AIRD BERLIS

An Expensive Power of Attorney, Courtesy of the Income Tax Act

Jul 26, 2019

By Donald Carr

John Smith is 65 and married. He has no children. John owns all of the issued shares of John Smith Manufacturing Limited, a highly-profitable manufacturer of widgets. He owns no shares of any other corporation, except what may be in his portfolio of investments, managed by the investment arm of a Canadian bank. Canada Revenue Agency recently conducted a "routine" audit of John's company.

Paul Brown is 40. He is the husband of John's wife's great niece. Paul runs a very successful chain of ladies wear stores, through Paul Brown Stores Limited, all of the issued shares of which are owned by him. Despite the difference in ages, he is very close, personally, to John. They met at a family celebration some years ago. They had discovered that both had a deep interest in stamp collecting. This led to frequent get-togethers to discuss their hobby and look at stamp albums, and in turn, to a strong friendship. John realized, some time ago, that Paul was not only very clever, but also felt a warm attachment to the Smith family.

There is no business connection between John Smith Manufacturing Limited and Paul Brown Stores Limited. The men know nothing about each other's business, except for what is in the public domain. They never discussed business.

Two years ago, John had engaged in some estate planning. His wife was to be his sole beneficiary, with gifts to family members if she predeceased him. Because they had no children and no other friends would be able, practically, to look after John's estate and because John knew of Paul's abilities, John had executed a Will naming Paul as the sole executor and trustee. As a natural part of the planning, he also had executed an unconditional enduring power of attorney, naming Paul as attorney.

Last week, both John Smith Manufacturing Limited and Paul Brown Stores Limited received a Notice of Reassessment from CRA. The amounts claimed as owing by each corporation were substantial. The reassessments were based upon CRA's statement that the two corporations were associated under the provisions of the *Income Tax Act*!

"How on earth can that be?," John exclaimed when he phoned Paul on receipt of the Notice.

Each of them consulted their respective accountant.

Quite puzzled, the accountants conferred with each other and then contacted CRA, believing that some gross error had occurred.

No!

CRA politely replied that:

(a) in the course of its audit of John Smith Manufacturing Limited, the CRA auditor had, when reviewing some correspondence files at the company, coincidently, come across a copy of the power of attorney executed by John in favour of Paul; and

(b) pursuant to subsection 256 (1.4) of the *Income Tax Act*, for the purpose of determining whether a corporation is associated with another corporation, Paul was deemed to own the issued shares in John Smith Manufacturing Limited. Thus, that corporation and Paul Brown Stores Limited were associated!

Subsection 256 (1.4) reads:

"For the purpose of determining whether a corporation is associated with another corporation with which it is not otherwise associated, where a person … has a right at any time under a contract, in equity or otherwise, either immediately or in the future and either absolutely or contingently,

(a) to … control the voting rights of shares of the capital stock of a corporation, the person … shall, except where the right is not exercisable at that time because the exercise thereof is contingent on the death, bankruptcy or permanent disability of an individual, be deemed to own the shares at that time, or"

(b) [irrelevant for this discussion]

After Smith hurriedly consulted his counsel, they pointed out to CRA that the "offending" power of attorney had, upon signing, been deposited immediately with Smith's lawyers, under a written direction, to be held in escrow and not released by them, unless they received a certificate from a physician licensed to practice in the jurisdiction where Smith then resided, to the effect that it was that physician's opinion, upon examination of Smith, that he "cannot manage his affairs."

The lawyers argued, first, that the power of attorney was not currently in effect. Secondly, it would not be released and would only become effective if, as and when the stated physician's certificate was received. And that may never happen! Brown could not now vote the shares.

As to the question of delivery of the power of attorney and it not being in effect, CRA pointed to the fact that it could "contingently" become operative. Thus, it fell within the wording of Subsection (1.4).

As to the fact that the power could not be released by the law firm, nor used, unless Smith could not "manage his affairs," CRA stated that the only exception to the effect of the Subsection is to be found in Subsection (1.4) (a), which refers only to "permanent disability," not to "cannot manage his affairs"!

"But, how can anyone determine that there is permanent disability?," argued the lawyers. "We have all heard of people in a coma and then, even years later, recovering."

"Not our problem," responded a sympathetic CRA agent.

This tale of woe, though hypothetical, could easily occur.

A lawyer preparing a power of attorney may well know if the client controls a corporation. However, lawyers likely do not enquire if the individual proposed to be named as attorney controls a corporation! Should lawyers now be careful to pose that question? Certainly.

Is it feasible, though, to expect that an attorney will never control a corporation? Even if it were to be practical to ask the intended attorney to be careful and never control a corporation – which it isn't – to stretch a point, it is possible that the attorney might become a beneficiary of controlling shares from an estate, or by gift, or by becoming an attorney or personal representative of another person controlling a corporation and, thus, triggering association.

Another issue. What competent lawyer would recommend to a client that a power of attorney should be stated to become effective only if the client became "permanently disabled"? It is usually intended to have the power of attorney come into effect upon the grantor's inability to manage affairs, even if temporarily. The grantor might be hospitalized and be unable to manage affairs while there. And, in any event, is it probable that a physician will opine that a patient is *permanently* disabled?

One might assume that neither CRA nor the Ministry of Finance intended that the innocent appointment of an attorney in a document that might never become effective – or, if it did, not for some considerable time in the future – would trigger associated corporation status of totally unconnected or "unrelated" corporations. However, that is what can easily occur under the present legislation. And that has long been the opinion of CRA. See Technical Interpretations 9106955, 972653 and CRA Views, 1998 Round Table, 9814370.

Is it not appropriate that submissions be made to the Ministry of Finance in this regard, with a view to there being some amending legislation? As a matter of fact, 21 years ago, at the end of the response by the representative of CRA at the Round Table referred to above, there was a virtual “invitation” to raise any concern that one might have with the policy behind those *Income Tax Act* provisions with the Ministry of Finance.

Unless, and until the legislation is amended, one must lessen the chances of falling afoul of it, by ensuring that either (i) the attorney does not individually control any corporations (and hope that will never occur) or, (ii) more than one attorney be appointed, with the provision that the attorneys must act unanimously. Those protective measures, however, may eliminate appointing the only appropriate person as a sole attorney, or may create an impossible or burdensome situation of having to find at least two such people.

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