"Personal Corporations" Under the Income Tax Act — to Use or not to Use? *

Kenneth H. Brown **

The various techniques whereby individuals utilise corporations as vehicles to take title to their investments are generally well known.

The role which can be played for this purpose by the particular type of corporation known as the "personal corporation" (as defined in s. 68 of the Income Tax Act),[1] the limitations which exist with respect to that role, and the objectives which can and those which cannot be achieved by the use of this type of corporation, appear however to be less clearly understood; an examination of these aspects of the matter may therefore be of some interest.

It should be observed at the outset that, so far as certain of the objectives are concerned, the individual can with equal advantage transfer his investments to any type of corporation, i.e. it need not necessarily be a "personal corporation".

Thus an investor who owns a substantial and varied portfolio of securities will realize that these have their legal "situs" in various countries, provinces and states, each of which will require transfer documents on the death of the owner and will probably also impose its own death duties on the securities which have their

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* *Editor's Note:* This article was written several months before the introduction of Bill C-259 (the new *Income Tax Act*), which became effective on Jan. 1, 1972 and which does not segregate "personal" corporations as a separately-defined class as does the present *Act*; nor therefrom the underlying securities, through the personal corporation (in whose hands it is not taxed), to the shareholders, in whose hands it is taxed.

Nevertheless the greater part of the article deals in some depth with topics which remain relevant for various purposes under the proposed new *Act* and of income tax law generally, such as the question whether to use an investment holding company at all, the meaning of "direct or indirect control" of corporations, and what constitutes the carrying on of an active business by a corporation. Moreover, the present law concerning personal corporations will of course be relevant for many years in litigation arising out of pre-1972 facts.

For these reasons it has been decided to publish the article as received.

** Q.C., Advocate, of Lafleur & Brown, Montreal.

1 R.S.C. 1970, c. I-5.

legal "situs" within its jurisdiction, except to the extent that these duties may be abated by tax conventions with the jurisdiction in which the owner himself was domiciled.

The investor accordingly sells or transfers his securities to a corporation and takes in exchange, shares or debt of that corporation. The corporation becomes the owner of the securities; it never dies, so that the death of the individual has no effect whatever, by way of administration, documentation, or imposition of death duties, in the various jurisdictions in which the securities forming the underlying portfolio have their legal situs. In other words, no change of ownership of the securities having their situs in those jurisdictions results from the death of the individual, so nothing has to be done in those jurisdictions.

The investor, when he dies, leaves only his shares in, or the debt owing to him by, the corporation to which he had transferred his securities. This corporation will have been so incorporated that its outstanding shares held by the deceased individual, and its debt owing to him, have their legal situs in the province in which he was domiciled, so that their value is dutiable only in that province (if it imposes succession duties) and under the Federal Estate Tax Act, and the only documentation required is that which relates to the transfer of the shares and/or debt of that one corporation.

The basic point, which must constantly be borne in mind, is that the above advantages will flow, and can *only* flow, from the transfer of *ownership* of the individual's securities to a corporation (which, as I have said, need not necessarily be a "personal corporation").

This basic point necessitates a note of caution: the common practice of merely transferring one's securities into the *name* of a corporation (usually a bank or trust company) as nominee for oneself will not in law achieve the above objectives. The securities in that case remain *owned* by the individual, with the various consequences, upon his death, as to administration and liability to death duties in jurisdictions other than that of his own domicile which I have already described. The fact that his ownership is "masked" by registration of the securities for example in the name of a trust company does not change the fact of his ownership and the resulting liabilities; these *may* possibly pass unnoticed in the outside jurisdictions because of the registration in the name of the corporate nominee, but they continue to exist in law, and this type of "mask" is readily penetrated under today's sophisticated methods of ascertaining where true ownership lies.

Assuming, therefore, that there has been a genuine transfer of ownership of the securities from the individual to a corporation, what is the significance of whether the transferee is a "personal corporation" or not?

First of all, if the transferee is *not* a "personal corporation", the income from the securities will simply form part of the corporation's income from all sources and, to the extent that the income is not exempt from tax under the Act, it will bear tax at the regular corporate rates. If and when what is left of it is distributed, or deemed to be distributed, to the shareholders as interest or as a dividend, it will be taxed in the hands of the shareholders at their respective individual graduated rates minus (if it is received as a dividend) the credit (20% of the amount of the dividend) which is provided under s. 38 of the Income Tax Act.

The first step, therefore, before deciding whether or not to utilise a "personal corporation", should be for the individual to calculate, on the basis set out in the preceding paragraph, what the total tax impact (in the hands of the corporation and in his own hands as shareholder) would be, on the total income stream from the underlying securities to his own pocket, if he did *not* use a "personal corporation" but an ordinary corporation, *e.g.* his business corporation if he has one.

This brings us to the main consideration: that of the "personal corporation" itself. Much detail will appear later, but for the moment it will suffice to say that as regards income tax treatment the main characteristic of a "personal corporation" (as distinct from an ordinary corporation) is that it is not taxed on its income, but all its income is deemed to be distributed to its shareholders as a dividend on the last day of its fiscal year, and the shareholders are taxable accordingly, as if the corporation did not exist.

The relevant "definition" provisions are found in ss. 68(1) and 68(2) of the *Income Tax Act*:

"68. (1) In this Act, a 'personal corporation' means a corporation that, during the whole of the taxation year in respect of which the expression is being applied,

(a) was controlled, whether through holding a majority of the shares of the corporation or in any other manner whatsoever, by an individual resident in Canada, by such an individual and one or more members of his family who were resident in Canada or by any other person on his or their behalf;

(b) derived at least one-quarter of its income from

(i) ownership of or trading or dealing in bonds, shares, debentures, mortgages, hypothecs, bills, notes or other similar property or an interest therein,

(ii) lending money with or without securities,

(iii) rents, hire of chattels, charter-party fees or remunerations, annuities, royalties, interest or dividends, or

(iv) estates or trusts; and

(c) did not carry on an active financial, commercial or industrial business.

(2) For the purpose of paragraph (a) of subsection (1), the members of an individual's family are his spouses, sons and daughters whether or not they live together."

If a corporation falls within the foregoing definition, the following provisions of s. 67 automatically apply:

"67. (1) The income of a personal corporation whether actually distributed or not shall be deemed to have been distributed to, and received by, the shareholders as a dividend on the last day of each taxation year of the corporation.

(2) No tax is payable under this Part on the taxable income of a corporation for a taxation year during which it was a personal corporation.

(3) The part of the income of a personal corporation that shall be deemed, under this section, to have been distributed to and received by a shareholder of the corporation, shall be the proportion thereof that the value of all property transferred or loaned to the corporation by the shareholder or any person by whom his share was previously owned is of the value of the property so acquired by the corporation from all its shareholders."

The provisions of the definition section, s. 68, require examination under the three headings of "control", "sources of income", and "active business", the only necessary preliminary observation being that it is immaterial whether the corporation was incorporated in Canada or elsewhere.

I. **Control**

The first question is whether, throughout its fiscal year in question, the corporation was "controlled" by or on behalf of the persons specified in s. 68(1)(a).

