256(5.1) - DE FACTO CONTROL: A RETURN TO THE PAST

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2017 Ontario Tax Conference & Live Webcast

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Introduction

The meaning of *de facto* control as set out in subsection 256(5.1) of the *Income Tax Act*[1]has proven difficult to pin down despite describing what on the surface would appear to be a relatively simple concept. As all tax practitioners know concepts rarely translate into legislation that is clear, easy to interpret and without ambiguity, however, the application of *de facto* control in particular has proven to be a controversial provision which has been the subject of a good deal of litigation.

This paper is a follow up to Philip Friedlan's 2010 paper[2] and to Helen Plecko and Gareth Williams' 2015 paper[3] dealing with the same subject. This paper does not aim to be a comprehensive review of the entire history of *de facto* control, rather, this paper aims to update the reader on the significant developments with respect to *de facto* control that have occurred in the wake of its two predecessors.

This paper is composed of four parts. The first part provides a brief review of the legislative history and case law relating to *de facto* control. The second part reviews the recent case law

and in particular the leading case of *McGillivray Restaurant Ltd. v. Canada*[4]which ostensibly resolved a longstanding tension in the case law surrounding *de facto* control. The third part examines the new draft legislation which proposes to substantially revise the meaning text of subsection 256(5.1) through the addition of subsection 256(5.11). The fourth part of this paper will briefly examine some planning implications arising from the current state of the *de facto* control analysis.

Background and Legislative History

The Concept of Control and the Introduction to *De Facto* Control

The starting point for the concept of *de facto* control is the simpler concept of control. As is well known, the term "control" under the Tax Act refers to "*de jure*" control not "*de facto*" control.[5] Generally speaking, *de jure* is control that rests in the ownership of such a number of shares as carries with it the right to a majority of the votes in the election of the board of directors.[6] In the *Duha Printers* case Iaccobucci, J. stated that the *de jure* control test was an exercise in determining the person who has "effective control" of the corporation and further stated the principles for determining *de jure* control as follows:

> (1) ……..
>
> (2) The general test for de jure control is that enunciated in Buckerfield's, supra: whether the majority shareholder enjoys "effective control" over the "affairs and fortunes" of the corporation, as manifested in "ownership of such a number of shares as carries with it the right to a majority of the votes in the election of the board of directors".
>
> (3) To determine whether such "effective control" exists, one must consider:
>
> (a) the corporation's governing statute;
>
> (b) the share register of the corporation; and
>
> (c) any specific or unique limitation on either the majority shareholder's power to control the election of the board or the board's power to manage the business and affairs of the company, as manifested in either:
>
> (i) the constating documents of the corporation; or
> (ii) any unanimous shareholder agreement.
>
> (4) Documents other than the share register, the constating documents, and any unanimous shareholder agreement are not generally to be considered for this purpose.
>
> (5) If there exists any such limitation as contemplated by item 3(c), the majority shareholder may nonetheless possess de jure control, unless there remains no other way for that shareholder to exercise "effective control" over the affairs and fortunes of the corporation in a manner analogous or equivalent to the Buckerfield's test.[7]

Thus a *de jure* control analysis requires an initial examination of the ownership of the voting shares carrying with them the right to appoint a majority of the board of directors. However, this initial analysis must give way to a determination of who has effective control of the corporation

which requires consideration of: the corporation's governing statute, and any specific or unique limitation on either the majority shareholder's power to control the election of the board or the board's power to manage the business and affairs of the company (including any unanimous shareholder agreement).

Prior to the introduction of subsection 256(5.1) the phrase "controlled, directly or indirectly, in any manner whatever" was interpreted by the courts to mean "*de jure*" control.[8] However, this meaning was modified in 1987 as part of tax reform and subsection 256(5.1) was introduced which expanded the concept of control to include *de facto* control for certain provisions of the Tax Act.

Subsection 256(5.1)

Subsection 256(5.1) of the Tax Act provides that:

> For the purposes of this Act, where the expression "controlled, directly or indirectly in any manner whatever," is used, a corporation shall be considered to be so controlled by another corporation, person or group of persons (in this subsection referred to as the "controller") at any time where, at that time, the controller has any direct or indirect influence that, if exercised, would result in control in fact of the corporation, except that, where the corporation and the controller are dealing with each other at arm's length and the influence is derived from a franchise, licence, lease, distribution, supply or management agreement or other similar agreement or arrangement, the main purpose of which is to govern the relationship between the corporation and the controller regarding the manner in which a business carried on by the corporation is to be conducted, the corporation shall not be considered to be controlled, directly or indirectly in any manner whatever, by the controller by reason only of that agreement or arrangement.

Generally speaking the provision is composed of two parts. The first part says that, a corporation shall be considered to be controlled by another corporation, a person or a group of persons (the "controller") at any time where, at that time, the controller has any direct or indirect influence that, if exercised, would result in control in fact of the corporation.

The second part provides an exception with respect to certain arm's length arrangements. A corporation will not be considered to be controlled in fact within subsection 256(5.1) by another corporation or person or group of persons (the "controller")

(a) where the corporation and the controller deal at arm's length with each other,

(b) the influence is derived from a franchise, licence, lease, distribution, supply or management agreement or other similar agreement or arrangement, and

(c) the main purpose of such agreement or arrangement is to govern the relationship between the corporation and the controller regarding the manner in which a business carried on by the corporation is to be conducted.

