Corporate Control: An Evolving Concept

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PRÉCIS
La notion de contrôle d’une société est tirée de la common law et elle est fermement ancrée dans les régimes fiscaux canadien et américain. Les autorités fiscales s’en servent en général pour limiter l’utilisation d’avantages fiscaux. Cet article trace brièvement l’évolution réglementaire de la notion de contrôle au Canada, qui traduit partiellement une réaction directe du ministère des Finances aux abus perçus comportant l’usage multiple ou la vente d’encouragements fiscaux. Les arrêts de principe rendus dans des causes fiscales au Canada et au Royaume-Uni portant sur le contrôle y sont brièvement examinés, ainsi que les diverses interprétations de Revenu Canada. Les dispositions réglementaires canadiennes actuelles sont examinées dans cet article, qui fournit aussi une liste-témoin des incidences d’un changement de contrôle. Il comporte également un choix représentatif des règles comparables en vigueur aux États-Unis.

ABSTRACT
The concept of corporate control has evolved from the common law and is firmly entrenched in the Canadian and US tax systems. It is generally used by tax authorities to limit the use of tax benefits. This article briefly traces the statutory evolution of the concept of control in Canada, which reflects, in part, a direct response by Finance to perceived abuses involving multiple use or selling of tax incentives. The landmark Canadian and UK tax cases on control are briefly reviewed, and the various interpretations by Revenue Canada are noted. The article reviews the current Canadian statutory provisions and provides a checklist of the implications of a change of control. It also provides a representative selection of the comparable rules in the United States.

INTRODUCTION
This article discusses the concept of corporate control in the context of Canadian and US tax law. It begins with a brief review of the use of the word “control” in Canadian income tax legislation before 1971 and the

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statutory evolution of the concept since that time. Against this background, the landmark Canadian and UK decisions on control are discussed. The article then considers the implications for Canadian tax purposes of an acquisition of control under the existing tax law and reviews Revenue Canada’s current administrative practice. The article concludes with a survey of selected US tax rules dealing with corporate control.

**CONTROL IN THE CANADIAN TAX CONTEXT**

**Statutory Evolution of the Concept**

Before 1972, the Income Tax Act\(^1\) contained several references to control. For example, in 1960, control replaced ownership for the purposes of the associated company rules in section 39. Previously, the concept of association relied on the ownership of 70 percent or more of the common shares of a company. In 1963, subsection 27(5) of the Income Tax Act was amended to prevent a corporation from benefiting from a carryforward of business losses if a person or persons acquired control after June 13, 1963. Control was also referred to in subsections 28(3) and 62(3) and paragraph 62(3)(a) of the Income Tax Act as it then read. Subsection 68(1) used the words “controlled, whether through holding a majority of the shares of the corporation or in any manner whatsoever.” Both subsection 20(3), relating to designated surplus, and paragraph 62(3)(a) referred to a corporation as being controlled by another if more than 50 percent of its issued share capital having voting rights in normal circumstances belonged to the other corporation.

After 1971, the Income Tax Act contained many more references to control and acquisition of control. For example, control was relevant for designated surplus, part IV tax, the status of private corporations, foreign affiliates, related companies for non-arm’s-length determinations, association rules, superficial losses, and eligible capital expenditures. A variety of expressions were used—for example, “control,” “controlled, directly or indirectly,” and “controlled, directly or indirectly in any manner whatever, whether by virtue of a beneficial interest in one or more trusts or otherwise”—but neither the courts nor Revenue Canada made a clear distinction between these phrases.\(^2\) Bill C-139, which received royal assent on September 13, 1988, imposed some consistency by modifying the references in the Act to read as either “controlled” or “controlled directly or indirectly in any manner whatever.” It was established that where “controlled” alone was used, it would mean direct control. The most recent development is the proposed enactment of section 251.1 in the draft legislation of April 26, 1995.\(^3\) “Controlled” is defined in proposed subsection

\(^1\) RSC 1952, c. 148, as amended.


\(^3\) Canada, Department of Finance, Draft Amendments to the Income Tax Act, the Income Tax Application Rules, the Canada Pension Plan, the Children’s Special Allowance Act, the Customs Act, the Old Age Security Act, the Unemployment Insurance Act and a Related Act, April 26, 1995 (herein referred to as “the draft amendments”).
251.1(2) for purposes of the definition of “affiliated persons” as meaning “controlled, directly or indirectly in any manner whatever.” Although, the concept of affiliated persons is relevant only for certain provisions of the Act, including those relating to the deductibility of losses, this definition of the term “controlled” will likely apply in any future legislation pertaining to corporate control.

The various statutory amendments and additions have evolved in direct response to abuses or perceived abuses by taxpayers and to the ingenuity of tax practitioners. Typically, a taxpayer who could not avail himself of a tax incentive would attempt to sell that tax benefit to a purchaser who could use it. A lucrative market developed for the sale of loss companies that had non-capital losses carried forward or incurred in the current year, or latent (unrealized) inventory or terminal losses or capital losses. Similarly, a market developed for the sale of capital dividend accounts, refundable dividend tax on hand, and investment tax credits. The Income Tax Act was subsequently amended to deem a year-end to occur on an acquisition of control in order to restrict the transfer of accrued losses in respect of non-depreciable capital property, depreciable property, eligible capital property, doubtful debts, and inventory.4 The current and proposed provisions of the Act dealing with control and acquisition of control are outlined below.

The Jurisprudence

Although referred to in the Act, “control” is not a defined term. Consequently, the meaning of the word for income tax purposes is derived from the case law. Initially, until Canadian courts had gained some experience in dealing with the concept of control, reference was made to the UK jurisprudence.5

In B.W. Noble, Ltd. v. The Commissioners of Inland Revenue,6 Mr. Justice Rowlatt stated that a person has “a controlling interest” if his holding is such that he is more powerful than all the other shareholders put together in a general meeting. He stated that ownership of exactly 50 percent of the corporation’s shares does not constitute control. This concept was approved in Rex v. Staples.7 This concept has been relied upon in structuring Canadian corporations that are to be jointly held by Canadian residents and non-residents. Provided that the non-resident owned 50 percent but not more than 50 percent of the shares, the corporation should continue to be a Canadian-controlled private corporation (CCPC).

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4 Subsection 249(4) of the Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as “the Act”). Unless otherwise stated, statutory references in this article are to the Act.


6 (1926), 12 TC 911, at 926 (KB).

7 [1940] 4 DLR 699 (BC SC).
CORPORATE CONTROL: AN EVOLVING CONCEPT

In *Himley Estates Ltd., and Humble Investments, Ltd. v. The Commissioners of Inland Revenue*,\(^8\) a minority shareholder who had de facto control was held not to control unless his control was de jure control. The case of *IRC v. J. Bibby & Sons*\(^9\) held that legal control was determinative. In that case, the court rejected an attempt to attribute control to the beneficiaries of a trust. Lord Simonds said, “[t]hose who by their votes can control the company do not the less control it because they themselves may be amenable to some external control.”\(^10\)

*British American Tobacco Co. v. IRC*\(^11\) held that the court may pierce the corporate veil in determining indirect control. In that case, the court looked through an intermediary corporation to determine that the parent of the intermediary corporation controlled the corporation controlled by the intermediary corporation. Subsection 256(1.2) now provides a lookthrough rule for the purpose of determining association.

In *Cree Enterprises Ltd. v. MNR*,\(^12\) it was held that under former subsection 28(3), the corporate veil could be pierced to determine whether a corporation was controlled by a corporation and persons not dealing at arm’s length with the corporation, and that two or more corporations may each control another corporation at the same time.

