TAX FOR THE Owner-Manager

Editor: Thomas E. McDonnell, QC

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Estate Planning: Shareholders' Reasonable Expectations

Four recent cases from different parts of Canada emphasize the need to have all participants in an estate plan concur in a "master plan" for the devolution of a family business if subsequent litigation is to be avoided. In each of the four cases, a father implemented an estate plan that froze the value of his interest in the operating company, left him with voting control through a separate class of shares, and transferred future growth to the children. In all four cases, one or more of the children became active in the management of the corporation. In three of the cases, a rift developed between the father and those children (in the fourth case, the rift developed between the widowed mother and the children). In all four cases, litigation resulted because the expectations of the participants had not been realized.

In *Reeson v. Reeson* (2004 SKQB 399), an estate freeze clearly contemplated the eventual sale and redemption of all the father's shares. A buyout bonus was to be paid to the children to enable them to purchase the father's shares. Animosity developed between the father and a son who was the CEO of the company. Ultimately, the father, as chairman of the board of directors, asked the son to tender his resignation and agree to a redemption of his shares. The son responded with an action for wrongful dismissal and oppression. The court concluded that the termination of the son's employment was valid and did not give rise to a claim for oppression; however, the forced redemption was oppressive, and the terms of the redemption were altered substantially.

The son argued that the minutes of the meeting that finalized the plan of redemption and buyout constituted a contract among the parties. The court found that although the parties had demonstrated a general concurrence in the plan, and this concurrence had created reasonable expectations in the children that the father's shares would be redeemed and they would become equal owners of the company, the plan did not constitute a contract. The court said, "When do reasonable expectations become enforceable commitments? Not, I suggest, when the expectations are based on familial affection only."

In *Wood v. Wood* (2004 ABQB 775), the court had to consider whether a sale of an interest in the operating company to a competitor following the breakdown of relations between a father and his daughter constituted oppressive conduct toward the other shareholder. The father became involved in a cattle business in 1952 and bought out his last remaining partner in 1994. At that time, a new share structure and estate freeze was implemented. The existing common shares were cancelled and were replaced by preferred shares, which were divided equally between the father and the mother. Forty-nine common shares were issued to their daughter, who was involved in the business, and 51 common shares were issued to the family trust. Special voting shares were issued to the father in order to allow him to retain voting control. In 2000, the father and his daughter had differences over the management of the corporation; the daughter sold her shares to her father and withdrew from the business. This marked the failure of the estate plan. With no other family member to take over the business, the father had to choose between resuming his previous level of day-to-day involvement in the business and finding someone else to do so. He decided to bring a third party into the business. This was accomplished by selling the trust's common shares to the third party, which resulted in the father and the third party each holding 50 common shares and the father and mother holding the class C preferred shares.

The mother argued that the reorganization of the business and the sale of the shares to a third party was

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oppressive conduct. She identified her reasonable expectations as follows:

1) that she would be involved as a shareholder in the family business,
2) that her investment would be preserved for family interests, and
3) that the succession of the family business would be to the family members.

With respect to point 1, the court concluded that there had never been any intention to involve the mother in the business of the company. She was given an equity interest, but no voting interest, to recognize her matrimonial property interest in her husband's assets. With respect to points 2 and 3, when the daughter left the company it became clear that the goal of the original estate freeze could not be achieved; its fundamental foundation—continuity of family ownership—had ceased to exist.

In *Schelew v. Schelew Injunction Application* (2005 NBQB 132), the father sought to restrain three of his sons, who were the majority shareholders of the operating company, from exercising their voting rights with respect to certain issues, including the removal of the father and the fourth son as directors of the corporation.

The father founded the business in the late 1950s. In 1978, he carried out an estate freeze whereby the common shares in the operating company were transferred equally to his four sons. In 2004, the father commenced the litigation, arguing that the transfer of the shares to his sons was conditional upon several alleged agreements entered into by the family members, including an agreement that the shares were transferred solely for the purposes of the estate freeze and for tax purposes and that the sons were therefore nominee shareholders who held their shares for the benefit of the father. Another alleged agreement was that the father would maintain de facto control of the company and that the children would never interfere in any way with his management. Three of the four sons denied the existence of these agreements and said that they had never heard of them until they read the statement of claim. The court noted that none of the alleged agreements (including one entitled "Inheritance Planning Agreement" and another entitled "Estate Planning Agreement") was ever reduced to writing.