In the technical notes to subsection 256(5.1) it was stated that the arm's length exception was supposed to distinguish between control of the corporation and control over the business carried

on by the corporation.[9] The example provided the Technical Notes indicates that a franchise agreement or a lease that provides the franchisor or lessor a measure of control over the products by the corporation or the hours during which that corporation conducts its business, would not in itself result in the franchisor or lessor having control over the corporation.[10]

It has been left to the courts to determine whether the controller in any particular scenario has direct or indirect influence that, if exercised would result in control in fact.

Why *De Facto* Control Matters

The concept of *de facto* control affects a number of different provisions in the Tax Act. The introduction of subsection 256(5.1) also resulted in a number of provisions being amended to incorporate the concept. The term "controlled, directly or indirectly, in any manner whatever" now appears multiple times in the Tax Act and a few times in the Income Tax Regulations. The most commonly relied on provisions which incorporate the term are the following:

(a) paragraph (a) of the definition of Canadian-controlled private corporation[11],
(b) the affiliated person rules and the definition of "controlled"[12], and
(c) provisions with respect to the associated corporations[13].

In addition to these extremely consequential provisions, *de facto* control also affects a number of other provisions in the Tax Act. The provisions of the Tax Act and the regulations in which the words "controlled, directly or indirectly in any manner whatever," appear are listed in Appendix A to this paper.

In fact the concept of *de facto* control is not even limited to the Tax Act itself. Recent amendments to the Land Transfer Tax Act[14] apply a special tax in respect of a "foreign entity". That term is defined to include a "foreign corporation" which is defined to mean:

1. A corporation that is not incorporated in Canada.

2. A corporation, the shares of which are not listed on a stock exchange in Canada, that is incorporated in Canada and is controlled, directly or indirectly in any manner whatever, within the meaning of section 256 of the *Income Tax Act* (Canada), by one or more of the following:

    i. A foreign national.

    ii. A corporation that is not incorporated in Canada.

    iii. A corporation that would, if each share of the corporation's capital stock that is owned by a foreign national or by a corporation described in paragraph 1 were owned by a particular person, be controlled, directly or

indirectly in any manner whatever, within the meaning of section 256 of the *Income Tax Act* (Canada), by the particular person;[15]

It should be noted that subsection 256(5.1) does not apply to certain important provisions in the Tax Act including the acquisition of control rules (subsections 249(4) and 256(7) and section 111), the rules for determining if persons are related to each other (section 251) and the definition of "private corporation" (subsection 89(1)).

How the Courts have Interpreted *De Facto* Control: Pre- *McGillivray FCA decision* Case Law

Introduction

This section and the next section of the paper revisit the interpretation of subsection 256(5.1) in light of the court decisions since the 2010 Friedlan Paper.

The interpretation of subsection 256(5.1) has proven extremely difficult for the courts as evidenced by the two competing sets of interpretative modes which were developed (and applied) prior to this tension (ostensibly) being resolved by the Federal Court of Appeal in *McGillivray*.[16]

This first approach (which might be termed the strict or "board control" approach) was articulated by the Federal Court of Appeal (FCA) in *Silicon Graphics Limited v. The Queen*.[17]

Board Control Approach - Silicon Graphics Case [18]

In *Silicon Graphics* the issue was whether a predecessor corporation, incorporated under the *Business Corporations Act* (Ontario), ("Alias") to the appellant in which more than 50% of the common shares were held by non-residents was a CCPC throughout the relevant taxation years, namely 1992 and 1993. The Tax Court had held that once the number of non-resident shareholders reached 50% plus one, the control and right to elect the board of directors passed to non-resident shareholders and that a common connection between those non-resident shareholders were not a requirement. Accordingly, non-residents had *de jure* control. The Tax Court did not address the issue of *de facto* control. The FCA overturned the decision and held that there was no *de jure* control of the company by non-residents as there was no evidence of any common connection among them. The Court also held that there was no *de facto* control by non-residents because the Crown provided no evidence to support such a finding.

The Crown argued that a U.S. public company ("Silicon U.S.") had *de facto* control because of its $5,000,000 loan to Alias and the fact that it determined which creditors would be paid and the amount of that payment and the Canadian company was required to prepare a daily cash forecast to submit to the U.S. lender for approval. In addition, the respondent also submitted that the actions and involvement of the U.S. lender extended beyond what was necessary for safe guarding its rights and interest in respect of the loan and that the following evidence indicated the ongoing significant influence of Silicon U.S. over Alias, namely:

(a) the founder of Silicon U.S. was a director of Alias,

(b) the President, the COO and CEO of the Canadian company had been previously a senior officer of Silicon U.S.,
(c) Silicon U.S. had made financial contributions to Alias for software development and marketing, and
(d) Alias was dependent on Silicon U.S. given the fact that Alias' software only operated on the Silicon U.S.'s hardware during the relevant years.

The FCA rejected the Crown's submissions and stated the following at paragraphs 66 and 67:

> The case law suggests that in determining whether **de facto control** exists it is necessary to examine external agreements (*Duha Printers*, supra at 825); shareholder resolutions (*Société Foncière d'Investissement Inc. v. Canada*, [1996] 1568, [*sic* – [1995] T.C.J. No. 1568] T.C.J. No. para. 10 (T.C.C.)); and whether any party can change the board of directors or whether any shareholders' agreement gives any party the ability to influence the composition of the board of directors (*International Mercantile Factors Ltd. v. The Queen* (1990), 90 DTC 6390 at 6399 (F.C.T.D.), aff'd (1994), 94 DTC 6365 (F.C.A.); and *Multiview Inc. v. The Queen* (1997), 97 DTC 1489 at 1492-93 (T.C.C.)).
>
> It is therefore my view that in order for there to be a finding of **de facto control**, a person or group of persons must have the clear right and ability to effect a significant change in the board of directors or the powers of the board of directors or to influence in a very direct way the shareholders who would otherwise have the ability to elect the board of directors.[19]

The foregoing formulation, namely that a finding of *de facto* control requires a person or group of persons must have the clear to right and ability to effect a significant change in the board of directors or the powers of the board of directors or to influence in a very direct way the shareholders who would otherwise have the ability to elect the board of directors, was the narrower of the two approaches developed by the courts.