In *Taylor v. MNR*,\(^13\) the taxpayer owned non-voting, redeemable preference shares of a corporation in the amount of $3 million. The taxpayer also owned 40 percent of the issued common shares. The remaining 60 percent were held equally by two unrelated individuals. There was a put and call of the shares held by the unrelated individuals at a fixed price of $10.00. The court held that the taxpayer did not control the company. The company would have been a “personal corporation” if it were “controlled, whether through holding a majority of the shares of the corporation or in any other manner whatsoever.” The term controlled directly or by any other means whatever has been interpreted by the English courts to mean voting power through legal means.\(^14\)

A landmark case on the issue of control is *Buckerfield’s Ltd. et al. v. MNR*.\(^15\) In that case, two corporate shareholders each held 50 percent of the shares of two other corporations. Each shareholder could nominate an equal number of directors, each participated in management, and each

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\(^8\) (1932), 17 TC 367 (CA).
\(^9\) [1945] 1 All ER 667 (HL).
\(^10\) Ibid., at 673. This case was followed in *Rubenstein v. MNR*, 65 DTC 494 (TAB).
\(^11\) [1943] 1 All ER 13 (HL).
\(^12\) 66 DTC 5158 (Ex. Ct.).
\(^13\) 61 DTC 513 (TAB).
\(^15\) 64 DTC 5301 (Ex. Ct.).

(1995), Vol. 43, No. 5 / n° 5
had a right of first refusal. The issue was whether the corporations were controlled by a group. Mr. Justice Jackett followed the case of British American Tobacco Co.\textsuperscript{16} and held that the word “controlled” contemplates the right of control that rests in ownership with 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. He confirmed the holding in Minister of National Revenue v. Wrights’ Canadian Ropes Ltd.\textsuperscript{17} that the ownership of less than 50 percent of the shares of another corporation was conclusive that the corporation was not controlled. He dismissed the argument that a number of persons acting in concert would constitute a group that controlled. The wording in the particular provision that applied in the case did not prevent a group from coming together specifically to take advantage of the low rate of tax. The current association rules in section 256 consider corporations to be associated if they are controlled by the same group of shareholders, whether or not those shareholders act in concert.

It appeared that control over day-to-day operations or management of the company exercised by officers or directors did not constitute control. The power to elect directors was viewed as significant. The concept of control involved legal or de jure control rather than factual or de facto control. Where the term “control” was used alone, it meant having more than 50 percent of the votes. The concept of de jure control continues to apply except where the expression “controlled, directly or indirectly in any manner whatever” is used as a result of the enactment of subsection 256(5.1).

In Vineland Quarries and Crushed Stone Ltd. v. MNR,\textsuperscript{18} the court had to address whether or not, for the purposes of determining control, it is permissible to pierce the corporate veil and look at the ownership through holding companies. Mr. Justice Cattanach considered the British cases noted above and the Buckerfield's decision and concluded that where the registered shareholder is a body corporate, it is permissible to look beyond the share register in order to see where effective control lies. As noted above, subsection 256(1.2) now contains a lookthrough rule for determining the association of corporations, trusts, and partnerships.

In MNR v. Dworkin Furs (Pembroke) Ltd. et al.,\textsuperscript{19} the issue was whether control meant de facto or de jure control. The Supreme Court adopted the definition of control in the Buckerfield's case and concluded that control meant de jure control, established by the ownership of more than 50 percent of the voting shares. In Dworkin Furs, a corporation owned 48 percent of the shares of another corporation, and 2 percent of the shares of that corporation were held in the names of nominees. The bylaws of the company did not provide the chair with a casting vote. The fact that

\textsuperscript{16} Supra footnote 11.

\textsuperscript{17} (1946), 2 DTC 927 (PC).

\textsuperscript{18} 66 DTC 5092 (Ex. Ct.).

\textsuperscript{19} 67 DTC 5035 (SCC).
the chair may have a casting vote is not determinative of control and does not confer de jure control. The reason is that the vote is cast by virtue of the person’s position as chair and as a shareholder.20 This may be a factor in determining de facto control for purposes of subsection 256(5.1).

In *B.W. Noble, Ltd.*,21 it was held that the fact that the chair of the board of directors held a casting vote was sufficient to constitute control. In that case, the individual also owned 50 percent of the voting shares. Similar results obtained in *Dealers Acceptance Corp. Ltd. v. MNR*22 and in *Dominion Fibre Drum Corporation v. MNR.*23 A contrary result obtained in *Pender Enterprises Ltd. v. MNR,*24 where Mr. Justice Noël disregarded the casting vote held by an individual as president where that person was one of two equal shareholders of the company. The rationale was that the consent of both shareholders was required to call a meeting.

In *Yardley Plastics of Canada Ltd. v. MNR,*25 it was held that the minister could not select any aggregation of shareholders as constituting a group that controls.

In the case of a trust, it is the beneficial owner of property held by a nominee or a bare trustee who will be regarded as controlling the trust property.26

In *Vina-Rug (Canada) Ltd. v. MNR,*27 it was established that, in determining de jure control, more than one group of persons can be aptly described as a “group of persons.” It is immaterial whether or not other combinations of shareholders may own a majority of voting shares in either company, provided that each combination is in a position to control at least a majority of votes to be cast at the general meeting of shareholders. Revenue Canada has indicated that de jure control of a corporation is considered to have been acquired by a group of persons where there is evidence that such persons have a common link or interest or that they act together to control the corporation.28

In *Interpretation Bulletin IT-64R2*, Revenue Canada stated that persons who are members of a controlling group “will presumably have sufficient common connections or business in trusts to make it reasonable to assume

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20 See also *Aaron’s (Prince Albert) Ltd. et al. v. MNR*, 66 DTC 5244 (Ex. Ct.).
21 Supra footnote 6.
22 66 DTC 771 (TAB).
23 66 DTC 46 (TAB).
24 65 DTC 5202 (Ex. Ct.).
25 66 DTC 5183 (Ex. Ct).
26 See *Dworkin Furs*, supra footnote 19. Refer to *Hudson’s Investments Co. (London) Ltd. v. MNR*, 68 DTC 83 (TAB).
27 68 DTC 5021 (SCC).
that they could be in a position to exercise control of the corporation.”29 Subsection 256(1.2) now clarifies that, for the purposes of the association rules, a group of persons refers to any two or more persons each of whom owns shares in the capital stock of the corporation. There is no requirement that the group act in concert. A similar conclusion was reached in S. Madill Ltd. v. MNR.30 However, in 1993, Revenue Canada took the position that the transfer of shares by three unrelated individuals, who were equal shareholders, to their holding companies would be regarded as an acquisition of control.31 This interpretation seems to depart from the requirement that the group requires a common link or interest so that it is reasonable to assume that they would act in concert. For other purposes of the Act (that is, other than association), paragraph 256(1.2)(a) does not apply, and the members of a group that controls must have a common link or interest or act in concert.32

In Arctic Geophysical Ltd. v. MNR,33 the ability to require the redemption of preference shares and thereby acquire control did not confer control on the person having that ability. As a result of this case, the Act was subsequently revised to provide in paragraph 251(5)(b) that the person who has the right to cause the redemption or to purchase for cancellation of the shares will be viewed as owning those shares.

Restrictions on the voting power of shareholders contained in a shareholders’ agreement will not affect the control of the corporation unless these restrictions are also incorporated into bylaws and articles of association of the corporation so as to become part of the constitution of the company.34

On the basis of Dworkin Furs,35 provisions contained in articles of association or in a shareholders’ agreement requiring the unanimous approval of the shareholders would preclude control by any one shareholder unless he or she owned all of the shares. In International Iron & Metal Co. Ltd. v. MNR,36 the court came to a contrary conclusion. The fact that a

29 Interpretation Bulletin IT-64R2, December 20, 1983, paragraph 16. This bulletin was replaced with Interpretation Bulletin IT-64R3, March 9, 1992. The latter, in discussing the concept of control, incorporates the de facto control test, which now prevails for the purposes of the association rules and the rule that deems any group of persons to be a group for the purposes of the association rules “without considering whether any group acts in concert to control the corporation”: IT-64R3, paragraph 20.