The father suspected that three of the four sons were conspiring to remove him and the fourth son as directors of the operating company and terminate the property management contract with the father's management company. The father sought to enjoin the sons from exercising the voting rights attached to their shares at a validly called shareholders' meeting. The court denied the request for an injunction.

In *Cohen v. Jonco et al.* (2005 MBCA 48), the widow of the father who implemented the estate freeze sought an oppression remedy against her sons, who were operating the business. The widow's expectations were clearly set out in the father's will. The father had held freeze shares and special voting shares. Under the terms of the will, the special voting shares were to be passed to one son who, for a period of five years from the date of the father's death, was to have unfettered discretion to vote the shares and to decide the time at which the holding company would redeem or purchase for cancellation the freeze shares and then wind up the company. Following the windup, there was to be an equalization among all the children.

For several years following the father's death, dividends were paid to his widow. However, after a corporate reorganization in 2001, the dividends ceased. In November 2003, the widow demanded that the preferred shares be redeemed, citing the provisions in her husband's will which contemplated that the holding company would be wound up within five years of his death. The decision of the Manitoba Court of Appeal extensively discusses what constitutes oppressive conduct and how the rights and interests of a shareholder are to be determined. In essence, the reasonable expectations of shareholders are a question of fact, but they cannot simply be a wish list. The expectations must be reasonable in the circumstances, and their reasonableness is to be ascertained on an objective basis. Shareholder interests are intertwined with shareholder expectations. Quoting an Ontario decision, the court said that "[t]hey must be expectations which could be said to have been (or ought to have been considered as) part of the compact of the shareholders." The court concluded that "personal considerations are relevant if they are part of the compact among shareholders. These personal considerations certainly involve the background and dealings in a family corporation, and how shareholders came to own shares (for example, purchase versus a will). The compact among shareholders can change over time. It is not static." The court found that in light of the will and the lack of any other "compact among the shareholders," the widow had demonstrated that she had every reason to expect that the holding company would have been liquidated and her class C preferred shares redeemed. The sons' failure to do so was unfairly prejudicial to her interests and unfairly disregarded the intentions of the father and the reasonable expectations of his widow.

The bottom line? It is reasonable to assume that circumstances will change so that not all the expectations of the parties to an estate plan will be or can be satisfied. Consequently, an effective plan should outline the original expectations of the parties and how changing facts might alter those expectations. It should also allow for some flexibility so that changing expectations can be addressed as future circumstances may dictate.

Robin MacKnight
Wilson Vukelich LLP
Markham, Ontario

CRA Audit Powers and Tax Evasion: Jarvis Applied

Stanfield v. Canada (Minister of National Revenue) (2005 FC 1010) involves the application of the principles set out in *Jarvis* ([2002] 3 SCR 757). *Jarvis* dealt with the extent to which the CRA could use its audit powers in connection with a criminal investigation or prosecution under section 239 of the Income Tax Act without violating a taxpayer's Charter rights.

In *Stanfield*, a large number of applicants sought by way of judicial review to quash requests for audit information made by the CRA in letters and questionnaires; they also sought an order preventing the CRA from taking any action or proceedings against them for failure to respond to the requests for information.

The information requests were made pursuant to subsection 231.1(1) of the Act. The sole issue in the case was whether the requests were within the parameters of the audit functions in that subsection or whether they were made for the predominant purpose of collecting documents and information for a criminal investigation. The Crown's position was that there was no ongoing criminal investigation of the applicants and that the requests for information were necessary for ordinary audit purposes.

The taxpayers had claimed large losses relating to commodities-trading schemes developed by promoters. The audit, at least for 1998, was part of a national audit project. The taxpayers' filing of their 1999 tax returns resulted in an audit of the 1998-2000 taxation years by auditors from the CRA's Tax Avoidance section. One aim of the audits was to determine whether the applicants had invested in suspected tax shelters or other tax-avoidance schemes created by various promoters.