This approach had the benefit of greater conceptual clarity perhaps at the expense of expansiveness and conceptual adherence to the notion of *de facto* control detached from legal concepts of simple *de jure* control.

Operational Control Approach

The second and more expansive approach (which might be termed the operational control approach) was applied in a number of cases including: *Transport M.L. Couture Inc. v. The Queen*[20], *Plomberie J.C. Langlois Inc. v. The Queen*[21], *Taber Solids Control (1998) Ltd. v. The Queen*[22], *Mimetix Pharmaceuticals Inc. Her Majesty the Queen*[23], *Kruger Wayagamack Inc. v. the Queen*[24], amongst other cases. Succinctly, this approach looks at a broad manner of factors influencing operational control including family relationships and influence, commercial relationships, economic dependence, degree of integration and location of operational decision-making authority. This approach, however, does not limit consideration to whether or not a person or group of persons must has the clear right and ability to effect a significant change in the board of directors or the powers of the board of directors or to influence in a very direct way the shareholders who would otherwise have the ability to elect the board of directors.

The decision of the Tax Court in *McGillivray Restaurant Ltd. v. the Queen*[25] cited *Mimetix Pharmaceuticals* for the proposition that a *de facto* control analysis could look to "economic controlling influence, control of day-to-day operations, controlling the corporation's fortunes by making all the decisions, who was in an economic position to exert the kind of pressure that would enable [the controller] to have [the controller's] will prevail with respect to that business…."[26]. Thus the operational control approach can result in a finding of *de facto* control on the basis of operational control, economic dependence and effective control of board decisions making without finding a link between this operational control and the board of directors and its decision-making.

This tension as between the stricter "board control" approach and the broader "operational control" approach went unresolved for many years with cases relying on one test or the other without any apparent consistency leading to considerable uncertainty regarding the application of subsection 256(5.1).

McGillivray and Post- McGillivray Case Law

Introduction

This unresolved tension in the case law appeared to have been settled with the Federal Court of Appeal decision in *McGillivray*.[27] However, although *McGillivray* was the most important *de facto* control case since the 2010 Friedlan Paper was written, there have in fact been six cases decided by the courts, four of which were ultimately decided by the Federal Court of Appeal. These cases are listed in Appendix B to this paper.

One of the cases, *Alberta Printed Circuits Ltd. v. Her Majesty the Queen* [28] held that the *de facto* control test in subsection 256(5.1) could be used to determine if parties were dealing with each other at arm's length under the Tax Act (generally).

These cases were rendered mostly dead letter with the issuance of the decision in *McGillivray* which provided a definitive interpretation of *de facto* control. However, in light of the proposed legislation some of these cases may prove interpretively helpful in the future.

The Plecko and Williams Paper provided a helpful discussion of a number of these decisions which are listed in Appendix B to this paper. The Plecko and Williams Paper also prepared a useful appendix that summarized the *de facto* control cases that had been rendered at the time the Plecko and Williams's paper was issued. This appendix was organized by case, and by the factor found determinative by the court. These materials may be of great assistance in future given the uncertainty surrounding the proposed legislative changes to the *de facto* control test.

2010 Friedlan Paper and the *McGillivray*[29] decision

Although the longstanding tension in the *de facto* control case law came to head in the *McGillivray* decision, the ultimate view adopted by the courts was perhaps suggested in the 2010 Friedlan Paper. The following comments were made in the 2010 Friedlan paper regarding the meaning of *de facto* control, in light of the then current case law.

Based on the dictionary meaning of "influence", it was stated in the 2010 Friedlan Paper paper that for the provision to apply, the controller must have direct or indirect authority, clout, leverage or power that, if exercised would result in control in fact of the corporation. It was also stated in the 2010 Friedlan paper that the use of the words "if exercised" in subsection 256(5.1) indicated that for there to be control in fact, the controller did not have to exercise that influence and that the courts had confirmed this view.

Based on the case law at the time, the 2010 Friedlan Paper also concluded at page 12 that "it would be reasonable to take the view that in order for a person to have *de facto* control of a corporation, that person must have the ability to control the board of directors and/or its decision making power. However, the factors to be considered are not limited."

This paper will now review the ultimate resolution given by the courts in *McGillivray* to the meaning of subsection 256(5.1) prior to the proposed legislative amendments.

Decision in McGillivray[30]

The issue in *McGillivray* was whether in the relevant taxation years McGillivray Restaurant Ltd. (McGillivray Ltd.) was associated with G.R.R. Holdings Ltd. ("GRR.") and MorCort Properties Ltd. ("MorCort"), on the basis that a certain individual, Mr. Howard, who had both *de jure* and *de facto* control of both GRR and MorCort, also had *de facto* control of McGillivray Ltd. within the meaning of subsection 256(5.1) .

The facts in the case as described in the decision of Ryer, J.A., speaking for a unanimous Federal Court of Appeal (FCA), were relatively simple. Mr. Howard and Mrs. Howard were married to one another. Mr. Howard owned all of the issued shares of GRR and MorCort. In 1997, GRR had entered into franchise agreements with Keg Restaurants Ltd. (the "Keg").

