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LIFTING THE CORPORATE VEIL IN CANADIAN INCOME TAX LAW

G. T. Tamaki*

The theory that a corporation is a distinct legal personality separate from its shareholders and from other corporations, is firmly imbedded in the pattern of Canadian fiscal legislation. The purpose of this article is to consider some of the circumstances and the manner in which Parliament has wholly or partially disregarded the effect, for income tax purposes, of what has often been described as the "corporate veil" and to examine the judicial approach to this question.[1]

From the purely conceptual viewpoint, if each corporation is a legal person separate from its shareholder members and from other corporations, there is no reason why it should not be treated as an independent taxpayer without regard to its relationship to the shareholders or other persons, including corporations. Moreover, it would pay tax on exactly the same basis as natural persons. However, it is obvious that this legalistic comparison cannot be carried too far. A corporation cannot have medical expenses to pay, dependants to support, alimony payments to make, or incur many other obligations of natural persons; if corporate persons had to pay income taxes at the graduated rates considered appropriate for individuals, most corporations would soon be driven out of business; and if corporate distributions of earnings to shareholders, which in the strict theory of the law are always income to the recipient, were taxed at all times as ordinary income to both natural and corporate shareholders there would be little incentive to incorporate or for corporations to distribute their "tax-paid" earnings when made. On the other hand, to ignore the corporate entity entirely in order to tax the shareholders on the basis of distributed (or undistributed) earnings of the corporation would be

*B.A., LL.B., LL.M., Montreal. Of the Bars of Quebec, Saskatchewan and Nova Scotia. Lecturer in Taxation, Faculty of Law, McGill University.

[1]On the general subject of "Lifting the corporate veil", see L.C.B. Gower, *The Principles of Modern Company Law*, (2nd Ed.) London, 1957, Chapter 10, and the references cited therein.

equally cumbersome and unrealistic, except possibly for closely-held "one-man" or "family" corporations.[2]

The Legislative Pattern

The Canadian income tax system, in common with that of many other countries, everywhere recognizes the legal existence of a corporate taxpayer distinct from its shareholders and from other persons. Thus, under the Income Tax Act, each corporation is a separate taxpayer and is subject to tax upon its earnings at special corporate rates.[3] No consolidation of profits and losses of groups of corporations, even as between parent and subsidiary corporations, is permitted.[4] Moreover, the distribution of its earnings by a corporation by way of a dividend is normally regarded as resulting in income to the recipient, although special concessions are found as to the extent of the taxability thereof in the hands of corporate and individual shareholders. The principle of corporate personality is thus carefully preserved although the tax effect of the principle may be modified in special instances.

The two most widely-known exceptions to the strict application of the rule of the separate corporate personality in fixing the incidence of tax under the Income Tax Act, are found in the provisions relating to the income of certain investment corporations. First, there is the concept of a "personal corporation" which is in essence a closely-held family investment corporation controlled by a Canadian resident individual.[5] Such a corporation, which normally serves as a corporate pocket for personal or family investments, is recognized as a separate legal entity but is exempted from corporate tax and instead its annual income is taxed in the hands of the shareholders whether or not it is distributed to them. Actual distributions subsequently made are not taxed a second time. The result is that shareholders whose rates of tax are in excess of the corporate rates cannot reduce their burden of tax simply by "incorporating" their holdings. At the same time, shareholders of personal corporations are not penalized if their tax rates are less than the corporate

[2]The idea of a "family" corporation having the right to elect to be treated as an ordinary corporation or as a partnership of shareholders was found in Section 22 of the Income Tax Act, R.S.C. 1927, C.97, until repealed in 1932 by S.C. 1932, C.43. For a comprehensive analysis of the problems of corporate taxation in general, see Final Report of the Royal Commission (U.K.) on the Taxation of Profits and Income, 1955, Cmd. 9474.

[3]R.S.C. 1952, C.148. The corporate rates for 1961, including Old Age Security Tax of 3%, are 21% on first $35,000 taxable income and 50% thereafter. These rates are subject to special rules applying to "associated corporations" discussed below.