On April 6, 2001, a member of the Vancouver Investigations Division advised the auditors that the audit was now considered a criminal investigation, that the auditors should have no further contact with any of the taxpayers or their representatives, and that no further work should be done on the files. The applicants' files were transferred to the Investigations Division. As of June 2, 2004, the taxpayers' original returns were still in the control of the Investigations Division.

Apparently because 1998 would soon become statute-barred, the Investigations Division allowed the audit of 1998 tax returns to recommence, resulting in the issuance of notices of reassessment. The CRA sent out the requests for information by way of letters and questionnaires to deal with the prospect that 1999 and 2000 would also become statute-barred. There was regular and ongoing contact between the Investigations Division and the auditors in the Tax Avoidance section who were responsible for the applicants' audits. One of the auditors in the Tax Avoidance section who was involved with some of the applicants' audits had been seconded to the Investigations Division and had acted as a liaison between the two sections of the CRA.

Noël J used the seven guiding factors established by the SCC in *Jarvis* and five additional sub-factors of his own to conduct an in-depth analysis of the facts. The sub-factors related to, among other things, the links between the audit and the criminal investigation, the nature of the information flow between the Audit and Investigation divisions, and the level of importance of the contacts between the two divisions.

In the end, the court found for the taxpayers, holding that the predominant purpose of the letters and questionnaires was to aid in the furtherance of a criminal investigation and thus was not within the parameters of the audit functions contained in subsection 231.1(1).

The case illustrates that taxpayers and their advisers must monitor the CRA's actions in the course of an audit for indications that the audit is being used to further a criminal investigation; it provides an extensive set of guidelines that tax advisers can use to determine whether the CRA has exceeded its audit powers in any particular case.

Philip Friedlan
Friedlan Law Office
Toronto and Markham, Ontario

Subsection 256(2) and Foreign Corporations

Subsection 256(2) of the Income Tax Act can cause two corporations that are not otherwise associated with each other to become associated if each acquires an interest in a third corporation.

Assume, for example, that A and B, two brothers who reside in Canada, each own 100 percent of a CCPC, A Co and B Co, respectively. Pursuant to subsection 256(1), A Co and B Co are not associated. However, if A Co and B Co each acquire, say, 50 percent of a third CCPC, C Co, A Co and B Co will both be associated with C Co pursuant to paragraph 256(1)(d). As a consequence, subsection 256(2) will cause A Co and B Co to be associated with each other.

If C Co were a foreign corporation instead of a CCPC, would subsection 256(2) still associate A Co and B Co? The answer could be significant. As will be seen, if foreign corporations can be ignored in the application of subsection 256(2), A Co and B Co will not be associated for any purpose of the Act. If foreign corporations must be considered, A Co and B Co will be associated except for the purposes of section 125—that is, the small business deduction.

Holiday Luggage (86 DTC 6601 (FCTD)) interpreted subsection 256(2), as it then read, in circumstances where C Co was a US corporation. At that time, the relevant portion of subsection 256(2) read as follows: "When two corporations are associated . . . with the same corporation at the same time, they shall, for the purposes of this Act, be deemed to be associated with each other."

The court held that two corporations cannot be associated unless they are both subject to part I of the Act. Notwithstanding the very general definition of "corporation" in subsection 248(1), the court stated that "it is not intended in section 256 to bring a non-resident corporation not doing business in Canada within the grasp of 'corporation' so as to trigger off the 'deemed' provisions of the section. The section is 'for purposes of the Act.' I find that such is not one of the Act's purposes."

The relevant portion of subsection 256(2) has read as follows since it was amended by the February 10, 1988 federal budget:

> [T]hey shall . . . be deemed to be associated with each other at that time, *except that, for the purposes of section 125, where the third corporation is not a Canadian-controlled private corporation at that time*, . . . the third corporation shall be deemed not to be associated with either of the other two corporations in that taxation year. [Emphasis added.]

Unfortunately, this version of subsection 256(2) does not necessarily incorporate the decision in *Holiday Luggage* into the law.

If the third corporation (C Co) is not a CCPC, subsection 256(2) will not associate A Co and B Co, but only for the purposes of section 125. Therefore, A Co and B Co will continue to be associated for all other purposes of the Act. It is thus important to determine whether or not, as in *Holiday Luggage*, C Co will be ignored in determining whether or not A Co and B Co are associated or whether subsection 256(2) must be relied upon for them not to be associated.

