Marcil Lavallée

JANUARY 2022

TAX LETTER

IN THIS ISSUE

Associated Corporations 1

Loans To Your Adult Children 3

Standby Charge For Use Of Employer's Car 4

6 Around the courts

ASSOCIATED CORPORATIONS

Under the Income Tax Act, there are various rules pertaining to relationships between taxpayers, including individuals, trusts, and corporations. For example, there are rules that apply to "related" persons, "non-arm's length" persons, "affiliated" persons, and "associated" corporations.

The rules are generally restrictive in nature, and the tax policy reasons for the rules are sometimes the same but sometimes different. Some of the rules intersect; for example, whether persons are related, or non-arm's length, may affect whether corporations are **associated** which is the topic of this article.

If corporations are associated, there are some significant limits on tax benefits that would normally be available to the corporations. For example, if Canadian-controlled private corporations (CCPCs) are associated, they must share the $500,000 small business deduction limit that normally applies to a single corporation. Under the small business deduction, the first $500,000 of active business income each year is normally subject to a much lower tax rate than the general corporate tax rate that applies to other corporate income.

As another example, associated CCPCs must share certain enhanced investment tax credits, (for scientific research and experimental development) which otherwise may be available in full to each corporation.

So when are corporations associated?

There are various ways that two or more corporations can be associated. Some of the main situations are summarized below.

1. One corporation controls the other corporation. For these purposes, “control” usually means ownerships of more than 50% of the voting shares of the other corporation, although for the associated corporation rules, there is an extended meaning of control, discussed below.

   This situation would apply, for example, where you have a holding corporation that in turn controls a lower subsidiary corporation. The corporations are associated.

2. The corporations are controlled by the same person or group of persons. For these purposes, a group of persons simply means two or more persons. Persons include individuals, corporations and trusts.

   In terms of group control, each member of the shareholder group does not have to own the same percentage of voting shares in each corporation.

   For example, assume John owns 30% of the shares in Corp A and Bill owns 30% of the shares in Corp A. John owns 20% of the shares in Corp B and Bill owns 40% of the shares in Corp B. In this case, Corp A and Corp B will be associated because they are both controlled by John and Bill as a group.

3. You control corporation Corp A and a person related to you controls another corporation Corp B. (The concept of related persons is discussed below.) Either you own 25% or more of the shares of Corp B or the related person owns 25% or more of the shares of Corp A. Corp A and Corp B will be associated.

   This rule is sometimes called the “cross-ownership rule”, because it applies only if one of the related persons owns at least 25% of the shares of the other person’s controlled corporation. It is a bright-line test.

   For example, if I control Corp A and my spouse controls Corp B (spouses are related), but I own only 10% of the shares of Corp B, the corporations are not necessarily associated (though they could be under a different rule, discussed further below).

Extended meaning of “control”

For many tax purposes, “control” means owning more than 50% of the voting shares of the corporation (which gives one the power to elect the board of directors, who then manage the corporation). This is sometimes called *de jure* or common law control, as it is the regular legal concept of control developed by the Canadian courts.

However, for purposes of the associated corporation rules, the meaning of “control” is extended by specific rules in the Income Tax Act.

For example, a special rule says that control of a corporation exists where a person or group of persons owns more than 50% of all of the shares on a fair market value basis, or more than 50% of the common shares on a fair market value basis, regardless of whether those shares carry more than 50% of the shareholder votes.

Under another rule, if your child under the age of 18 owns shares in one corporation and you own shares in another corporation, you are deemed to own the child’s shares. For example, if you control Corp A and your minor child controls Corp B, you are deemed to own their shares in Corp B, which will result in Corp A and Corp B being associated. There is an exception to this deeming rule: It does not apply if it can reasonably be considered that your child manages the business and affairs of Corp B and does so without a significant degree of influence by the parent (you).

