DE FACTO CONTROL: MEANING, IMPLICATIONS AND PLANNING UNDER SUBSECTION 256(5.1) OF THE INCOME TAX ACT

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INTRODUCTON

The concept of *de facto* control under subsection 256(5.1) of the Income Tax Act[1] has a significant impact on certain aspects of the Tax Act such as the affiliated person rules. This paper will explore and review of the meaning of "*de facto*" control under subsection 256(5.1) of the Tax Act, consider its implications and discuss some planning issues relating to *de facto* control. The paper will review the relevant jurisprudence as well as the administrative position of the Canada Revenue Agency ("CRA"). It should be noted that the topic of *de facto* control under subsection 256(5.1) of the Tax Act has also been dealt with in a number of papers over the years.[2]

BACKGROUND

De Jure Control

As is well known, the term "control" under the Tax Act refers to "*de jure*" control not "*de facto*" control.[3] In general terms, *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.[4] Iaccobucci, J. stated in the *Duha Printers* case that the *de jure* control test was an exercise in determining the person who has "effective control" of the corporation and set out the principles for determining *de jure* control as follows:[5]

> "(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."

Pre 256(5.1) – Controlled, Directly or Indirectly…..

Prior to the introduction of subsection 256(5.1), the term "controlled, directly or indirectly, in any manner whatever" was interpreted by the courts to mean "*de jure*" control.

In *HSC Research Development Corporation v. The Queen*[6], O'Connor TCCJ analyzed the history of the use of "controlled, directly or indirectly, in any manner whatever" and noted the following:

> "In the pre-1972 Act, the words "control" or "controlled" were in most cases used without qualification. When those provisions were carried forward into the 1972 Act they were generally carried forward without change. In new provisions which were added to the 1972 Act, however, such as the definitions of "Canadian-controlled private corporation" or "private corporation", the qualification "directly or indirectly, in any manner whatever" was in most cases added. This language was included in the definition of "excluded corporation" in subsection 127.1(2) when it was enacted in 1983. Have the courts distinguished between "control" and "controlled, directly or indirectly, in any manner whatever"?"[7]

O'Connor, TCCJ then made the following additional statements:

> "The cases reviewed above show that prior to the amendments to the Act made in 1988 which added subsection 256(5.1), the courts consistently construed the words "controlled, directly or indirectly, in any manner whatever" to apply a *de jure* and not a *de facto* test for control."[8]

> "In the present case, there is internal and external evidence to show that the addition of subsection 256(5.1) effected a change in the law. Prior to the enactment of subsection 256(5.1), which is applicable to taxation years commencing after 1988, the Act did not define the phrase "controlled, directly or indirectly, in any manner whatever". As noted above, until the addition of subsection 256(5.1), this phrase was used interchangeably with the terms "control" and "controlled directly or indirectly" to denote the concept of control. For example, prior to the 1988 amendments, the Act referred to corporations "controlled, directly or indirectly, in any manner whatever" in the following provisions…."[9]

The Provision – 256(5.1)

Section 256(5.1) of the Tax Act was introduced as part of the 1987 tax reform to the tax system and expanded concept of control to include *de facto* control for certain provisions of the Tax Act.

This provision provides for the purposes of the Tax Act, where the expression "controlled, directly or indirectly, in any manner whatever," is used, 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. Subsection 256(5.1) contains 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.

The Department of Finance stated in the technical notes to subsection 256(5.1) that the arm's length exception is supposed to distinguish between control of the corporation and control over the business carried on by the corporation.[10] The example set out in these notes states 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.[11]

It should be noted that the provision leaves the determination of whether the controller has and direct or indirect influence that, if exercised would result in control in fact to the courts.

The following are relevant definitions of the noun "influence" in the online Merriam-Webster Dictionary:

3 a: the act or power of producing an effect without apparent exertion of force or direct exercise of command

b: corrupt interference with authority for personal gain

4 : the power or capacity of causing an effect in indirect or intangible ways: SWAY"

The relevant definitions from The Short Oxford English Dictionary on Historical Principles, Third Edition are as follows:

"4. The exertion of action of which the operation is unseen, except in its effects, by one person or thing upon another, the action thus exercised

5. The capacity of producing effects by insensible or invisible means; ascendancy of a person or social group; control not formally or overtly exercised."

Synonyms of the word as provided in the online Merriam-Webster Dictionary include "authority, clout, leverage, pull and sway".

Based on the foregoing, you can state 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.

The use of the words "if exercised" in subsection 256(5.1) indicates that for there to be control in fact, the controller does not have to exercise the influences. The courts have confirmed this view.

Where Subsection 256(5.1) Applies

As part of the introduction of subsection 256(5.1), a number of provisions were amended so that the concept of *de facto* control would apply to those provisions.