In making its determination in *Holiday Luggage*, the court said, "It is my fundamental view that every word or every expression in a statute must be interpreted *in its context*, even in the face of statutory definitions" (emphasis added). In contrast to the version under consideration in *Holiday Luggage*, the current version of subsection 256(2) expressly takes into account circumstances in which the third corporation is not a CCPC. This could mean that in the context of the current version, a foreign corporation would associate A Co and B Co but for the specific exemption provided in subsection 256(2). However, this matter is not absolutely clear. It could be argued that *Holiday Luggage* still applies because the non-CCPCs referred to in current subsection 256(2) are not foreign corporations but Canadian-resident corporations that are not CCPCs.

Perry Truster
Truster Zweig LLP
Richmond Hill, Ontario

Are You a Lobbyist? Amendments to the Lobbyists Registration Act

Tax practitioners typically do not consider themselves lobbyists. A lobbyist is commonly thought of as someone who seeks to influence the legislative process on behalf of a particular organization or interest group. The amendments to the Lobbyists Registration Act (LRA) in force as of June 20, 2005 broaden the reporting requirements for lobbyists and may result in the LRA's application to tax practitioners in certain circumstances. The objective of the LRA amendments is to provide the Canadian public with greater access to the communications between public office holders and lobbyists, as well as disclosure of the interests they represent. The information collected under the LRA is a matter of public record and is accessible through an online public registry.

This article focuses on the LRA amendments that are applicable to tax practitioners, specifically the provisions governing "consultant lobbyists." The LRA defines a consultant lobbyist as an individual who receives payment for undertaking to communicate with a public office holder on behalf of any other person or organization. A public office holder includes, among other persons, any officer or employee of the federal government. Thus, a tax practitioner who communicates on behalf of a client with an official of the CRA or the Department of Finance may be subject to the LRA. The LRA amendments also include provisions respecting "in-house lobbyists" of corporations and organizations. Although those amendments are beyond the scope of this discussion, it is worth noting that the most senior officer in the corporation or organizataion is required to take responsibility for filing the LRA return.

Prior to the LRA amendments, the reporting requirements generally were triggered when the communication with the public office holder was carried out in an attempt to influence him or her. The "attempt to influence" requirement has been removed; the current test is strictly a "communications" test with specific inclusions and exemptions. Communicating with a public office holder for the purposes of the LRA includes, among other things, an oral or written communication respecting the development of any legislative proposal by the Government of Canada. It is irrelevant whether the communication was initiated by the lobbyist or the public office holder. (Prior to the amendments, a communication that was initiated by the public office holder was exempt from LRA reporting.) A tax practitioner should be subject to LRA reporting if he or she is engaged by a client to correspond with Finance respecting a proposed amendment to the Income Tax Act. In addition, a consultant lobbyist is required to register under the LRA if he or she arranges a meeting between a public office holder and any other person.

Certain communications are exempt under the LRA, including those respecting the enforcement, interpretation, or application of any act of Parliament or regulation thereunder. The LRA does not apply to communications with public office holders if the communication is restricted to a request for information. The exemptions relieve tax practitioners from LRA compliance in common circumstances of representing clients in tax disputes (enforcement matters) and requests for rulings from the CRA, which typically involve the CRA's views on the interpretation of the Act or its application to a particular situation.

If a consultant lobbyist is required to report under the LRA by filing a return, he or she must do so no later than 10 days after entering into the undertaking (to communicate with the public office holder) with the client. Generally, a renewal return must be filed within 30 days after the expiry of every six-month anniversary of the initial return. No renewal return is required if the consultant lobbyist completes or terminates the undertaking and advises the LRA registrar, in the prescribed form and manner, before the expiry period for that return. A consultant lobbyist need file only one return per undertaking, notwithstanding that there may be several communications with one or more public office holders for a particular undertaking.

Lobbyists who register must disclose the nature of their past public sector employment, even if the employment was for a short duration.

Industry Canada's Web site (http://strategis.ic.gc.ca) includes a link to the Lobbyist Registration Branch, which provides access to the registry, a guide to registration, LRA interpretation bulletins, and other information relevant to the application of the LRA.