[4]See, however, Section 75 of The Income Tax Act, S.C. 1948, C.52, which was repealed for the 1952 R.S.C. and subsequent years by Section 26 of S.C. 1951, C.51.

[5]Sections 67 and 68 of the Income Tax Act. Even in the case of personal corporations, the separate legal existence of the corporation is carefully preserved. See Maclean J. in *Richardson v. M.N.R.* [1940-41] C.T.C. 258, at p. 263. See also G. McGregor, "Personal Corporations — A study of their background and treatment under the Canadian income tax", Canadian Tax Papers, No. 18. Canadian Tax Foundation.

rates. A somewhat similar modification in the rigid application of the corporate personality rule is available to investors who are non-residents of Canada. Non-residents who incorporate a Canadian investment corporation which qualifies as a "non-resident-owned investment corporation" can be placed in substantially the same Canadian tax position as if they owned Canadian investments directly and paid the normal 15% withholding tax on income from such investments. In this case, the corporation pays a 15% corporate tax and no further tax is levied upon the distribution of the balance of its earnings to the non-resident shareholder.[6]

Disregard of the corporate veil in a somewhat different manner is also evident in the rules relating to so-called "associated corporations" for determining the effective rates of corporate tax, which under the Act depend upon the size of each corporation's taxable income. Because the general corporate tax rate is considerably higher than the special rate applicable to a stated maximum amount of taxable income, the lower rate is made available only once for a group of so-called "associated corporations".[7] In this case, the identity of the controlling shareholders rather than the mere legal existence of separate corporate entities is made the test of entitlement to the lower rate of corporate tax designed to assist the genuinely smaller businesses.[8]

The facade of incorporation is also partially disregarded in the provisions affecting certain transactions between closely-related corporations and between a corporation and its shareholders. The technique employed in the Income Tax Act to discourage any tendency for such corporations to enter into artificial arrangements for tax avoidance purposes is to write into the statute the detailed tax consequences, often penal in nature, of transactions or relationships between persons (including, but not limited to, corporations) not dealing with each other at arm's length.[9] Thus, the concept of the separate corporate personality will not protect the taxpayer from tax in cases of "rigged" prices for sales or purchases, artificial transactions with non-residents, unreasonable deductions or expenses or other methods of artificially reducing income.[10]

The legislative attempts to deal with the problem of the tax treatment of distributions to shareholders of earnings already taxed in the hands of the corporate entity show that this aspect of the theory of corporate personality has been the most troublesome to administrator and taxpayer alike. As has

[6]Section 70 of the Income Tax Act. See also Section 69 for special treatment accorded to "investment companies".

[7]Section 39 of the Income Tax Act. See Note 4 for rates applicable.

[8]However, the detailed definition is such that it has led to more rather than less corporations, often without any business justification whatsoever.

[9]Sections 139(5), 12(3), 17, 137 of the Income Tax Act.

[10]This also applies to capital cost allowances for depreciable property acquired in a non-arm's length transaction. Section 20(4) of the Income Tax Act. For other examples of the statutory disregard of the veil of incorporation, see Sections 27(5) and 28(2). For offences by a corporation and its officers, see Section 134.

already been indicated, the logical conclusion flowing from the strict theory of a separate corporate personality is that every distribution by way of dividends to another person is income to the recipient. In order to ease the burden of multiple taxation on the same initial corporate profit, the Income Tax Act modifies the rule by providing that normally inter-corporate dividends are (except when paid to a non-resident corporation) tax-free to the recipient. However, this partial disregard of the corporate entity does not extend to dividends received by natural persons, for when dividends are ultimately received by a resident shareholder who is a natural person, he is taxed at graduated rates, depending upon his total taxable income but with a special tax reduction, often referred to as a "dividend tax credit", equal to a flat percentage (now 20%) of the dividend.[11] At the same time the Canadian tax system has always adhered to the principle that the sale of shares in the capital stock of a corporation, being the sale of a source of income, does not give rise to income (unless, of course, it is the taxpayer's business to deal in such sources of income) even if such shares represent an interest in the accumulated income of the corporation. The idea that shareholders who are natural persons should not be permitted to extract the undistributed income of their corporate entity tax-free if their effective personal rates of tax are over the dividend tax credit, referred to above, is reflected in the most complex and detailed system of safeguards and special taxes which exists anywhere in the Income Tax Act. These provisions have grown in *ad hoc* fashion over the years and it is generally claimed by Canadian business and conceded by the fiscal authorities, that their cumulative effect is to place undesirable restrictions upon corporate organization and enterprise.[12]

