

Tax Topics

April 11, 2019
Number 2457

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PART 1: SHAREHOLDERS AGREEMENTS, THE ACT, AND THE NON-SPECIALIST ADVISOR: THE IMPACT OF CONTROL

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Special thanks to Caroline Elias, associate at Minden Gross LLP, for her assistance in reviewing earlier versions of the Series and to Joan Jung, tax partner at Minden Gross LLP, from whose presentations and papers I've borrowed liberally. All errors and omissions are my own.

There are many potential interactions that can occur between shareholders agreements and the *Income Tax Act* (Canada) (the "Act").² This three part series of articles (the "Series") will focus on interactions stemming from the impact that shareholders agreements can have on control of a corporation for the purposes of the Act.³

Before discussing the relationship of shareholders agreements to control under the Act, it will be helpful to understand what is meant by control for purposes of the Act and to also review some of the key tax implications of control under the Act. These items will be the focus of Part 1 of the Series.

What Is Meant by Control in the Act?

The Act contemplates two different kinds of control: *de jure* control, which throughout the Series will often be referred to as "DJC"; and *de facto* control, which throughout the Series will often simply be referred to as "DFC".

It is possible to tell which type of control is being discussed in the Act because when the word "control" is used on its own, the Act is referring to DJC, and when the words "controlled directly or indirectly in any manner whatsoever" are used the Act is referring to DFC.

DJC Basics

"*De jure*" control is a fancy way to describe a person or group of persons as having legal control of a corporation.⁴

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² *Income Tax Act*, RCS 1985 c1 (5th Supp).

³ Unless otherwise noted in this Series, all statutory references are to the Act.

⁴ The origin of the phrase "*de jure*" is Latin and means "of law".

The classic definition of control, on which DJC is based, comes from the *Buckerfield's Ltd. et. al. v. Minister of National Revenue*⁵ decision, which described control as:

the right . . . that rests 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.

This classical concept of DJC has been refined in the case law over time. In particular, in the decision of the Supreme Court of Canada ("SCC") in *Duha Printers (Western) Ltd. v. The Queen* ("*Duha*"),⁶ the SCC explained that the test is an attempt to determine who is in a position to have "effective control of the affairs and fortunes of a corporation".⁷

While Canadian corporate statutes typically provide the directors of a corporation with managerial control of a corporation, the majority shareholder or majority group of shareholders is usually considered to have indirect or effective control since the majority shareholder or majority group of shareholders has the ability to elect the board.⁸ Therefore, the majority shareholder or majority group of shareholders will generally be considered to have effective control over the corporation.

DFC Basics

De facto control is a fancy way to say that a person has factual or fact-based control over a corporation.⁹ Unlike DJC, which is based on case law, this type of control is specifically provided for in subsection 256(5.1), which came into existence as part of extensive changes to the "association" rules in section 256 in 1988, and introduced the expression "controlled directly or indirectly in any manner whatsoever" to the Act.

As set out by the Federal Court of Appeal ("FCA") in *Silicon Graphics Ltd. v. The Queen* ("*Silicon Graphics*"),¹⁰ DFC will exist whenever a person or group of persons 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.¹¹

In addition, DFC will generally include DJC.¹²

Previously, there was a debate in the case law about whether DFC was limited to the *Silicon Graphics* tests for determining DFC, or whether an examination of DFC required a consideration of broader fact situations, including influence over operational control of a corporation. The debate appeared to be settled by the FCA in *McGillivray Restaurant Ltd. v. Canada* ("*McGillivray*"),¹³ which held that a DFC analysis should be confined to the *Silicon Graphics* tests.

Although this may have been the last judicial word, the Department of Finance appears to have legislatively overcome *McGillivray* with the recent introduction of subsection 256(5.11). Subsection 256(5.11) requires DFC determinations to take into account "all factors that are relevant in the circumstances", which, among other things, is generally understood to include whether a person or group of persons could exercise direct or indirect influence over the operational control of a corporation.¹⁴

⁵ [1965] 1 Ex CR 299, 303.

⁶ 98 DTC 6334 (SCC).

⁷ *Ibid*, at 36.

⁸ A discussion of the impact of groups of shareholders on DJC and DFC is found at the end of this article.

⁹ Again the origin is Latin and means "of fact".

¹⁰ 2002 DTC 7112 (FCA).