Consultant lobbyists who are subject to LRA reporting must comply with the Lobbyist's Code of Conduct. The Code of Conduct is published in the *Canada Gazette*; however, it is not considered a statutory instrument for the purposes of the Statutory Instruments Act.

The penalty for contravention of the LRA (except for the Code of Conduct) is a fine of up to $25,000. However, if an individual knowingly makes a false or misleading statement in a return or any other document submitted to the registrar, that individual is guilty of an offence and is liable on summary conviction to a fine of up to $25,000 or to imprisonment for a term not exceeding six months, or both. If the judicial proceedings are by way of indictment, the maximum penalties are increased to a fine not exceeding $100,000 or to imprisonment for a term not exceeding two years, or both.

R. Mark Coleman
Felesky Flynn LLP, Calgary

Change in Quebec's Price Adjustment Clause Policy

When property is transferred in a non-arm's-length situation, the parties to the transaction usually include a price adjustment (PA) clause as part of the attributes of consideration received in the form of preferred shares or "preferred share-like" partnership units. The PA clause serves as a means for the parties to adjust the consideration received in the transaction on a tax-free basis should the taxing authorities disagree with the parties' determination of FMV.

The taxing authorities will accept the PA clause if, inter alia, the parties have made a bona fide attempt to determine FMV and each party attaches a letter to its tax return containing certain information in the taxation year in which the transaction in question arose (See IT-169, "Price Adjustment Clauses," August 6, 1974, and Quebec's IMP. 28-4/R1, March 31, 2004, for more details. It should be noted that while Quebec last modified its administrative position on PA clauses in 2004, the federal position on PA clauses has not changed since IT-169 was issued in 1974.) The major change in Quebec's administrative policy is that a prescribed form with the box checked "Yes" to indicate that a PA clause exists in respect of a particular transaction is now considered sufficient notice given by the parties. If the box is checked, it is not necessary for the parties to advise the minister in a letter in each of their tax returns for the particular taxation year of the existence of a PA clause or the obligations arising therefrom.

The PA clause question appears on form TP-518-V (the federal equivalent is form T2057, which is used in a subsection 85(1) rollover); form TP-529-V (the federal equivalent is form T2058, which is used in a subsection 85(2) rollover); and form TP-614-V (the federal equivalent is form T2059, which is used in a subsection 97(2) rollover). IT-169 is silent on this issue. The CRA has indicated in *Information Circular* 01-1, at paragraph 71, that a letter need not be filed if the "yes" box is checked on form T2057. The change in Quebec's administrative position is welcomed by tax advisers as a reduction in the compliance burden associated with PA clauses.

Manu Kakkar
Kakkar and Associates Limited
London, Ontario

Statute-Barred Assessments: Relying on Professional Advice

It is not uncommon for small-business owners (particularly those with little or no formal accounting training) to hire internal or external accountants to look after accounting and tax compliance matters. It is also not uncommon for small-business owners to trust implicitly in the judgment of the professionals when accounting or tax issues arise. But what happens when tax professionals err, or when the CRA auditors ultimately disagree with their professional judgment? Can the CRA claim that the business has made a misrepresentation owing to neglect, carelessness, or wilful default and issue an income tax or GST assessment outside the normal statutory limitation period for assessment? These questions were addressed by the Tax Court of Canada in *Bondfield Construction* (2005 TCC 78). The court's decision provides some solace for business owners.

Bondfield involved a construction company that did approximately $100 million in business per year and employed some 20 workers. The president and sole shareholder had no formal accounting or tax training; he hired a chartered accountant to act as Bondfield's comptroller, charging him with all accounting matters, including the supervision of the internal accounting staff. In addition, the president engaged an external accounting firm to review and monitor Bondfield's accounting activities and to provide audited financial statements.

During the relevant periods, the comptroller and the external accounting firm never indicated that there were problems with Bondfield's GST procedures. Although the president reviewed the audited financial statements annually, he never went through the GST documentation to determine whether the procedures were correct or incorrect, and he never discussed the GST procedures directly with the comptroller.

The CRA's audit showed that Bondfield's GST filings were in error; Bondfield had claimed input tax credits (ITCs) in respect of GST attributable to "back-charges" and had not remitted GST applicable to particular PST amounts. These errors came about as follows.