30 72 DTC 6027 (FCTD).

31 See Window on Canadian Tax (Don Mills, Ont.: CCH Canadian) (looseleaf), paragraph 2508.

32 See Revenue Canada Views [database online], document no. 236, December 1990.

33 68 DTC 5013 (Ex. Ct.).


35 Supra footnote 19.

36 69 DTC 5445 (Ex. Ct.).

(1995), Vol. 43, No. 5 / n° 5
shareholder may be bound under contract in a particular way regarding the election of directors was irrelevant to the meaning of control. In other words, it was not possible to mitigate the control by way of an external contract.

In *Lou’s Service (Sault) Ltd. v. MNR*, shareholders who acquired voting rights after a corporation failed to pay dividends for two consecutive years were found to control the corporation.

In *Oakfield Developments (Toronto) Ltd. v. MNR*, it was held that a group of shareholders that controlled 50 percent of the voting power controlled the corporation. The group was entitled to all of the surplus profits on a distribution by way of dividends (after payment of the fixed dividend to the preferred shareholders entitled to the remaining 50 percent of the votes). On a winding up, members of the group were entitled to all of the surplus after a return of capital and the payment of a 10 percent premium to the preferred shareholders, and their voting power was sufficient to authorize the surrender of the company’s letters patent. These factors were sufficient to cause a determination that the group that held the shares entitled to only 50 percent of the votes controlled the company.

The court in *Oakfield Developments* distinguished the *Dworkin Furs* case on the basis that in *Dworkin Furs* the voting rights were split equally between two unrelated groups, there was only one class of shares, and each group had the same rights or entitlement as to profits by way of dividends or on a windup. *Oakfield Developments* went beyond *Buckfield’s* by holding that a group of shareholders that did not have the right to elect a majority of the board of directors controlled.

In *Donald Applicators Ltd. v. MNR*, the Supreme Court of Canada held that the ownership of a class of shares that entitled shareholders to voting control over all decisions except the election of directors was sufficient to constitute control. The holders of that class of voting shares had the power to pass or defeat any special or extraordinary resolution that might be proposed, the power to change the articles of the company and to repeal an article, and the power to remove directors. The *Buckfield’s* case was distinguished.

In *MNR v. Consolidated Holding Co. Ltd.*, the court looked at the provisions of the will of a deceased shareholder in determining that two corporations were related because they were controlled by the same group. The provisions of the will were permitted to overrule the provisions of the company’s articles. If the majority of voting shares of a corporation are owned by a trust, the trustees of the trust will control the corporation.

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37 67 DTC 5201 (Ex. Ct.).
38 71 DTC 5175 (SCC).
39 71 DTC 5202 (SCC).
40 72 DTC 6007 (SCC).
In Les Produits Alimentaires Anco (1961) Inc. v. MNR,\(^{41}\) the shares of a corporation were held by a Canadian company whose shares in turn were held by a US corporation. Canadian residents owned most of the shares of the US corporation. The taxpayer failed to qualify as a CCPC, even though it was otherwise indirectly controlled by Canadian residents and was directly controlled by a Canadian corporation.

In H.A. Fawcett & Son, Limited v. The Queen,\(^{42}\) the court held that mere ownership of shares entitling the holder to voting control was sufficient to constitute control, whether or not the right to vote was exercised. The father died two days before the company’s year-end. His son was his executor and the beneficiary of the shares, and controlled two other companies. It was held that all of the companies were associated by virtue of common control during the two days after the father’s death.

In Regal Wholesale Ltd. v. The Queen,\(^{43}\) the beneficial ownership by the persons who held endorsed share certificates was sufficient to establish control.

In The Queen v. Imperial General Properties Limited,\(^{44}\) the facts were almost identical to those in Oakfield Developments, except that in Imperial General Properties the preference shareholders also owned 10 percent of the common shares. The votes were held 50-50 between a related group of common shareholders and an unrelated group of preferred shareholders. The shareholders that had the right to wind up the company were found to control. The court distinguished Dworkin Furs, where the votes of both groups of shareholders were required to wind up the corporation.

In The Queen v. Lusita Holdings Limited,\(^{45}\) the issue was whether an individual who was a member of a related group that controlled one corporation was also considered to control a second corporation where he was a co-trustee of four separate trusts. He also had the ability to replace the other trustee. It was held that his right to replace the other trustee did not constitute a right to acquire shares or to control the voting shares in the future. The test for control was de jure and not de facto control. He did not, as a co-trustee, have de jure control of the votes of the shares owned by the trust.

The Fawcett and Lusita cases gave rise to concerns that an individual who acted as an executor or trustee may be regarded as owning those shares personally and may associate the corporation with other corporations controlled by the trustee. This would be of concern where a public corporation acts as a trustee, for example, on the death of an individual. In 1980, at the annual conference of the Canadian Tax Foundation, Revenue

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\(^{41}\) 79 DTC 573 (TRB).
\(^{42}\) 80 DTC 6195 (FCA).
\(^{43}\) 77 DTC 5152 (FCA).
\(^{44}\) 85 DTC 5500 (SCC).
\(^{45}\) 84 DTC 6346 (FCA).
Canada indicated that the status of a private corporation does change where shares are acquired by a public corporation, as trustee, on the death of the individual.\textsuperscript{46} This was a change in administrative practice and resulted in so much criticism that, by letter to the Canadian Tax Foundation dated March 25, 1981, Revenue Canada agreed not to change the status of a private corporation on the acquisition of control by a public corporation acting as executor or trustee under a will. In 1992, Revenue Canada issued a technical interpretation stating that the distribution of shares to beneficiaries of a trust who were unrelated to the trustee would result in a change of control.\textsuperscript{47} Subsection 256(4) provides that corporations controlled by the same trustee will not be associated if the trust was a testamentary trust and was not one of several trusts created by non-arm's-length individuals.

In \textit{Rostal Sales Agency Ltd. v. The Queen},\textsuperscript{48} all of the shares of a corporation were owned by an inter vivos trust. The settlor of the trust was a member of a related group that controlled the second corporation. The trustee was unrelated to the settlor. The settlor did not have the power to remove the original trustee but only successor trustees. The settlor did have the power to appoint additional trustees. Revenue Canada took the position that the power to appoint replacement trustees gave the settlor the power to appoint himself as a trustee and thus the right to control the votes. The court held that as the settlor did not have the power to remove the original trustee, he did not have the right at the relevant times to control the voting rights.

In \textit{Express Cable Television Ltd. v. MNR},\textsuperscript{49} it was held that a taxpayer can rebut Revenue Canada’s selection of a controlling group establishing that other persons or groups are also groups with a majority of voting shares and thus have legal control.

In \textit{CJOY Ltd. v. MNR},\textsuperscript{50} the court came to the surprising conclusion that a minority shareholder could be part of a group that controls. Subsequent amendments to the association rules permitted this type of approach. However, in \textit{Southside Car Market Ltd. et al. v. The Queen},\textsuperscript{51} it was held that if a single person owns sufficient shares to exercise control, the group cannot be said to control. This decision was overruled by the enactment of paragraph 256(1.2)(b).


\textsuperscript{47} See Window on Canadian Tax, supra footnote 31, at paragraph 1955.

\textsuperscript{48} 83 DTC 5036 (FCTD).

