

THE PROBATER

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SUPREME COURT OF CANADA - INCOME SPLITTING IS ENDORSED.

The Supreme Court of Canada recently released its decision in the Neuman v. M.N.R. case.

The Supreme Court of Canada has dealt with the tax treatment of dividends for attribution purposes and has made it clear that the attribution rules do not change merely because the benefiting shareholder has failed to make a legitimate contribution to the paying corporation.

The Supreme Court of Canada looked at whether discretionary dividend income from a closely held family corporation to a non-arm's length shareholder, who had not contributed to or participated in the business of the corporation, namely the taxpayer's wife, should be attributed to the taxpayer as being a payment or transfer of property pursuant to the discretion of or with the concurrence of the taxpayer, as set out in section 56(2) of the *Income Tax Act*.

The facts in the Neuman case were that a Winnipeg lawyer Melville Neuman was president and his wife was the sole director of Melru Ventures, a family holding company. The husband and wife were the company's only shareholders and the husband held all of the common shares and all of the preferred shares.

Revenue Canada, relied on section 56 of the *Income Tax Act*, which prohibits income – splitting in certain circumstances. Revenue Canada took the position that the husband was liable for tax on the dividends received by his wife.

The decision was successfully appealed to the Federal Tax Court and the trial division upheld the decision. However, the Federal Court of Appeal overruled the courts below.

The Federal Court of Appeal's decision brought with it a considerable amount of uncertainty with respect to this widely used estate planning technique. Essentially, the Federal Court of Appeal was imposing a “contribution test” on shareholders in non-arm's length situation.

The Supreme Court of Canada agreed that in order for subsection 56(2) of the *Income Tax Act* to apply, four pre-conditions must be present, which are set out in the language of the subsection itself.

- (1) The payment must be to a person other than the re-assessed taxpayer;
- (2) The allocation must be at the direction or with the concurrence of the re-assessed taxpayer;
- (3) The payment must be for the benefit of the re-assessed taxpayer or for the benefit of another person whom the re-assessed taxpayer wish to benefit;
- (4) The payment would have been included in the re-assesses taxpayer's income if it had been received by him or her.

The Supreme Court of Canada carefully reviewed the four pre-conditions of subsection 56(2) of the *Income Tax Act* and held that it did not apply to dividend income because dividend income, by its very nature, cannot satisfy the fourth pre-condition that the payment would have been included in the re-assessed taxpayer's income if it had been received by him or her. The rational of the court seems to be that the dividend income cannot meet the fourth pre-condition test because the dividend, if not paid to a shareholder, remains with the corporation as retained

earnings, and the assessed taxpayer, as either director or shareholder of the corporation, has no entitlement to those monies.

The Neuman decision seems to finally remove the concern with respect to the attribution of discretionary dividends paid to a non-arm's length person. Having said that, it is important to note that the Neuman decision only deals with the specific matters raised in subsection 56 (2) of the *Income Tax Act* and does not deal with the general policy of anti-avoidance rules which are set out throughout the *Income Tax Act* .

If you have any questions about the impact of the Neuman decision, please feel free to contact Hull & Hull

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