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. In my view, the most important provisions of the Tax Act where the term appears are the following:

(a) paragraph (a) of the definition of Canadian-controlled private corporation,[12]
(b) the affiliated person rules and specifically, the definition of "controlled"[13], and
(c) the associated corporation provisions.[14]

The following is a list of some, but not all, of the other provisions of the Tax Act where the term "controlled, directly or indirectly, in any manner whatever" appears and the concept of control in fact under subsection 256(5.1) is relevant:

(a) subsection 24(2), which deals with the situation where an individual ceases to carry on business that is subsequently carried on by a corporation controlled by the individual,

(b) provisions dealing with limitation on claiming capital gains reserves or capital losses, namely paragraph 40(2)(a) (limitation on claiming a capital gains reserve), 40(2)(h) (limitation on claiming capital losses), paragraph 44(7)(b) (capital gains reserve on replacement under replacement property rules) and paragraph 87(2)(k) has the continuation rules relating to paragraph 40(2)(h),

(c) the anti-avoidance provisions in subsection 83(2.2) and (2.4) relating to capital dividends,

(d) the portion of the definition of "capital dividend account" in subsection 89(1) of the Tax Act dealing with property that was property of a non-resident and subsection 89(1.1) which deals with the computation of the capital dividend account where control is acquired by a non-resident,

(e) subsection 125(6.2) which deals with specified partnership income,

(f) the definition of "excluded corporation" in subsection 125.5(1) which subsection forms part of the provisions relating to the Film or Video Services Production Credit,

(g) definition of "excluded corporation" in subsection 127.1(2) of the Tax Act.

Provisions Where Subsection 256(5.1) Does Not Apply

As part of the introduction of subsection 256(5.1), a number of provisions were amended so that 256(5.1) did not apply. These provisions included subparagraph 85.1(2)(b)(i) which relates to shares for share exchanges, the definition of "private corporation", subsection 186(1) which relates to Part IV Tax and paragraph (b) of the definition of "term preferred shares" in subsection 248(1).[15]

It is important to note that 256(5.1) does not apply to the provisions relating to the acquisition of control rules such as subsection 249(4) and those found rules in section 111 of the Tax Act nor does it apply in the determination of whether persons are related to each other.

JURISPRUDENCE

There are fourteen tax cases in which the courts dealt with control in fact and subsection 256(5.1) of the Tax Act. The issue in the cases to which control in fact was relevant was either CCPC status or whether corporations were associated with each other. Five of the cases were dealt by the Federal Court of Appeal ("FCA") and are discussed in the next section. The remaining cases are dealt with later in the paper.

Federal Court of Appeal Cases

Silicon Graphics Case

In *Silicon Graphics Limited v. The Queen*[16], 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."[17]

The FCA also concluded that *de facto* control always remained in Canada by reason of the following facts:

(a) the majority of the board of directors and the entire management team were residents of Canada;

(b) the principal place of the business of the company was Toronto;

(c) the Toronto management team annually prepared a slate of people to be elected to the board of directors, which slate was always accepted by the shareholders.[18]

Mimetix Pharmaceuticals Case

The issue in *Mimetix Pharmaceuticals Inc. v. The Queen*[19] was whether or not the appellant was CCPC. CCPC status would have entitled the appellant to additional investment tax credits and refundable SR & ED based investment tax credits. Fifty percent (50%) voting shares were held by two Canadian residents and a non-resident corporation (U.S. Mimetix) owned the other fifty percent (50%) of the voting shares. U.S. Mimetix held an exclusive licence to a pharmaceutical product and for no consideration had sub-licensed to the appellant on a non-exclusive basis certain rights related to the product including the right to conduct clinical trials in Canada.

For most of the relevant year, 1996, there were three directors of the appellant, one of whom was a U.S. resident, Mr. Eaton, and three officers, one of whom was Mr. Eaton. Mr. Eaton unilaterally authorized another U.S. resident to be the signing officer for the Canadian company. This individual was authorized to sign all agreements, invoices and cheques with respect to the appellant's business operations.

Lamarre, T.C.C.J.concluded on the evidence that two American residents controlled the day-to-day operations of the appellant from the United States and also controlled its fortunes by making all decisions. The Tax Court concluded that the control and supervision of the affairs and business of the appellant was exercised by Mr. Eaton, a non-resident director, and that he made decisions without the approval of the board of directors. The Tax Court concluded that U.S. Mimetix through the two non-resident individuals was the controlling mind of the appellant.

U.S. Mimetix, as the appellant's sole investor, had invested $3,000,000 in preferred shares of the appellant and made an interest-free loan of $1.1 million to the appellant. The appellant did not deal with U.S. Mimetix in many instances on a commercial basis. The administration of the appellant was carried out for no fees from San Francisco by the U.S. Mimetix. The Tax Court concluded that the business and financial arrangements constituted a form of economic

controlling influence that was covered by *de facto* control under subsection 256(5.1). In reaching this decision, Lamarre, T.C.C.J. placed reliance on the factors set out in paragraph 23 of the Final Draft of Interpretation Bulletin IT-64R4 dated June 26, 2001.

The Tax Court held that the appellant was in fact controlled by U.S. Mimetix and therefore was not a CCPC in its 1996 taxation year. The decision of the Tax Court was upheld unanimously by the FCA.

Transport M.L. Couture Inc./ 9044-2807 Québec Inc. Case

Transport M.L. Couture Inc. and 9044-2807 Québec Inc. v. The Queen[20] dealt with the issue of whether the two appellants ("ML1" and "ML2") and Transport M.L. Couture et Fils Inc. ("Transport") were associated.

One individual ("Marie-Louis") held all the shares of ML1 (directly or indirectly), his five children indirectly held all the shares of Transport and his spouse held 90% of the shares of ML2. All the companies were in the trucking business. The Court concluded that Transport did not have the *de jure* control of ML1 and ML2. The Court concluded that Transport had *de facto* control of ML1 and ML2 because of:

(a) the economic dependence of ML1 and ML2 on Transport,

(b) the operational control of ML1 and ML2 business by Transport, and

(c) the family relationship between the shareholders of all these companies.