\textsuperscript{49} 82 DTC 1431 (TRB).

\textsuperscript{50} 67 DTC 6 (TAB).

\textsuperscript{51} 82 DTC 6179 (FCTD).
In *The Queen v. B.B. Fast & Sons Distributors Ltd.*,\(^52\) it was held that each member of a group must own at least one share of each corporation for the purposes of paragraphs 256(1)(d) and (e).

In *International Mercantile Factors Ltd. v. The Queen*,\(^53\) two public companies together owned 50 percent of the voting shares of the taxpayer and a private company owned the remaining 50 percent of the voting shares. The shareholders’ agreement prevented a change in the composition of the board of directors of the taxpayer. As the public companies were entitled to appoint four directors and the private company one director, the taxpayer was found not to be a CCPC.

In a technical interpretation dated November 15, 1991, Revenue Canada concluded that *International Mercantile Factors* had not cast doubt on the decision in *International Iron & Metal*. Revenue Canada concluded that a corporation that proposed to increase its shareholdings in another corporation to more than 50 percent would acquire control notwithstanding the existence of a voting agreement that restricted the voting rights of the corporate shareholder.\(^54\)

In *Noranda Mines Limited v. MNR*,\(^55\) the court found that a 45 percent shareholder effectively controlled a corporation. In Bill C-139, the explanatory notes indicated that control under subsection 256(5.1) (discussed below) may exist where a person having 49 percent of the votes is in a position to have the employees who hold the balance of the shares follow his wishes.

In a technical interpretation dated May 5, 1994, Revenue Canada concluded that where two equal shareholders controlled a corporation, the corporation would be controlled by a group consisting of the two shareholders.\(^56\)

**Implications of Control**

As noted earlier, the Act contains many references to control of a corporation. The following are some examples.

**Private Corporation**

A “private corporation” is defined to exclude a corporation that is controlled by one or more public corporations (other than prescribed venture capital corporations or prescribed federal Crown corporations or any combination thereof).\(^57\) A loss of status as a private corporation will entail a loss of refundable dividend tax on hand\(^58\) and a loss of the capital dividend account.\(^59\)

\(^52\) 86 DTC 6106 (FCA).
\(^53\) 90 DTC 6391 (FCTD).
\(^54\) See *Window on Canadian Tax*, supra footnote 31, at paragraph 1535.
\(^55\) 87 DTC 379 (TCC).
\(^56\) See Revenue Canada Views [database online], document no. 9410850, May 5, 1994.
\(^57\) Subsection 89(1).
\(^58\) Subsection 129(3).
\(^59\) Subsection 89(1.1).
Canadian-Controlled Private Corporation
A “Canadian-controlled private corporation” is defined in subsection 125(7) to mean a private corporation that is a Canadian corporation other than a corporation controlled, directly or indirectly in any manner whatever, by one or more non-resident persons, by one or more public corporations (other than a prescribed venture capital corporation), or by any combination thereof. Eligibility as a CCPC is relevant for the enhanced capital gains exemption, the small business deduction, the treatment of stock options, and the capital dividend account (if a corporation controlled by non-residents becomes a CCPC).

Corporate Partnership
Subsections 125(6.2) and (6.3) deem a corporate partnership controlled by a non-resident to have no active business income, thereby excluding all partners from claiming the small business deduction in respect of such income.

Small Business Corporation
One of the criteria for qualification as a small business corporation is that it be a CCPC.

Controlled Foreign Affiliate
A controlled foreign affiliate is defined as a foreign affiliate of a taxpayer that was, at that time, controlled by

(a) the taxpayer,
(b) the taxpayer and not more than four other persons resident in Canada,
(c) not more than four persons resident in Canada, other than the taxpayer,
(d) a person or persons with whom the taxpayer does not deal at arm’s length, or
(e) the taxpayer and a person or persons with whom the taxpayer does not deal at arm’s length.

Specified Financial Institution and Restricted Financial Institution
A “specified financial institution” is defined to include a corporation that is controlled by one or more banks, trust companies, credit unions, or insurance corporations, and the definition specifically provides that one corporation is controlled by another if shares having more than 50 percent

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60 Section 110.6.
61 Section 125.
62 Subsection 89(1.1).
63 Subsection 248(1).
64 Subsection 95(1).
of the votes in all circumstances belong to the other corporation and/or non-arm’s-length persons. A “restricted financial institution” similarly is defined to include a corporation controlled by one or more banks, trust companies, credit unions, or insurance corporations, but there is no expanded definition of control such as that applicable to specified financial institutions.65

**Part IV Tax**

Subsection 186(1) provides that every corporation that was, in a taxation year, a corporation (other than a private corporation) resident in Canada and controlled, whether by reason of a beneficial interest in one or more trusts or otherwise, by or for the benefit of an individual (other than a trust) or a related group of individuals (other than trusts) or a private corporation, shall, on or before the last day of the third month after the end of the year, pay part IV tax.

**Connected Corporation**

The definition of a “connected corporation” in subsection 186(4) provides that a payer corporation is connected with a particular corporation at any time if the payer corporation is controlled (otherwise than by virtue of a right referred to in paragraph 251(5)(b)) by the particular corporation at that time.

**Arm’s Length**

For the purpose of determining whether a person deals at arm’s length with a corporation, the definition of “related persons” in subsection 251(2) makes several references to the person or persons who control the corporation.

**Control by Related Groups**

For the purposes of the definition of related persons and the definition of a Canadian-controlled private corporation, subsection 251(5) provides special rules for control by related groups, options, etc. Where a related group is in a position to control a corporation, it shall be deemed to be a related group that controls the corporation whether or not it is part of a larger group by which the corporation is in fact controlled.

**Options**

Where a person has a right under contract, in equity, or otherwise, either immediately or in the future, either absolutely or contingently, to acquire shares in the capital stock of a corporation or to control the voting rights of shares, such person shall (except where the right is not exercisable at that time because the exercise thereof is contingent on the death, bankruptcy, or permanent disability of an individual) be deemed to have the same position in relation to the control of the corporation as if the person

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65 Subsection 248(1) (both definitions).
owned the shares at that time. Similarly, if a person has the right to cause a corporation to redeem, acquire, or cancel any shares of its capital stock owned by the other shareholders of the corporation, the person shall (except where the right is not exercisable at that time because the exercise thereof is contingent on the death, bankruptcy, or permanent disability of the individual) be deemed to have the same position in relation to the control of the corporation as if the shares were so redeemed, acquired, or cancelled by the corporation at that time.

**Control for Purposes of the Association Rules**
The Act has greatly expanded the meaning of control for purposes of the association rules. The tests for association under subsection 256(1) make several references to control. There is an extended definition of control under subsection 256(1.2), which applies for purposes of the association rules only.

**Group of Persons**
A group of persons in respect of a corporation means any two or more persons each of whom owns shares of the capital stock of the corporation. In addition, for greater certainty, a corporation that is controlled by one or more members of a particular group of persons in respect of that corporation shall be considered to be controlled by that group of persons, and a corporation may be controlled by a person or a particular group of persons notwithstanding that the corporation is also controlled or deemed to be controlled by another person or group of persons.

**Equity and Votes Test**
A corporation shall be deemed to be controlled by another corporation, a person, or a group of persons at any time where shares of the corporation having a fair market value of more than 50 percent or common shares of the corporation having a fair market value of more than 50 percent are owned at that time by the other corporation, the person, or the group of persons.