Judicial Approach

While the legislative attempts to modify the tax effects of the strict rule of corporate personality have become increasingly numerous and complex, the existence of the rule has been carefully recognized in the taxing statutes and the courts have also jealously preserved the legal theory of a separate corporate personality, the logical result of which was so strikingly illustrated in *Salomon v. Salomon & Company*.[13]

In the most celebrated case arising under the Income War Tax Act, the predecessor to the present Income Tax Act, the Judicial Committee of the Privy Council ruled that it was "manifestly against sound and fundamental principles" for the Minister of National Revenue to ignore the taxpayer's legal existence separate from its shareholders and its predecessors in exercising a statutory discretion on the amount of depreciation allowance to be granted

[11]See Sections 6(1)(a)(i), 28(1) and 38 of the Income Tax Act.

[12]See in this connection Reports of the Proceedings of the Canadian Tax Foundation Conference for 1959, 1960 and 1961. See also the Budget Speeches of the Minister of Finance of March 31, 1960 and of June 20, 1961.

[13][1897] A.C. 22.

to the taxpayer. In this case, *Pioneer Laundry and Dry Cleaners, Ltd. v. M.N.R.*,[14] the Minister of National Revenue, who was empowered by statute to fix, in his discretion, a reasonable amount as a depreciation allowance for property owned by a corporation, denied the taxpayer corporation the normal allowance based on its cost of the assets on the ground that it had acquired, through its parent corporation, fully depreciated property from a predecessor corporation with the same name and shareholders but at an enhanced price.

The Exchequer Court of Canada upheld the Minister's decision on the ground that although the appellant corporation was a different legal entity from the former corporation, it was in reality the successor and pointed out that the purchase was made through the intervention of the taxpayer's parent corporation which came into existence on the same date as the taxpayer. In the Supreme Court of Canada, the majority upheld the Exchequer Court and agreed that the Minister had properly decided not to grant an allowance. However, the Judicial Committee upheld the minority view in the Supreme Court that in the absence of fraud or improper conduct, which was not alleged by the Crown, the legal status of the taxpayer cannot be disregarded and that it was improper for the Minister to ignore the legal position in order to regard "the substance of the matter". Lord Thankerton, speaking for the Committee said:

> Their Lordships agree with the Chief Justice and Davis J. that the reason given for the decision was not a proper ground for the exercise of the Minister's discretion, and that he was not entitled, in the absence of fraud or improper conduct, to disregard the separate legal existence of the appellant company and to enquire as to who its shareholders were and its relation to its predecessors. The taxpayer is the company, and not its shareholders. Their Lordships agree with the reasons given by these learned Judges, and their application of the authorities cited by them, and it is unnecessary to repeat them.

One of the authorities cited by the Chief Justice and Davis J. in the Supreme Court, was that of *The Duke of Westminster's Case*,[15] the leading authority for the rule that in taxation matters the legal position cannot be disregarded in favour of what was sometimes referred to as the doctrine of "the substance" in order to tax a person who has legally ordered his affairs in such a manner as to lessen the burden of tax.[16]

The so-called doctrine of "the substance" became an issue again in the Supreme Court of Canada in 1953 in *Army & Navy Department Stores, Ltd.* v.

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[14][1938-39] C.T.C. 411.

[15][1936] A.C. 1.

