto: Canadian Tax Foundation, 2016), 31:1-43.

4 CRA document no. 2018-0749481C6, May 16, 2018.

Subsection 248(1) expands the definition of "shareholder" to include a "member"[5] or other person who is entitled to receive the payment of a dividend.[6] "Dividend" is in turn defined, in a manner that is less than helpful, simply to include a stock dividend (other than a stock dividend that is paid to a corporation or to a mutual fund trust by a non-resident corporation). In the absence of comprehensive definitions of the fundamental terms "corporation" and "shareholder," it is necessary to look in more detail to the general corporate law.[7]

B. Corporations

Corporations are legal fictions, deemed by statute to exist in order to induce business people to carry on business activities that they would not otherwise carry on if they bore personal liability for the activities. As a matter of tax policy, there is no inherent or obvious reason why a corporation, having no material existence, should have to pay income tax. The Act could, for example, allow a corporation to elect to be treated as a partnership among its shareholders, as is done in the United States by means of limited liability companies, S corporations, and unlimited liability companies. This approach could potentially be justifiable from a policy perspective: arguably, only the people who are the shareholders of corporations suffer any economic burden because of the imposition of corporate income tax. Furthermore, taxing corporations requires the Act to provide a number of complex mechanisms whose purpose is to facilitate integration—that is, to help ensure that the corporation and its shareholders do not together pay significantly more (or less) tax than the shareholders would have paid if they carried on the corporation's activities personally.[8]

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5 The use of the term "member" in the Act hearkens back to the use of that term in the 1800s when the corporation was still in its formative stage, although the term is still used in some Canadian statutes. In CRA document no. 2011-0415831E5, November 17, 2011, the CRA stated: "The federal and provincial not-for-profit acts and other equivalent provincial legislation that we have consulted refer to the persons who have an interest in a society as 'members' of that society and prevent the incorporated society from distributing profits or property to such members. . . . [O]ur view is that a member of a society incorporated or continued under the Canada Not-for-profit Corporations Act, under Part II of the Canada Corporations Act, under a provincial societies Act or equivalent provincial legislation would generally be considered a shareholder under subsection 248(1), and therefore subject to the application of subsection 15(1) of the Act, notwithstanding that the society or corporation is prohibited from paying dividends to its members."

6 Because the definition focuses on the right to receive a dividend rather than on the ownership of a share, a person may be a shareholder even if she no longer owns any shares. (See CRA document no. 2002-0143945, September 20, 2002, which affirmed that a person who is entitled to receive a dividend, but who no longer owns shares at the time the dividend is received, is a "shareholder" for the purposes of subsection 83(2).)

7 *Will-Kare Paving & Contracting Ltd. v. Canada*, 2000 SCC 36, at paragraph 30.

8 For example, the capital dividend account rules in subsection 83(2) and the penalty backup in part III could all be eliminated if Canada did not tax corporations.

C. Corporations and Legal Personality

A corporation is deemed by statute to be a person that is distinct from the persons who own it or caused it to be created. As discussed further below, the separate existence of a corporation means that although shareholders are owners of the corporation, they do not own its assets, and management and control of a corporation is exercised by officers and directors: in this regard, ownership of property is segregated from control of the property.[9] It has been said that the separation of corporate ownership from control created a basis for fundamental corporate-law principles, including the fiduciary duty of officers and directors and the principle that shares within the same class must be dealt with even-handedly—which are principles that originated to protect shareholder interests.[10]

As a separate person, a corporation may be sued for contractual or other liabilities that it incurs. More importantly, the persons who hold shares in the corporation may not be sued for the liabilities of the corporation to the extent that they are protected from liability by statute, except in unusual circumstances (see the discussion of piercing the corporate veil in chapter 21, "Tax Planning and Tax Avoidance"). Thus, a corporation not only has a legal personality that is distinct from the personalities of its creators, owners, and managers, but it also has a liability profile that is distinct from the profiles of its creators, owners, and managers, and it is this latter characteristic of a corporation that provides the real impetus for its creation. Without limited liability, there would generally be fewer reasons to create a corporation: a partnership or a joint venture may suffice. A corporation's distinct existence and the limited liability of its shareholders are often referred to as the "corporate veil," while attempts to sue or affect the shareholders of the corporation are known as trying to "pierce the corporate veil."

II. The Nature of the Corporate Personality

A. Legal Personality

Incorporation in Canada generally creates a separate legal person. The essential characteristic of a legal person is the capacity to enforce legal rights and to assume legal duties.[11] For non-tax purposes, the word "person" in a statute includes both an individual (a human being or natural person) and an artificial entity (a corporation).[12]

Subsection 248(1) defines a "person" to include any corporation. Under subsection 248(1), a taxpayer includes any person, whether or not the person is liable to pay tax. Therefore, both "taxpayer" and "person" include a corporation. Some taxpayers have espoused a doctrine that attempts to distinguish between a "natural person" and a "statutory

9 *McClurg v. Canada*, [1990] 3 SCR 1020, at 1056.

10 Ibid., at paragraphs 62 through 64.

11 *Saskatoon Real Estate Board v. Saskatoon* (1988), 61 Sask. R. 215 (CA). This case has continued to be relied on, including in recent years: see *Elbow River Marketing Limited Partnership v. Canada Clean Fuels Inc.*, 2012 ABQB 277; and *Branco v. American Home Assurance Company*, 2013 SKQB 98.