The words "controlled, whether through holding a majority of the shares of the corporation or in any other manner whatsoever", which appear in s. 68(1)(a), appear to be very broad, and to be capable of embracing almost any conceivable *type* of control. I suggest, however, that they are not as comprehensive as that, and that the key to their real meaning and limitations lies in realizing that the word "whatsoever" qualifies the word "manner", and not the word "control".

There is clear authority for this interpretation in the U.K. case of *Himley Estates Ltd.* and *Humble Investments Ltd.* v. *C.I.R.*[2]

[2] (1932), 17 T.C. 367, at p. 377.

In the Court of Appeal Lord Hanworth, M.R., speaking of the words "where the control is by any other means whatever in the hands of those persons", said, referring to the word "whatever": "It is true that that word is found, but it is in reference to the 'any other means', and not with regard to the word 'control'."

The word "control", as applied to corporations, has a well-established legal meaning, which for the moment I shall summarize as "controlling voting power". The *manner* whereby it is attained, and in which it may subsist, may vary, but the *control* itself, in its legal sense, must always exist, and the word "whatever" refers only to the means whereby this *legal* control is exercised. If this be so, it follows that the wording under consideration does *not* mean that the control itself may be of any *type* whatsoever, but does mean that there must be control in the *legal* sense, attained and maintained in any *manner* whatever.

The simplest situation, that of majority voting power according to the share register itself, arose in *B. W. Noble Limited* v. *C.I.R.*,[3] where Rowlatt, J., held that "controlling interest" referred to "the man whose shareholding in the company is such that he is the shareholder who is more powerful than all the other shareholders put together in general meeting".

In *Buckerfields Ltd.* et al. v. *M.N.R.*,[4] the Exchequer Court of Canada followed the same rule (although for the purposes of s. 39 of the *Income Tax Act*, not s. 68) when it held that Companies C and D, 50% of each of whose shares were held by each of Companies A and B, were "controlled" by Companies A and B because of these shareholdings and regardless of all other considerations.

The first variant occurs when a registered shareholder is a mere nominee for someone else who is the real owner of the shares. This situation is of no consequence in Canada because s. 68(1)(a) refers to the holding of a majority of shares by an individual, *etc.* "or by any other person on his or their behalf". This obviously includes reference to pure nomineeships which do not affect real ownership of the shares, so we are still talking of the simple case of direct "controlling voting power".

The second complication arises when a second corporation is interposed between the individual and the corporation whose status is in question. For example, I own the majority of the shares of Company A, which in turns owns the majority of the shares of

3 (1926), 12 T.C. 926.

4 [1964] C.T.C. 504.

Company B Obviously I control Company A under the *Noble*[5] case, and the question whether I also have a "controlling interest" in Company B was answered affirmatively by the House of Lords in the oft-quoted case of *British American Tobacco Co.* v. *C.I.R.*[6] The well-known passages from Lord Simon's judgment include specific approval of the finding of Rowlatt, J., in the *Noble*[7] case, and deal with the interposition of another company as follows:

> The word 'interest' however... is a word of wide connotation and I think the conception of 'controlling interest' may well cover the relationship of one company towards another, the requisite majority of whose shares are, as regards their voting power, subject, whether directly or indirectly, to the will and ordering of the first-mentioned company.

Two points emerge clearly from this most important judgment. The first is that the words "controlling interest" are always linked to what I might call a flow of "controlling voting power", even through intervening corporations. The second is that no proprietary factor in the legal sense is necessary. It is clear from the judgment that if it were, the decision would have gone the other way. The holding was that in the case I put a moment ago, I have no legal proprietary interest in Company B, but nevertheless have a "controlling interest" in it through my majority shareholding control of the intervening Company A.

The case was followed in Canada in *Glaspie* v. *M.N.R.*[8]

The cases so far discussed deal with "a" controlling interest, and it has already become clear that there may be more than one "controlling interest" in a company. The *Noble*[9] case establishes that, in the example I gave, Company A has a "controlling interest" in Company B on the sole basis of the share register of the latter company. The *British American Tobacco*[10] case holds that I, also, have a "controlling interest" in Company B through my direct shareholding control of its parent Company A.

Now s. 68(1)(a) speaks of only one "control", namely ultimate control by or on behalf of certain individuals. This concept, I suggest, would be paralleled by using the words "*the* controlling interest" instead of "*a* controlling interest" in the cases so far discussed.

The provocative case of *Vancouver Towing Company Limited* v. *M.N.R.*[11] presented, but did not have to solve, the problem whether

[5] *Supra*, n. 3.
[6] [1943], 1 All E.R. 13, at p. 15.
[7] *Supra*, n. 3.
[8] (1963), 33 Tax A.B.C. 274.
[9] *Supra*, n. 3.
[10] *Supra*, n. 6.
[11] [1947] C.T.C. 18 (Ex. Ct., Cameron, J.).

"the controlling interest" could consist of anything but controlling voting power. It was not a "personal corporation" case but the facts were substantially as stated in my own example of Companies A and B (one Jones having shareholding control of Company A, which in turn had shareholding control of Company B), with the additional feature that under the Articles of Association of Company B (the lower company) Jones was managing director of that company for life, with complete control of its board of directors, sole authority to exercise the powers vested in the board, and power to appoint, dismiss and replace ordinary directors. In short, Jones controlled Company B through his extraordinary powers as managing director under that company's Articles of Association quite independently of his indirect "controlling voting power" through Company A.

Unfortunately the only question in the case was whether (for the purposes of s. 15A of the *Excess Profits Tax Act*), the upper company, Company A, had *"a* controlling interest" in the lower company, Company B, and the Court held that it had — purely on the basis of voting control as established in the *Noble*[12] and *British American Tobacco*[13] cases.

But the intriguing passage from the judgment, reads as follows: [14]

> It should be noted that the words in the section are *'a* controlling interest', not *'the* controlling interest' or *'the* control'. Unquestionably Jones has the ultimate control in the appellant company and has complete control of its board of directors. He also has an indirect controlling interest in the company itself...

It seems clear that if the Court had had to go beyond deciding who had *"a* controlling interest" (and we have already found that there can be more than one of these) and decide who had *"the* controlling interest" in Company B, the finger would have been put on the individual who had indirect shareholding control and also the extraordinary powers as managing director under the Articles, *i.e.* Jones, in both capacities. From our point of view it is a pity that these two forms of control were not in the hands of different persons, and that the question was not: which of them had *"the* controlling interest".

However, my submission is that even if in that eventuality it had been the extraordinary powers as managing director which determined where "the" control lay, *these powers were derived from the same source which confers decisive voting rights in all*

[12] *Supra*, n. 3.
[13] *Supra*, n. 6.
[14] *Supra*, n. 11, at p. 28.

the other cases, namely the Articles of Association themselves, and not from some source outside the corporate structure.

This, I submit, is the entire key to the meaning of "control" in the legal sense. You must look, and look only, at the relevant *Companies Act* and the Articles of Association, and see who "controls" through the mechanisms which are found there and there only. In practically every case it will be found that the ultimate control lies in voting power. But the reason *why* the Courts have held for this "controlling voting power" is that this control results from the normal company law and the Articles of Association. I would agree that if validly enacted Articles stripped any real control from the voting of shares and vested that control elsewhere, then the "elsewhere" would "control", but again only by reason of the Articles, *i.e.* only because the "control" was provided for by the corporate procedures laid down in the governing company law and the Articles themselves.