[16]The reservation in the *Pioneer Laundry and Dry Cleaners Ltd. Case* of fraud or improper conduct as a ground for ignoring the corporate veil is one which the courts have always recognized as an exception to the *Salomon* rule. For examples, see Gower, *op. cit.* However, as was indicated in the *Pioneer Laundry and Dry Cleaners, Ltd. Case*, avoidance of tax by legal means is not considered by the courts to be fraud or improper conduct. See also, the Supreme Court of Canada decision in *M.N.R.* v. *Sheldon's Engineering Co. Ltd.* [1955] C.T.C. 174, for a more recent application of the rule of strict construction of taxing statutes to transactions of successor and predecessor corporations and their shareholders.

M.N.R.,[17] in which the Court (Estey, J. diss.) held that shares owned by a corporation in which an individual had a stock interest were not owned "directly or indirectly" by the individual. The Supreme Court reaffirmed the rule that a shareholder does not own, even indirectly, assets of the corporation.

The principle of the separate personality of a corporation does not always work to the advantage of the taxpayer. In a recent Exchequer Court decision, for example, the taxpayer's claim that the business it carried on in Canada was in reality that of its non-resident parent corporation was rejected on the ground that unless the corporation which carried on the business was nothing but a "sham", the mere fact of ownership by a person of all the shares of the corporation will not make its business that of the owner of the shares.[18] This view is one which is amply supported by the decided cases.[19]

The consequences of the courts' refusal to look through the veil of incorporation to treat the shareholders as the real taxpayer are many and varied. For example, the expenses incurred by a parent corporation to assist its subsidiary to meet its promotional costs, are not deductible to the parent.[20] Reasonable interest and other payments by a corporation to its shareholders cannot be disallowed solely on the ground that such payments are being made to a shareholder whether corporate or individual.[21] Pre-incorporation expenses paid by a predecessor are not deductible to the corporate taxpayer.[22] On the other hand, where a statutory provision makes it necessary for a corporation to meet certain conditions to qualify for beneficial tax treatment, such as the right to deduct prospecting and drilling and exploration expenses by corporations whose "principal business" is mining or producing oil or natural gas, a corporation whose principal business so qualifies can be formed or acquired to take advantage of the special concessions granted to such corporations.[23]

[17][1953] C.T.C. 293.

[18]*United Geophysical Co. of Canada Ltd.* v. *M.N.R.* [1961] C.T.C. 134.

[19]See in this connection, *Stanley* v. *The Gramaphone and Typewriter, Ltd.*, 5 T.C. 358; *Rogers Majestic Corporation, Ltd.* v. *City of Toronto* [1943] C.T.C. 215; *Aluminum Company of Canada, Ltd.* v. *City of Toronto* [1944] C.T.C. 1.

A corporation can of course, act as an agent to perform services for any other person, including a shareholder. For example, a non-resident corporation can be held to be carrying on business within the taxing jurisdiction if it employs a subsidiary corporation as agent to carry out work for the parent. See *Firestone Tyre & Rubber Co. Ltd.* v. *Lewellin*, 37 T.C. 111. However, such an agency relationship will not be implied solely because of the parent and subsidiary relationship. See *Firestone Tyre & Rubber Co. of Canada, Ltd.* v. *C. of I.T.* [1942] C.T.C. 254. See also, Cohen L. J. in *Ebbw Vale U.D.C.* v. *S. Wales Traffic Area Licensing Authority* [1951] 2 K.B. 366 at p. 370, where he said "under the ordinary rules of law, a parent company and a subsidiary company, . . . are distinct legal entities, and in the absence of an agency contract between the two companies one cannot be said to be the agent of the other."

[20]*Canadian Ice Machine Ltd.* v. *M.N.R.* 17 Tax A.B.C. 214.

[21]*Wright's Ropes (Canadian) Ltd.* v. *M.N.R.* [1947] C.T.C. 1; *Falaise Steamship Co. Ltd.* v. *M.N.R.* [1959] C.T.C. 67.

[22]*Boah Construction Co. Ltd.* v. *M.N.R.*, 14 Tax A.B.C. 243.