Mr. Howard, having decided that one of the restaurants should be relocated, obtained professional advice in respect of this new location. McGillivray Ltd. was incorporated for the purpose of acquiring and operating this new location of the Keg Restaurant. Upon its organization, Mrs. Howard was issued 760 voting common shares for $76.00 and Mr. Howard was issued 240 voting shares for $24.00. Mr. Howard was elected as the sole director and appointed as the sole officer of McGillivray Ltd. Mr. Howard did not require his wife's approval to make decisions on behalf of McGillivray Ltd. There was no written shareholders' agreement. After receiving the Keg's required consent, the franchise agreement held by GRR applicable to the new location was assigned to McGillivray Ltd. Mr. Howard had assured the Keg (as well the employees of GRR) that notwithstanding these changes, things would be run on the same basis as in the past. A similar assurance had been given to Mrs. Howard.

In the Tax Court decision[31], Justice Boyle noted that there were two competing interpretations of subsection 256(5.1) (the aforementioned "board control" test and the broader "operational control test"). Justice Boyle highlighted the decision in *Silicon Graphics* which provided the narrow interpretation "under which a person would only be considered to have *de facto* control if that person had the clear right and ability to either effect significant change in the board of directors or the powers of the board of directors or to influence in a very direct way the shareholders who would otherwise have the ability to elect the board of directors." Justice Boyle then made note of the broader test based on the decisions of the Federal Court of Appeal in

Mimetix Pharmaceuticals Inc. and *Plomberie J.C. Langlois Inc.*, that required looking beyond the ability to affect the composition or powers of the board, and to consider broad manners of influence in making the determination of who in fact had effective control of a corporation.

Justice Boyle, having decided that the latter two decisions were binding, applied the second broader test and held that Mr. Howard could not have had any more effective factual control over the management and operation of McGillivray Ltd. and its business.

At the Federal Court of Appeal Justice Ryer, speaking for a unanimous Court, held that the correct test for determining the issue of *de facto* control was the narrow test as set out in paragraph 67 of the decision of Justice Sexton in *Silicon Graphics* which is as follows:

> It is therefore my view that in order for there to be a finding of *de facto* control, a person or group of persons must have the clear right and ability to effect a significant change in the board of directors or the powers of the board of directors or to influence in a very direct way the shareholders who would otherwise have the ability to elect the board of directors.

In reaching this decision, Justice Ryer stated that the test in *Silicon Graphics* had been affirmed in *9044 2807 Québec Inc. v. Canada*[32] and concluded that that case had not altered the test for *de facto* control enunciated in *Silicon Graphics*. The Justice further stated that, while *Mimetix Pharmaceuticals* and *Plomberie J.C. Langlois* appeared to have employed the second broader test identified by Justice Boyle, the narrower test set out in *Silicon Graphics* had not been directly challenged in either of those decisions. Ryer, J.A. held that those decisions should not be followed to the extent that either of them could be taken as having prescribed a test for *de facto* control that was inconsistent with the *Silicon Graphics* test. The Justice also held that the decision in *Lyrtech RD Inc. v. Canada*[33] should not be followed to the extent that it could be taken as having repudiated the *Silicon Graphics* test.

The FCA in *McGillivray* rejected any assertion that the test for control in fact should be based on "operational control". The Court further held that the difference between *de facto* and *de jure* control related to the breadth of factors that can be considered in determining whether a person or a group of persons has effective control by means of an ability to elect the board of directors of a corporation. In the case of *de facto* control, a broader range of factors (such as a non-unanimous shareholders' agreement) can be considered. The FCA stated that while the list of such factors is open ended, "a factor that does not include a legally enforceable right and ability to effect a change to the board of directors or its powers, or to exercise influence over the shareholder or shareholders who have that right and ability, should not be considered as having the potential to establish *de facto* control."

Ryer, J.A., stated that the Tax Court had found that Mr. and Mrs. Howard had reached an unwritten agreement under which the identity and composition of the board of directors of McGillivray Ltd. would be under control of Mr. Howard. The FCA held that as long as such agreement was not repudiated by Mrs. Howard, that such agreement was influence of the type contemplated by subsection 256(5.1) as interpreted in *Silicon Graphics*. Consequently, as Mr. Howard was found to have *de facto* control of McGillivray Ltd., the appeal was dismissed.

It should also be noted that, although not apparently relevant to the decision of the FCA, the property on which the McGillivray Keg Restaurant was located was owned by MorCort and that the administration, accounting, head office and similar functions were provided to McGillivray by GRR for which a management fee was charged.

Decision in Aeronautic Development Corporation Case

The holding in *McGillivray* which provided welcome clarity to the *de facto* control analysis was somewhat upended by the decision in *Aeronautic Development Corporation v. The Queen*.[34]

[35]In *Aeronautic Development* case the issue was whether the Appellant ("ADC") was entitled to refundable research and development credits (the "Refundable ITCs") at the rate of 35% in respect of its expenditures in respect of its 2009, 2010 and 2011 taxation years. The Minister of National Revenue as represented by the Canada Revenue Agency (the "Minister") had disallowed the claim on the basis that ADC was not a Canadian-controlled private corporation ("CCPC") in relevant taxation years because from August 17, 2009 until December 31, 2011, it was controlled in fact by Mr. Silva, a U.S. citizen and resident.

Mr. Silva, an engineer and an architect with extensive experience in the aeronautical field, was an early investor in another Canadian company that helped to develop and market a small amphibious aircraft known as the Seawind, that failed and whose intellectual property was acquired by Mr. Silva.

Mr. Silva completed the design for the Seawind and implemented a corporate structure to carry out the certification and subsequent production work in order to access the Refundable ITCs. A Canadian corporation was established for this purpose but it too failed and went bankrupt. Mr. Silva then acquired the assets of this second failed venture.

