Valovic v. The Queen, 2020 DTC 1072 (Tax Court of Canada) Background

The decision in Valovic v. The Queen (2020 DTC 1072) reaffirms the principle that dividend payments can only be related to the shareholding and cannot be used as consideration for prior services provided to the corporation. Mr. and Mrs. Valovic (the “Valovics”) were equal shareholders of Ivan’s Electric Limited (“Ivan’s Electric”). Ivan’s Electric employed both the Valovics: Mr. Valovic was an electrician and was responsible for the majority of the electrical work undertaken, while Mrs. Valovic was responsible for the administrative work and bookkeeping.

From 1995 to 1997, the Valovics received salaries from Ivan’s Electric. In 1998, Ivan’s Electric began paying a combination of employment income, business income, and dividend income. The Valovics received dividends from Ivan’s Electric during taxation years that Ivan’s Electric was liable for amounts owing under the Income Tax Act (the “Act”).

The Minister of National Revenue (the “Minister”) assessed the Valovics under section 160 of the Act for the transfer of property, the dividends, to a non-arm’s length entity at less than fair market value. As a result, the Valovics were jointly and severally liable for the amounts owing by Ivan’s Electric in respect of the outstanding corporate tax liability.

The Valovics argued that the dividends were consideration for the services the Valovics provided to Ivan’s Electric, and that the provided services had a fair market value, at a minimum, equal to the dividends they received. The Valovics stated the mix of payments they received was determined by their accountant, Mr. Hill, with the intent to compensate the Valovics for their services to Ivan’s Electric. The Valovics were unaware of why the nature of the payments changed from salary to a combination of salary, dividends, and other payments, but were acting on the advice of Mr. Hill.

Lastly, the Valovics asserted that although the method of compensation may have changed to a combination of salary, business income, and dividends, the aggregate amounts paid were consideration for the services that they provided.

Tax Court Decision

The primary issue on appeal was whether, in accordance with section 160, the Valovics provided consideration for the dividends with a fair market value equal to or greater than the dividend amounts they received. The Court determined that section 160 of the Act was satisfied and the assessment of the Valovics pursuant to section 160 was upheld,1 such that the Valovics were jointly and severally liable with Ivan’s Electric for the outstanding tax liability of Ivan’s Electric. Concurring with the previous Supreme Court of Canada Neuman v. MNR (98 DTC 6297) decision, the Tax Court and Federal Court of Appeal have consistently rejected the position, including under section 160, that dividends are valid consideration for prior services, and here Justice Monaghan concurred with those decisions. Justice Monaghan agreed with the Minister that the services provided were not valid consideration for the dividends the Valovics received from Ivan’s Electric. In the Court’s view, citing Neuman, dividends are a gratuitous payment that can only be related to a shareholding and not to any other consideration the shareholder may provide. Even if the Court accepted that the dividends were paid as de facto compensation for their services in lieu of employment income, this was irrelevant and the appeal of the application of section 160 must fail. Of particular interest is that Justice Monaghan expressly rejected an argument that section 160 should recognize the "economic reality" of the payment. The "economic reality" of a dividend is relevant for the tax on split income ("TOSI") rules, which provide for unfavourable tax consequences on payments of "split income" (such as dividends) where the dividend exceeds the economic contribution of the family member receiving the payment. It seems reasonable for a taxpayer to assume that, if they can only receive dividends commensurate to their contribution without offending the TOSI rules, then that same contribution should be taken into account for purposes of applying section 160.

Conclusion

In summary, the Tax Court found that the dividends paid by Ivan's Electric were not paid in exchange for consideration for purposes of section 160 of the Act and held that dividends can only be related to a shareholding. Consideration provided to the corporation is an inappropriate justification for the payment of a dividend, and payment of the dividend can lead to joint and several liability if the dividend-paying corporation has an outstanding tax liability.

The full case can be found here:

https://decision.tcc-cci.gc.ca/tcc-cci/decisions/en/item/484816/index.do