

HELLO, NEUMAN

By Craig Zawada

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It would be stretching things to say that everyone has been anxiously awaiting the Supreme Court of Canada's decision in *Neuman v. Minister of National Revenue*. It is just an income tax case, after all. There were, however, many corporate lawyers and accountants who breathed a huge sigh of relief when *Neuman* was handed down. If you are a shareholder of a corporation, and want to reduce your personal tax load, you will also be interested.

Neuman involved one of the oldest yet most effective tax avoidance measures in the book: income splitting. It works because Canada employs a “progressive” rate tax system, with the rates increasing as income rises. As a result, a household where a wife makes \$70,000.00 per year, and the husband nothing will (generally) pay more tax than where the spouses each earn \$35,000.00.

There are many ways to channel money to lower income earners, but one of the most popular is through shareholdings in a company. Corporate law allows separate classes of shares to be created, each with different rights. For example, the high income earner may take Class “A” voting shares, and retain control over the company. Children may be given Class “B” nonvoting shares. They will not have a formal say in operations, but dividends can be paid only to their Class “B” shares, thereby diverting some income to those in a lower tax bracket.

This was at the heart of the *Neuman* case. Melville Neuman had set up a corporation in which he owned Class “G” voting shares. His wife Ruby owned Class “F” shares and was the only director of the company. As director, she caused the corporation to pay a dividend of \$5,000 to Melville, and \$14,800 to her. She then immediately lent the \$14,800 to Melville in return for a promissory note. Ruby died before the loan was ever repaid.

Revenue Canada (now Canada Customs and Revenue Agency) tried to include the \$14,800 dividend in Melville's income, using the *Income Tax Act's* “attribution rules.” These rules prevent taxpayers from diverting certain income to avoid taxation. For instance, if someone gives their spouse an income producing asset, such as land, the income might still be taxed in the donor's hands. In Revenue Canada's eyes, at least, the *Neuman* corporation was just an extension of Melville, and his wife was only a conduit to avoid some of his personal income taxes.

The case was complicated by a Supreme Court of Canada ruling in 1990. In that decision (*McClurg v. MNR*), the Court hinted that payment of dividends within a family group might offend the attribution rules if there had not been “a contribution to the company.” In other words, the shareholder had to be actually doing something to earn his or her money – bookkeeping, janitorial duties, anything of value. Due in large part to *McClurg*, the lower court decisions in *Neuman* were split; the Tax Court of Canada and the Federal Court – Trial Division found for the taxpayer, while the Federal Court of Appeal decided in favour of Revenue Canada.

In a somewhat technical judgment, the Supreme Court unanimously held that Mr. Neuman's planning did not infringe the *Income Tax Act*, and his wife's dividend should not be included in his income. The Court upheld the right to declare “discretionary dividends” – dividends declared on one class of shares to the exclusion of other classes. These dividends could be safely paid whether or not the shareholder worked for or contributed to the corporation's affairs. This

was important, because Mrs. Neuman's only “contribution” to the company was holding the shares.

Because of *Neuman*, income splitting through discretionary dividends seems to be alive and well in Canada. Taxpayers need to be careful, though. Any mistake or omission in the procedures needed could be enough to invalidate the dividends, and make them taxable. Mr. Neuman was a lawyer, and presumably knew how to properly record all the transactions. A review of the process by professional advisors is strongly encouraged.

Don't break out the champagne yet, though. There are a couple of potential clouds on the horizon. First, the Supreme Court did not shut the door on the general anti-avoidance rule (GAAR). GAAR is a controversial provision of *The Income Tax Act* that allows Revenue Canada to strike down certain tax avoidance schemes, even when they comply with the letter of the law. It is possible that some discretionary dividend plans could offend GAAR, and allow Revenue Canada to tax the amounts.

There is also Parliament to worry about. Any tax scheme that diverts too much money from government coffers is always at risk. In fact, the attribution rules have already been changed to prevent a *Neuman* type of transaction. No doubt the Department of Finance will be keeping a close eye on the effect of this decision to see if more changes are necessary.

Until that time, however, owners of businesses should consider discretionary dividends as an important tax planning tool. Not only can it be effective, it is relatively inexpensive in relation to other planning devices.

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