It follows that in my opinion no form of pressure or control which can be brought to bear upon the company or its controlling shareholders from *outside* the corporate structure itself will confer "control" in the legal sense, no matter how powerful it may be. I may have the power of life and death over the people who hold the controlling voting power, so that as a practical matter they dare not act except as I direct, but I have no status, under the Articles, within the corporate structure itself, and I therefore cannot "control" the corporation in the legal sense. Similarly, I may be a large creditor, with power to "break" the corporation by calling my loan and suing, in which case the corporation will no doubt as a practical matter pay heed to what I say. But within the corporate structure, for example at general meetings (on which the Courts have always laid the main emphasis) I have no status whatever, much less "control".

Relevant to this irrelevancy between "control" by voting power (or, I submit, any other form of control which might actually be found in the Articles of Association) on the one hand, and control by some form of outside pressure on the other, is the case of *I.R.C.* v. *J. Bibby & Sons Ltd.*[15] in which the House of Lords had to decide whether the company was one "the directors whereof have a controlling interest therein". The facts established that the answer would be in the affirmative if shares held by some of the directors as trustees under certain trusts were counted, but not otherwise. The House of Lords held in the affirmative following the decision

[15] [1945], 1 All E.R. 667.

in the *British American Tobacco* [16] case to the effect that beneficial or proprietary interest was not required.

As to the shares held by some of the directors as trustees under certain trusts, Lord Simonds said: [17]

> Those who by their votes can control the company do not the less control it because they may themselves be amenable to some external control. Theirs is the control, though in the exercise of it they may be guilty of some breach of obligation whether of conscience or of law.

Similarly in *Barclays Bank Ltd.* v. *I.R.C.*,[18] the House of Lords considered the position where a company had issued an outstanding 8,350 ordinary shares of which a deceased shareholder was registered as holder of 1,100, which he owned beneficially, and was also registered as one of four trustees of certain trust settlements with respect to 3,650 additional shares which he had created for the benefit of his wife and children, himself taking no beneficial interest. His name appeared in the share register as the first of the four trustees and, under the Articles of Association of the company, this entitled him to vote in respect of the 3,650 shares. The House of Lords again held that it was irrelevant that a shareholder who had the apparent control was amenable to some sort of outside control, in this case the trust settlements. They therefore held that he "controlled" the company with the 1,100 shares which he owned beneficially and the 3,650 which comprised the trust settlements.

To like effect is the Canadian case of *Rubenstein* v. *M.N.R.*[19] in which shares held by an individual as trustee where held to be on the same footing as, and therefore to be added to, those which he owned personnaly in order to determine whether he had "control".

It is also clear that potential "control" is insufficient, no matter how little remains to be done to translate potentiality into actuality. In the English case of *Himley Estates Ltd.* and *Humble Investments Ltd.* v. *C.I.R.*[20] the question was whether a company was controlled by not more than five persons. An individual held all the common shares. The other fourteen shareholders, each holding as many voting preferred shares as the individual held common shares, were unrelated in any way. The individual and his solicitor were the sole directors and could at any time have caused the company to issue additional shares from Treasury and thereby acquired voting control. It was held that they did not control the

[16] *Supra*, n. 6.
[17] *Supra*, n. 15, at pp. 673.
[18] [1960], 2 All E.R. 817.
[19] (1965), 39 Tax A.B.C. 7.
[20] (1932), 17 T.C. 367.

company, however much they might reasonably have expected as a practical matter to have the "willing co-operation de facto" of the other shareholders in connection with all matters whatsoever relating to the company, and the power to put themselves into legal control if the co-operation had not been forthcoming.

Again, coming closer to home, we have the case of *Rous & Mann Press Limited* v. *M.N.R.*[21] The owners of an incorporated business agreed, by written contract, to sell it progressively to five key employees. The device adopted was to form a new company which (simplifying its capital structure) would issue a large number of redeemable voting preferred shares to the former owners and all its common shares to the five key employees. The new company bought the fixed assets of the old company at realistic values. At the moment of this purchase and for some time afterwards, the owners of the old company, *although obligated by contract to take up preferred shares of the new company which would give them voting control,* had only taken one share each. The question before the Tax Appeal Board related to the basis on which the new company could depreciate the fixed assets, for the Minister had decided that both companies were controlled by the same owners, who admittedly controlled the old company and contracted to control the new one (but did not in fact control it) at the moment of transfer of the fixed assets.

The Board, in a carefully-written judgment referring to all the relevant authorities, including the *Himley* [22] case, decided that even an *obligation* to assume control could not help the Minister if control had not *in fact* been assumed. The contractual obligation to take up the majority of voting shares was between the groups of shareholders and not with the new company itself. The judgment, however, makes it clear that the same result would have followed if the controlling shares of the new company had been subscribed for but not actually allotted and issued.

In the Australian case of *Federal Commissioners of Taxation* v. *West Australian Tanners & Fellmongers Ltd.,*[23] there were several combinations of not more than seven shareholders of a company, any one of which could have controlled the company. In choosing between them the Court said: [23a]

> ...only that group which not only has the capacity to control, but also exercises it, can be regarded as in control.

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21 (1953), 9 Tax A.B.C. 56.
22 *Supra,* n. 20.
23 (1945), 8 A.T.D. 25.
23a *Ibid.,* at p. 28.

It is true that s. 139(5d)(b) of the *Income Tax Act* provides in substance that a person who has a right to acquire shares in a corporation, or to control the voting rights of shares, will (with certain exceptions) be deemed to have control of the corporation as if he owned the shares.

It is expressly stated, however, that this provision applies only to the purposes of s. 139(5a), which in turn relates back to the definition of "related persons" in s. 139(5) in connection with the question of "arm's length" dealing: in other words, s. 139(5d)(b), referred to in the preceding paragraph, does not affect the word "control" in the definition of a "personal corporation" as found in s. 68(1)(a).

My submissions on the subject of "control" within the meaning of s. 68(1)(a) are therefore these:

1. The *control* itself can *not* be of any type whatever but must be "control" in the legal sense, *i.e.* through the corporate procedure provided by the governing statute and the Articles of Association.

2. In practically every case this will mean "controlling voting power" either directly or through intervening controlled corporations. The only exception will be if *valid* Articles of Association place elsewhere the ultimate control which is normally vested in the majority of voting shares.

3. A person in a position to bring even the strongest forms of pressure *from outside* against the company or its controlling shareholders does not "control" the company unless his "control" can also be exercised by the *internal* procedures provided by the Articles and the governing statute.

4. Potential control is not sufficient, even if there is a contractual obligation to assume actual control.

5. It is only the "manner" in which this *legal* control may be exercised, which may take any form "whatsoever".

In what other *manner* "whatsoever", then, one may ask, can control in the legal sense subsist, *i.e.* otherwise than by the "holding" of the majority of the shares? Because of course the words "or in any other manner whatsoever" must be given some meaning rather than none. Two examples come readily to mind, though there may well be others.

The first centres on the word "holding" — a majority of the shares. Beneficial ownership, or indirect ownership through an intervening controlled corporation, is not specifically mentioned. The case of "control" of Company B through Company A (*i.e.* the

British American Tobacco[24] case) is therefore one example of what "in any other manner whatsoever" may mean.