ADC was then incorporated in Nova Scotia in April, 2009 with its sole shareholder being Seawind Corp. an American corporation controlled by Mr. Silva.

Subsequently, the Appellant entered into an agreement with Seawind Corp. (the "Development Agreement") to provide the services to Seawind Corp. necessary to complete the prototyping and certification of Seawind. The Development Agreement provided that the Appellant would be reimbursed for the expenses incurred in relation to the prototyping and certification process but would be required to remit the amount of all Refundable ITCs to Seawind Corp subject to receiving an additional 5% in relation to its certification expenses.

The material, equipment, and tools acquired by the Appellant were funded by Seawind Corp. and were to become the property of Seawind Corp. upon the completion of the certification work.

Seawind Corp. was the sole client of the Appellant throughout the period in question and operations shut down when Seawind Corp. was unable to fund the Appellant's activities.

On August 17, 2009, nearly four months after the execution of the Development Agreement, ADC issued additional common shares such that from that date forward a majority of its common shares were held directly or indirectly by residents of Canada.

As a preliminary matter, the Tax Court rejected both the Crown's attempt to introduce at the trial a new argument that Seawind Corp had *de jure* control of ADC based on the argument that the

voting rights of certain shares held by the Canadian resident could not be exercised until fully paid and the argument itself.

Thus, the question for the Court was whether ADC was not a CCPC in the relevant taxation years because it was controlled, directly or indirectly in any manner whatever, by one or more non-resident persons.

The Minister had alleged that Mr. Silva had exercised *de facto* control over ADC by means of economic influence derived from rights contained in the Development Agreement and through other commercial agreements between the parties.

The Tax Court turned to the question of whether in light of the decision in *McGillivray* "economic influence" is a factor to be considered in a *de facto* control analysis. Justice Hogan noted that *McGillivray* had held that "a factor that does not include a legally enforceable right and ability to effect a change to the board of directors or its powers or to exercise influence over the shareholder or shareholders who have that right and ability, ought not to be considered as having the potential to establish *de facto* control." However, the Justice also noted that subsection 256(5.1) makes clear that control in fact is "based on the ability to exercise direct or indirect influence".

The Tax Court held that, since Parliament does not speak in vain, the wording of subsection 256(5.1) which provides for an exclusion in relation to certain types of arm's length commercial agreements, suggests that Parliament intended that agreements not falling within the exclusion should be considered. In the Court's view, to conclude otherwise, would render the exclusion relating to the aforementioned arm's length agreements in subsection 256(5.1) redundant. Therefore, the Court held that unless the relevant commercial agreements and arrangements fall within the narrow purview of the aforementioned exclusion, they must be considered in a control in fact analysis.

Justice Hogan then held that in order to make a finding of control in fact the evidence must show that that the controller has the ability to affect the economic interest of the voting shareholders in a manner that allows the controller to impose his or her will on them, should he or she decide to do so.

The Justice then considered the relations between the Appellant and Mr. Silva and Seawind Corp. The Court noted, among other things, that the terms of the Development Agreement were lopsided, that the Appellant was dependent on funding from Seawind Corp., that the Appellant did not own the intellectual property resulting from its development work.

The Tax Court then concluded that it would be hard to conceive that the shareholders of ADC resident in Canada would have exercised their voting rights independent of Mr. Silva's wishes and held that Mr. Silva, "had he chosen to do so, could have imposed his will on the Canadian Resident Shareholders of the Appellant with respect to the composition of, or a change in, the board of directors of the Appellant." Justice Hogan appears to have concluded that as a result of the commercial agreements between ADC and the relevant non-residents there was sufficient control by non-residents over operational-like factors that the non-residents had effective control over the voting of the resident shareholders.

Hogan, J. also held that the exclusion relating to commercial agreements is applicable only if (a) at the relevant time the corporation and the controller are dealing at arm's length and (b) the main purpose of the agreement is to govern the relationship of the corporation and the controller regarding the manner in which the business of the corporation is carried on. The Tax Court Justice found that Mr. Silva and Seawind Corp. were not dealing at arm's length with ADC and consequently the exclusion was not applicable. Consequently, the appeal was dismissed.

Reconciling *McGillivray* and *Aeronautic Development Corporation* Cases

With all due respect to Justice Hogan, in the writers' view the decision of the Tax Court in the *Aeronautic Development Corporation* case is not consistent with the holding in *McGillivray*. Justice Hogan appears to have de-emphasized a critical component of the holding from *McGillivray* which held that "*De facto* control, like *de jure* control, is concerned with control over the board of directors and not with control of the day-to-day operations of the corporation or its business"[36], that "The difference between *de facto* and *de jure* control, then, is limited to the breadth of factors that can be considered in determining whether a person or group of persons has effective control, by means of an ability to elect the board of directors, of a corporation", and that "a factor that does not include a legally enforceable right and ability to effect a change to the board of directors or its powers, or to exercise influence over the shareholder or shareholders who have that right and ability, ought not to be considered as having the potential to establish *de facto* control."[37]

In *Aeronautic Development Corporation* the relevant commercial agreements do not appear to include a legal right to elect the board of directors or to directly influence the voting of the relevant shareholders. However, Justice Hogan appears to have concluded that as a result of the commercial agreements between the Appellant and the relevant non-residents there was sufficient control by non-residents over operational-like factors that the non-residents had effective control over the voting of the resident shareholders. In the writers' view, this analysis is inconsistent with the holding in *McGillivray* because it renders the distinction between operational control and control over the board of directors meaningless. It does so by saying that commercial agreements can by conferring operational control be a sufficient source of influence to affect voting decisions of shareholders. In which case there is (arguably) no distinction between operational control and control over the board of directors.