The Court's holding was based on the following factual conclusions. Transport was the only customer of the two appellants, provided the management for those companies and provided the services of all drivers needed for the transport trucks belonging to those companies. In addition, the two appellants did not have any employees and did not have establishments separate from Transport. In addition, the original trucking business of ML1 ceased to exist after Marie-Louis transferred his assets to it and afterwards carried on general trucking business which was the same business and an extension of the business of Transport. Further, Marie-Louis had no involvement in running of ML1. If Transport did not renew its management contract and stopped using the services of ML1 and ML2, the companies would not have been able to operate at a profit. The Court also concluded that Marie-Louis who was suffering from Alzheimer's disease and his spouse being elderly and, in former case, were under the influence of their five sons. Accordingly, the Court concluded that Transport had control in fact of ML1 and ML2.

In *9044-2807 Québec Inc. v. The Queen*[21] (an appeal by ML1 and ML2), the FCA upheld the Tax Court decision that Transport had *de facto* control over ML1 and ML2 on the basis of the operational control exercised by Transport, the economic dependence of ML1 and ML2 on Transport and the family relations between the shareholders. In reaching his conclusion, Noel, JJ.A., speaking for a unanimous court, stated the following:

> "It is not possible to list all the factors which may be useful in determining whether a corporation is subject to *de facto* control (*Duha Printers*, [1998] 1 S.C.R. 795, para. [38]). However, whatever factors are considered, they must show that a person or group of persons has the clear right and ability to change the board of directors of the corporation in question or to influence in a very direct way the shareholders who would otherwise have the ability to elect the board of directors (*Silicon Graphics*, [2002 DTC 7112] FCA 260, para. [67]). In other words, the evidence must how that the decision-making power of the corporation in question in fact lies elsewhere than with those who have *de jure* control."[22]

Lenester Sales Ltd. Case

Lenester Sales Ltd. and Sushi Sales Limited v. The Queen[23] deals with the issue of whether two franchisee corporations were associated by virtue of being associated with the franchisor corporation on the basis of *de facto* control under subsection 256(5.1). In the relevant year, 1997, the franchisor held 49.9% of the shares of each franchisee company and in each case, another individual owned 50.1% of the shares of the franchisee corporation (directly or indirectly). There was a shareholders' agreement that required there to be two directors, a nominee of the franchisor corporation and a nominee of the individual operator of the franchise. There was no casting vote. The agreement contained a shotgun clause. The franchisor corporation would lease retail premises and then sublease them to the franchisee corporations or if it owned the store, lease it to the franchisee. There was also a franchise agreement between the franchisor and each franchisee which placed restrictions on the way business was conducted. There was also a pooling arrangement with respect to cash receipts. The franchisor performed the purchasing function. The operators of the franchisees had substantial autonomy in the way they ran the business.

The Court concluded that this was a perfectly ordinary franchise operation with the necessary and usual conditions and restrictions imposed by the franchisor. Bowman, A.C.J.T.C., as he then was, applied the meaning of *de facto* control as set out in the *Silicon Graphics Limited* case and concluded that the franchisor had no right to effect a significant change in the board of directors and the powers of the board of directors or to influence in a direct way the shareholders who would otherwise have the ability to elect the board of directors. In addition, relying on what Mr. Justice Bowman stated was as a broader interpretation of the meaning of *de facto* control in other cases, such as his decision in *Société Foncière D'Investissement Inc.*(discussed later in this paper) and the Tax Court decision on *Transport M.L. Couture*, the Court concluded that the franchisor had no direct or indirect influence that would result in control in fact of the franchisees. Bowman, A.C.J.T.C., also concluded that the franchising arrangement fell within the exception provided for in subsection 256(5.1). Accordingly, the appeal was allowed.

The FCA in *The Queen v. Lenester Sales Ltd. and Sushi Sales Limited* dismissed the Crown's appeal concluding that the franchisor did not have *de facto* control over the franchisee and that the Trial Judge did not err in his selection of the legal tests for determining whether the necessary degree of control existed. The Court did not indicate which of the two tests it favoured. The Court did not express an opinion as to whether the franchisees came within the franchise exception in subsection 256(5.1).

Plomberie J.C. Langlois Inc. Case

In *Plomberie J.C. Langlois Inc. v. The Queen*,[24] the shares of the appellant were held 50-50 by another corporation ("Holdco") whose sole shareholder was a Mr. René Simoneau and another individual, Mr. Hallas, who was unrelated to Mr. Simoneau. The issue was whether Mr. Simoneau had *de facto* control over the appellant so that it was associated with other corporations controlled by Mr. Simoneau.

The appellant was in the business of industrial, commercial and institutional plumbing whose sole director, chairperson and secretary was Mr. Simoneau. Holdco also had other subsidiary companies, apparently involved in complimentary businesses. Mr. Hallas was in charge of its operational management. Mr. Simoneau was responsible for office management, advertising, wages, invoices, cheque signing, banking matters and the line of credit. The appellant's office was located in the same place as a wholly-owned subsidiary of Holdco. The appellant paid rent based on its revenue. Secretarial costs were shared with that subsidiary and some of its employees worked for the appellant. The invoices of the appellant indicated a relationship between it and the subsidiary. In addition, Mr. Simoneau and other companies in his group gave sureties for the appellant.