The second obvious example is the case of a company without share capital. "Control" must lie somewhere, and one must, presumably, look to the Articles of Association to find where it is. The speculations inherent in the possibility of, say, a charitable corporation or a research foundation without share capital being within the meaning of its Articles "controlled" by persons designated in s. 68(1)(a), who however cannot under the objects clauses possibly under any conditions "get at" any of the assets for their own benefit, are challenging, to say the least.

The question of what happens to the status of a "personal corporation" upon the death of the controlling shareholder arose in *Settled Estates Ltd.* v. *M.N.R.*[25]

The controlling shareholder left his estate to executors who were residents of Canada, for beneficiaries who did not themselves constitute a family group as contemplated in s. 68(1)(a), nor was there evidence that any of them resided in Canada.

The appellant company nevertheless contended that it was still a personal corporation because the executors themselves (one of whom was an individual and the other a trust company) constituted "an individual resident in Canada".

This contention was based on the definitions of "individual" contained in s. 139(1)(u) and of "person" as found in s. 139(1)(ac). The relevant portions of those two definition sections may be combined to read as follows:

> 'individual'... includes... the executors, administrators or other legal representatives of such individual...

In other words, the appellant argued that because the word "individual" is in s. 139 defined so as to include that individual's executors, the executors can themselves constitute an "individual" within the meaning of s. 68(1)(a).

The Tax Appeal Board, the Exchequer Court and the Supreme Court of Canada all held that for the purposes of s. 68(1)(a) the word "individual" could not bear that expanded meaning but must mean a natural living person resident in Canada. The reasoning underlying this conclusion was that although for general purposes the word "individual" will include the individual's executors, such will not be the case where the contrary clearly appears from the

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[24] *Supra*, n. 6.

[25] [1959] C.T.C. 284; [1960] C.T.C. 173.

context. The context in s. 68(1)(a) does indicate the contrary, in that it consists of reference to an "individual" resident in Canada, or *such an "individual" and one or more members of his family.*

Therefore, said the Board and the Courts, for the particular purposes of s. 68(1)(a), the word "individual" must only refer to a natural living person capable of having a family. The executors resident in Canada could therefore not be said to be an individual residing in Canada, despite the definitions set out in ss. 139(1)(u) and 139(1)(ac). And, it will be remembered, the legatees themselves were not the spouse, sons and daughters of the deceased. In the result, the appeal was dismissed.

It would, however, apparently be different if the beneficiaries *did, themselves,* consist of "an individual resident in Canada" or "such an individual and one or more members of his family" (*i.e.* spouse, sons and daughters) "who were resident in Canada", for in that case the executors, wherever they themselves might reside (and this would not matter), would control the company "on behalf" of an individual or group resident in Canada and qualified in his or their own right under the requirements of s. 68(1)(a).

In this regard Judson, J., of the Supreme Court of Canada said (although *obiter*), in the *Settled Estates* [27] case:

> The last mode of control is by any other person on behalf of an individual or on behalf of an individual and members of his family. I can think of situations where executors could exercise control under this third mode of control, for example, if T dies leaving all his shares in a personal corporation to executors and trustees in trust for an individual or for that individual and members of his family. But that is not the present case.

That situation, however, did arise in *Dawson Investments Ltd.* v. *M.N.R.* [28] The deceased left his controlling shares in a personal corporation to executors and trustees upon trusts for his spouse, a son and a daughter. The spouse and son resided in Canada, the daughter in the U.S. The son and daughter also owned shares in their own right, but taking *all* the issued shares into account, the control lay in or was being exercised for a family group residing in Canada which consisted of the testator's spouse and son. The Tax Appeal Board held, distinguishing the case from the *Settled Estates* [29] case on that ground, that the company retained its status as a personal corporation.

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[27] [1960] C.T.C. 173, at pp. 176-177.
[28] (1963), 33 Tax A.B.C. 433.
[29] *Supra,* n. 27.

It is worth noting parenthecally that in two cases decided under the *Income War Tax Act*, where the definition of a "personal corporation" in s. 2(i) of that *Act* was for present purposes substantially as it now, personal corporations were also held not to lose that status upon the death of the controlling shareholder when, *and because*, the executors and trustees administered the controlling shares on behalf of the widows and children of the deceased, who themselves constituted groups meeting the requirements of the definition: *Port Credit Realty* v. *M.N.R.*;[30] *Ernest Gilman, Incorporated* v. *M.N.R.*[31]

II. Sources of income

Under s. 68(1)(b), a company must, in order to be a personal corporation, derive at least 25% of its income from:

(i) ownership of or trading or dealing in bonds, shares, debentures, mortgages, hypothecs, bills, notes or other similar property or an interest therein,

(ii) lending money with or without securities,

(iii) rents, hire of chattels, charterparty fees or remunerations, annuities, royalties, interest or dividends, or

(iv) estates or trusts.

This requirement has not occasioned much litigation or difficulty of interpretation.

It has however been pointed out in two cases that the company must, in order to meet the requirement, have *some net* income from the sources mentioned, *i.e.* it cannot qualify if it has gross income but a net loss from these sources (*No. 84* v. *M.N.R.*;[32] *Manson* v. *M.N.R.*[33]

The latter case presented an additional point of controversy in that its income from the abovementioned sources consisted of rental income of $2,837.14 and mortgage interest of $3,502.96, whilst its expenses of $6,504.28 all related to the rental income. If (as the Crown contended) all of the expenses of $6,504.28 were applied against the rental income of $2,837.14 and the mortgage interest of $3,502.96 were to be considered as a separate item not subject to any expenses, more than one-quarter of the company's income would have been derived from the above-noted sources and the company would be a personal corporation.

30 [1937] Ex. C.R. 88.
31 [1937] Ex. C.R. 98.
32 (1953), 8 Tax A.B.C. 107.
33 (1961), 27 Tax A.B.C. 275.

It was however held that the income from the rent and the mortgages must be combined and the total of the expenses deducted therefrom. On this basis the Company had a loss of $164.18 from the stipulated sources and, as stated above, was held not to be a personal corporation.

Before leaving the subject of sources of income, it should be observed that in the cases of the above items (ii), (iii) and (iv), the receipts to be taken into the calculation will be receipts of an income, and not of a capital character, while receipts from item (i) will also include profits from "trading or dealing in" bonds, shares, debentures, mortgages, etc.

The question of the extent to which trading will amount to the carrying on of an active financial, commercial or industrial business (which disqualifies the company from personal corporation status apart from all other considerations) is a separate matter and will now be discussed under the heading "Active Business".

III. **Active Business**

Under s. 68(1)(c) a corporation is excluded from the definition of a "personal corporation" if at any time during the taxation year it carried on an active financial, commercial or industrial business. To remain outside the definition, therefore, the company must carry on a business and it must be an active business.

The expression "carrying on business" is dealt with in s. 2(2) and s. 139(7) of the *Act*, but only from the viewpoint of non-residents, for the obvious reason that a resident is taxable on all his income and he does not need to be "carrying on" a business in order to be taxable on the profit from a business transaction, let alone carrying on an "active business".

The approach must therefore be to look at the definition of a "business" in s. 139(1)(e), then decide whether a business is being "carried on", and then further decide whether it is an "active" business.