12 Interpretation Act, RSC 1985, c. I-21, as amended, section 35: "'person,' or any word or expression descriptive of a person, includes a corporation."

person" together with the view that a natural person is exempt from income tax. There is no validity to this doctrine, and section 2 of the Act makes no distinction between the types or capacities of persons. As a result, both human beings and corporations resident in Canada have been held liable to pay Canadian income tax.[13]

B. Corporate Personality

Because legal personality depends on capacity, and because statutes generally confer on corporations the capacity of a natural person, it follows that a corporation can enter into valid and enforceable legal relationships with its shareholders, employees, or subsidiaries.[14] Thus, shareholders can enter into contracts of employment with, make valid loans to, or borrow funds from their own corporations.

In the leading case, *Salomon v. Salomon & Co. Ltd.*,[15] the House of Lords established that a corporation is a distinct legal entity from its controlling shareholder. Aron Salomon had carried on business as a sole proprietor. To expand the business and give his children interests in it, he transferred it to a company that he had incorporated.[16] He sold the business to the corporation at a price of £39,000; the corporation paid £9,000 cash and issued 20,000 fully paid £1 shares and £10,000 in debenture loans secured on its assets. The business failed. The corporation became insolvent and went into liquidation. Salomon wanted to enforce the debentures in the liquidation because, if they were enforceable, he would rank as a secured creditor and could collect the unpaid principal and arrears of interest ahead of the ordinary trade creditors. To protect their claims, the creditors contended that because Salomon was responsible for forming and operating the corporation, he should be prohibited from enforcing the debentures and instead be made personally liable for the corporation's debts.

The House of Lords decided both questions in Salomon's favour. Because Salomon had complied with the formal incorporation requirements, his corporation was a distinct legal person. A controlling shareholder could also be a debenture holder in his own corporation. The corporation's debts were its own, and Salomon was not personally liable to pay them. Although Salomon dominated the corporation, the House of Lords held that this "one-man company" was not an abuse of the right of incorporation:

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13 *R v. Klundert*, 2008 ONCA 767, at paragraph 19.

14 See the cases cited in note 11, supra.

15 [1897] AC 22 (HL). In the United Kingdom, only individuals and partnerships can become bankrupt. Insolvent corporations are put into liquidation. In Canada, insolvent corporations can be put into bankruptcy. In bankruptcy, a shareholder such as Salomon would be prevented from enforcing debentures and would not rank as a secured creditor: Bankruptcy and Insolvency Act, RSC 1985, c. B-3, as amended, section 139; *Sukloff v. A.H. Rushforth & Co. Ltd. et al.*, [1964] SCR 459; *Ghassemvand v. Premium Weatherstripping Inc.*, 2017 BCCA 309; and *Installations Doorcorp inc./Doorcorp Installations Inc. (Syndic d')*, 2012 QCCA 702.

16 In Canada, a sale of business assets by a sole proprietor to his own corporation is a sale between legal persons and must comply with provincial bulk sales legislation: *Thomson v. Nelson* (1913), 11 DLR 851 (BCSC).

> It has become the fashion to call companies of this class "one man companies." That is a taking nickname, but it does not help much in the way of argument. If it is intended to convey the meaning that a company which is under the absolute control of one person is not a company legally incorporated, although the requirements of the Act of 1862 [the Companies Act] may have been complied with, it is inaccurate and misleading: if it merely means that there is a predominant partner possessing an overwhelming influence and entitled practically to the whole of the profits, there is nothing in that that I can see contrary to the true intention of the Act of 1862, or against public policy, or detrimental to the interests of creditors.[17]

The rule[18] in *Salomon* remains the cornerstone of corporate law and taxation.[19] Because this principle is so fundamental, the courts assume that those who transact business with a corporation are aware that they are dealing with a legal entity.[20] Even if a corporation is managed or controlled by one person or a few closely related persons, it is separate and distinct from its shareholders and operators.[21]

Another leading case, *Lee v. Lee's Air Farming Ltd.*,[22] illustrates that a one-person corporation can contract with the individual by whom it is dominated. Geoffrey Woodhouse Lee incorporated Lee's Air Farming Ltd.; he was its only real shareholder and its sole governing director. The corporation employed Lee as its chief pilot. It had purchased insurance on its employees' lives. When Lee was killed in a plane crash, the insurer refused to pay the policy proceeds on the basis that no contract of employment existed between Lee and the corporation because they were not distinct persons. However, the Privy Council held that the insurer was liable on the policy because a corporation and its only shareholder can contract with each other, and Lee and his corporation had done so. Therefore, Lee was an employee of his own corporation.

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17 *Salomon*, supra note 15, at 53.

18 The rule refers to the recognition of the corporation as a separate person. It is often forgotten that the court decided a second aspect of the case, which might be known as the second rule. It was argued that the principal sold his business to the corporation at an inflated price and that this created a fraud on the corporation sufficient to undo the sale. However, the court noted that all of the shareholders had been aware of the true value of the business and yet had agreed to the sale, so there could not be a fraud. Thus, the court identified the corporation with its shareholders for this purpose.

19 *Port Coquitlam Building Supplies Ltd. v. 494743 BC Ltd.*, 2018 BCSC 2146; *Meredith v. Canada (Attorney General)*, 2002 FCA 258; *Balstone Farms Ltd. v. Minister of National Revenue*, [1967] 2 Ex. CR 217; and *McClurg*, supra note 9, at paragraph 60.

20 *Imperial Oil Ltd. v. C & G Holdings Ltd.*, 1989 CanLII 3966 (NLCA); and *Sun Sudan Oil Co. v. Methanex Corp.* (1992), 5 Alta. LR (3d) 292, at 310 (QB) (plaintiff a sophisticated international oil corporation advised by lawyers).

21 See the cases cited above, and *Malcolm D. Lennie Professional Corp. v. Target Ten Inc.* (1991), 81 Alta. LR (2d) 411 (MC).