New Draft Legislation

As part of the 2017 Federal Budget 2017[38] and in response to "recent jurisprudence such as *McGillivray Restaurant Ltd.*" proposed subsection 256(5.11) was introduced effective for taxation years commencing on or after March 22, 2017 and provides as follows:

> For the purposes of this Act, the determination of whether a taxpayer has, in respect of a corporation, any direct or indirect influence that, if exercised, would result in control in fact of the corporation, shall
>
> (a) take into consideration all factors that are relevant in the circumstances; and

> (b) not be limited to, and the relevant factors need not include, whether the taxpayer has a legally enforceable right or ability to effect a change in the board of directors of the corporation, or the board's powers, or to exercise influence over the shareholder or shareholders who have that right or ability.

The intent of this new subsection would appear to restore the broader "operational control" test that was rejected by the Federal Court of Appeal in *McGillivray*. As a matter of statutory interpretation it is not entirely clear that this is the result of the proposed legislation.

As a reminder, the Federal Court of Appeal in *McGillivray* interpreted subsection 256(5.1) to mean that in order for there to be a finding of "*de facto* control, a person or group of persons must have the clear right and ability to effect a significant change in the board of directors or the powers of the board of directors or to influence in a very direct way the shareholders who would otherwise have the ability to elect the board of directors".

It is worth setting out what the Federal Court of Appeal stated at paragraph 33 of its decision in *McGillivray*

> In the *de facto* control analysis, as one would expect, there are a broader range of attributes – beyond voting power determined in the context of constating documents and share registers – that must be considered to determine whether the requirements of subsection 256(5.1) have been met in any given case. For example, the rights of a person under the provisions of a shareholders agreement, other than a unanimous shareholders agreement, under which shareholders agree that the person will be able to select the directors, would fall within the definition of "influence", within the meaning of subsection 256(5.1). So, must the requisite influence arise out of legally binding or enforceable arrangements, or can other kinds of influence lead to a finding of *de facto* control? For example, does a person who by threats or other vile means, at one end of the spectrum, or by matrimonial or familial love and affection, at the other end of the spectrum, have the requisite influence over a shareholder, who would otherwise have *de jure* control of a corporation, that would be sufficient to establish that such person has *de facto* control over that corporation?

The Court then concluded that it did not have to analyze the meaning of *de facto* control from first principles because this analysis had been previously done by the Federal Court of Appeal in *Silicon Graphics* which had developed the aforementioned board control approach. The Federal Court of Appeal in at paragraph 49 in *McGillivray* also noted that, "an interpretation of *de facto* control as contemplated by subsection 256(5.1) that fails to include a requirement that the influence in question must be grounded in a legally enforceable right or ability runs counter to the clear admonition of the Supreme Court of Canada in *Canada Trustco Mortgage Co. v. Canada*" which required that the Tax Act be interpreted "in order to achieve consistency, predictability and fairness so that taxpayers may manage their affairs intelligently".

Proposed subsection 256(5.11) states that "the determination of whether a taxpayer has, in respect of a corporation, any direct or indirect influence that, if exercised, would result in control in fact of the corporation (a) shall take into consideration all factors that are relevant in the circumstances; and (b) shall not be limited to, and the relevant factors to be considered in making

the determination need not include, whether the taxpayer has a legally enforceable right or ability to effect a change in the board of directors of the corporation, or the board's powers, or to exercise influence over the shareholder or shareholders who have that right or ability".

Thus control in fact under the new legislation does not require a finding that the controller has a legally enforceable right or ability to effect a change in the board of directors of the corporation, or the board's powers, or to exercise influence over the shareholder or shareholders who have that right or ability. Furthermore the court must take into consideration all factors that are relevant in the circumstances.

Does the controller still need to have at least the informal ability to change the board of directors, affect the board's powers or to exercise the influence over the shareholders? What type of influence is sufficient to give *de facto* control and what type of influence is permissible?

What we are left with is a conceptual mess because the whole concept of *de facto* control has been tied to legal control. If it is not required to be shown that the relevant controller has some mechanism by which that person can directly or indirectly control the board of directors, affect its powers or exercise influence over the shareholders we have no statutory tipping point at which some measure of influence will result in control in fact. The only categories of influence which will clearly not result in a finding of *de facto* control would be when the putative controller and the corporation are dealing at arm's length and the influence is derived from a franchise, licence, lease, distribution, supply or management agreement or other similar agreement or arrangement, the main purpose of which is to govern the relationship between the corporation and the controller regarding the manner in which a business carried on by the corporation is to be conducted.

The test as it stands provides no clear guidance as to when some party's influence over a corporation amounts to *de facto* control. The Plecko and Williams Paper makes the incisive observation that the OECD's BEPS proposal deals with scenarios analogous to those dealt with under the Tax Act using the concept of *de facto* control using tests that are "reasonably mechanical and not very complex".[39]

In the *Aeronautic Development Corporation* case the Tax Court appears to have settled on a test tying together the "board control" approach to the "operational control" approach by in effect requiring that in order for there to be a finding of *de facto* control the operational control must be sufficient so as to give the party sufficient influence or rights to effect board control. If the whole concept of *de facto* control is divorced from its nexus with board control then it remains completely unclear what level of control is required. This task is made monumentally more challenging by the nature of a corporation which is a legal person but whose decisions are ultimately determined by officers (appointed by the directors and under the supervision of directors) and by directors (appointed by the shareholders). Absent some link to board control there is no principled approach to distinguish one situation of influence which results in control in fact from another sort of influence which does not result in control in fact other than to say influence is a spectrum which at some point can result in a finding of *de facto* control.