"Business" is defined in s. 139 (1)(e) as follows:

> 'business' includes a profession, calling, trade, manufacture or undertaking of any kind whatsoever and includes an adventure or concern in the nature of trade but does not include an office or employment;

the use of the singular "an" adventure... should be noted.

Now while a resident is taxable under s. 3 on "income" from any of the sources comprised within that definition, it is not necessary that he "carry on" any one of those activities with any degree of continuity or repetition; indeed, consistently with the fact that "an" adventure or concern in the nature of trade constitutes "business" as defined in s. 139(1)(e), the profit from an isolated transaction has frequently been brought into charge for tax purposes *Chutter* v. *M.N.R.*;[34] *M.N.R.* v. *Taylor*;[35] *Alexander* v. *M.N.R.*;[36] and previous leading U.K. cases including *C.I.R.* v. *Livingston*;[37] *Rutledge* v. *C.I.R.*[38]

In such a case, however, it would not necessarily result that the taxpayer would be held to be "carrying on" a business. Most of the cases dealing with the expression "carrying on business" have arisen under the extra-provincial corporate licensing Acts of the various provinces, and, while care must be taken in evaluating these cases because of special definitions which sometimes affect the interpretation, it is true to say that the expression "carrying on business" is construed as involving a degree of continuity: of "carrying on", as distinct from some isolated exercise of a corporate power. So far as tax cases are concerned, some support for this view is found in *No. 418* v. *M.N.R.*,[39] and I have found nothing to the contrary.

I therefore submit that if a company is to be taken out of the definition of a personal corporation by reason of s. 68(1)(c), its business transactions must possess some substantial degree of continuity and repetition. This concept is, I think, emphasized by the use of the word "active", which is defined in the *Concise Oxford Dictionary*, 3rd Ed., as "given to outward action; working, effective, energetic, diligent".

As may be expected, the numerous decided cases on what constitutes an "active business" rest on their individual facts. It is nevertheless possible (though admittedly intrepid!) to distil from these cases certain general principles or "signposts". Therefore, rather than simply analyse cases one by one, I propose to enunciate each of the general principles or "signposts" which I think can be discerned, and discuss briefly the principal cases which I think support each of them.

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34 [1955] C.T.C. 377.
35 [1956] C.T.C. 189.
36 (1963), 34 Tax A.B.C. 377.
37 (1926), 11 T.C. 538.
38 (1929), 14 T.C. 490.
39 (1957), 17 Tax A.B.C. 132.

1. *A close connection with personal or family-controlled operations of a basically investment nature will probably defeat any contention that there is an active business.*

In *No. 74* v. *M.N.R.*,[40] a company called "B Finance" was owned by a father and two sons. In another company called "B Motors" the father owned almost all the preferred shares, and the sons owned a majority of the common. The income of "B Finance" was derived solely from the financing of lien notes received by "B Motors" from its customers and from interest on loans which it made to "B Motors". There were only six or seven transactions per year between the companies. They were accomplished by book entries, *i.e.* no cheques passed. "B Finance" had no employees of its own, no office, no sign on a door, and no telephone listing. Its records were kept in the office of "B Motors", whose employees did all the work. It had no other business and did no soliciting and its capital was nominal.

The Tax Appeal Board held that in view of all these considerations the business was not "active", and that the company was a personal corporation.

Similarly, in *Manson* v. *M.N.R.*,[41] a company owned a building which was rented to four tenants, a major tenant being a company controlled by the appellant's wife. The company claimed that it carried on an active business because it obtained tenants, collected rents, employed building staff and attended to maintenance. It had, however, no office, clerk, or stenographer, and it did no advertising or promotion. The gross rents totalled about $27,000 per year.

The Tax Appeal Board held that the company "was merely a landlord in not a large way and what was done by it hardly merited description as either an active financial or commercial business". Of the business, the Board said, "It may be a business, but if it is such, I can only regard it as a passive and not an active business," adding that the company "had chiefly to receive rents and make certain disbursements as a matter of routine". Its operations were not "large or busy".

The judgment also pointed out that the volume or extent of the assets and income was one important factor as an indication of the extent and therefore the "activity" or otherwise of operations; that the assets and income were much less in this case than in *No. 74*[42] which I have already discussed (the "B Finance" case), and that

[40] (1952), 7 Tax A.B.C. 250.
[41] (1952), 7 Tax A.B.C. 298.
[42] *Supra*, n. 40.

even in the latter case it had been held that there was not an "active" business.

2. *Of significance also will be the question whether the company has an office and employees, whether it engages in advertising, promotion and contacts with the public and whether it maintains full records and holds normal meetings.*

These factors were lacking in both the cases which I have discussed under principle No. 1.

Similarly in *Finning* v. *M.N.R.*,[43] Company A was assessed as a personal corporation but claimed to be carrying on an active business. It purchased customers' notes, principally from an operating company (Company B) which was owned by the same family, and then pledged them to the bank at lower interest rates in order to obtain financing loans. Its profits consisted of the spread between the two interest rates.

During the three years in question it purchased 863 such notes from Company B and only four from outside interests. It had no office, no telephone listing, no employees and did no advertising; it was in fact entirely run by employees of the operating company B from the latter's office.

It was held that Company A did not carry on an active business but on the contrary was passive in the sense that it "did nothing with its own mind at all". It was accordingly held to be a personal corporation.

In *Smith* v. *M.N.R.*,[44] a company which was assessed as a personal corporation controlled six other companies which were active in the field of oil drilling equipment. The company claimed that it carried on the active business of managing these other companies and was thus not a personal corporation. It had no office, no staff, and no telephone listing. Its only income was a dividend of some $25,000 from one of the six operating companies. Its expenses amounted to $358.

Here again it was held that the company "virtually did nothing" and was a personal corporation.

In *Sawle* v. *M.N.R.*,[45] a company owned four small buildings in Welland, Ontario. The annual rental from the largest was some $24,000 and the annual rentals from the other three (in which there were seven tenants) totalled approximately $12,300. The company in addition had investment income of about $1,000.

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[43] [1961] C.T.C. 425.
[44] (1963), 34 Tax A.B.C. 259.
[45] [1967] Tax A.B.C. 757.

The company employed a janitor who was supposedly full-time, but really only worked part-time (his salary was $25 per week) to look after the heating in the main building and to see that the stairways and halls were cleaned.

The administrative expenses were negligible and the company had no office or employees of its own but was run from the office of one of its shareholders (who conducted an engineering practice) in Ste. Catharines.

It was held that the company conducted very little activity and was passive rather than active in the matter of carrying on business; it was in consequence held to be a personal corporation.

By contrast, in *No. 196* v. *M.N.R.*,[46] the appellant was the principal shareholder in two private companies which owned and administered (except for the actual leasing) three large commercial buildings on a main street. There were sixty-one tenants and the gross rents were about $91,000. The appellant had offices in one of the buildings and took an active part in the administration. Holding that the companies did "carry on an active business" the Tax Appeal Board said "both corporations were operating actively the business of managing and maintaining commercial buildings for the purpose of deriving revenue therefrom", and added that the supervision and efficient operation of the buildings "could well be in the category of a full-time occupation for each of the corporate owners".