22 [1961] AC 12 (PC). This case is relied on in Canadian tax law: see *Pluri Vox Media Corp. v. Canada*, 2012 FCA 295; and *Fournier v. Canada (Minister of National Revenue)*, [1996] TCJ no. 526.

There is no barrier in tax law to a principal shareholder being an employee of her own corporation.[23] However, when the contract of employment is oral, and only the controlling shareholder testifies concerning its terms, a court may find that a particular contract has not been proved as a matter of evidence, despite the validity of the principle in *Lee*.[24] To avoid this problem, all such contracts of employment should be in writing.

A one-person corporation that employs the individual who dominates it has the legal status of an employer. For example, the corporation, as an employer, may be able to recover damages for its loss if the dominating individual is wrongfully injured by another person and is unable to work.[25] If a corporation wrongfully terminates the employment of an employee-shareholder, the former employee can recover damages from the corporation, but the burden of proof is on the claimant to establish the contract.[26]

The distinction between employees and self-employed independent contractors applies to the working relationship between sole owners and their one-person corporations. Self-employed independent contractors enjoy certain tax advantages over employees.[27] A corporation may hire a controlling shareholder either under a contract of service as an employee or under a contract for services as an independent contractor. Under a contract for services, the contractor earns income from business rather than from employment for the services provided to the corporation, and is taxed accordingly.[28]

While it is clear from the case law that a single-person corporation can have an employee agreement with its sole shareholder, it may also have a contractor relationship with this person.[29] In these situations, the case law suggests that the test for employee

23 *Tercier et al. v. MNR*, 84 DTC 1620 (TCC); *Mid-West Feed Limited et al. v. MNR*, 87 DTC 394 (TCC); and *The Queen v. Burns*, 73 DTC 5219 (FCTD). In fact, the rules that govern personal services businesses contemplate an individual entering into a contract of employment with her corporation (the rules are discussed in chapter 5, "The Use of Professional and Personal Service Corporations").

24 See *Coulter v. MNR*, 86 DTC 1048 (TCC); *Boily v. MNR*, 88 DTC 1605 (TCC); and *McDougall v. The Queen*, 98 DTC 1005 (TCC).

25 Whether a corporate employer has an action for loss of the employee's services under the doctrine of *per quod servitium amisit* may depend on the jurisdiction, since it has been abolished by statute in some places: see *Rotary Air Force Management Inc. v. Allcock Estate*, 2003 SKQB 281.

26 *Matheson v. Matheson International Trucks Ltd.* (1984), 4 CCEL 271 (ONHC). The burden is, of course, a civil standard of proof (*Rodrigues v. Powell*, 2007 CanLII 29343, at paragraph 33 (ONSC)) and the test is objective (*Duxbury v. Crook*, 2018 SKQB 353, at paragraph 18). See also *Dillon v. Melanson*, 2015 SKQB 18; *Phil Lloyd's v. North Forty* (1983), 25 Sask. R. 40, at 48-49 (QB); and *Lingelbach v. James Tire Centres Ltd.* (1994), 120 DLR (4th) 456 (Sask. CA).

27 For example, the independent contractor is entitled to deduct expenses that are denied to an employee, and the corporation is not required to take source deductions from the independent contractor's remuneration.

28 See *McDougall*, supra note 24; *Moauro v. MNR*, 92 DTC 1071 (TCC); *The Queen v. Kuhl et al.*, 74 DTC 6024 (FCTD); and *Murray v. MNR*, 87 DTC 559 (TCC). See also *Healy Financial Corporation v. The Queen*, 94 DTC 1705 (TCC).

29 *Coulter*, supra note 24; and *Vaillancourt v. MNR*, 1999 CanLII 503 (TCC) (which relied on *Lee*, supra note 22).

versus contractor is as follows: Did the person enter into a formal employment agreement with the corporation and did the corporation, through formal acts such as corporation resolutions, control the employee, or did the worker (to use a neutral word) control the corporation? In many one-person corporations, the worker is more likely to be a contractor than an employee. For example, in *Scalia v. MNR*, the Federal Court of Appeal stated:

> On analysing the evidence, however, we find that the applicant had such ascendancy over the company, its activities and the decisions of its board of directors, which was composed of himself, his nephew and his sister-in-law, that there could not have been the independent relationship between himself and the company that is necessary to the creation of a true subordinate relationship. It would perhaps have been easier for the judge to refer, as did the Minister, to the exception that was in force at the relevant time under paragraph 14(a) of the Regulations, as interpreted and applied by the courts, but ultimately the judge's approach was not in error, since the control that a corporation which is an employer may exercise over the person who completely dominates it is more fictitious than real (as Parliament confirmed in 1990 when it enacted the new paragraphs 3(2)(c) and (d) of the Act).[30]

These comments may well apply to most one-person corporations. A corporation can sue and be sued as a legal entity that is distinct from its shareholders.[31] Because the corporation is a distinct entity, and to prevent multiple suits by shareholders, the courts developed the rule in *Foss v. Harbottle*,[32] which permits only the corporation to sue for a wrong done to it. A similar rule in the civil law of Quebec prohibits shareholders from suing personally for a wrong done to the corporation unless the court lifts the corporate veil.[33] Qualifications to the rule in *Foss v. Harbottle* permit shareholders to sue for wrongs to them that also harmed their corporations.[34] Shareholders may sue third parties for wrongs done to their corporations through derivative actions or assignments of claims.[35]

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30 *Scalia v. MNR*, [1994] FCJ no. 798 (CA). This case was relied on in later cases, including *Vaillancourt*, supra note 29; *Gélinas v. MNR*, 2001 CanLII 766 (TCC); and *Couture v. MNR*, 2004 TCC 266.

