Advisor Inc. Pitfalls

COURT REPORT
BY JAMIE GOLOMBEK

Financial advisors who use a personal corporation to run their practice need to ensure that they are meticulous in the structuring of their business affairs to make sure that the corporation is actually providing the business of financial advice and not the advisor in his or her own personal capacity.

This issue was highlighted by the Tax Court of Canada last month in an important decision (*Boutilier v. the Queen*, 2007 TCC 96). The case has already caused a stir in the advisory community and has advisors questioning and, in some cases, revisiting how they conduct their affairs.

Often, advisors desire to run their advisory practices through private corporations for tax and estate planning purposes. The ability to access low corporate tax rates and defer personal tax on the income earned by leaving it in the corporation until it's paid out can result in a significant tax deferral advantage.

The structure also allows the advisor's spouse and children (over the age of 18) to own shares of the corporation, either directly or quite often, through a family trust. This provides a significant opportunity for the advisor to income split by flowing out the after-tax corporate income in the way of dividends to a lower-income (or in extreme cases, a zero income) spouse or kids.

Finally, assuming the advisor's practice qualifies as a small business corporation at the time of sale, the advisor can take advantage of the lifetime capital gains exemption available on the sale of shares to shelter up to $500,000 of capital gains from tax. This exemption can multiplied if a spouse or kids also own qualifying shares.

That being said, in order to take advantage of these tax planning opportunities, advisors must ensure that the corporation is actually carrying on the business – something easier said than done. The reason? Provincial securities law across Canada currently prohibits advisors from registering as incorporated salespersons and therefore, the license to sell securities must be held individually. Similarly, the Mutual Fund Dealers Association's Rule 2.4.1, "Payment of Commissions to Non-Registered Entities," prohibits the payment of mutual fund commissions to personal corporations.

But late last year, the securities commissions of four provinces – British Columbia, Saskatchewan, Ontario and Nova Scotia – have extended a previously-issued exemption suspending the rule's enforcement until Dec. 31, 2008, effectively allowing mutual fund commissions to be paid to personal corporations in those four provinces.

Still, just because the commissions can be physically paid to an advisor's corporation does not necessarily mean that the corporation has "earned" those commissions for tax purposes. This was the issue in the recent case in which a Halifax advisor and his dealer had an oral agreement in which his mutual fund trailing commissions would be paid to his numbered Nova Scotia company. The advisor's company reported the income on its corporate tax return and paid tax on it.

The Canada Revenue Agency felt that the money should be taxed in the advisor's hands personally and reassessed him, arguing that "the transfer of the fees to the corporation was simply a scheme to artificially reduce [his] income. He remained beneficially entitled to those fees."

The judge agreed and found that the transfer was specifically caught by an anti-avoidance rule of the *Income Tax Act* that was designed to prevent the avoidance of tax that could result when a right to income is transferred between parties that don't deal at arm's length, including one's personal corporation.

Essentially the question boiled down to who "beneficially earned" the trailer fees, the corporation or the advisor? The judge concluded, based on the facts of the case, that it was indeed the advisor who beneficially earned the trailers.

But the judge left the door open for other cases, specifically saying that "given the right set of circumstances, a company could be engaged in the active business of providing services to earn trailer fees." Those circumstances may include a formal employment contract between the advisor and his or her corporation, business expenses being paid from the corporation and remuneration paid to the advisor from the corporation – all of which were absent in the current case. AER

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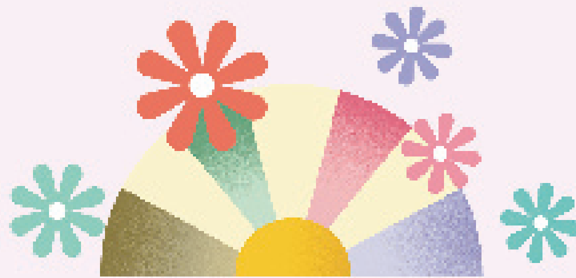

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