A borderline case which might have gone in the taxpayer's favour had he been represented by counsel and realized that he had to give actual evidence of the alleged activity, was *Van der Voort* v. *M.N.R.*[47] The appellant and partners owned and operated two fairly large apartment buildings from 1933 until 1953 when the buildings were sold to a private company which operated them until 1955 and then sold them. The company reported as a personal corporation until the buildings were sold in 1955 but then reversed its position and claimed that it had not been a personal corporation because of the active business functions of administering the buildings.

One gathers from the report that since there were two apartment buildings involved, the submission of appropriate evidence might have revealed a degree of activity approaching that which was proved in *No. 196*[48] which I mentioned a moment ago. However, the Tax Appeal Board held: [49]

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46 (1954), 11 Tax A.B.C. 312.
47 (1958) 21 Tax A.B.C. 28.
48 *Supra*, n. 46.
49 *Supra*, n. 47, at p. 30.

No evidence was given before me as to the extent of the activities carried on by Van der Voort Agency Limited other than the ordinary activities connected with the looking after a block of apartments and receiving the rents therefrom. Under these circumstances, I am of the opinion that this cannot be considered as the carrying on of an *active* commercial business.

3. *The volume of business is important and is often related to the question of closeness to personal or family-controlled operations of an investment nature.*

This point has already been made in *No. 74*,[50] *No. 196*[51] and in the *Manson*[52] case, all of which I have already discussed under Principles Nos. 1 and 2 above in other contexts.

In *Glaspie* v. *M.N.R.*,[53] the company concerned was a diversified investment company, investing in securities, mortgages, real estate, *etc.* The book value of its assets was approximately $1,500,000. For various reasons its investment portfolio had been neglected for some years and in 1959 a number of overdue revisions were carried out. The evidence however was to the effect that there were no radical changes and that what was done amounted to a reorganization of the portfolio rather than dealing in securities, *etc.*

Two weeks before the end of its fiscal year the company had bought for $300 a small smoking supply shop, which it operated for the two weeks at a net loss of $91.44.

The company was held to be a personal corporation: its securities transactions did not constitute carrying on an active business for the reasons stated above and, as for the tobacco shop, the Court said: [53a] "It would be ridiculous to hold that by reason of this one small operation Glaspie Lumber Company Limited could be considered to be other than a personal corporation."

In *Portigal* v. *M.N.R.*,[54] a company was incorporated in 1959 for broad investment purposes, including power to invest and deal in mortgages and other interests in land, to lend money, *etc.* During 1959 it made three loans against notes; in 1960, it made one mortgage loan; in 1961, four mortgage loans; in 1962, three mortgage loans and one loan against a note, and, in 1963, two mortgage loans; making

[50] *Supra*, n. 40.
[51] *Supra*, n. 46.
[52] *Supra*, n. 41.
[53] (1963), 33 Tax A.B.C. 274.
[53a] *Ibid.*, at p. 284.
[54] [1967] Tax A.B.C. 1117.

a total of fourteen loans which averaged $33,500 and bore interest averaging about 10%.

The Minister treated the company as a personal corporation for the first four years but in 1963 the company set up a reserve of $8,000 for bad debts, paid the principal shareholder a salary of $6,000, charged up $800 travelling expense, and took the position that it was carrying on an active business and was not a personal corporation in that year.

The Minister ruled that the company was still a personal corporation, disallowed the deductions, and attributed the company's income to its shareholders accordingly.

It was held that the company's "activities were not sufficient to qualify it as being in an active financial business for the purpose of s. 68(1)(c) of the *Act*" and therefore remained a personal corporation.

4. *The old "corporate objects" test which was finally discarded by the Supreme Court of Canada in the* Sutton Lumber *case*[54a] *still seems to be of some significance as regards s. 68(1)(c).*

It will be remembered that this former doctrine maintained that if a company had certain powers (notably powers to "sell" assets) under its Memorandum of Association, and more particularly if the inclusion of those powers in the Memorandum of Association was unnecessary because the powers were already given by the relevant Companies Act, the carrying out of any operations within the ambit of those powers would result in the profit therefrom being of an income nature because this was the "company's business".

Two cases seem to indicate that there are still, or were until fairly recently, subsisting traces of this doctrine when it comes to deciding whether a company is carrying on an "active business" for the purposes of s. 68(1)(c).

In *Baker Estates Ltd.* v. *M.N.R.*,[55] a company was formed "to make investments", including investments in real estate. It acquired blocks of flats together with some vacant land and later purchased more lands for the construction and sale of 30 two-unit dwellings. It in fact built two apartment buildings on the land which it originally bought. These buildings cost $81,000 against an estimated cost of $55,0000 - $60,000. The company then took advice as to the feasibility of proceeding with the 30 two-unit dwellings, having

[54a] [1953] C.T.C. 237.
[55] (1954), 11 Tax A.B.C. 391.

regard to its financial resources and the probability that these dwellings would also cost more than estimated. As a result of the advice received, it abandoned the balance of its building plan and, being unable to sell the land en bloc, sold the individual lots and was assessed on the gains.

The Tax Appeal Board held that the company did not deviate from its business as an investor. It did not dispose of the buildings which it originally acquired or those which it later built itself. It did dispose of investments which upon advice turned out to be an unacceptable risk. Mr. Monet said: [55a] "The appellant did not engage in the business of real estate transactions for the purpose of realizing a profit or gain and consequently the profits it realized are in the nature of capital gain." He held that in consequence the appellant was not disqualified as a personal corporation.

The point here relevant is that in the judgment considerable emphasis was laid on the objects clause in the Memorandum of Association as interpreting the true nature ("to make investments") of the operations which in fact took place.

In *No. 585* v. *M.N.R.*,[56] a company was incorporated on April 4th 1950, with the corporate powers of a contractor and builder. It bought land and began to build a block of flats, borrowing money from CMHC to do so. It then granted an option to sell the building, and sold it in 1951. Meanwhile the building had been completed and some rents had been received in 1951 before the building was sold. Upon the sale of the building in 1951 the company changed its name and altered its objects to those of a holding company. The Minister treated the rent as income from a non-personal corporation while the company contended that it was a personal corporation since the apartment building was built for investment purposes and the company did not carry on an active business.

The Tax Appeal Board held that the corporate objects (namely those of a contractor and builder) were in the nature of trade and were in fact carried out. The company bought lands, built apartments, borrowed money, leased apartments, and sold its building — all as empowered in its charter. The name and the objects were not changed until after this was done. The Board therefore held the company not to be a personal corporation and in so doing attached considerable significance to the corporate objects themselves.

Despite these cases the more recent tendency is, as in my opinion it should be, to attribute prime importance to what the company

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[55a] *Ibid.*, at p. 398.

[56] (1958), 21 Tax A.B.C. 56.

in fact did rather than to what it was entitled to do or might have done.

Thus in *Stekl* v. *M.N.R.*,[57] (a case which will be discussed more extensively later upon a different point), the Court said:

> Before commenting on the evidence I should refer to two arguments advanced by counsel for the appellant. He submitted, in effect, that since the Company's memorandum of association provided that the object for which it was incorporated was for investment purposes only it did not have the power to engage in business and that if it did so its act was *ultra vires* and void. But it is obvious that this cannot affect the taxability of a profit made by it if such profit was from a transaction that was a business transaction or an adventure or concern in the nature of trade. The taxability of the profits of a corporation depends on the true nature of its transaction, that is to say, on what it did, not on what it was empowered or not empowered to do.