Lamarre Proulx, J. held that Mr. Hallas had an operational role not a decision-making role. The Court concluded that Mr. Simoneau had *de facto* control based on the fact that he was the sole director and therefore, had a dominant influence over the direction of the appellant, even though Mr. Hallas as an equal shareholder had the power to remove the authority from Mr. Simoneau. The Court did not give significance in the provisions of the shareholders' agreement in reaching his decision because it was not respected by the shareholders . The FCA in *Plomberie J.C. Langlois Inc. v. The Queen*,[25] unanimously upheld the decision of the Tax Court.

Discussion of the FCA Cases

In the *Silicon Graphics Limited* and the *9044-2807 Québec Inc.* cases, the FCA clearly states that for a person to have *de facto* control that person must have the ability to control the board of directors or board decision making. However, the FCA does not limit the factors that may be considered in deciding the issue.

Has the FCA also approved a less stringent test in other cases, a test that accepts that there is *de facto* control, if there is control or potential control over the corporation's affairs as opposed to the board of directors or board decision-making?

In the *Mimetix Pharmaceuticals Inc.* case, the FCA upholds the Tax Court finding of *de facto* control on the basis of operational control, economic dependence and effective control of board decisions making. The finding is reached without a specific statement as in the *Silicon Graphics Limited* and the *9044-2807 Québec Inc.* cases regarding the link between such control and the board of directors and its decision-making. On the facts, however, it is clear that there was control of the board of directors.

In the *Lenester Sales*, the FCA upholds Mr. Justice Bowman's finding of no *de facto* control under the test in *Silicon Graphics* as well as the apparently broader test in the *Société Foncière d'Investissement* case (discussed later in the paper) and the Tax Court decision in *Transport M.L. Couture Inc.* The FCA did not indicate which of the tests it favoured. However, the FCA in the latter case, as noted above, enunciated a test related to control of the board of directors. The FCA in the *Plomberie J.C. Langlois Inc.* case upheld the Tax Court finding of *de facto* control based on the controlling individual being the sole director.

It would seem, therefore, that based on the decisions of the FCA, it would be reasonable to take the view that 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 is the view that is basically expressed by Miller, J. in the Taber Solids case discussed later in the paper. It should be remembered that in *Duha Printers*, the Supreme Court stated that the *de jure* control test is a test to determine who has effective control of the affairs and fortunes of the corporation. Subsection 256(5.1) asks the courts to decide whether on a factual basis effective control resides or could reside with a person (or group of persons) other than with the shareholders by virtue of that person's (or group of persons') direct or indirect influence(i.e. direct or indirect clout, leverage or sway).

Pre-2007 Tax Court Cases

The section provides brief summaries of other Tax Court decisions in respect subsection 256(5.1) reported in the DTCs for 2006 and prior years.

In *Société Foncière D'Investissment Inc. v. R.*[26], an informal procedure case, Mr. Allain held 0.2% of the appellant's shares while each of his daughters held 49.9% of those shares and Mr. Allain controlled two other companies. A board of directors' resolution gave extensive powers to Mr. Allain. Bowman, J.T.C.C., as then he was, held that the resolutions gave Mr. Allain practically absolutely control over the affairs of the appellant even though the other shareholders had the power to divest him of this authority. Accordingly, the appellant was associated with the other two companies. The exception in subsection 256(5.1) did not apply because Mr. Allain and the appellant did not deal with each other at arm's length. In the decision, the Court commented, in *obiter*, that a person would have *de facto* control over a corporation if that person had a controlling influence, whether economic, contractual or moral, over the corporation's affairs.

The issue in *Multiview Inc. v. The Queen*[27] was whether the appellant, in which a non-resident individual was a direct and indirect shareholder of the appellant and an individual Canadian resident was an indirect shareholder, was a CCPC so that it was entitled to claim the refundable SR & ED credit. Each individual had equality of control and equal representation on the board of directors. The Court found that the non-resident did not have *de jure* or *de facto* control of the appellant. In reaching the decision, Brulé, T.C.C.J. used the factors set out in paragraph 19 of Interpretation Bulletin IT-64R3 as a guide.

In *Rosario Poirier Inc. v. The Queen*[28] Rosario Poirier ("Rosario") has *de jure* control of the appellant, Rosario Poirier Inc.("RPI") and his son, Luc, was the sole shareholder and director of

another corporation ("Trab"). The sole issue in the case was whether the two corporations were associated because RPI had control in fact of Trab.

Archambault, T.C.C.J. concluded that there was such control based on the following facts. First, Rosario had been authorized to buy the Trab's board of directors to sign all documents considered necessary and to make any decisions relating to Trab. Therefore, Rosario had control in law of the appellant and by virtue of that resolution, the appellant, through Rosario, exercised managerial rights with respect to Trab. Trab, to a large degree, was economically dependent on the appellant because the appellant was Trab's only customer. In addition, the activities of Trab were integrated with the appellant, all personnel required for the operation of Trab's businesses were employees of the appellant and Trab had no place of business separate from the appellant. Rosario was fully involved in running Trab.

L.D.G. 2000 Inc. v. The Queen[29] is a case in which a corporation (the "Parent") held 50% of the shares of the appellant, L.D.G. 2000 Inc.("LDG"), a furniture manufacturer, and all of the shares of the another company ("Bermex") with remaining 50% shares of LDG being owned equally by two individuals who did not have any direct or indirect interest in the Parent.