There is also a *de facto* control rule (control in fact). This rule can apply regardless of the rules discussed above. Under this rule, you (called the "controller" under this rule) will have control of a corporation if you have "any direct or indirect influence that, if exercised, would result in control in fact of the corporation". However, this rule does not apply if you and the corporation are dealing with each other at arm's length and the influence is derived from a franchise, licence, lease, distribution, supply or management agreement or other similar agreement or arrangement, the main purpose of which is to govern your relationship with the corporation and the manner in which a business is carried on by the corporation.

Meaning of "related" persons

As discussed above, whether corporations are *associated* sometimes depends on whether persons, including corporations, are *related*.

In general terms, under the Income Tax Act the following persons are related. Note that the actual list is a bit more detailed.

- You and your parents, grandparents, great-grand parents, and so on;
- You and your children, grandchildren, and so on
- You and your spouse or common-law partner
- You and your siblings
- You and your in-laws; e.g. sister-in-law, father-in-law, son-in-law
- You and a corporation that you control
- You and a corporation, if you are part of a related group that controls the corporation
- Two corporations if they are controlled by one person or by a group of persons

LOANS TO YOUR ADULT CHILDREN

Parents often lend money to their children to help with the purchase of a major personal or consumer item. A common example is a loan to help with the purchase of a child's first home.

Generally, there are no problematic tax issues for these loans to adult children. (A loan to a child *under* 18 generally triggers the "attribution rules", which we have discussed in other Tax Letters.)

If you are paid interest, you are required to include the interest in income. The child cannot deduct the interest on a personal loan. However, if they use the loan for investment purposes – say, to buy a rental property instead of a personal residence – they can deduct the interest they pay you.

An interest-free loan used for personal purposes by your child poses no tax problems. However, if the interest-free loan is used by your child for *investment* purposes, there is a special attribution rule in the Income Tax Act that may apply (subsection 56(4.1)).

This attribution rule can apply if "it can reasonably be considered that one of the main reasons for making the loan... was to reduce or avoid tax" by causing the resulting investment income to be included in the child's income rather than your income. This rule might apply if you are in a high tax bracket and your child is in a low tax bracket and one of the main reasons for the loan was to shift investment income into your child's hands to reduce overall tax. If this was the case, the investment income may be attributed to you and included in your income. The Canada Revenue Agency does not often apply this rule, but it is an important rule to remember because it can be applied.

The attribution rule does not apply to capital gains of your child if they sell the investment. It can only apply to income from property, which includes interest income, dividends, and rental income.

One way to avoid the attribution rule is to charge interest at the prescribed rate under the Income Tax Act at the time of the loan. This rate is typically low, as it is based on 90-day Federal Treasury bill rates. For example, throughout 2021, the prescribed rate was 1%. At the time of writing, the prescribed rate for the first quarter of 2022 had not yet been announced.

Forgiving the loan

Where the loan is used for the child's personal purposes, if you subsequently forgive the loan, there are no income tax consequences for the child. The forgiveness is basically treated like a gift, which is similarly tax-free for the recipient of the gift.

However, if the loan is used by the child for investment purposes (or business purposes) and you subsequently forgive the loan, there can be adverse tax consequences for the child. In general terms, the amount of the forgiveness will reduce some of their tax attributes or tax costs, such as their non-capital or net capital loss carry-forwards and / or the cost of their depreciable or non-depreciable capital properties. If there is a remaining amount left after these reductions in tax attributes or tax costs, your child will usually be required to include half of that amount in income.

The forgiveness rules are complex; the above is a very general summary. We will discuss the rules in more detail in a later Tax Letter.

Exception: Forgiveness under your will or bequest

If the loan to your child remains outstanding upon your death, and it is settled or forgiven under the terms of your will or otherwise as part of a bequest or inheritance for your child, there are no income tax issues. In particular, the debt-forgiveness rules do not apply to loans that are settled in this manner upon death, including loans used for investment or business purposes. The rationale for this rule is that the forgiveness is basically treated as an inheritance, and in Canada inheritances are not subject to income tax for recipients.

