TAX FOR THE Owner-Manager

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De Facto Control at the FCA: The End of the McGillivray Saga

In *Aeronautic Development Corporation v. Canada* (2018 FCA 67), the FCA dismissed the taxpayer's appeal of the TCC's decision (2017 TCC 39) in which it found de facto control under subsection 256(5.1) after the decision in *McGillivray Restaurant Ltd. v. Canada* (2016 FCA 99).

The issue in dispute was whether the appellant (ADC) was entitled to refundable R & D credits at the rate of 35 percent for its expenditures in respect of its 2009, 2010, and 2011 taxation years. The minister had argued that ADC was not a CCPC in the relevant taxation years because it was "controlled, directly or indirectly in any manner whatever" by a non-resident of Canada within the meaning of subsection 256(5.1).

The facts were relatively straightforward. ADC was incorporated in Nova Scotia in April 2009. Its sole shareholder was Seawind Corp. (SC), a US corporation controlled by Mr. Silva, an American engineer who was involved in the development of an amphibious aircraft known as the *Seawind*. Subsequently, ADC entered into a development agreement with SC to provide SC with the services necessary to complete the prototyping and certification of *Seawind*. After the execution of the development agreement on August 17, 2009, ADC issued additional common shares, and from that date forward a majority of its common shares were held directly or indirectly by residents of Canada.

The TCC upheld the minister's contention that ADC was not a CCPC in the relevant taxation years because it was controlled in fact by non-residents. The TCC considered the FCA's holding in *McGillivray*, which had limited a finding of de facto control to situations where a person or group of persons has "the clear right and ability either 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 FCA also stated in *McGillivray* that in determining whether there was de facto control, only factors that "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 . . . shareholders who have that right and ability" should be considered. However, the TCC in *Aeronautic Development*, relying on the proposition that Parliament does not speak in vain, held that for a court to find control in fact, "the evidence must show 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." The TCC then went on to perform what seems to be the sort of operational analysis specifically prohibited by the holding in *McGillivray*.

On appeal in *Aeronautic Development*, the FCA agreed with ADC that the TCC had erred in applying the concept of de facto control as set out in subsection 256(5.1) because it had examined a broad range of operational control factors rather than asking only whether there was some legally enforceable arrangement that gave rise to de facto control. Notwithstanding this error, however, the FCA found no reason to interfere with the TCC's decision: the development agreement was held to be a legally enforceable agreement capable of establishing de facto control in and of itself. (The FCA stated that ADC had conceded on this issue.)

The FCA then turned to the question whether the exception in subsection 256(5.1), which concerns certain commercial agreements entered into between arm's-length parties, could save ADC from the finding that it was not a CCPC in the relevant taxation years. The exception, in general terms, provides that if an agreement is of the sort that falls within the ambit of subsection 256(5.1) and the agreement is arm's-length, then its existence cannot be the basis of a finding of de facto control.

The FCA reviewed the TCC's finding that in the relevant period ADC and SC were not dealing at arm's length. The FCA found that the TCC had made no reviewable error for the period after 2009 with respect to the question whether the development agreement was arm's-length. Specifically, the FCA held that the TCC had correctly relied on, among other things, the fact that ADC was nearly totally economically dependent on SC and that Mr. Silva had the ability to force the two companies to disregard the agreement's terms (as he had done when certain markup payments were not made to ADC) to conclude that the parties were not dealing at arm's length.

Therefore, because the development agreement was capable in and of itself of establishing de facto control and it was not one that fit within the exceptions applicable to arm's-length commercial agreements, the FCA found that the TCC had properly held that ADC was not a CCPC in the relevant taxation years. Accordingly, the appeal was dismissed.

This case probably represents the final decision under subsection 256(5.1) prior to the introduction of subsection 256(5.11). Subsection 256(5.11) was intended to overturn the decision in *McGillivray* and restore an earlier understanding of the de facto control test that includes a consideration of operational control and economic influence.

Thus, the indeterminate operational test applied by the TCC in *Aeronautical Development* will be much closer to the analysis performed from now on than the FCA's relatively more straightforward analysis in *McGillivray*.

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