**Lookthrough Rule**
There is a lookthrough rule that deems shares held by a holding corporation to be owned by the shareholder(s) of the holding corporation. Similarly, where shares of a corporation are owned by a partnership, the shares are deemed to be owned by the partners; and where shares are

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66 Subparagraph 251(5)(b)(i) and proposed subparagraph 251(5)(b)(iii) in subclause 123(2) of the draft amendments.
67 Subparagraph 251(5)(b)(ii).
68 Paragraph 256(1.2)(b).
69 Paragraph 256(1.2)(c).
70 Paragraph 256(1.2)(d).
owned by a trust, the shares are deemed to be owned by the beneficiaries of the trust. There are special rules for testamentary and inter vivos trusts.71

**Security Arrangements**
Subsection 256(6) provides for relief where a corporation would otherwise be considered to be controlled and it is established that, at the particular time, an enforceable arrangement was in effect under whose terms it was reasonable to expect that, on the satisfaction of a condition or the happening of an event, the controlled corporation would cease to be controlled by the controller and would become controlled by an arm’s-length person or group of persons. It must also be established that the purpose for which the corporation was controlled was the safeguarding of rights or interests of the controller in respect of any indebtedness owing to the controller, or any shares of the capital stock of the controlled corporation that were owned by the controller and were to be redeemed by the controlled corporation or purchased by the person or group of persons referred to above.

**Investment Tax Credits**
Subsection 127.1(2) contains two definitions that refer to control for purposes of the investment tax credit rules. An “excluded corporation” is defined to be a corporation controlled directly or indirectly in any manner whatever by a person exempt from tax, a public authority, or a combination of these. A “qualifying corporation” must be a CCPC.

**Superficial Losses**
The superficial loss rules in section 54 preclude the claiming of a capital loss where identical property is acquired within 30 days of a disposition by a corporation controlled, directly or indirectly in any manner whatever, by the taxpayer.

**Loss Denial on Transfer of Property**
Subsection 85(4) denies a loss on a transfer of property to a corporation that immediately after the disposition is controlled, directly or indirectly in any manner whatever. The draft amendments will repeal subsection 85(4). It will be replaced by subsections 40(3.3) and (3.4) for non-depreciable capital property transfers and subsection 14(12) for transfers of cumulative eligible capital. The new provisions refer to losses on transfers of property within 30 days to persons affiliated with the transferor. As indicated below, “affiliated persons” are defined in proposed section 251.1 with reference to control.

**Terminal Losses**
Terminal losses are denied if property is transferred to a corporation that, immediately after the transaction, is controlled directly or indirectly by

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71 Paragraph 256(1.2)(f).
The draft amendments propose to replace subsection 85(5.1) with subsection 13(21.2). Subsection 13(21.2) defers the recognition of a terminal loss on a transfer by a corporation to an affiliated person until there is an arm’s-length sale or an acquisition of control.\textsuperscript{73} The definition of “affiliated persons” in proposed section 251.1 includes a corporation and a person by whom the corporation is controlled, and each member of an affiliated group of persons by which the corporation is controlled.\textsuperscript{74} Two corporations are affiliated where a corporation is controlled by a person or group that is affiliated with a person or group that controls the other corporation.\textsuperscript{75} A corporation and a partnership may be affiliated if the corporation is controlled by a particular group of persons, each member of which is affiliated with at least one member of the majority-interest group of partners.\textsuperscript{76} “Controlled” is defined for the purposes of section 251.1 to mean controlled directly or indirectly in any manner whatever.\textsuperscript{77}

**De Facto Control**

Subsection 256(5.1) provides for de facto control of a corporation. For the purposes of the 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, 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.

Although the degree of influence is 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 that apply naturally to related persons.\textsuperscript{78} The ability to elect a majority of directors, to control the day-to-day management and operation of the business, and ownership of large debt are all factors that might indicate such influence.\textsuperscript{79}

There is an exception 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,

\textsuperscript{72} Subsection 85(5.1).

\textsuperscript{73} Proposed clause 13(21.2)(e)(iii)(D) in subclause 5(4) of the draft amendments.

\textsuperscript{74} Proposed paragraph 251.1(1)(b) in subclause 124(1) of the draft amendments.

\textsuperscript{75} Proposed paragraph 251.1(1)(c), ibid.

\textsuperscript{76} Proposed paragraph 251.1(1)(d), ibid.

\textsuperscript{77} Proposed subsection 251.1(2), ibid.

\textsuperscript{78} For some examples of de facto control, see “The Department’s Comments on Control,” in *Access to Canadian Income Tax: Tax Authorities Papers* (Montreal: DACFO) (looseleaf), 89 TAP 250.

or some other similar agreement or arrangement, whose main purpose 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. Interpretation Bulletin IT-64R3[^80] sets out Revenue Canada’s views on de facto control.

De facto control embraces all of the means, except de jure control, by which a person may exercise control over a corporation. De facto control may even exist without the ownership of any shares. It can take many forms—for example, 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. A potential influence, even if it is not actually exercised, may be sufficient to result in de facto control.

Whether a person or group of persons can be said to have de facto control of a corporation, even though that person or group does not legally control more than 50 percent of its voting shares, will depend on each fact situation. The following are some general factors that Revenue Canada may consider in determining whether de facto control exists:

- the percentage of ownership of voting shares (when such ownership is not more than 50 percent) in relation to the holdings of other shareholders;
- ownership of a large debt of a corporation that may become payable on demand (unless exempted by subsection 256(3) or (6)) or a substantial investment in retractable preferred shares;
- shareholders’ agreements, including the holding of a casting vote;
- commercial or contractual relationships of the corporation (for example, 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.

In order to establish that an unrelated group of persons controls a corporation, there must be evidence that a common link or interest exists between them. Furthermore, this common link or interest must involve more than their mere status as shareholders. In other words, the persons comprising the group must act in concert to control the affairs of the corporation. The mere fact that it is necessary for two or more shareholders to agree before the corporation can undertake a certain course of

[^80]: Supra footnote 29.
action does not necessarily mean that those shareholders are acting together to control the corporation and therefore constitute a group that controls the corporation. As stated in Interpretation Bulletin IT-419, “acting in concert generally means a predetermined agreement to act in a certain manner.”81 This suggests that it is necessary to show that there is some arrangement whereby the shareholders have agreed to vote their shares in the same manner or to have their nominees to the board vote together on most matters. Alternatively, it is necessary to establish that shareholders have common interests such that it is reasonable to conclude that they will vote their shares together.

Furthermore, as indicated in paragraph 12 of IT-419, the concept of acting in concert generally requires the parties to act in a highly interdependent manner and without separate interests. Acting in an interdependent manner, however, is not equivalent to sharing a common goal. For example, if each shareholder will agree to a given course of action only if he or she judges that course of action to be in his or her own interest, it cannot be said that the shareholders are acting in concert to control the corporation. This analysis is reflected in the following words of Thurlow J in Swiss Bank Corporation et al. v. MNR:

[W]here several parties—whether natural persons or corporations or a combination of the two—act in concert, and in the same interest, to direct or dictate the conduct of another, in my opinion the “mind” that directs may be that of the combination as a whole acting in concert or that of any one of them in carrying out particular parts or functions of what the common object involves. . . . On the other hand if one of several parties involved in a transaction acts in or represents a different interest from the others, the fact that the common purpose may be to so direct the acts of another as to achieve a particular result will not by itself serve to disqualify the transaction as one between parties dealing at arm’s length.82

Other than the general comments in IT-419 cited above, Revenue Canada has not developed any guidelines on the concept of acting together or acting in concert to control a corporation. However, one or more of the following are pertinent when dealing with this issue:

1. Any direct or indirect influence on any shareholder;
2. The ability to elect a majority of the Board of Directors, the right to change the Board of Directors or the ability to overrule the Board of Directors;
3. Control the day-to-day management of a corporation;
4. Ability to appropriate corporate property or corporate profits;
5. The right to wind up the corporation.83

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82 71 DTC 5235, at 5241 (Ex. Ct.), aff’d. 72 DTC 6470 (SCC).
83 See Revenue Canada Views [database online], document no. 9312877, August 26, 1993.
Acquisition of Control

On an acquisition of control, the Act restricts a corporation’s ability to deduct previously unused losses and to take advantage of other deductions. An acquisition of control normally takes place where a person or group of persons acquires more than 50 percent of the voting shares of the corporation. Revenue Canada has taken the position that an acquisition of control may occur where no single shareholder controls the corporation and a shareholder disposes of his or her shares to another shareholder, with the result that the possible group that controlled the corporation has changed. However, the case law suggests that this will be the case only where a group of shareholders that owns more than 50 percent of the votes is related or acting in concert, or where a particular shareholder or group has certain fundamental rights with respect to the corporation (such as the ability to cause a winding up) that are not available to other shareholders.