STANDBY CHARGEFOR USE OF EMPLOYER'S CAR

If your employer provides you with a car for work purposes, they will often let you drive it home and use it for personal purposes as well. If so, you will normally be required to include a "standby charge" in your income.

But the value of having that car for personal purposes is difficult to determine. As a result, the Income Tax Act provides an arbitrary formula that is used to calculate the benefit.

The formula differs depending on whether the employer *leases* or *owns* the car.

Employer leases the car

If the employer *leases* the car, your taxable benefit for a taxation year will be calculated as follows.

You begin with 2/3^{rds} of the employer' leasing costs (including GST/HST) for the time during the year that the car was provided to you.

This initial amount is reduced by a "reduction factor", **but only if** your use of the car for employment purposes exceeds your personal use of the car for the year, **and** your personal kilometers driven are less than 1,667 per 30-day period in which you use the car. If you meet these criteria, the initial amount is multiplied by the reduction factor A/B, where A equals your personal kilometers driven during the year, and B equals 1,667 per 30-day period. (If you have the car for the entire year, B is 20,004.)

EXAMPLE

Your employer provides you with a car for the entire year. The employer's lease costs for the year including GST/HST are $9,000. During the year, you drive 10,000 personal kilometers and 17,000 employment kilometers.

The initial amount is 2/3 of the $9,000 employer's lease costs, which is $6,000.

However, your employment kilometers exceed your personal kilometers, and your personal kilometers for the year are less than 20,004. As such, you qualify for the reduction factor.

The standby charge included in your income will equal $6,000 x 10,000/20,004 = $3,000 (rounded off).

If you do not use the car for any personal driving in the year, there is no standby charge.

Employer owns the car

If your employer *owns* the car, the formula for the standby charge is as follows.

Initially, the amount is calculated using the formula 2% x C x D, where C is the employer's cost of the car including GST/HST and D is the number of 30-day periods (rounded off) in which the car is available for your use.

If you meet the reduction factor criteria discussed above, the benefit is reduced by multiplying this amount by A/B as noted above.

EXAMPLE

Your employer provides you with a car for all 12 months during the year. The employer's cost of the car including GST/HST was $30,000. During the year, your drive 10,000 personal kilometers and 17,000 employment kilometers.

The initial amount is 2% of the $30,000 employer's cost of the car ($600), times 12 months (rounding off), or $7,200.

However, your employment kilometers driven exceed your personal kilometers driven, and your personal kilometers for the year are less than 20,004. As such, you qualify for the reduction factor.

The standby charge included in your income will equal $7,200 x 10,000/20,004 = $3,600 (again, rounded off).

As above, if you do not use the car for any personal driving, there is no standby charge.

What if I pay the employerfor the use of the car? (Very rare)

If you are subject to the standby charge but pay your employer any amount in the year for the use of the car (this is rarely the case), the amount you pay reduces your standby charge accordingly.

Reduced standby charge for employees employed by car dealerships

If you are employed in selling or leasing cars and your employer (typically a car dealership) provides you with a car that they own, there may be a reduced standby charge.

The employer can use the above formula to calculate the standby charge using the 2% of the cost of the car they provide to you. However, they have the option of using the same formula, but instead using 1.5% of the greater of the average cost of the new cars they acquired in the year and the average cost of all cars they acquired in the year.

Operating cost benefit

If you include a standby charge and your employer pays for any of your **personal-use** car expenses, you will also be required to include the operating cost benefit in your income. The expenses could include gas, repairs and maintenance, and insurance.

The operating cost benefit is also based on an arbitrary formula. There are two possibilities.

First, the general rule is that the operating cost benefit will equal the prescribed rate multiplied by the number of personal kilometers you drove in the year. For 2021, the prescribed rate was 27 cents per kilometer of personal use (24 cents if you were employed selling or leasing cars).