After the Parent acquired its LDG shares, LDG became a major supplier of unfinished furniture which it sold almost exclusively to Bermex. Bermex financed LDG's operations and the arrangements between the two were not at arm's length. Angers, T.C.C.J. found that the appellant was economically dependent on Bermex. Further, the Parent and Bermex directed the management and administration of LDG. The Tax Court concluded that the Parent through Bermex exercised *de facto* control of LDG so that LDG and the Parent were associated in the years in question. In reaching his conclusion on *de facto* control of the appellant, Angers, T.C.C.J. referenced the comments in paragraphs 17, 18 and 19 of Interpretation Bulletin IT-64R3.

The issue in *Timco Holdings Ltd. and W.C.D. Developments Ltd. v. The Queen*[30], was whether or not the appellant companies ("Timco" and "Developments") were associated by virtue of Mr. Duntz, the individual controlling shareholder of Developments, a Canadian resident and the sole director of Timco in the relevant years , having *de facto* control of Timco. The shares of Timco were held equally by a non-resident individual and Developments. There was no evidence of an agreement involving Mr. Duntz and the non-resident individual regarding the election of the latter as an officer and director of Timco. The appellants carried on a real estate related business through a joint venture along with a third company.

In this case, Little, J., relied on the comments of Noel, JJ.A in *9044-2807 Québec Inc.* case at paragraph 24 and the comments of the FCA in the *Silicon Graphics* case at paragraphs 66 and 67. The Court concluded that Mr. Duntz could not control the election of directors of Timco because of:

(a) the shareholdings of Timco,

(b) the fact that there were no agreements that gave that individual the power to elect the directors of Timco, and

(c) the individual had no influence over the non-resident individual.

The Court also rejected the Crown's argument that the resident individual controlled the joint venture, noting that a provision of the joint venture agreement required unanimity regarding the sale of its undertaking and raising of financing. The Court concluded that the evidence did not show that the decision making power of Timco lay elsewhere than those who had *de jure* control.

Post-2006 Cases

The section provides summaries of the Tax Court decisions in respect subsection 256(5.1) reported in the DTCs for 2007 and later years.

Corpor-Air Inc. Case

In *Corpor-Air Inc. v. The Queen,*[31] the appellant's sole director and shareholder was an individual whose spouse, Mr. Stever, apparently controlled, directly or indirectly, a number of other corporations (the "Stever Group"). The issue in this case was whether the appellant was associated with the corporations in the Stever Group because Mr. Stever had *de facto* control of the appellant. Stever Group of companies provided various services to airline companies. The appellant's operations consisted mainly of providing counter services to airlines.

Bédard, J. found that Mr. Stever had *de facto* control because of the economic dependence of the appellant on the Stever Group. In finding the existence of economic dependency, the Court relied on the following facts:

(a) the appellant's only client was virtually the Stever Group,

(b) the appellant owned no capital assets, rendered its services to the Stever Group at the latter's facilities, and also used the Stever Group assets, and

(c) the size of the loans between the corporations.

In reaching this conclusion, the Court stated that the statements made in paragraph 23 of Interpretation Bulletin IT-64R4 were a reasonable description of the relevant factors in deciding whether *de facto* control exists.

Avotus Corporation Case

In *Avotus Corporation v. The Queen,*[32] the principal issue was whether the appellant was controlled by a non-resident of Canada and, therefore, not a CCPC. The 50% of its shares were held by Richard Malone who was a director and chairman of the board and 50% were held equally by two other individuals, one of whom was a director. The by-laws of the appellant gave the chairman of the board a casting vote at any shareholders or directors meetings. Mr. Malone ceased to be a resident of Canada in September, 1994. Paris, J. held that regardless of whether Mr. Malone was aware of the provision, the power to cast the deciding vote provided in the by-

laws gave Mr. Malone *de facto* control. The Court also found that he had *de jure* control because had the power to elect a majority of the directors by virtue of the provisions of the amalgamation agreement and by-laws, both of which were constating documents.

Brownco Inc. Case

In *Brownco Inc. v. The Queen*[33] the appellant was in the business of home construction and its shares were held equally by two other corporations ("Bost" and "147"). The issue was whether Bost controlled the appellant at any time during the appellant's 2002 and 2003 taxation years thereby causing the two corporations to be associated. The appellant was part of a group of companies operating in the property development and residential home construction business most of which were operated under the trade name of "Grandview Homes". Mr. Bostajian controlled Bost and was the secretary and treasurer of the appellant, Mr. Brown was the President of the appellant and along with his wife held all the shares of 147. Pursuant to an unanimous shareholders' agreement, the board of directors was to consist of at least two directors with Bost and 147 having the right to elect one director. Mr. Bostajian, the nominee of Bost, was chairman of the board of directors. The agreement provided that in the event of a tie, the chairman had the deciding vote. The unanimous shareholders' agreement divided the responsibilities of the management of Brownco between the two corporate shareholders with Bost being responsible for, among other things, the acquisition of building lots and bank financing. Bost had additional management responsibilities outside the terms of that agreement. Bost provided the financing for the appellant's operations. The Court held that the casting vote gave Bost *de facto* control over the appellant. Paris J. did not find that there was *de* facto control based on economic dependence or influence as was argued by the Crown. The Court went on to hold that the exception provided in subsection 256(5.1) did not apply.

Taber Solids Case

In *Taber Solids Control (1998) Ltd., Taber Solids Control Ltd. v. the Queen*[34] the Court had to decide whether, two CCPCs, Taber Solids Control Ltd. ("Old Taber") and Taber Solids Control (1998) Ltd. (" New Taber") were associated with each other. The CRA reassessment was based on subsection 256(2.1) of the Tax Act and *de facto* control under subsection 256(5.1).