The same reasoning would no doubt have applied in reverse had the objects been of a business nature but the operations of an investment nature.

Mention should also be made of the case of *Mendel* v. *M.N.R.*,[58] in which a company met the requirements for being held to be a personal corporation in 1960, but in 1961 acquired an active business *with effect from January 1st 1960*. The Minister assessed the shareholders on the basis that the company was a personal corporation in 1960 and they appealed, claiming that, the effective date of acquisition of the active business having been January 1st 1960, the company could not have been a personal corporation in that year.

The Tax Appeal Board held that whatever effect the agreement of acquisition of the active business in 1961 might have had between the parties to it as regards back-dating its effect to January 1st 1960, the Minister was right in assessing on the basis of the facts as they actually existed in 1960, *i.e.* what the company actually did during that year, and it did not in fact carry on an active business.

The four general principles or "signposts" which I have tried to outline may perhaps be of some assistance in assessing first of all the nature and secondly the extent of operations which will be held to constitute an "active business". It is obvious, however, that each decided case has rested solely on its own facts and I think that the only discernible overriding principle is that an "active business" will only be reasonably certain to be held to exist and be "carried on" if it is substantial in volume, divorced as far as possible from business of an investment nature operated by a

[57] [1959] C.T.C. 442, at p. 452.
[58] (1965), 37 Tax A.B.C. 305.

closely-held group, if it is a "real" business, preferably involving offices, employees, contacts with the public, *etc.*, instead of being a "sham" or "token" business, and if it is conducted in accordance with objects clauses indicating a business of a financial, commercial or industrial nature.

It will be recalled that, entirely apart from personal corporation considerations, a taxpayer can be subject to tax on the profit from an isolated "adventure in the nature of trade", because under s. 139(1)(e) such a transaction, even though isolated, is a "business".

We have also seen, however, that in order to fall outside the definition of "personal corporation" on the business ground, the business must be "carried on" and it must be "active". Both elements are lacking in the case of the isolated (even though itself taxable) transaction.

This is aptly illustrated by the case of *Stekl* v. *M.N.R.*[59] The company, which had been largely dormant until 1952, purchased a large apartment block in that year; in 1953, it acquired a substantial portfolio of securities, and a timber license, the latter from the appellant for $15,000.

The company was at all material times controlled by the appellant.

In 1955 the company sold the timber license, in a transaction which the Court held to be a trading nature, for net $47,000, *i.e.* at a profit of $32,000. The company's other income, all from investments, was just over $7,000.

The Minister ruled that the company was a personal corporation and assessed the shareholders on its income of $39,000. The appellant appealed as regards his share.

Dealing with the appellant's contention that if the company was engaged in business resulting in a taxable profit it could not be a personal corporation, Thorson, P., said: [59a]

> The submission was based on Section 68(1)(c) of the Act which included in the definition of a personal corporation the requirement that during the whole of the taxation year in respect of which the expression was applied the corporation 'did not carry on an active financial, commercial or industrial business'. In my opinion, even if the Company transaction relating to the timber *(sic)* was an adventure in the nature of trade that did not put it into the category of having carried on an 'active' business in 1955 in such a way as to deprive it of its character as a personal corporation.

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[59] [1959] C.T.C. 442.
[59a] *Ibid.*, at pp. 452-3.

While this disposed of the appeal, and is undoubtedly good law, a curious feature of the case is that no-one raised the point that only $7,000 out of the company's income of $39,000 (*i.e.* less than 25%) arose from the sources listed in s. 68(1)(b), namely ownership of or dealing in securities, lending money, receiving rents, royalties, interest, dividends, *etc.*, and income from estates or trusts. This is quite a separate point from that with which the Court dealt, the latter relating as it does to a different element of the definition of "personal corporation".

It would certainly seem that if the point concerning less than 25% of the income having been derived from the sources mentioned in s. 68(1)(b) *had* been raised, it would have sufficed to decide the case the other way, whether or not as a separate matter the company carried on an active business.

IV. **Tax status**

It will be recalled that if the company meets the definition of "personal corporation" throughout its taxation year, it pays no tax for the year but all its income is deemed to be distributed to the shareholders as a dividend on the last day of the taxation year; the shareholders however do not receive the 20% dividend tax credit under s. 38 on this "global" dividend because that credit only applies to dividends from taxable corporations (s. 38(1)).

Thus the general principle is to disregard the company for tax purposes, as if it were a mere "conduit pipe" through which the income passes directly from source to shareholders' pockets and is taxed in their hands as if received directly from source.

Simple though this concept may appear to be, it does involve a number of complexities, some of which arise from the fact that as a matter of corporate law the company *is* a separate entity from its shareholders despite its being supposedly ignored for tax purposes.

It is appropriate to comment briefly on the more important of these.

1. If a company meets the definition of personal corporation throughout its taxation year, it is automatically and conclusively held to be a personal corporation for that year, *i.e.* there is no option or election open to the shareholders as to the basis on which they, or the company, or both, will be taxed (as there is, for example, in the case of companies eligible, under s. 70, to be taxed as non-resident-owned investment corporations).

2. S. 68(1) requires that to be a personal corporation a company must meet all the requirements during the *whole* of the taxation year in question. Therefore if any event occurs during the year inconsistent with the definition, *e.g.* if the company begings to carry on an active business, the company will not be a personal corporation for *any part* of the year.

The solution in such a case is to change the company's fiscal year with the consent of the Minister as provided in s. 139(1)(r), so that the date of the change will be the end of a fiscal period, and the personal corporation status will therefore be valid up to that date. The reverse procedure could of course be followed if a company, not being a personal corporation but wishing to become one during a fiscal year, should discontinue its active business and concurrently terminate its fiscal year with the approval of the Minister under s. 139(1)(r).

3. The company's income is deemed to be distributed to its shareholders as a dividend not in proportion to their respective holdings of shares but in the proportions in which each of them or their respective predecessor shareholders transferred or loaned property to the company (s. 67(3)). A person who contributes all or most of the assets therefore cannot shift the incidence of tax by having some shares issued to others than himself.

4. In cases where a company which has always been a personal corporation actually pays a dividend, the dividend is of course not taxable in the hands of the shareholders because it has already been taxed to them as and when earned by the company.

If, however, a dividend is actually paid by a company which has been a personal corporation in some years and not in others, the dividend will be taxable to the shareholders who actually receive it (*i.e.* not in the proportions in which they or their predecessors contributed property to the company) to the extent that the dividend is paid out of theretofore undistributed income of the company earned in years in which it was not a personal corporation. S. 67(7) lays down the rules for determining the amount of undistributed earnings falling in this category.

5. Provision has to be made for the "flow-through" to the shareholders of such benefits as they would be entitled to receive if the income came to them directly from the underlying sources. For example to the extent that the income of a personal corporation deemed to be received by a shareholder at the end of the corporation's fiscal year consists of dividends received by the personal corporation from taxable Canadian corporations, the shareholder

receives the 20% dividend credit against his tax which he would receive under s. 38 if the dividends were paid directly to him (s. 67(10)). Similarly, to the extent to which the income of the personal corporation which he is deemed to receive consists of income from foreign sources upon which the foreign countries concerned have levied withholding tax, the shareholder will be entitled to credit for the withholding tax to the same extent as if he had received the income directly from the foreign sources (s. 67(11)).