The second option applies only if you drive more employment kilometers in the year than personal kilometers. In this case, you can choose to have ½ of your standby charge included as your operating cost benefit (of course, you must still include the standby charge in income as well). To use this option, you must notify your employer before the end of the year.

Since it is an arbitrary formula, the operating cost benefit will typically differ from the actual personal car expenses that your employer paid.

If you repay your employer **all** the personal car expenses they paid, either in the year or within 45 days after the year (i.e., by February 14), there will be no operating cost benefit. This will be the case even if the benefit under the arbitrary formula was more than the personal car expenses they paid.

> EXAMPLE
>
> Your employer provided you with a car throughout the year and you were subject to the standby charge. They also paid $3,000 of your personal-use car expenses. The initial amount of your operating cost benefit was $4,000.
>
> You repay them $3,000 in the year or within 45 days after the year. There is no operating cost benefit.

If you do not fully repay the expenses, your repayment will reduce the benefit but not necessarily eliminate it. In the above example, if you repaid only $2,900 of the $3,000, your taxable benefit would be $1,100 ($4,000 minus your $2,900 repayment). Therefore, not repaying $100 would create an $1,100 taxable benefit.

COVID-19 measures

As noted above, your standby charge for a year can be reduced if your employment kilometers exceeded your personal kilometers for the year. Also, for the operating cost benefit, you have the option of using ½ of your standby charge if your employment kilometers exceeded your personal kilometers.

As a result of the COVID-19 pandemic, the government allows **you to use your 2019 employment and personal use figures for 2020 and 2021**. For example, if your employment kilometers were greater than personal kilometers in 2019 but not in 2021, you can use the 2019 amounts and qualify for the above reduction in your standby charge in 2021 or the ½ option for your operating cost benefit.

AROUND THE COURTS

ABIL not allowed

In general terms, you can have an allowable business investment loss (ABIL) if you have a loss on a loan to a Canadian-controlled private corporation that is also a small business corporation. Other conditions can apply.

An ABIL is a type of an allowable capital loss (which is half of an actual capital loss). The main difference is that an ABIL can be used to offset all sources of income, whereas a regular allowable capital loss can normally offset only taxable capital gains and not other sources of income.

In the recent case of *Dias*, the taxpayers lent money to a numbered corporation ("201"). 201 was not a small business corporation. 201 in turn lent some money to two small business corporations. The taxpayers incurred a loss on their loan to 201. They claimed an ABIL, taking the position that 201 was merely a "conduit", and that their loan ultimately went to the small business corporations. The CRA disagreed on the grounds that the taxpayers' loan was to 201, which was not a small business corporation, and therefore the requirements for the ABIL were not met.

On appeal to the Tax Court of Canada, the Tax Court judge held in favour of the CRA and disallowed the ABIL. The judge did not buy into the "conduit" argument, largely because the loan from the taxpayers to 201 did not "match" the loans from 201 to the small business corporations.

This letter summarizes recent tax developments and tax planning opportunities; however, we recommend that you consult with an expert before embarking on any of the suggestions contained in this letter, which are appropriate to your own specific requirements.

OTTAWA
400-1420 place Blair Towers Place
Ottawa ON K1J 9L8
T 613 745-8387
F 613 745-9584

GATINEAU
100-200 rue Montcalm St
Gatineau QC J8Y 3B5
T 819 778-2428
F 613 745-9584

Marcil-Lavallee.ca
Marcil Lavallée, S.E.N.C. | G.P.
Société de comptables professionnels agréés
Partnership of Chartered Professional Accountants

MOORE

Marcil Lavallée is an independent member firm of Moore North America, which is itself a regional member of Moore Global Network Limited (MGNL). MGNL has grown to be one of the largest international accounting and consulting groups worldwide. Today the network comprises 260 offices in 112 countries throughout the world, incorporating 30,000 people and with fees of more than US $2.742 billion.