Prior to a reorganization that occurred in late 1998, two spouses, Ken Taber ("Ken") and Beth Taber ("Beth") each held 50% of the shares of Old Taber which carried on the business of the rental, repair and rebuilding of specialized equipment used in the oil and gas industry in western Canada.

The corporate reorganization resulted in the separation of the rental and servicing businesses. Old Taber retained the equipment and rented it to New Taber. New Taber performed all repair and servicing work for third party customers. After the restructuring, Beth owned all the shares of Old Taber and appears to have been its sole director and employee while Ken owned the majority of the shares of New Taber and a family trust held the remainder.

Based on the evidence, the Tax Court held that Old Taber and New Taber were not associated by virtue of subsection 256 (2.1).

For the meaning of control in fact under subsection 256(5.1), the Tax Court relied on paragraph 67 of the decision of the FCA in *Silicon Graphics Ltd*. and on paragraphs 24-26 in *9044-2807 Québec Inc.* Mr. Justice Miller concluded that to determine if a corporation was controlled in fact by a person, the test was whether that person has the potential to control the decision making power of the board of directors. To reach a conclusion, the Court needed to decide which decisions are made by the board of directors and which decisions are management decisions or go to operational control. Miller, J. also concluded that operational control (that is management decision making) alone was not sufficient to constitute *de facto* control as contemplated under subsection 256(5.1), but was a factor to consider.

In the view of Miller J., the question to be answered was whether Ken or New Taber had any direct or indirect influence over Old Taber's board of directors' decision-making.

In Mr. Justice Miller's view, the only operational decision that Old Taber had to make was to whom and on what terms the company would rent out the equipment. Since New Taber was Old Taber's only customer, this decision was needed to be only once. The Tax Court Justice held that Ken had actual influence over this operational decision because Beth did not have the contacts in the industry or third parties and because Old Taber was economically dependent on New Taber.

With respect to the decision-making of Old Taber's board of directors, the Court concluded that its principal decision related to the timing of the purchase and sale of centrifuges. Ken had in-depth knowledge of the industry and knew where and when to both acquire and dispose of centrifuges and, therefore, Miller J. concluded that Ken had actual controlling influence over decisions to dispose of centrifuges. The Court held that the actual influence of Ken was not sufficient to establish control over the purchase of new equipment. Miller, J. also held that even though decisions regarding the purchase of centrifuges was a joint decision of Ken and Beth, New Taber, being the sole customer and sole suppler of centrifuges to Old Taber, had potential influence, based on Old Taber's complete economic dependence on New Taber, to control the decisions regarding purchase of centrifuges.

The Court, therefore, concluded that subsection 256(5.1) was applicable and that Old Taber and New Taber were associated corporations.

Ekamant Case

Another recent case dealing with this case of whether a corporation was a CCPC is *Ekamant Canada Inc. v. the Queen*.[35] In that case, Archambault, J. discussed subsection 256(5.1) but did not make a decision on this issue which appears not to have been raised by the parties.

Discussion of Tax Cases

It is clear that the courts will consider a wide range of facts in order to reach a decision on the issue. The courts will consider the shareholders, the constating documents of corporations, such as shareholders agreements, the make up of the board of directors, family relationships,

commercial relationships between corporations including economic dependence and degree of integration. The courts will also examine who is making operational and managerial decisions and where board of director decision-making lies.

In a few cases, namely, the *Timco Holdings Ltd.* case and the *Taber Solids* case, the Tax Court links the finding of *de facto* control to control of the board of directors and/or its decision-making. In other Tax Court decisions, such a link is not required or is not specifically stated. In those cases, the finding of *de facto* control might be considered to be a finding of effective control over the affairs and fortunes of the relevant corporation.

In the *Timco Holdings Ltd.* case, the fact that the relevant individual was a sole director did not result in a finding of *de facto* control. However, in the *Plomberie J.C. Langlois Inc* case , the Tax Court decided otherwise. In addition, in the *Avotus Corporation* and the *Browncо Inc.* cases, the Tax Court held that the individual who was one of the two directors and the chairman of the board of directors had *de facto* control because he had a casting vote. In several cases, the Tax Court references and uses as a guide on the factors listed by the CRA in the Interpretation Bulletin IT-64R4 (or in predecessor bulletins) as factors to consider in determining where *de facto* control exists.

As discussed above, in the most recent Tax Court decision, *Taber Solids*, Miller, J. concluded that for a person to have *de facto* control of a corporation that person had to have the potential to control the decision-making power of the board of directors. To reach a conclusion on this issue, Miller J. stated that operational control was a factor to consider.

At the end of the day, the distinction in the FCA cases as to the appropriate test may not be that significant. In the end what should be determined under subsection 256(5.1) is whether on a factual basis a person or group of persons has direct or indirect influence (clout, leverage or sway), that, if exercised, would result in that person or group of persons having effective control over the affairs and fortunes of the corporation in the sense of the *Duha Printers* case.

Canada Revenue Agency Views

This section provides the CRA's views on *de facto* control under subsection 256(5.1) of the Tax Act.