31 Although the capacity to sue and be sued is a consequence of incorporation, legislatures can confer the same capacity on unincorporated bodies: see *Prepaid Funeral Services Council v. Memorial Gardens (Sask.)* (1996), 141 DLR (4th) 532 (Sask. QB) (but a body cannot confer such powers unto itself).

32 (1843), 67 ER 189 (VC Ct.); cited with approval in *Hercules Managements Ltd. v. Ernst & Young*, [1997] 2 SCR 165. Of course, as noted above, a shareholder can still sue when the cause of action actually belongs to the shareholder individually. This is not so much an exception to the rule in *Foss* as it is an application of the rule: see *Hunter West Consulting Group Inc. v. 0748697 BC Ltd.*, 2019 BCSC 591, at paragraph 45.

33 *Houle v. Canadian National Bank*, [1990] 3 SCR 122, at 177-80. *Houle* reiterated the "exception" to the rule in *Foss v. Harbottle*, that shareholders may sue where they have their own causes of action that can be proven out separately from the damages to the corporation. For a more recent case, see *Brunette v. Legault Joly Thiffault, s.e.n.c.r.l.*, 2018 SCC 55.

34 *Barings v. Coopers & Lybrand*, [1997] 1 BCLC 427 (CA); and *Gerber Garment Technology Inc. v. Lectra Systems Ltd.*, [1997] RPC 443 (CA).

35 See *Barrett v. Duckett*, [1995] 1 BCLC 243 (CA) (derivative action); and *Norglen v. Reeds Rain Prudential*, [1998] 1 All ER 218 (HL) (insolvent corporation ineligible for legal aid validly assigning claim to individual shareholder as person eligible to finance litigation with legal aid funding).

In criminal proceedings, if a corporation is charged with a criminal offence, its officers can be subpoenaed and compelled, by means of the sanction of punishment for contempt, to testify against it.[36] An accused corporation cannot prevent its officers' testimony as a violation of its privilege against self-incrimination.[37]

The concept of the separate corporate personality extends so far that even if two corporations have the same directors, shareholders, employees, and management, they are still considered to be two separate persons in law.[38]

C. The Nature of a Corporation

A reference in the Act to a "corporation" includes any corporation, regardless of where it is incorporated.[39] A Canadian corporation generally means a corporation that is incorporated under provincial, territorial, or federal legislation. However, it is possible that the legal nature or attributes of a foreign company may not be exactly the same as what Canadian law regards as the legal nature or attributes of a corporation. Typically, this issue arises in the context of the foreign affiliate rules, under which subsection 95(1) defines the term "foreign affiliate" to mean a non-resident corporation that meets certain criteria. When a foreign jurisdiction does not share Canada's concept of incorporation, or provides for registration of limited liability entities that have partnership as well as corporate characteristics, difficulties may arise.

In *Backman v. Canada*,[40] the Supreme Court of Canada considered whether a Texas limited partnership was a partnership for the purposes of the Act. The Act does not define the term "partnership." The court relied on a two-step process: first, it determined the essential elements of a partnership under Canadian law; then, it examined the relevant foreign law to see whether it attributed to the partnership all or a sufficient number of those elements. Although *Backman* concerned the partnership concept, the two-step analysis may be applied to other entities.

36 See *R v. N.M. Paterson and Sons Ltd.*, [1980] 2 SCR 679; *R v. Amway Corp.*, [1989] 1 SCR 21; *R v. S. (R.J.)*, [1995] 1 SCR 451, at 506-7; and *British Columbia Securities Commission v. Branch*, [1995] 2 SCR 3 (respectively, corporate officers competent and compellable witnesses to testify against corporation at securities inquiry investigating violations of the corporation; witnesses protected against use of their testimony or evidence derived from their testimony in subsequent proceedings that might be brought against them for their personal wrongdoings; and if evidentiary protections insufficient to ensure fair trial for officers, they may be excused from testifying at inquiry). See also *R v. Nova Scotia Pharmaceutical Society* (1990), 58 CCC (3d) 161 (NSTD); aff'd 69 CCC (3d) 136 (NSCA), sub nom. *R v. Winsor*; aff'd on other grounds, [1992] 2 SCR 606. More recently, see *Ontario (Ministry of Labour) v. W Roofing Ltd.*, 2011 ONCJ 494.

37 Ibid.

38 *Apex Corporation v. Ceco Developments Ltd.*, 2005 ABQB 656, at paragraphs 27-28 (upheld with respect to liability and substantially upheld with respect to damages, 2008 ABCA 125).

39 See *International Fruit Distributors Ltd. v. MNR*, 55 DTC 1186 (SCC); aff'g 53 DTC 1222 (Ex. Ct.).

40 2001 SCC 10.

The Canada Revenue Agency (CRA) discussed corporations and foreign entity classification in archived *Interpretation Bulletin* IT-343R[41] in the context of the foreign affiliate rules, and issued technical interpretations that discuss whether foreign entities are corporations for the purposes of the Act.[42] According to IT-343R, a corporation is an entity created by law that has a legal personality and existence separate and distinct from the personality and existence of those who created or own it. A corporation has its own capacity to acquire rights and to assume liabilities, and any such rights are not those of the persons who control or own it. According to IT-343R, as long as an entity has such a separate identity and existence, it is a corporation, even if the law ignores a facet of its separate existence or identity under certain circumstances. The guidance set out in IT-343R has been tempered by later guidance. For example, *Income Tax Technical News* (ITTN) no. 38 also confirmed the two-step approach:

> Since the introduction of IT-343R in 1977, CRA has changed its position regarding the significance of the separate legal entity status in the classification of foreign entities. Separate legal entity status is still considered a distinctive feature of corporations, but it is not a feature of corporations alone. The fact that an entity is a separate legal entity is not in itself determinative of its status for tax purposes. . . .
>
> Our approach remains as stated last year, that is, to determine the status of an entity for Canadian tax purposes, we generally follow the two-step approach described below:
>
> 1. Determine the characteristics of the foreign business association under foreign commercial law;
> 2. Compare these characteristics with those of recognized categories of business associations under Canadian commercial law in order to classify the foreign business association under one of those categories.
>
> Even if we consider all the characteristics of an entity, the most important attributes are the nature of the relationship between the various parties and the rights and obligations of the parties under the applicable laws and agreements.