There are instances where a person may acquire a minority interest in a corporation and Revenue Canada may assume that the parties are acting in concert and that a new group has acquired control of the company. For example, Revenue Canada may seek to make this assumption where someone acquires a minority interest in a company that has loss carryforwards. The minority interest may be acquired in order to avoid a change of control that would result in the expiry or elimination of the loss carryforwards. Revenue Canada may assume that there was a pre-existing arrangement for the minority shareholder to increase his or her interest and therefore try to argue that there has been an acquisition of control.

A person is deemed not to have acquired control of a particular corporation if that person, immediately before the share redemption, acquisition, or cancellation,

• was related to the particular corporation otherwise than by reason of an option;

• was the executor or trustee of an estate that acquired the shares by virtue of the death of any other person;

• was related to a deceased person and acquired the shares by way of a distribution from an estate arising on the death of that person; or

• was a corporation arising from the amalgamation of two or more predecessor corporations each of which was, immediately before the amalgamation, related (otherwise than by reason of an option).

Subsection 256(8) deems shares subject to an option to have been acquired at the time the option or right was acquired if one of the main purposes was to avoid the negative implications of an acquisition of control.

In certain circumstances, the acquisition of a particular corporation’s shares will not result in an acquisition of control of that or any other corporation. These circumstances include
• the acquisition of shares by any person from a related person;
• the acquisition of shares from any person by a person related to that particular corporation;
• the acquisition of shares by an estate; and
• the acquisition of shares by any person from the estate of a related person.

The replacement of an executor, administrator, or trustee as a result of that person’s death or inability to fulfil his or her functions will not result in a change of control. However, the change in an executor, administrator, or trustee, coupled with a substantial change in beneficial ownership of an estate, will be considered an acquisition of control of the corporation.

Where control of a corporation is acquired by a person or a group of persons at a particular time on a particular day, control will be deemed to have been acquired at the commencement of that day unless the corporation elects in its return of income for a taxation year ending before the acquisition of control not to have subsection 256(9) apply.

Once it has been established that there has been an acquisition of control, certain tax consequences follow. These are summarized below.

**Deemed Year-End**

When an acquisition of control occurs, the taxation year of the corporation is deemed to end immediately before that time. This rule was enacted to curtail trading in current-year losses or deductions. Current-year losses and accrued losses in respect of depreciable and non-depreciable capital property, inventory, eligible capital property, and doubtful debts will all be deemed to have been realized in the year deemed to end on the change of control. This will give rise to the normal consequences, including the filing of the corporation’s tax return and payment of taxes due.

With the commencement of the new taxation year, the corporation may adopt a new fiscal period without seeking the concurrence of the minister. If the acquisition of control occurs within seven days after the end of the corporation’s immediately preceding taxation year, subject to certain exemptions, the corporation may elect in its tax return to extend the preceding taxation year to end immediately before the acquisition of control. The deemed taxation year-end rule does not apply if the corporation is a foreign affiliate that does not carry on business in Canada and control was acquired after July 13, 1990.

The deemed year-end shortens the carryforward or carryback of non-capital losses, farm losses, restricted farm losses, charitable donations, and investment tax credits. It may require a proration of the claim for capital cost allowance. It affects the timing for unpaid amounts, shareholder loans, loans to non-residents, and the claiming of reserves for

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84 Subsection 249(4).
gains on capital property and on inventory. It affects the timing of payment of bonuses; contributions to a registered retirement savings plan, an employee profit-sharing plan, and a deferred profit-sharing plan; and the deduction for cumulative eligible capital. It is relevant for the replacement property rules. A proration may be required of the small business deduction. The deemed year-end also affects the time limit for an election for leasehold inducements under subsection 13(7.4).

**Net Capital Loss Carryforwards**

When there is an acquisition of control, a corporation loses its net capital loss carryforwards. A corporation’s net capital loss incurred in a taxation year ending after control was acquired cannot be carried back to a taxation year ending before control was acquired.85

**Non-Capital Loss Carryforwards**

On an acquisition of control, non-capital loss carryforwards and farm loss carryforwards of a corporation will cease to be deductible unless the particular business that gave rise to the loss is carried on by the corporation for profit or with a reasonable expectation of profit throughout the particular year. Losses attributed to capital property and allowable business investment losses will expire.86 Non-capital losses will be deductible against the corporation’s income from the same or a similar business.

**Accrued Capital Losses**

Where the adjusted cost base of non-depreciable capital property of a corporation exceeds the fair market value of the property immediately before control of the corporation is acquired, such excess is required to be deducted from the adjusted cost base of the property.87 The excess is deemed to be a capital loss of the corporation for its taxation year deemed to end immediately before the acquisition of control. The capital loss may not be carried forward on an acquisition of control. This provision precludes the trading of latent capital losses.

**Election for Deemed Disposition of Capital Property**

Before an acquisition of control occurs, a corporation may make an election for the deemed disposition of any other capital property, including its depreciable property, with a view to generating a capital gain (and possibly recaptured depreciation) to offset capital losses (and possibly non-capital losses) that cannot be carried forward following the change of control.88 If the designated property is depreciable property having a capital cost exceeding the designated proceeds of disposition, the original cost is

85 See paragraphs 111(4)(b) and 111(1)(b).
86 Subsection 111(5).
87 Paragraphs 111(4)(c) and 53(2)(b.2).
88 Paragraph 111(4)(e).
the same as the capital cost, and the difference between that cost and the proceeds of disposition is treated as having been previously claimed as capital cost allowance.

**Accrued Terminal Losses**

In order to prevent the transfer of an unrealized terminal loss, on an acquisition of control, a corporation is required to deduct from its income for the taxation year ending immediately before the acquisition of control, the difference between the undepreciated capital cost of depreciable property and the aggregate of the fair market value of the property at that time and the amount of capital cost allowance or terminal loss otherwise allowed in respect of that class.\(^89\) The deduction thus arising will be treated as a non-capital loss or farm loss for that taxation year, and that loss may be deducted in the future only if the business has not been discontinued and if the loss is applied against profits from the same or a similar business.

**Accrued Losses with Respect to Cumulative Eligible Capital**

On an acquisition of control, the Act requires deduction of the amount, if any, by which the cumulative eligible capital in respect of the business before the acquisition of control exceeds the total of three-quarters (one-half before July 1988) of the fair market value of the eligible capital property and the amount of eligible capital deduction claimed in the taxation year ending immediately before the acquisition of control.\(^90\)

**Reserve for Doubtful Debts**

On an acquisition of control, any debt that would otherwise have been deductible as a doubtful debt is deemed to be a separate debt and is required to be deducted as a bad debt in computing the corporation’s income for that taxation year.\(^91\) The maximum reserve for accounts receivable must be claimed on an acquisition of control. This deduction may create or increase non-capital losses or farm losses for that taxation year. For a debt to be deductible, the business must not have been discontinued, and the corporation must carry on the same or a similar business.