IT-64R4

The CRA provides its views on subsection 256(5.1) and *de facto* control in an Interpretation Bulletin – dated August 14, 2001 and consolidated to October, 2004. [36]

The CRA states that *de facto* control may exist without the ownership of any shares and can take various forms such as the ability of a person to change the board of directors or reverse its decisions, to make alternate decisions concerning the actions of the corporation, to directly or indirectly terminate the corporation or its business or to appropriate profits and property.[37]

The CRA lists some general factors that may be used in determining whether *de facto* control exists as follows:

(a) the percentage ownership of voting shares (when such ownership is not more than 50%) in relation to the holdings of other shareholders;

(b) the ownership of a large debt of a corporation which may become payable on demand (unless exempted by subsection 256(3) or (6)) or a substantial investment in retractable preferred shares;

(c) shareholder agreements including the holding of a casting vote;

(d) commercial or contractual relationships of the corporation, e.g., economic dependence on a single supplier or customer;

(e) possession of a unique expertise that is required to operate the business; and

(f) 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.[38]

As discussed earlier, these factors have been used in number of cases to assist the court in deciding whether there was *de facto* control.

The CRA also states that close family ties especially lend themselves to the development of significant influences. CRA further states that generally such persons must demonstrate their economic independence and autonomy before escaping presumptions of fact which apply to related persons. CRA states with respect to siblings, unless the facts indicate otherwise, generally the CRA would not regard one sibling would not be considered to have influence over another. The CRA also states that the composition of the board of directors and the control of day-to-day management and operation of the business would be considered.[39]

Technical Interpretations

In a 2008 technical interpretation, the CRA was asked to comment on the status of a corporation as a CCPC where: (i) the powers of the board of directors are limited by the terms of a unanimous shareholders agreement, (ii) various rights are conferred on its shareholders and (iii) a disqualifying shareholder holds a significant ownership interest that may give rise in this document. The CRA did not reach a conclusion regarding *de facto* control, however, the agency did provide extensive comments. The CRA stated the following:

> "According to paragraph 125(7) of the ITA, a corporation will not qualify as a CCPC if it is "controlled, directly or indirectly in any manner whatever by […] one or more public corporations". The wording of that provision specifically refers to de facto control, which is defined in subsection 256(5.1) as any direct or indirect influence that, if exercised, would result in control in fact of that corporation.

> The Courts have expressed divergent views regarding the scope to be given to de facto control defined in 125(7) of the ITA. A narrower approach was used in Silicon Ltd. where the determining factor was the ability of a given party to influence the composition of the Board of Directors, or the way the Board members exercise their powers. However, a broader approach was used in Mimetix International Inc. v. R. 2001 DTC 1026 (TCC) affirmed by 2003 DTC 5194 (FCA), and 9044-2807 Quebec Inc. v. R. 2004 DTC 6636 (FCA) where the operational control of a corporation over another was an essential consideration in determining whether de facto control existed.
>
> In that regard, the CRA has confirmed that the circumstances giving rise to de facto control are not as narrow as those set out in Silicon Graphics. Although it is the CRA's view that the broad approach described in Mimetex International Inc. and 9044-2807 Quebec Inc. can be used for determining whether factual control exists for the purposes of the ITA, we will nevertheless apply the tests described above to the facts of the present matter to determine whether a disqualifying person had de fact control over xxxxxxxxx during its 2005 taxation year."[40]

The CRA was asked the following questions in Question 20 at the Round Table on Federal Taxation, APFF-2008 Conference:

(a) Can the CRA indicate to what extent the existence of such influence, namely influence of the controller of a corporation and even if not exercised, can confer control in fact?

(b) Can the CRA provide examples of circumstances which would permit one to conclude it is sufficient that the influence exists, resulting in control in fact?[41]

The CRA provides extensive comments on this issue. The CRA's position regarding these issues are summarized as follows:

> "The CRA mentions in paragraph 21 of Interpretation Bulletin IT-64R4 (Consolidated), "Corporations: Association and Control", that with respect to subsection 256(5.1) of the ITA, the existence of the influence of the "controller" would be sufficient to result in de facto control, even if this influence is not actually exercised. This position is based on the wording of subsection 256(5.1) of the ITA and is supported by case law. Up to the present, jurisprudence has established that control in fact of a corporation would generally result from three major types of influence. Furthermore, the CRA has formulated general comments in paragraphs 19 to 23 of Interpretation Bulletin IT-64R4 on the notion of control in fact which is mentioned in subsection 256(5.1) of the ITA. Particularly, paragraph 13 of Interpretation Bulletin IT-64R4, contains a non-exhaustive list of certain general factors that permits one to determine whether control in fact exists. Whether or not a "controller" has any direct or indirect influence that, if exercised, would result in control in fact of a corporation within the meaning of subsection 256(5.1) of the ITA, can be determined only after an analysis of all the facts and circumstances with respect to a given particular situation. Consequently, we do not believe that it is

> appropriate, under the circumstances, to formulate other general comments on the notion of control in fact."[42]

In taking this position, the CRA relies on the decisions in *Avotus Corporation*, paragraphs 68 to 70 in that case, the decision of the Tax Court in *Corpor-Air Inc.* and paragraph 27 in particular and the decision in *Transport M.L. Couture Inc.*, specifically paragraph 30 of that Tax Court decision, which decision was confirmed by the FCA.