The two-step process seems to be well established from the CRA's perspective, having been relied upon in recent years.[43] Thus, a foreign entity may be classified as a corporation for the purposes of the Act, even if it is not called a "corporation," a "company," or any other similar name. For example, a partnership, a cooperative, or a foundation may be classified as a corporation, because it is an entity's legal attributes, not its name, that determine its Canadian classification. In the CRA's view, the classification of a foreign entity for Canadian income tax purposes is a question of fact.[44]

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41 IT-343R, supra note 3.

42 See, for example, CRA document nos. 2007-0221261I7, February 20, 2007; and 2002-0132163, July 24, 2002.

43 CRA document nos. 2015-0581511C6, May 28, 2015; 2015-0610611C6, November 24, 2015; 2015-0581961C6, June 18, 2015; and 2016-0642051C6, May 26, 2016.

44 CRA document no. 2012-0451261C6, October 5, 2012.

D. The Corporate Capacity To Own Property

A corporation, as a legal person, has the capacity to own property in its own right. Directors, officers, employees, or shareholders do not have any legal or equitable interest in the assets of their corporation.[45] Because a corporation owns its assets in its own right, a sole shareholder can be convicted of theft from her own corporation.[46] Financial contributions to a corporation by way of share capital or loan and assets purchased by the corporation with these funds belong to the corporation, not to the shareholder.[47]

E. Corporate Personality and Limited Liability

As was determined in *Salomon*, a corporation alone is liable on its contracts and for its wrongdoing because it is an entity distinct from its shareholders and those who run it. Shareholders can invest in the share capital of a corporation with the assurance that their liability for the corporation's obligations is limited to the amount of their share equity.[48] Generally speaking, creditors of a corporation can gain access only to the corporation's assets. However, if a shareholder has personally guaranteed the corporation's debts, creditors can proceed against the shareholder's property (a common method by which creditors bypass limited liability). Alternatively, a creditor may be entitled to pierce the corporate veil according to the principles discussed in chapter 21, "Tax Planning and Tax Avoidance."

Conversely, a shareholder's creditor is unable to impose liability on a corporation for the shareholder's debts because the corporation is a distinct legal entity.[49] For the Privy Council, Lord Russell of Killowen warned:

> [Their Lordships] believe it to be of supreme importance that the distinction should be clearly marked, observed and maintained between an incorporated company's legal entity and its actions, assets, rights and liabilities on the one hand, and the individual shareholders and their actions, assets, rights and liabilities on the other hand.[50]

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45 *Wotherspoon v. Canadian Pacific Ltd.*, [1987] 1 SCR 952, at 1032-33; *Army & Navy Department Stores*, supra note 1, at 511 (shareholders individually or collectively have no ownership, direct or indirect, in property of corporation); *K.J. Beamish Construction Co. Limited v. MNR*, 90 DTC 1584 (TCC); *Cronish v. City of Toronto* (1984), 30 LCR 294 (OMB); *Envision*, supra note 1; and *McClurg*, supra note 9, at paragraph 61.

46 *R v. Marquardt* (1972), 18 CRNS 162 (BCCA); motion for leave to appeal dismissed, [1972] SCR xii.

47 *Rockwell Developments Ltd. v. Newtonbrook Plaza Ltd.* (1972), 27 DLR (3d) 651 (ONCA).

48 "Limited liability is the rule not the exception; and on that assumption large undertakings are rested, vast enterprises are launched, and huge sums of capital attracted": *Anderson v. Abbott*, 321 US 349, at 362 (1943). But see Charles S. Reagh, "Nova Scotia Unlimited Liability Companies," in *Guide to the Leading 500 Lawyers in Canada* (New York: America Lawyer Media, 1998), 66-71.

49 *Export Brewing & Malting Co., Ltd. v. Dominion Bank*, [1937] 2 WWR 568 (PC).

50 Ibid., at 579.

F. Residence of a Corporation

The principal basis for asserting jurisdiction to tax in Canada is residency. Canada taxes based on residency because, on a policy basis, "a person who enjoys the legal, political and economic benefits of association with Canada should bear the appropriate share of the costs of association."[51] Whether a corporation enjoys legal, political, and economic benefits in its capacity as a fictional legal person with no physical existence could be a topic for lively, scholarly debate. However, if corporations are to be taxed in Canada and if the principal basis for taxing is residency, rules for corporate residency have to be applied. The rule that has developed is that a corporation is resident for tax purposes in the place where its central management and control (sometimes referred to as its central mind and management) abides.[52] While the Act "contains certain deeming rules with respect to residency, generally residence is a question of fact."[53]

Central management and control will be found to be exercised where the board of directors carries out its responsibilities, although if a shareholder is found to exercise de facto control and that shareholder resides and makes decisions in another country, the corporation may be found to reside where the shareholder is resident.[54] Cogent evidence is required to displace the otherwise strong presumption that a corporation's directors exercise control over it.[55]

Before we examine common-law residence rules in greater detail, it is necessary to discuss two other rules set out in the Act.

First, paragraph 250(4)(a) provides that any corporation that was incorporated in Canada after April 26, 1965 is deemed to be resident in Canada. If this rule applies, then no resort is required to a mind-and-management test.