While the "conduit pipe" and "flow-through" concepts have developed progressively over the years since the "personal corporation" was first introduced into the *Income War Tax Act* in 1926, it is not yet true to say that the existence of the corporation is 100% ignored for tax purposes and that the shareholder is treated 100% as if the corporation did not exist.

For example, there is no provision in the *Act* for the deduction of charitable donations from taxable income by a personal corporation because the corporation has no taxable income (administratively, however, the Department does allow equivalent relief to the shareholders, but this is still not a matter of statutory right); further, if a shareholder lends money to a personal corporation, the interest received is fully taxable and the shareholder is not entitled to relief in the form of the 20% credit in respect of dividends from the underlying securities, or of credit for foreign withholding taxes imposed by the country of origin, as mentioned above.

Again, ss. 8(1) and 137(2) of the *Act*, taxing benefits conferred by corporations on their shareholders, appear to be applicable to personal corporations and to be contrary to the pure "conduit-pipe" concept. Losses sustained by a personal corporation which is wholly owned by another personal corporation have been held *(Richardson* v. *M.N.R.)* [60] not to be deductible from the income attributed to a shareholder of the latter corporation because the two corporations were "separate taxable persons".[61]

On the whole, however, it is fair to say that the "conduit-pipe" principle, which involves ignoring the existence of the personal corporation for tax purposes, has gradually evolved reasonably closely to completion. Each case involving the contemplated use of a personal corporation should, nevertheless, be minutely scrutinised on all of its particular facts, to see whether any of the fore-

[60] [1940-41] C.T.C. 258.

[61] *Per* Maclean, J., at p. 263.

going or other imperfections in the "conduit-pipe" theory are likely to prove to be of consequence.

V. Personal Corporation — To use or not to use?

At the beginning of this article I pointed out that any corporation (not necessarily a personal corporation as defined in s. 68) could serve as a vehicle to which to transfer one's securities for *certain* of the purposes commonly desired, *i.e.* to centralize the administration and the situs of the securities both before and after one's death.

I also suggested that, if tax on the income from the securities is a consideration, the investor should first calculate what the total income tax impact would be if he transferred the securities to an ordinary (non-personal) corporation, the impact in that case consisting of tax on the income in the company's hands when received, and in the investor's hands when paid out by the company to him (a step which, together with payment of the tax thereon, could be postponed at the will of the investor if he controlled the company).

The intervening material will, I venture to hope, enable the investor to compare these calculations with the tax impact which would result if a personal corporation were used, *i.e.* there would be no tax on the company's income, but the income would be deemed to be distributed to the shareholders as a dividend at the end of each year and taxed in their hands accordingly.

Finally, the investor should decide just what he wishes to achieve, and evaluate the respective roles which the two types of company can play in achieving his objectives.

Some examples follow.

1. A very common (indeed perhaps *the* most common) objective is to "freeze" the value of the investor's holdings at their present levels for succession duty and estate tax purposes, whilst providing that future capital enhancement will enure to the eventual benefit of his children.

Here a personal corporation should definitely be used. There are sections of the *Income Tax Act* (notably s. 138A but others besides) under which the Department of National Revenue can attack a wide variety of transactions, including estate-planning arrangements of the type here under discussion, and one result of these attacks can be to impute taxable benefits to the investor as a result of events which occur *after* he transfers his securities and so attempts to "freeze" their value.

This is a separate and highly complex area of income tax law, but it will suffice for present purposes to say that the Department is much less likely to move against a plan based on a personal corporation than on a non-personal corporation, because in the former case the taxpayer is obviously not trying to reduce current taxes by accumulating income in a company: the income of the company is all deemed to be paid out to him as a dividend at the end of each year anyway, on the "conduit-pipe" principle.

Care should obviously, and for the same reason, be taken to see that such a company retains its "personal corporation" status at all times.

2. If the investor wishes the "personal corporation" status to survive his death and the company to be administered by his executors for his beneficiaries, he should ensure that the beneficiaries will *themselves* constitute a group as defined in s. 68(1)(a) and 68(2), *i.e.* an individual resident in Canada, or such an individual and one or more of: his spouse, sons and daughters, also resident in Canada.

Thus the investor's widow and children, in whatever proportions and with whatever interests inter se, would constitute such a group; two children each entitled to 50% would not; one child with 51% and another with 49% would, *etc.*

3. An investor seeking to achieve the objectives set out in both Nos. 1 and 2 above could therefore proceed somewhat as follows:

(a) cause a company to be incorporated, with voting preferred shares and common shares.

(b) subscribe (himself) for sufficient preferred shares to ensure voting control, and have his children (or trustees under irrevocable trusts for them) subscribe for common shares. The numbers of shares issued need not be large, provided that the proper proportion between voting preferred shares and common shares is created and maintained, the voting preferred always retaining control.

(c) sell his portfolio of securities to the company at their market value against further preferred shares, or debentures, or open-account debt, of the company. Some care should be devoted to this choice on technical grounds, but in any case the investor can receive during his lifetime, in the form of preferred dividends or interest, the entire income of the company, on which he pays tax in any event, and also have voting control of the company, while any enhancement in the value of the underlying securities increases the value of the common shares, which are owned by or for the children.

(d) provide in his Will that the income of his estate be paid by his executors to his widow during her lifetime, and the capital after her death to his children in equal shares.

4. The plan outlined above (or one of many admissible variations of it) will secure personal corporation status until the death of the widow, when the capital (which includes the controlling preferred shares) is divided between the children. The status could be preserved for still longer by providing, for example, that the preferred shares would not go to the children equally on the widow's death but say 51% to one child and 49% to the other or others, together with (if desired) a provision that the shares would remain in the hands of the executors until the children reach stated ages well above majority.

5. Moving into an area wider than (but including) estate planning, it will be evident that the "active business" aspect in the definition of a personal corporation not only constitutes the greatest pitfall in the matter of accidentally falling into or out of the definition, but also provides a mechanism for coming into or out of the definition at one's own will. The self-imposed "ground rules" should be:

(a) if you want personal corporation status, keep as far away from "active business" as you can.

(b) if you do not want the status, conduct a genuine, substantial business and not a "sham" or a "token" one.

(c) if you want to change the status, and the new status to become effective immediately, either commence or discontinue the active business (as the case may be) at the end of the company's fiscal year if possible; otherwise change the fiscal year with the Minister's consent, under s. 139(1)(r), so that the date of commencement or discontinuance of the active business will constitute a new fiscal period.

VI. Conclusions

It will be seen that the personal corporation need only be used (as distinct from a non-personal corporation) as a vehicle for taking ownership of an individual's securities when, in addition to securing centralization of administration and situs of the securities, the investor desires to accomplish one or both of the following objectives:

1. to pay personal income tax on the entire annual income from the security portfolio on the "conduit-pipe" principle; and

2. to freeze the value of his securities at their present value for succession duty and estate tax purposes in connection with the planning of his own estate, and in conjunction therewith to ensure that all enhancement in value of the underlying securities from the time of vesting them in the corporation onwards will enure to the benefit of his children.

In all other cases there will be some element of option as to whether to use a personal corporation or a non-personal corporation but if the decision is to use the personal corporation the greatest care is necessary to comply at all times with all elements of the statutory definition which look relatively simple but which in fact contain many pitfalls.