It could be argued that the product of the proposed legislation is in effect a smell test. If this is the case any planning related to incentives under the Tax Act which depend upon there not being a finding of *de facto* control is rendered needlessly uncertain. Robin MacKnight correctly pointed out the obvious implication of the proposed changes to the *de facto* control test in relation to the SR&ED program:

> What is a Canadian innovator to do now? If the innovator seeks funding from public companies or non-residents, it is a virtual certainty that the CRA will challenge claims for the enhanced SR & ED credits on the basis of de facto control. Will investors be interested in funding SR & ED, knowing CRA's likely assessing policy? Investors want to fund innovation, not expensive tax appeals. Even giving 51 percent ownership to Canadian employees, which could grant de jure control, would not necessarily override economic influence and control.[40]

As a practical matter, practitioners should probably look to the broad range of factors that were employed by the courts in the earlier jurisprudence relating to the operational control version of the *de facto* control test. In archived Interpretation Bulletin IT-64R4 the CRA provided a list of factors to be examined including, among other things: commercial or contractual relationships of the corporation, e.g., economic dependence on a single supplier or customer, possession of a unique expertise that is required to operate the business and the influence that a family member, who is a shareholder, creditor, supplier, etc., of a corporation, may have over another family member who is a shareholder of the corporation. The CRA further noted in that bulletin that "although the degree of influence … always a question of fact, close family ties (between parents and children or between spouses) especially lend themselves to the development of significant influences. Generally, these persons must demonstrate their economic independence and autonomy before escaping presumptions of fact which apply to related persons." Reference should also be made to the relevant earlier case law and factors which were found to be influential therein.[41]

Planning Considerations

The comments made in the 2010 Friedlan Paper remain relevant today. At pages 21-22, Philip Friedlan wrote the following:

"…….. In a general sense, planning to avoid the application of subsection 256(5.1) will involve taking steps to limit the facts on which the CRA may assess or a court may conclude that a person or group has de facto control under subsection 256(5.1).

Planning that involves arm's length parties will be easier to implement than in related party/ family cases. In arm's length cases, the exception in subsection 256(5.1) will be available.

The following must not be done if *de facto* control is to be avoided:

(a) do not appoint the relevant individual as a sole director of the corporation,

(b) do not appoint the relevant individual as a director and the chairperson and then provide in the corporation's by-laws that the chairperson have a casting vote,

(c) do not give the relevant person power to control the board of directors or its decision-making power in a shareholders' agreement.

A finding of any one or more of the following could lead to a finding of *de facto* control:

(a) economic dependence,
(b) operational/managerial control,
(c) family influence.

The foregoing factors will be very difficult to deal with in family run enterprises. For example, consider the case of two corporations (Opco1 and Opco2). Opco1 is controlled by a particular family member. To avoid a finding of *de facto* control of Opco2 by the family member who controls Opco1, Opco2 must operate as independently as possible from Opco1. Ideally, that family member should not be a shareholder, director or officer of Opco2. Opco1 should not be the financier of Opco2 or be its sole or major customer. The companies should operate out of separate premises. The decision-maker for each company both with respect to operational and managerial decisions and with respect to the board of directors must be different. Of course, these steps may be impractical from a business perspective. In any event, the CRA with respect to the association rules could seek to apply the deeming rule in subsection 256(2.1) of Tax Act."

Conclusion

As practitioners know change is a constant in the tax world. The past several years have seen very significant changes to the tax landscape. 2017 and 2018 may prove even more significant. Arguably the change to *de facto* control is small matter in the context of these larger changes; however, although seemingly trivial in the scheme of things the *de facto* control test as it stands may prove extremely challenging to apply. Practitioners must now be cognizant that any planning which is affected by *de facto* control must now be examined through this new much broader and unfortunately significantly more indeterminate and unworkable test than the one articulated by the Federal Court of Appeal in *McGillivray*.

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[1] R.S.C. 1985 (5th Supplement) c.1., as amended (referred to herein as the "Tax Act"). Unless otherwise indicated, all statutory references in the paper are to the Tax Act.
[2] Philip Friedlan, "De Facto Control: Meaning, Implications and Planning under Subsection 256(5.1) of the Income Tax Act," in 2010 Ontario Tax Conference (Toronto: Canadian Tax Foundation, 2010), 4:1-21. (the "2010 Friedlan Paper")
[3] Helena Plecko and Gareth Williams, "Various Aspects of Control, Including De Facto Control" in 2015 British Columbia Tax Conference (Toronto: Canadian Tax Foundation, 2015), 11:1-15. (the "Plecko and Williams Paper")
[4] 2016 FCA 99
[5] *Duha Printers (Western) Ltd. v. the Queen* 98 DTC 6334 (SCC) at paragraphs 35-39.
[6] *Buckerfield's Limited et al. v. M.N.R.*, 64 DTC 5301 (Exch Ct.) and *Duha Printers* supra Note 5.
[7] *Duha* supra Note 5 at paragraph 85.
[8] See *HSC Research Development Corporation v. The Queen*, 95 DTC 225 (TCC) and Philip Friedlan's paper supra note 2 for further commentary.
[9] Explanatory Notes under subsection 256(5.1), Canada, Department of Finance to Bill C-139, June 30, 1988.
[10] *Ibid.*
[11] Definition of "Canadian-controlled private corporation" in subsection 125(7) of the Tax Act. (The term "Canadian-controlled private corporation" being referred to herein as "CCPC").