If the work of an original subcontractor was deficient, Bondfield would engage a second subcontractor to remedy the deficiencies. The second subcontractor would invoice Bondfield for the remedial work plus GST, and Bondfield would record a "back-charge" to the original subcontractor's account (equal to the second subcontractor's charges including GST), thereby reducing the amount Bondfield paid to the original subcontractor. If the "back-charge" was accepted by the original subcontractor, Bondfield claimed ITCs for both the GST charged by the original subcontractor and the GST charged by the second subcontractor for the "back-charge." Further, Bondfield calculated and collected, but did not remit, GST in respect of PST paid on construction materials used in its contracts, taking the (incorrect) position that GST on such amounts did not have to be remitted.

Although the comptroller was eventually fired (and was later convicted of defrauding Bondfield), the CRA nevertheless assessed Bondfield for the errors, and even extended the assessment into periods that would otherwise be statute-barred under subsection 298(1) of the Excise Tax Act (ETA), alleging that Bondfield had made a misrepresentation that was attributable to neglect, carelessness, or wilful default and thus was assessable pursuant to ETA paragraph 298(4)(a) (the equivalent of subparagraph 152(4)(a)(i) of the Income Tax Act).

The Tax Court overturned the assessment, holding that the onus was on the minister to establish (1) that a misrepresentation was made by Bondfield and (2) that the misrepresentation was due to neglect, carelessness, or wilful default.

Bondfield submitted that it had a bona fide filing position respecting the GST back-charge issue. Although the court did not agree with Bondfield's interpretation of the applicable law, it found that it had acted in good faith. Accordingly, it did not make a misrepresentation for the purposes of the penalty provisions. With respect to the GST on PST adjustments, the court found that Bondfield had made no attempt to conceal the GST it under-remitted in any of the relevant documents, and that it had attached the relevant worksheets documenting the adjustments with its GST filings. In the Tax Court's view, that issue was open and obvious for the CRA's auditors to discover.

The Tax Court also determined that Bondfield could not be viewed as guilty of any neglect, carelessness, or wilful default. To the contrary, Bondfield had implemented an elaborate system of checks and balances, including internal and external accountants and audit procedures and high-quality accounting and software systems. In the court's view, if the external accounting firm did not detect the errors, Bondfield itself could not be expected to recognize them.

The CRA argued that the comptroller and the external accountants were "agents" of Bondfield, and that Bondfield was therefore liable for their actions for GST purposes. The Tax Court rejected that argument because, in its view, (1) the comptroller was acting outside the scope of his authority, and (2) the external accountants could not be considered the directing mind of Bondfield with respect to GST matters.

Finally, the Tax Court determined that Bondfield had been duly diligent, and it overturned all of the penalties assessed under ETA section 280 for the failure to remit GST during the non-statute-barred periods.

Bondfield is a roadmap for small-business owners who want to do what is required to avoid penalties under tax legislation and limit their exposure to the normal (four-year) CRA audit processes. The case also stands for the proposition that a business owner's reliance on internal or external professional advice will go a long way toward legitimating his or her actions for tax purposes. A business will always be liable for errors in tax compliance; however, provided that there is proper reliance on professional advice, that liability will be limited to the tax and interest applicable to the normal four-year assessment periods.

Robert G. Kreklewetz and Vern Vipul
Millar Kreklewetz LLP, Toronto

De Facto Control: Update

In *Income Tax Technical News* no. 32, July 15, 2005, the CRA was asked to what extent it is abiding by the principles set out by the Federal Court of Appeal in *Lenester Sales* (2004 DTC 6461 (FCA)) and *9044-2807 Québec Inc.* (2004 DTC 6141 (FCA)) in determining the scope of the rule in subsection 256(5.1) of the Income Tax Act and the concept of control in fact. The CRA responded that, in its view, there are two tests for determining whether control in fact exists for the purposes of subsection 256(5.1). The first is the narrower test enunciated in *Silicon Graphics* (2002 FCA 260), which requires that a person or a group of persons must have the clear right and ability to effect a significant change in the board of directors or the board's powers, or to directly influence the shareholders who would otherwise have the ability to elect the board.