¹¹ *Ibid*, at para 67.

¹² *Transport ML Couture Inc. v. Canada*, 2004 DTC 6636 (FCA).

¹³ 2016 DTC 5048 (FCA).

¹⁴ Not all commentators would agree that the impact of the introduction of subsection 256(5.11) is as broad as has been stated above. For example, see Raymond Adlington, "De Facto Control" (2015) 15:5 Tax Hyperion 7.

Key Tax Implications of DJC & DFC

DJC and DFC drive many rules in the Act relating to the taxation of private corporations. A number of the most critical rules impacted by these control concepts are listed below.

1) Related Person Concepts in section 251¹⁵

- a. DJC will determine whether a corporation is related to a person or a person who is a member of a related group of persons or other related persons (paragraph 251(2)(b));
- b. DJC by a person or certain groups of persons will determine whether two or more corporations are related to one another (paragraph 251(2)(c));
- c. Since being related is one of the tests of non-arm's length status, DJC will cause persons and corporations to be deemed to be acting at non-arm's length ("NAL") (paragraph 251(1)(a)); and
- d. While DJC will deem corporations and persons to be acting at non-arm's length, DFC will generally be an extremely relevant but not necessarily conclusive factor in making NAL determinations (paragraph 251(1)(c)).

2) Canadian controlled private corporation ("CCPC") definition in subsection 125(7)¹⁶

The CCPC definition contains separate DJC and DFC tests, in particular:

- a. Paragraph (b) of the CCPC definition contains a test that will deny CCPC status if all of the DJC rights of non-resident and most public corporation shareholders are notionally ascribed to a single shareholder and that notional shareholder would have DJC over the corporation (paragraph (b)) of the definition of CCPC in 125(7); and
- b. Paragraph (a) of the CCPC definition contains a test that will deny CCPC status if a particular non-resident person or public corporation (subject to certain exceptions) or a particular group of such persons has DFC over the corporation (paragraph (a) of the definition of CCPC in 125(7)).

3) Loss restriction event in subsection 251.2(2)

Changes in DJC will impact the determination of whether there has been a loss restriction event, which, among other things, can cause a corporation to:

- a. Realize a deemed year-end (subsection 249(4));
- b. Have no ability to carry forward or carry back net capital losses (subsection 111(4)); and
- c. Have its losses streamed (subsection 111(5)).

4) Affiliated (section 251.1) and associated person (section 256) rules

- a. DFC among a limited defined group of persons drives the application of the affiliated person rules; and
- b. DFC, along with certain cross shareholding thresholds, drives the application of the association rules.

For convenience, all of the tax implications mentioned above are summarized in the box below.

¹⁵ Related and non-arm's length status are relevant to too many provisions in the Act to mention in this Series. An excellent article to review that discusses the main relational rules in the Act is Ron Dueck and Stephanie Daniels "Update and Review of the Related, Affiliated, and Associated Rules: Overlaps, Differences, and Their Significance," in 2014 British Columbia Tax Conference (Toronto: Canadian Tax Foundation, 2014), 10:1-82.

¹⁶ CCPC status itself is relevant to many taxing provisions in the Act, including:

- The small business deduction (subsection 125(1));
- Capital gains exemption treatment (section 110.6);
- Allowable business investment losses (paragraph 39(1)(c));
- Stock option benefit deferral (subsection 7(1.1)) and the related stock option deduction (paragraph 110(1)(d.1));
- Access to enhanced investment tax credits (subsection 127(10.1)) and refundable investment tax credits (section 127.1); and
- The new concept of non-eligible refundable dividend tax on hand ("NERDTH") (subsection 129(4)).

Tax Consequence	DJC	DFC
Related Persons — s. 251(2)(a) and (b).....	X	
NAL — deemed — s. 251(1)(a).....	X	
NAL — factual — s. 251(1)(c).....	X	X
CCPC — notional non-qualifying person test — s. 125(7) "Canadian-controlled private corporation" (a)	X	X
CCPC — traditional test — s. 125(7) "Canadian-controlled private corporation" (b).....	X	
Loss restriction event — s. 251.2(2)		
deemed year-end — 249(4)		
capital losses — 111(4)		
loss streaming — 111(5).....	X	
Affiliated person rules — s. 251.1	X	X
Association rules — s. 256	X	X

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