The rules discussed above for net capital losses, non-capital losses, accrued terminal losses, accrued losses with respect to cumulative eligible capital, and reserves for doubtful debts do not apply if, at the time of acquisition of control, the corporation becomes or ceases to be exempt from part I tax.

**Accrued Inventory Loss**

If there is an accrued inventory loss as a result of a decline in market value relative to original costs, inventory must be written down to reflect

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\(^{89}\) Subsection 111(5.1).

\(^{90}\) Subsection 111(5.2).

\(^{91}\) Subsection 111(5.3).
such losses in the taxation year deemed to end immediately before the acquisition of control. \(^{92}\) The writedown will create or increase non-capital losses or farm losses, which will be deductible on a change of control only if the conditions set out above are met.

**Resource Expenses**
Subsection 66.7(10) of the successor corporation rules restricts the deduction of resource expenses after an acquisition of control by deeming the undeducted expenses to have been incurred by the original owner. The result is to restrict the deduction of these expenses to income generated from the production or sale of properties owned by the corporation before the acquisition of control.

**Scientific Research and Experimental Development**
The carryforward of scientific research and experimental development expenses is limited after an acquisition of control to income earned from the business or a similar business. \(^{93}\)

**Investment Tax Credit**
The carryforward or carryback of investment tax credits is restricted by subsections 127(9.1) and (9.2). Investment tax credits may be carried forward on an acquisition of control only against income from the same or a similar business.

**Capital Dividend Account**
If a private company controlled by non-residents becomes a CCPC, its capital dividend account is eliminated. \(^{94}\)

**Unused Surtax Credit**
Subsection 181.1(7) limits the deduction of an unused surtax credit on an acquisition of control. The business must be carried on with a reasonable expectation of profit, and there are limitations based on the same or a similar business.

**Unused Part I.3 Tax Credit**
Subsection 125.3(3) limits the deduction of unused part I.3 tax credits on an acquisition of control.

**Amalgamation**
An amalgamated corporation may use the non-capital losses, net capital losses, restricted farm losses, farm losses, and limited partnership losses of predecessor corporations. \(^{95}\) The restrictions for the use of losses on an

\(^{92}\) Subsection 10(1).

\(^{93}\) Paragraph 37(1)(h) and subsection 37(6.1).

\(^{94}\) Subsection 89(1.1).

\(^{95}\) Subsection 87(2.1).
acquisition of control, set out in subsections 111(4) to (5.4), apply. Losses incurred by the amalgamated corporation may not be carried back for deduction in any predecessor corporation unless the amalgamation was of a parent and a wholly owned subsidiary.96

**Windup**

When there is an acquisition of control of a parent or a subsidiary, no amount of the subsidiary’s non-capital losses or farm losses for a taxation year ending before the acquisition of control is deductible by the parent for a taxation year ending after the acquisition of control. There are relieving provisions allowing the losses from a business to be deducted against the income from the same or a similar business.97 The same relief is not available for capital losses of a subsidiary if there has been an acquisition of control of the parent or the subsidiary.98

**Losses on Certain Transfers**

As outlined above, where a corporation transfers property to a person affiliated with it, the transferor is denied a terminal loss and is deemed to have property of a separate class equal to the denied loss. Capital cost allowance may thus be claimed. The undepreciated capital cost of this class may be deducted as a terminal loss when control of the transferor is acquired.99

**Anti-Avoidance Rules**

There is an anti-avoidance rule that applies where control of a corporation is acquired and the main reason for the acquisition of control may reasonably be considered to be the recognition of accrued losses.100 Where this rule is applicable, the relieving provision in respect of such losses does not apply.

There is also an anti-avoidance rule that applies where a taxpayer acquires the right to purchase shares, or to control the voting rights of such shares, or to cause a corporation to acquire, purchase for cancellation, or redeem its shares, and it can reasonably be concluded that one of the main reasons for the acquisition is to avoid any limitation on the deductibility of any non-capital loss, net capital loss, farm loss, expense, or resource amount, to avoid the application of subsection 13(24) dealing with terminal losses or paragraph 37(1)(h) dealing with scientific research and experimental development, or to avoid certain limitations on the use of investment tax credits.101 In these circumstances, for the purposes of

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96 Subsection 87(2.11).
98 Subsection 88(1.2).
99 Proposed subparagraph 13(21.2)(e)(iii) in subclause 5(4) of the draft amendments.
100 Subsection 111(5.5).
101 Subsection 256(8).
determining whether control of a corporation has been acquired, the taxpayer shall be deemed to have acquired the shares at that time. The draft amendments propose to extend the foregoing list to include debt forgiveness and the deemed year-end on a change of control.

Another anti-avoidance rule applies to deny a terminal loss on depreciable property transferred to a Canadian corporation within 12 months preceding an acquisition of control where the property was not used in the corporation’s business before that period. A similar 12-month restriction applies to resource properties.

If property is rolled over to an unrelated corporation or partnership and disposed of within three years (the draft amendments would expand the reference to include arrangements made within three years) in order to generate a gain on the sale of the property to offset losses, the rollover will be denied and the vendor will be deemed to have disposed of the property at fair market value at the time.

CONTROL IN THE US TAX CONTEXT

As might be expected, the US tax system contains many special rules applicable to controlled taxpayers. A Lexis search of the use of the term “control” in the Internal Revenue Code produced a list of 159 Code sections in which the term appears. The term “related person” appears 87 times. In addition, in various contexts, there are several judicial doctrines in the case law that indicate a willingness to subject related-party transactions to close scrutiny. Since a comprehensive review of the various US control rules is beyond the scope of this article, only a representative selection of those rules is summarized below.

Types of Control Provisions

The US tax rules that apply specifically to controlled taxpayers can be grouped into several broad categories, according to their intended purpose. Some of the most important of these are the following:

1) rules designed to prevent segregation of income or activities in multiple corporations in order to
   a) avoid application of progressive tax rate schedules or to duplicate entitlement to various statutory allowances;
   b) achieve a tax advantage by applying different tax methods, accounting periods, or tax elections to certain income or activities; or
   c) avoid various expense disallowance rules;

102 Subsection 13(24).
103 Subsection 66(11.4).
104 Subsection 69(11).
105 Internal Revenue Code of 1986, as amended (herein referred to as “the Code” or “IRC”).
2) rules responding to the ability of controlling shareholders to determine when the distribution of corporate profits would be most tax-efficient;
3) rules defining when certain corporate organizations and restructurings may be accomplished on a tax-free basis;
4) rules restricting the sale of tax attributes; and
5) rules addressing the tax consequences of transactions between related parties.

Examples of each type of control provision are provided in the discussion that follows. First, however, it is useful to consider briefly the meaning of control for US tax purposes.

Defining Control
Like Canada’s Income Tax Act, the Code provides no comprehensive definition of “control.” In both jurisdictions, this omission tends to complicate matters. The Code does, however, contain both objective and subjective standards of control. Objective standards include ownership rules (80 percent for some purposes and 50 percent for others) and attribution rules. The most important subjective standards are those set out in IRC section 482, the transfer-pricing legislation. These different standards for determining control and its tax consequences are reviewed below in the context of specific rules.