The second and broader test, according to the CRA, is that the evidence must demonstrate that the decision-making powers of the corporation rest with persons other than those with de jure control. The CRA does not indicate which decision-making powers it is referring to, but it states that the examples of de facto control set out in *Interpretation Bulletin* IT-64R4, August 14, 2001, are still valid. This position is apparently based on the CRA's interpretation of the decision in *9044-2807 Québec Inc.* Relevant factors in that case included economic dependency, operational control, and familial connections among the shareholders of three corporations.

It may take a decision from the Supreme Court of Canada to settle the scope of the de facto control rule. In the meantime, the CRA is continuing to take a fairly broad approach to the rule. However, given the *Lenester Sales* decision, the CRA will have difficulty making a case for de facto control based on economic dependency unless a familial connection exists.

Jennifer Smith and Roger Taylor
Ernst & Young LLP, Ottawa

Practice Notes: Personal Services Businesses

The generally favourable tax treatment of the active business income of a CCPC is lost if the corporation carries on a personal services business (PSB). Income earned by a corporation from carrying on a PSB is denied the low rate of tax on active business income, and the corporation is severely limited in the deductions it may take in computing the income from that business.

The PSB provisions were added to the Income Tax Act in response to *Sazio* (69 DTC 5001 (Ex. Ct.)). In that case, the taxpayer formed a corporation through which he offered his services as a coach to a football team. He had previously been employed directly by the team in that capacity. *Sazio* is the classic example of what is now regarded as a PSB situation. However, there are many other situations in which individuals essentially

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Canadian Tax Foundation
595 Bay Street, Suite 1200
Toronto, Ontario M5G 2N5
Telephone: 416-599-0283
Facsimile: 416-599-9283
Internet: http://www.ctf.ca
E-mail: 1tmcdonnell2@rogers.com
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have a choice between becoming employed by a third party and offering their services as independent contractors through a corporation. The fact that the individual chooses to use a corporation will not automatically render the business a PSB, provided that the relationship would be characterized as a relationship between an independent contractor and a customer but for the interposition of the service provider's corporation.

If the relationship between the service provider and a customer would be one of employment but for the interposition of the corporation, then the corporation is carrying on a PSB and cannot claim any deductions other than the salary paid to the service provider (and the very limited number of amounts listed in paragraph 18(1)(p) of the Act). Depending on the circumstances, the prohibition against deducting salaries paid to other employees of the corporation can be punitive, since the employees will pay tax on their salaries even though the corporation is denied the deduction.

This was the situation in *Dynamic Industries* (2005 FCA 211). The corporation was owned by the wife of the service provider. She and her husband both received salaries from the corporation. During the three years under appeal, the husband provided services to one arm's-length company, SIIL, purportedly as an employee of Dynamic. Although the corporation had provided services to other customers in the years before and after those under appeal, SIIL was its only customer in those three years. The Tax Court judge applied the standard tests as set out in *Wiebe Door* (87 DTC 5025 (FCA))—ownership of tools, chance of profit and risk of loss, and integration of activities. The Tax Court judge concluded that the relationship between the service provider and SIIL was one of employment. He thought that the control test—that is, whether SIIL controlled the service provider's activities—was inconclusive on the particular facts and did not give it any weight one way or the other.

The Court of Appeal disagreed on all points and allowed the appeal. No new evidence was considered, and the argument proceeded on the basis that the findings of fact at trial were correct. Essentially, the Court of Appeal concluded that the Tax Court judge had misapplied the law as set out in *Wiebe Door* and *Sagaz* ([2001] 2 SCR 983).

Dynamic Industries illustrates that a case may be won or lost as much on the judge's subjective reaction to the facts as on an analysis of the facts and the applicable law. It is clear from the facts that the service provider did not form his company with a view to replacing an existing employment relationship; if the corporation had continued to serve a number of customers rather than just one, it is unlikely that the CRA would have challenged the relationship; the fact that there was only one customer took on an overwhelming significance for the CRA.

For individuals who want to use a corporation to provide services to arm's-length customers without becoming a PSB in the process, the *Dynamic Industries* case offers a useful blueprint of the factors to be considered in a PSB case as well as a reminder of the consequences of inadvertently falling within the PSB definition.

Thomas E. McDonnell
Thorsteinssons LLP, Toronto