Second, special rules apply in subsection 250(5.1) to corporations that are incorporated in one jurisdiction and continued into another. In many jurisdictions, a corporation that was incorporated elsewhere may be naturalized by submitting to the corporate law of its new home. Such an action is often described as a corporate "continuance" or "continuation." Subsection 250(5.1) describes the tax consequences of continuation into a different jurisdiction. The basic principle of subsection 250(5.1) is that a continued corporation is treated as having been incorporated in the jurisdiction into which it is continued. For example, a corporation that was originally incorporated in Canada but was subsequently continued abroad ceases to be treated as having been incorporated in Canada; therefore

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51 *St. Michael Trust Corp. v. Canada*, 2010 FCA 309, at paragraph 52 (aff'd *Fundy Settlement v. Canada*, 2012 SCC 14 [also known as *Garron*]), citing Vern Krishna, *The Fundamentals of Canadian Income Tax*, 10th ed. (Toronto: Carswell, 2009), at 85.

52 *De Beers Consolidated Mines, Limited v. Howe*, [1906] AC 455; cited in *The King v. British Columbia Electric Railway Co. Ltd.*, [1945] 3 DLR 613 (Ex. Ct.); and, more recently and significantly, in *Fundy Settlement/Garron*, supra note 51.

53 *Fundy Settlement/Garron*, supra note 51, at paragraph 7.

54 Ibid., at paragraph 9, citing *Unit Construction Co. v. Bullock*, [1960] AC 351 (HL). For more recent authority, see *Landbouwbedrijf Backx BV v. The Queen*, 2018 TCC 142.

55 *Landbouwbedrijf*, supra note 54, at paragraph 42.

it is no longer deemed to be resident in Canada (although it may remain resident by keeping its central management and control in Canada). Similarly, a corporation that is incorporated abroad—or incorporated in Canada and continued abroad—becomes resident in Canada on being continued here. The continued corporation is deemed to have been incorporated in its new home jurisdiction only for the purpose of applying the Act from the time of continuation (and only until continuation into a different jurisdiction).

In applying most provisions of the Act, a corporation's deemed incorporation under subsection 250(5.1) is considered to have taken place as of the date of its original incorporation. Paragraph 250(5.1)(b), however, provides that for the purposes of applying subsection 250(4) (which contains the 1965 incorporation rule), the continued corporation shall be treated as having been incorporated in the jurisdiction into which it has continued as of the date of the continuation.

If neither paragraph 250(4)(a) nor subsection 250(5.1) applies (for example, in the case of a non-Canadian corporation), the rule involving central management and control may be engaged to determine the corporation's residence.

G. Impact of Tax Treaties

In determining the residence of a corporation (as in determining the residence of any person), it is necessary to consider subsection 250(5). The subsection was enacted to prevent taxpayers from "cherry-picking" the best of both worlds: being resident in a foreign country with which Canada has an income tax treaty but not being resident in Canada for the purposes of the Act, or vice versa.[56] Subsection 250(5)[57] provides, essentially, that if a taxpayer is resident in Canada for the purposes of the Act under a standard test and is also resident in a foreign country for the purposes of the income tax treaty between Canada and the other country, then the taxpayer is for all purposes of the Act deemed to be resident in the other country, not in Canada. Speaking generally, a corporation is resident in another country under a tax treaty if it is liable to taxation by reason of its domicile, residence, place of management, place of incorporation, or any other criterion of a similar nature. In some cases, a corporation may be resident in both Canada and the other country under this test; the treaty may contain a tiebreaker rule to determine the corporation's definitive place of residence.[58] Subsection 250(5) facilitates the tiebreaker rules treating deemed residents under the rules as though they were non-residents of Canada.

56 See Brian J. Arnold, "The Relationship Between Tax Treaties and the Income Tax Act: Cherry Picking" (1995) 43:4 *Canadian Tax Journal* 869-905.

57 It appears that this provision was based on a UK provision. For a discussion of the UK provision, see Martin Palmer, "The United Kingdom 'Non-Resident' Company" (1999) 7:4 *Journal of International Trust and Corporate Planning* 263-70.

58 See, for example, article IV(3) of the Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital, signed at Washington, DC on September 26, 1980, as amended by the protocols signed on June 14, 1983, March 28, 1984, March 17, 1995, July 29, 1997, and September 21, 2007.

III. Shares and Shareholders

A. The Nature of a Share

The link between the shareholder and a corporation is the shareholder's share, which measures the shareholder's interest and in some cases the extent of the shareholder's liability for corporate actions.[59] Subsection 248(1) contains certain definitions that relate to shares which are, for the most part, not all that helpful:

> "share," except as the context otherwise requires, means a share or a fraction of a share of the capital stock of a corporation and, for greater certainty, a share of the capital stock of a corporation includes a share of the capital of a cooperative corporation (within the meaning assigned by subsection 136(2)), a share of the capital of an agricultural cooperative corporation (within the meaning assigned by subsection 135.1(1)) and a share of the capital of a credit union.
>
> "common share" means a share the holder of which is not precluded on the reduction or redemption of the capital stock from participating in the assets of the corporation beyond the amount paid up on that share plus a fixed premium and a defined rate of dividend.
>
> "preferred share" means a share other than a common share.[60]

The Act's definitions reflect the common-law notion of a share. In *K.J. Beamish Construction Co. Limited v. MNR*, the Tax Court defined a "share" as follows:

> "A share is intangible property, a chose in action, a relationship between the shareholder and the company involving rights and duties": Thorson P., *Braun v. The Custodian*, [1944] Ex. C.R. 30 at p. 40. See also *Palmer's Company Law*, 23rd (1982) ed. at p. 384:
>
>> A share in a company is the expression of a proprietary relationship: the shareholder is the proportionate owner of the company but he does not own the company's assets which belong to the company as a separate and independent legal entity.[61]