[23]See Section 83A of the Income Tax Act for the concessions to oil and mining corporations.

Furthermore, certain advantages open to corporate taxpayers and not to individual taxpayers can be obtained through incorporation, such as the installation of a registered employees' pension plan to include the controlling shareholders, or to make salary payments to the spouse of a principal shareholder which if paid directly by him would not be a deductible expense.[24]

While the courts have traditionally followed the rule in *Salomon v. Salomon & Company*[25] in the interpretation of the provisions of taxing statutes, they have sometimes refused to allow the veil of incorporation to prevent an examination of the acts of the natural persons who control the actions of the corporate taxpayer. Thus, the "residence" of a corporation for Canadian income tax purposes is determined in accordance with the long established English rule that it is the place where its "central management and control" abides, regardless of the place of incorporation or of the statutory head office or indeed the residence of the shareholders.[26] Central management and control is considered to be found where the controlling natural persons, not necessarily the nominal directors, in fact make their decisions, as was forcefully illustrated in the recent House of Lords decision in *Unit Construction Co. Ltd. v. Bullock.*[27]

The courts have also re-iterated that it is not what is stated in the corporate objects which govern the nature of the corporation's business, but the business in which it was in fact engaged.[28] It is obvious that only the natural persons who operate and manage the business can in fact carry on such business for the corporate taxpayer. In a recent case it was even held that the intentions of the promoters of a company were identical with the intentions of the corporation itself.[29] The Canadian courts have not yet dealt with the tax consequences of the use of a corporate vehicle to trade in real estate, but if a real estate trader sought to "incorporate" his landholdings for *the sole purpose* of later selling his shares in the landholding corporation, he would probably be taxed on the sale of the shares on the ground that he embarked on an adventure in the nature of trade in respect of the shares.[30]

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[24]Sections 11(1)(g); 21(2).

[25]It is interesting to note that if Mr. Salomon had been subject to the provisions of the Canadian Income Tax Act, he would have been taxable on the difference between the inflated price he received for the sale of his business to his corporation and the real value thereof. See *Losey v. M.N.R.* [1957] C.T.C. 146.

[26]Subject to Section 139(4a) of the Income Tax Act. See *B.C. Electric Co. Ltd. v. The King* [1946] C.T.C. 224; *Yamaska Shipping Co. Ltd. v. M.N.R.*, 28 Tax A.B.C. 187.

[27][1959] 3 A.E.R. 831.

[28]*Sutton Lumber & Trading Co. Ltd. v. M.N.R.* [1953] C.T.C. 237; *Irrigation Industries Ltd. v. M.N.R.* [1960] C.T.C. 329.

[29]*Regal Heights Ltd. v. M.N.R.* [1960] C.T.C. 384.

[30]*cf. Deceased Estate v. Commissioner of Taxes*, XVI South African Tax Cases 305; *Associated London Properties, Ltd. v. Henricksen*, 26 Tax Cases 46; but see *Becker v. F.C. of Taxation*, 10 A.T.D. 77, and *M.N.R. v. Strauss* [1960] C.T.C. 86.

Conclusion

The legislative efforts to modify the strict application of the rule in *Salomon's Case* have been affected by the concern on the one hand that the rule itself should be retained to preserve the corporate taxpayer as a source of revenue, and on the other that tax avoidance by natural and corporate taxpayers through the use of corporations and through artificial transactions must be discouraged. Such efforts have also been influenced by the realization that the strict theory of corporate personality must be modified in dealing with the taxation of corporate distributions but no generally acceptable principle has as yet emerged to cope with this difficult problem.[31] The courts have, however, consistently refused to depart from the *Salomon* rule for tax purposes unless they were clearly required by statute to do so. They have not hesitated on occasion to look through the veil of incorporation to examine the actions of the real persons behind it but only to determine the taxability of corporate profits and not to disregard the existence of the corporate taxpayer.

[31]For a review of some suggested solutions to the problem, see G. T. Tamaki, "Tax Free Corporate Distributions in Canada", The Canadian Chartered Accountant, February, 1962.