The CRA further stated in that technical interpretation that the jurisprudence had established that control in fact of a corporation can generally result from three major types of influence, namely moral influence, economic influence and contractual influence.[43]

Recently, the CRA was asked as to whether the small business deduction may be multiplied where a corporate partnership is introduced to operate a new business using two pre-existing holdcos, as corporate partners, in order to generate active business income in the hands of the holdcos. The CRA did not provide an opinion on this situation but commented as follows:

> "De facto control goes beyond de jure control and includes the ability to control "in fact" by any direct or indirect influence and may exist even without the ownership of any shares. It can take many forms, e.g., the ability of a person to change the board of directors or reverse its decisions, to make alternative decisions concerning the actions of the corporation in the short, medium or long term, to directly or indirectly terminate the corporation or its business, or to appropriate its profits and property. The existence of any such influence, even if it is not actually exercised, would be sufficient to result in de facto control.
>
> A recent example of a tax case in which it was held that de facto control existed, even where the appellant corporation was co-owned 50% by two unrelated individuals and a unanimous shareholder agreement "as drafted respected the equal division of the appellant's share capital and did not benefit one shareholder to the detriment of the other," can be found in the Federal Court of Appeal decision in Plomberie J.C. Langlois, 2006 FCA 113 (FCA)."[44]

The CRA obviously takes the expansive view of the meaning of *de facto* control under subsection 256(5.1) of the Tax Act.

PLANNING COMMENTS

This section provides some brief comments on planning to avoid the application of subsection 256(5.1). Obviously, planning to ensure that a particular person (or group of persons) does not have control in fact of a corporation under subsection 256(5.1) involves considering the Court decisions on the issue as well as the views of the CRA. As discussed earlier, the Courts will consider a wide range of factors in deciding this issue. 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

In this paper, the meaning and implications of *de facto* control under subsection 256(5.1) of the Tax Act has been explored. Jurisprudence on this provision has been reviewed and considered and the CRA administrative policy on the topic has been discussed. Planning to avoid *de facto* control has briefly been discussed.

Prior to the introduction of subsection 256(5.1) of the Tax Act, the courts have interpreted control to mean *de jure* control. This provision has given the CRA a powerful tool to limit the tax benefits provided by certain provisions of the Tax Act.

ENDNOTES

[1] R.SC 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] For example, Marc E. Marion, "Associated Corporations – Selected Tax Issues", 2008 Prairie Provinces Tax Conference (Toronto: Canadian Tax Foundation, 2008), 3:1-3:27 at 3:6-3:15; Mark Brender, "Developments in the Concept of Corporate Control", Report of the Proceedings of the forty-third Tax Conference (Toronto: Canadian Tax Foundation, 2008) 31:11-31:49; J. Douglas Bradley C.A.; Edwin G. Kroft, Victor Peters; and William J. Strain, FCA, "Emerging Income Tax Issues", Report of the Proceedings of the fifty-ninth Tax Conference (Toronto: Canadian Tax Foundation, 1992) 8:1-8:60 see section on "De Facto Control").

[3] *Duha Printers (Western) Ltd. v. the Queen* 98 DTC 6334 (SCC) at paragraphs 35-39.

[4] *Buckerfield's Limited et al. v. M.N.R.*, 64 DTC 5301 (Exch Ct.) and *Duha Printers* supra Note 3.

[5] Supra Note 3 at paragraph 85.

[6] 95 DTC 225 (TCC).

[7] Ibid at page 228.

[8] Ibid at page 231.

[9] Ibid at page 232.

[10] Explanatory Notes under subsection 256(5.1), Canada, Department of Finance to Bill C-139, June 30, 1988.

[11] Ibid.

[12] 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").

[13] Section 251.1 of the Tax Act and the definition of "controlled" in subsection 251.1(3) of the Tax Act.

[14] Section 256.

[15] Supra Note 10.

[16] 2002 DTC 7112 (FCA), 2001 DTC 379 (TCC).

[17] 2002 DTC 7112 (FCA) at paragraphs 66 and 67.

[18] Supra note 17 at paragraph 72.

[19] 2003 DTC 5193 (FCA), 2001 DTC 1026 (TCC).

[20] 2003 DTC 817 (TCC).

[21] 2004 DTC 6636 (FCA).

[22] Ibid at paragraph 24.

[23] 2003 DTC 997 (TCC), 2004 DTC 6461 (FCA).

[24] 2006 DTC 2997 (TCC) – decision dated November 2, 2004.

[25] 2007 DTC 5662 (FCA) – decision dated March 16, 2006.

[26] [1996] 3 CTC 2537 (TCC) (Informal Procedure).

[27] 97 DTC 1489 (TCC).

[28] 2002 DTC 1940 (TCC).

[29] 2003 DTC 827 (TCC).

[30] 2005 DTC 1628 (TCC).

[31] 2007 DTC 841 (TCC).

[32] 2007 DTC 215 (TCC).

[33] 2008 DTC 2591 (TCC).

[34] 2009 DTC 1343 (TCC).

[35] 2010 DTC 1039 (TCC) – decision dated August 19, 2009.

[36] Interpretation Bulletin - IT-64R4 - Corporations: Association and Control [Consolidated] dated August 14, 2001 and consolidated to October, 2004 at paragraphs 19 to 23.

[37] Supra Note 36 at paragraph 21.

[38] Supra Note 36 at paragraph 23.

[39] Ibid.

[40] Document No. 2007-025359117, Determination of CCPC Status, Canada Revenue Agency, March 18, 2008.

[41] Document No. 2008-0285211C6, Concept of Influence and De Facto Control, Canada Revenue Agency, October 10, 2008.

[42] Ibid at page 1.

[43] Supra Note 41.

[44] Document No. 2010-0359481E5, Small Business Deduction, Canada Revenue Agency, April 16, 2010.

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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.