The concept of a share was also elucidated by the Supreme Court in *Sparling v. Québec (Caisse de Dépôt et Placement du Québec)*, as follows:

> A share is not an isolated piece of property. It is rather, in the well-known phrase, a "bundle" of interrelated rights and liabilities. A share is not an entity independent of the statutory provisions that govern its possession and exchange. Those provisions make up its constituent elements. They define the very rights and liabilities that constitute the share's existence. The *Canada Business Corporations Act* defines and governs the rights to vote at shareholders' meetings, to receive dividends, to inspect the books and records of the company, and to receive a portion of the corporation's

59 *McClurg*, supra note 9, at paragraph 61.

60 In addition to these definitions, the Act defines a large variety of terms that address special circumstances, such as "short-term preferred share," "taxable preferred share," and "term preferred share." In this chapter, no consideration is given to these special definitions because they do not shed any light on the fundamental nature of a share.

61 *K.J. Beamish*, supra note 45, at 1596.

> capital upon a winding up of the company, among many others. A "share" and thus a "shareholder" are concepts inseparable from the comprehensive bundle of rights and liabilities created by the Act.[62]

A "shareholder" is defined by the Act to include a person who is entitled to dividends, as discussed in more detail above. The definition of a dividend in the Act is generally unhelpful. "Dividend" has been defined as follows in somewhat archaic language:

> According to the Oxford Dictionary, a dividend is the sum payable as the profits of a joint stock company and received by an undivided holder as his share.[63]

Similarly, in *Marshall v. The Queen*, the Tax Court stated:

> *The Dictionary of Canadian Law* defines "dividend" as a "payment from profits, whether in cash, specie or the shares of another company." *Black's Law Dictionary* defines the word "dividend" as
>
> > A portion of a company's earnings or profits distributed *pro rata* to its shareholders, usually in the form of cash or additional shares.[64]

Thus, while a share represents all of the shareholder's rights in a corporation, a dividend is a distribution by the corporation to the shareholder in accordance with those rights. The corporation may pay the distribution in cash, by transferring other assets of the corporation, or by issuing further shares in the corporation. Depending on the applicable corporate law, a dividend may be paid out of profits, capital, or otherwise. Since shares do not represent loans by the shareholders to a corporation, a dividend does not constitute the repayment of a debt or interest on a debt. A debt is a liquidated demand for money;[65] interest thereon is compensation for the use of the money, which forms the subject matter of the demand.[66]

Shares are initially issued by a corporation for an agreed issue price payable in the manner required by the applicable corporate law. (This is sometimes referred to as a "treasury issuance," but in Canada that is generally a colloquial expression, not a legal term.) In jurisdictions that allow par value shares, the minimum allowed issue price is the par value of the share. The capital of the shares in a corporation is a notional account that is determined in accordance with rules in the applicable corporate statute. Typically, the share capital of a corporation is based on the issue price paid to the corporation for the

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62 *Sparling v. Québec (Caisse de Dépôt et Placement du Québec)*, [1988] 2 SCR 1015, at paragraph 24. See also *McClurg*, supra note 9, at paragraph 66; and *10737 Newfoundland Limited v. The Queen*, 2011 TCC 346, at paragraph 38.

63 *Dupuis Frères Ltd. v. The Minister of Customs and Excise* (1927), 1 DTC 104, at 105 (Ex. Ct.); followed on this point in *Moose Jaw Flying Club Ltd. v. Minister of National Revenue*, 49 DTC 655, at 661 (Ex. Ct.). For a similar definition, see CRA document no. 57819, September 5, 1989.

64 *Marshall v. The Queen*, 2011 TCC 497, at paragraph 16. See also *Special Risk Holdings Inc. v. The Queen et al.*, 94 DTC 6151, at paragraph 10 (FCTD).

65 *Fingold et al. v. MNR*, 92 DTC 2011, at 2017 (TCC).

66 *Satinder v. The Queen*, 95 DTC 5340, at 5343 (FCA).

shares, and the capital of each share of a particular class is averaged over all shares of that class. Since this is a notional account, it is not necessarily represented by any assets in the corporation. For example, if the corporation incurs losses, it might spend all the funds it raised by issuing shares and have nothing left.

Once validly issued, a share may be transferred by the holder and purchased and sold as personal property by the parties in compliance with the rules affecting the transferability of shares. The capital of the shares does not generally change when the shares are transferred, unless the corporation redeems or otherwise buys back its own shares.

Historically, there were notions of a fictitious body of property referred to as the company's "stock," with members owning shares in the stock of the company. This concept of a company's "stock" is generally no longer applicable in Canada.

One of the rights typically attached to a share is a right to a portion of the property of the corporation when it is wound up or dissolved. A traditional or "plain vanilla" common share typically carries with it the right to vote, the right to receive dividends, and the right to a portion of any residual property of the corporation on a dissolution.[67] However, modern corporate statutes allow nearly unlimited combinations of rights and restrictions to be attached to shares, so for the purposes of the Act the term "common share" is defined solely with reference to the right to a portion of the surplus assets of the corporation on dissolution; then, to ensure that there are no gaps in the definitions, "preferred share" is defined simply as any share that is not a common share.

As noted above with reference to *Sparling*, it is sometimes said that a share is a bundle of rights.[68] This statement is usually made in the context of valuing shares (when, for example, two shares are assigned different values on the basis of a comparison of the rights attached to each share) or in the context of determining whether a taxpayer has disposed of a share (when, for example, a share is arguably disposed of after many of its particular rights are altered or deleted).