Examples of Special Rules for Controlled Corporations

Limitation on Multiple Corporation Benefits
Among the special rules restricting the availability of tax advantages through the use of multiple corporations are the following:
   - IRC section 1561 imposes limits on the members of a “controlled group of corporations” in respect of, among other things, the use of lower tax brackets and alternative minimum tax exemptions equivalent in the aggregate to those available to a single corporation. For these purposes, IRC section 1563 defines two types of controlled groups. The first are parent-subsidiary groups in which the parent owns at least 80 percent (by vote or value) of the subsidiary. The second are corporations that are commonly controlled (under both an 80 percent test and a 50 percent

107 The attribution rules differ according to context and are invariably complex. For example, they specify when a family member will be treated as owning stock owned by another family member; when shares owned by a corporation, a partnership, or a trust will be treated as owned by its shareholders, partners, or beneficiaries, as the case may be; when the holder of an option to acquire shares will be treated as having exercised such option; and when shares attributed from one person to another may be reattributed to a third person. Many related-party provisions use a modified version of the attribution rules in section 318. See generally Fred M. Ringel, Stanley S. Surrey, and William C. Warren, “Attribution of Stock Ownership in the Internal Revenue Code” (December 1958), 72 Harvard Law Review 209-65.
by five or fewer individuals, trusts, or estates. Special attribution rules must be taken into account, as well as rules excluding certain types of corporations from membership in a group and excluding consideration of certain types of stock.

- IRC sections 163(j) (the earnings-stripping rules, which limit the deduction of interest paid to related foreign persons eligible for reduction of the normal US withholding tax on interest pursuant to a tax treaty), 263A (requiring capitalization of certain interest expense), and 864(e) (allocating interest expense between US source income and foreign source income in calculating foreign tax credit limitations) all apply certain restrictions on interest deductions by analyzing the application of the rules as if related corporations were a single corporation. The rules reflect the fungibility of money and the ability of taxpayers, in the absence of aggregation rules, to isolate interest expense in related corporations that do not otherwise have characteristics that would trigger application of the interest expense limitation at issue. For example, in the absence of aggregation rules, the earnings-stripping limitation could be avoided by placing related-party debt in corporations with debt-equity ratios of less than 1.5 to 1 and placing third-party debt in more highly leveraged corporations.

**Limitation on Deferral of Dividend Distributions**

The United States does not have an integrated tax system for the taxation of corporate profits. Instead, the US tax system favours retention of corporate profits to avoid a shareholder-level tax. The Code contains a number of rules designed to eliminate the motivation to retain earnings in order to minimize shareholder-level taxes. Generally, such rules apply only if the corporation is controlled by shareholders who may direct the corporation to retain earnings rather than distribute dividends that would be subject to US tax. These rules include the personal holding company rules (IRC sections 541 to 547), the foreign personal holding company rules (IRC sections 551 to 558), and the controlled foreign corporation rules (IRC sections 951 to 964). For example, a foreign corporation will be a controlled foreign corporation (with certain types of earnings treated as though they were distributed as dividends on a current basis) if US shareholders own more than 50 percent (by vote or value) of the corporation either directly, indirectly, or constructively (10 percent or more of the voting stock of the foreign corporation). While the controlled foreign corporation rules set forth clear, objective definitions, various courts have gone beyond the statute to determine that a corporation is a controlled foreign corporation on the basis of other indicia of control by US shareholders.109

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108 The 80 percent test requires that five or fewer individuals own 80 percent (by vote or value) of the stock of each corporation. The 50 percent test requires overlapping ownership of more than 50 percent (by vote or value) (counting a shareholder owing 20 percent in one company and 50 percent in another as owning 20 percent for purposes of the 50 percent test).

109 See, for example, *Koehring Co. v. United States*, 583 F.2d 313 (7th Cir. 1978).
Other anti-deferral rules, however, do not contain control requirements. For example, the accumulated earnings tax rules (IRC sections 531 to 537) and the passive foreign investment company rules (IRC sections 1291 to 1297) may apply to corporations that are neither closely held nor controlled by US shareholders.

**Tax-Free Transactions**

Tax-free treatment for transfers of property in the course of an organization, reorganization, or acquisition of a corporation requires that the transferor or acquiring corporation control the corporation to be organized, reorganized, or acquired.

- IRC section 351 permits persons to transfer property to a corporation for stock on a tax-free basis if, immediately following the exchange, the transferors are in control of the transferee corporation. For these purposes, IRC section 368(c) defines control as ownership of “stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.” No indirect or constructive ownership is taken into account. For these purposes, the interests of unrelated transferors will be aggregated if made pursuant to a common plan. Moreover, while control must be held after the exchange, it need not be acquired in the exchange; that is, pre-exchange holdings of stock of the transferee generally will be taken into account.

- Certain tax-free reorganizations require control relationships. For example, under IRC section 368(a)(1)(B), a stock-for-stock acquisition is tax-free if control (the same 80 percent standard used for IRC section 351) of one corporation is acquired solely for voting stock of the acquiring corporation. IRC section 368(a)(1)(D), however, uses a 50 percent control standard—determined with application of attribution rules—in treating certain acquisitions of assets of one corporation by a commonly controlled corporation as a tax-free reorganization.

**Sale of Tax Attributes**

- IRC sections 381 to 384 target tax-motivated corporate acquisitions. For example, IRC section 382 generally restricts the ability to utilize loss carryforwards and built-in losses following a change of ownership of the loss company. For these purposes, an acquisition of more than 50 percent of the loss corporation’s stock will trigger the section 382 limitation, limiting the use of pre-change losses in each post-change year to the product of the value of the loss company and an interest rate published by the Treasury Department. This limitation is supposed to approximate the losses that the loss corporation could have utilized on its own (based on a conservative return-on-assets assumption). IRC section 383 provides similar restrictions on the use of an acquired corporation’s tax credits.

- IRC section 269 permits the Internal Revenue Service (IRS) to disallow deductions, credits, and other allowances if control (50 percent by vote or value) of a corporation is acquired and the principal purpose for
which the acquisition was made is evasion or avoidance of federal income tax by securing the benefit of a deduction, credit, or allowance that would not otherwise be enjoyed.

- The consolidated return rules also restrict the use of tax attributes of new members to offset tax liability generated by other members of the consolidated group. An 80 percent standard (by vote and value) determines eligibility to join in a consolidated return.

**Related-Party Transactions**

Because related-party transactions may have more important tax consequences than economic substance, various provisions address this issue:

- IRC section 267 defers or disallows various expenses or losses incurred in transactions between certain related parties. For example, IRC section 267(a)(1) disallows losses on sales of property to related persons. Regulations under IRC section 267(a)(3) do not permit deduction of interest on loans from foreign related parties until the interest is paid if the 30 percent US withholding tax otherwise applicable will be reduced pursuant to a tax treaty. IRC section 267 then sets forth various related-party relationships—generally applying a more than 50 percent ownership standard—and attribution rules. IRC section 707(b)(1) provides similar loss disallowance rules for sales between controlled partnerships and between a partnership and a controlling partner. Many related-party provisions incorporate the related-party definitions in IRC sections 267(b) and 707(b).

- IRC section 482 authorizes the IRS to reallocate income and other tax attributes between businesses that are “owned or controlled directly or indirectly by the same interests” in order to prevent evasion of taxes or clearly to reflect the income of such businesses. IRC section 482 has never contained an objective control standard. The regulations have referred to control, direct, or indirect, whether legally enforceable, and however exercisable or exercised. It is the reality of control which is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted.\(^{110}\)

Accordingly, the presence or absence of control is an issue to be determined on the basis of the facts and circumstances.\(^{111}\) Unfortunately, the uncertain control standard of IRC section 482 has been adopted in the definition of “related party” in section 6038A, which sets forth various reporting and record-keeping obligations for foreign-controlled US corporations.

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\(^{110}\) Treas. reg. section 1.482-2A(a)(3).

\(^{111}\) See *W.L. Gore & Assocs., Inc.*, 69 TCM 2037 (1995).