[12] Section 251.1 of the Tax Act and the definition of "controlled" in subsection 251.1(3) of the Tax Act.
[13] Section 256.
[14] RSO 1990, c L.6., as amended.
[15] *Ibid*, at section 1.
[16] *Supra* note 4.
[17] 2002 DTC 7112 (FCA), 2001 DTC 379 (TCC).
[18] The case summary set out below first appeared at pages 4:7/8 of the 2010 Friedlan Paper.
[19] *Ibid*.
[20] 2003 DTC. 817.
[21] 2004 TCC 734.
[22] 2009 TCC 527.
[23] 2001 TCJ No. 749, affirmed 2003 FCA 106.
[24] 2015 TCC 90 .
[25] 2014 TCC 357.
[26] Ibid at paragraph 37.
[27] *Supra* note 4.
[28] 2011 TCC 232
[29] *Supra* note 26.
[30] The following case summary first appeared in (2016) Tax for the Owner Manager 16(3) at pages 2/3.
[31] 2014 TCC 357
[32] 2004 FCA 23
[33] 2014 FCA 267 & also see the summary of this case in the Plecko and Williams Paper for further details at page 7.
[34] 2017 TCC 39.
[35] The following case summary first appeared in (2017) Tax for the Owner Manager 17(3) at pages 4/5.
[36] *Supra* note 4 at para 46.
[37] *Ibid* at para 48.
[38] see proposed subsection 256(5.11) of the Tax Act in subsection 32(1) of the Legislative Proposals Relating to Income Tax and Regulations the Excise Tax Act and Excise Act released by the Department of Finance on September 8, 2017.
[39] The Plecko and Williams Paper *supra* note 3.
[40] Robin Macknight, "Whither the SR & ED Program?" (2017) 17:3Tax for the Owner-Manager 6-7.
[41] See the 2010 Friedlan Paper, *supra* note 2 and the Plecko and Williams Paper *supra* note 3 for a comprehensive review of this earlier case law.

Appendix "A"

Provisions of Income Tax Act using the words of "controlled, directly or indirectly in any whatever,"

- Subsection 20(8) – No deduction in respect of property in certain circumstances
- Subsection 24(2) - Business carried on by spouse or common-law partner, or controlled corporation
- Paragraphs 40(2)(a) & (h) – Limitations relating to calculation of gains, losses or reserve
- Subsection 44(7) – Exchange of property - Where subpara. (1)(e)(iii) does not apply
- Subsection 83(2.2) – Capital Dividend - Where s.83(2.1) does not apply
- Subsection 83(2.4) – Capital Dividend - Idem
- Paragraph 87(2)(kk) – Disposition of shares of controlled corporation
- Definition of "capital dividend account" in Subsection 89(1)
- Subsection 89(1.1) – Capital dividend account where control acquired
- Subsection 125(6.2) – Specified partnership income deemed nil
- Definition of "Canadian-controlled private corporation" in Subsection 125(7)
- Definition of "eligible production corporation in Subsection 125.5(1) relating to the Film or Video Production Services Tax Credit
- Definition of "excluded corporation" in Subsection 127.1(2)
- Definition of "excluded corporation" in Subsection 127.1(1) – Refundable investment tax credit
- Paragraph 149(1)(t) – Farmers' and fishermen's insurer
- Subsection 149(1.3) – Votes or de facto control
- Subsection 149(4.1) – Income exempt under 149(1)(t)
- Subsection 149(4.2) – Idem – Where subsection 149(4.1) does not apply
- Definition of "charitable organization" in Subsection 149.1(1)
- Definition of "exempt shares" in Subsection 149.1(1)
- Definition of "public foundation" in Subsection 149.1(1)
- Definition of "controlled" in Subsection 251.1(3) relating to affiliated persons
- Subsection 251.2(3) – Trusts - exceptions (relating to loss restriction rules)
- Subsection 256(1) – Associated corporations
- Subsection 256(1.3) – Parent deemed to own shares
- Subsection 256(3) – Saving provision
- Subsection 256(5.1) Control in fact
- Subsection 256(6) – An anti-avoidance related to control
- Subsection256(6.2) – Application of subsection 256(5.1) to control in fact in subsection 256(6.1)

Income Tax Regulations Provisions using "controlled, directly or indirectly in any manner whatever"

- Subsection 1106(2) – Prescribed Taxable Canadian Corporation
- Section 2901 – Prescribed Expenditures
- Subsection 5100(3) relating to Deferred Income Plans, Investments in Small Business
- Subsection 9002(3) relating to Financial Institutions – Prescribed Entities and Properties

Appendix "B"

Court Cases since 2010 Friedlan Paper

Aeronautic Development Corporation v. The Queen
2017 TCC 39

McGillivray Restaurant Ltd. v. Canada
2016 FCA 99

Kruger Wayagamack Inc. v. The Queen
2015 TCC 90, (FCA decision at 2016 FCA, 192 did not deal with 256(5.1))

Solutions MindReady R&D Inc. v. The Queen
2015 TCC 17 (English translation)

Lyrtech RD Inc. v. The Queen
2014 FCA 267 (English translation)

McGillivray Restaurant Ltd. v. The Queen
2014 TCC 357

Lyrtech RD Inc. v. Canada
2013 TCC 12 (English translation)

Alberta Printed Circuits Ltd. v. The Queen
2011 TCC 232

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Philip Friedlan and Adam Friedlan, "256(5.1)—De Facto Control: A Return to the Past," in *2017 Ontario Tax Conference* (Toronto: Canadian Tax Foundation, 2017) 5: 1-18.