B. Rule for Hybrid Securities

Shares in a corporation are generally referred to as representing "equity" in the corporation, to distinguish shares from debt. It is possible for ownership interests in a corporation (sometimes referred to as "securities" as a result of the influence of securities law) to include aspects of both debt and equity. When this occurs, it may be necessary to determine the true nature of the interest by looking at the substance of the rights, on the basis of the intentions of the parties as revealed in the relevant documents and (where necessary) a consideration of the circumstances that surrounded the making of these documents. In *Re Central Capital*,[69] Laskin JA stated that when a security contains features of both equity

67 *McClurg*, supra note 9, at paragraph 66.

68 CRA document no. 9413775, September 1, 1994: "We are of the view that each share of a corporation represents a bundle of rights, privileges, restrictions and conditions attached to the share under the articles of incorporation of the issuing corporation."

69 (1995), 22 BLR (2d) 210 (ONGD); aff'd (1996), 132 DLR (4th) 223 (ONCA).

and debt, a court must determine the "substance" of the relationship between the holder and the corporation. It must look to what the parties intended, which is evident in the agreement between the parties—specifically, the words chosen by the parties to reflect their intention.

In *Dupuis Frères*,[70] the taxpayer was incorporated to buy the shares of another corporation, and paid for the purchase with redeemable, cumulative, non-participating preferred shares. The issue was whether the cumulative dividends paid on the shares could be deducted as interest on borrowed capital. The court said no. The court admitted that there is a superficial resemblance between preferred shares and debt, but held that the differences outweigh the similarities.

Dupuis Frères was followed in *MNR v. Société Coopérative Agricole du Comté de Châteauguay*.[71] The facts and issue in the latter case were almost identical to those in *Dupuis Frères*. However, on the back of the certificate under which the preferred shares were issued, there was a statement that the corporation would pay the principal amount received from the holder at maturity and would pay interest thereon at 5 percent per annum half-yearly until the principal had been paid. The court found that the preferred shares were debt and not shares.

In *Central Capital*, two persons sold their shares of existing corporations to Central Capital and took back preferred securities (to use a neutral word). The issue was whether the preferred security holders were debtors and therefore entitled to rank equally with other creditors on the bankruptcy of Central Capital. The court, by a majority of 2 to 1, stated that the preferred securities were shares, and the holders thereof were shareholders and therefore not entitled to rank equally.

Before the decision in *Central Capital*, it was the prevailing view among lawyers and textbook writers that at the time of a redemption or retraction of preferred shares, the redemption or retraction amount became a debt of the corporation. Thus, it was natural to secure this "debt" by a security interest. However, the decision in *Central Capital* means that such a debt is not a true debt, but rather a debt that is subordinate to the rights of all true creditors and subject to the solvency tests in the applicable corporate legislation. In other words, once a shareholder always a shareholder, even after redemption or retraction.

The CRA has issued technical interpretations that address the issue of whether preferred securities are shares or debts. The subject of the first technical interpretation is whether "interest" payable on preferred shares is deductible.[72] The CRA stated that because preferred shares are not debts and do not represent borrowed money, the "interest" is not deductible. In the second technical interpretation, the CRA concluded that preferred shares are not a "bond, debenture, note or similar obligation" for the purposes of regulation 4900(1)(h) because they are not debts.[73]

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70 Supra note 63.

71 52 DTC 1129 (Ex. Ct.); aff'd without written reasons on April 8, 1954 (SCC). See *Société Coopérative Agricole de Granby v. MNR*, 61 DTC 1205, at 1209 (SCC).

72 CRA document no. 57819, September 5, 1989.

73 CRA document no. 58753, December 21, 1989.

C. Sham and the General Anti-Avoidance Rule

Two other rules are relevant to whether a security should be characterized as a share or debt. First, in the absence of a sham or the application of the general anti-avoidance rule (GAAR) in section 245, the CRA and the taxpayer must both respect the form of a given transaction, regardless of whether the same economic effect could have been achieved in another way.[74] On the other hand, the name of a legal document is irrelevant: the substance of the document, as disclosed by the rights and obligations flowing from it, is the important matter. These two rules have been expressed as follows:

> [T]he essential nature of a transaction cannot be altered for income tax purposes by calling it by a different name. It is the true legal relationship, not the nomenclature that governs. The Minister, conversely, may not say to the taxpayer, "You used one legal structure but you achieved the same economic result as that which you would have had if you used a different one. Therefore I shall ignore the structure you used and treat you as if you had used the other one."[75]

IV. Piercing the Corporate Veil

In previous editions of this book, some space was devoted in this chapter to the concept of "piercing the corporate veil" and, to a lesser extent, the limited principles that allow the CRA to "look through" the legal form of a transaction or arrangement where agreements lack legal substance. In this edition, readers are directed to chapter 21, "Tax Planning and Tax Avoidance," which, among other things, reviews the full range of judicial anti-avoidance doctrines, including sham, window dressing, ineffective transactions, and piercing the corporate veil.

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74 This is subject to the obvious rule that if a document is legally ineffective, neither the minister nor the taxpayer may respect it.

75 *Continental Bank of Canada and Continental Bank Leasing Corporation v. The Queen*, 94 DTC 1858, at 1871 (TCC). For the same passage, see *Bowens v. The Queen*, 94 DTC 1853, at 1857 (TCC). See also "Revenue Canada Forum," in *Income Tax and GST Planning for the Purchase, Sale, and Canada-US Expansion of a Business*, 1996 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1996), 24:1-21, question 6, at 24:8, where the CRA stated, "[I]t is the legal form of the particular financial instrument, not its economic substance, that usually will determine its income tax treatment."