

DEDUCTIBILITY OF MANAGEMENT FEES PAID TO RELATED CORPORATIONS

Mark C. Stacey and Jacqueline Flett

We have previously written about using holding corporations in conjunction with operating corporations to achieve a higher level of limited liability protection. (See *Letter of the Law*, Summer 2005.) With this structure, one company is incorporated to operate the main business or profession of the company (Opco) and the other company (Holdco) is incorporated to own the the former's shares; in other words, Opco becomes a wholly-owned subsidiary of Holdco. In this structure, liability and risk are ordinarily in the hands of the Opco while the assets are usually held in the hands of the Holdco. In more complicated structures, a Holdco may have more than one Opco subsidiary.

Traditionally, one method of moving income from Opco to Holdco or between two related Opcos has been for one Opco to pay a management fee to its parent company or other related company. While the receiving company declares the management fee as income, the paying Opco is able to deduct the management fee paid.

However, a recent decision of the Tax Court of Canada in *Les Entreprises Réjean Goyette Inc. v. Her Majesty the Queen* questioned this deductibility of intercorporate management fees. In this case, a taxpaying subsidiary, Les Entreprises Réjean Goyette Inc., was appealing a decision by the Canada Revenue Agency to disallow the deduction of management fees paid to its related company, 2744-2870 Québec Inc. The two companies were subsidiaries of the same holding corporation. Les Entreprises Réjean Goyette Inc. lost in court so the management fees paid to 2744-2870 Québec Inc. were held to be not deductible.

The Court determined that the lack of a formal written management agreement between the two related companies raised the question of whether Les Entreprises Réjean Goyette Inc. was legally obligated to pay the management fees. The Court held further that Les Entreprises Réjean Goyette Inc. had not received valuable consideration for the management fees and the true purpose of the management fees was to shift income to the related company in order to offset non-capital losses.

The result of this decision is that the taxpayer was doubly taxed: 2744-2780 Québec Inc. paid tax on the management fees it received as income but Les Entreprises Réjean Goyette Inc. could not deduct them as an expense.

Despite this decision, the Opco/Holdco structure—and the payment of management fees—continues to be an advantageous method of structuring a business and protecting both assets and income. However, to preserve the deductibility of the management fees paid by an Opco to a Holdco or an otherwise related company, all such arrangements should have a valid management and/or services agreement in place to substantiate the management fee. The services which are supplied to the Opco should be clearly stipulated in the agreement and the management fee should be in line with the value of the services provided by the Holdco or related company.

The decision in *Les Entreprises Réjean Goyette Inc.* concerned deductions claimed in 2002 and 2003. Accordingly, any businesses which have claimed deductions for management fees paid to a related company in recent years, or intend to claim such deductions at any time in the future, should consider entering into a management and/or services agreement.