The Associated Corporation Rules: Getting Tax Reduction Under "Control"

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PRÉCIS

Les règles concernant les sociétés associées font partie de la législation fiscale depuis près d'un demi-siècle. À de nombreuses reprises, des tentatives ont été faites pour rédiger des lois qui empêcheraient les contribuables de se prévaloir, par diverses voies, du taux d'imposition réduit grâce à la déduction accordée aux petites entreprises. Le mois de février 1998 a marqué le 10e anniversaire du dépôt du budget fédéral qui a donné lieu aux règles actuelles. L'évolution législative qu'ont connue les règles ainsi que celle de la jurisprudence reliée sont décrites dans cet article qui aborde également les jalons importants de l'idée de contrôle et d'actionnariat.

Les dispositions législatives actuelles et l'arbre de décision servant à résoudre les problèmes en matière de sociétés associées en vertu des règles techniques sont analysés en détail, à l'aide d'exemples, dans le présent article. Enfin, la section finale comprend une comparaison de la définition pour l'impôt d'« association » et de la nouvelle définition d'« affiliation » proposée relativement aux nouveaux mécanismes pour minimiser les pertes.

ABSTRACT

The associated corporation rules have been part of our income tax laws for nearly half a century. Repeated attempts have been made to draft legislation that will prevent taxpayers from gaining multiple access to the reduced rate of tax available under the small business deduction. February 1998 marked the 10th anniversary of the federal budget that brought the current rules into existence. This article traces the statutory evolution of the rules and the development of the related jurisprudence. Landmark cases on the concepts of control and share ownership are reviewed. The article analyzes in detail the current statutory provisions, with examples, and presents a decision-tree for solving associated corporation problems under the technical rules. The final section compares the tax definition of "association" with the new definition of "affiliation" proposed in connection with the new stop-loss rules.

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HISTORICAL REVIEW

The predecessor to the associated corporation rules was introduced into the Income Tax Act for the first time in 1949 as companion legislation to the small business deduction provisions. The objective was to restrict taxpayers' ability to access the reduced rate of tax available under the small business deduction rules by splitting what was essentially a single business or economic entity into two or more corporations. As a result, corporations "related" under the new definition were required to aggregate their incomes so that only one low rate of tax could be accessed. The definition of "related" adopted the concept of common control:

> [O]ne corporation shall be deemed to be related to another in a taxation year if, at any time in the year,
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> (a) it, directly or indirectly, controls the other,
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> (b) it is, directly or indirectly, controlled by the other, or
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> (c) both corporations are controlled, directly or indirectly by the same person.[1]

The above provision, although appearing straightforward and easy to apply,[2] was retroactively repealed after only one year as a result of calls for "a less rigid limitation." The Honourable Douglas C. Abbott announced the change in his budget speech of 1950:

> [M]ere control will not be the criterion. I think it will achieve our original intention if some higher percentage of ownership is adopted in defining what we mean by related companies. It is proposed that companies shall not be deemed to be related companies unless there is related ownership of common stock to the extent of 70 per cent or more.[3]

The required percentage of common share ownership became the only test for denial of the low rate. Although this appears to provide for a higher threshold than the concept of control as developed by the courts, its straightforward approach perhaps provided taxpayers with more generous opportunities to circumvent its intent. At the same time, the legislation was criticized for casting too wide a net, catching situations that were not likely its intended target, such as corporations "conducting entirely dissimilar business at opposite ends of the country."[4] The government's policy objective of targeting corporations created for tax-reduction reasons, while still encouraging small business, was not being met.

These weaknesses were addressed by amendments made in 1960[5] (for 1961 and subsequent taxation years), whose major effect was to return to

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[1] SC 1949, c. 25, section 18(1).

[2] At that time, determination of control was based on straight share register control. See the discussion below under the heading "The Concept of Control."

[3] Canada, Department of Finance, Budget Speech, March 28, 1950, 12.

[4] Canada, *Report of the Royal Commission on Taxation* (the Carter commission), vol. 4 (Ottawa: Queen's Printer, 1967), 711.

[5] SC 1960, c. 43, section 11.

the test of control. For the first time, we saw the five technical rules that laid the foundation for section 256 in its current form,[6] incorporated into the following two general rules:

1) *paragraphs 39(4)(a) and (b)*: corporations with common control were associated;[7] and

2) *paragraphs 39(4)(c), (d), and (e)*: corporations with related shareholders(s) were associated if the related shareholder(s) owned at least one share of each corporation.

The next development came in 1963,[8] when a new rule provided for two corporations to be deemed associated on the basis of a purpose test. This addition was referred to by the Carter commission as an "admission that detailed legislation spelling out the circumstances in which the benefit from more than one low rate allowance will be denied has not been successful."[9] This change allowed the government the scope to enforce the legislation in a manner more consistent with its policy; however, for the taxpayer, it brought uncertainty and "an additional hurdle to be surmounted . . . when he had first passed the test of control imposed."[10]

With tax reform in 1971, the only substantive amendment was to change the cross-ownership requirement to "not less than 10% of the issued shares of any class of the capital stock."[11] Despite the advice of the Carter commission to repeal the technical rules and rely exclusively on an anti-avoidance, case-by-case provision, the government had decided that

> [t]o ensure that the low rate is not applied to more than $50,000 of business income by a group of related corporations, the present rules for determining associated corporations are retained. The maximum annual amount of $50,000 to which the low rate can be applied must be allocated within the group of corporations.[12]

The rules that are the focus of this article were proposed in the federal budget of February 10, 1988.[13] Six months earlier, the government had signalled its intention to amend the associated corporation rules

> so that they operate more effectively. Because of apparent weaknesses in these rules, a single economic entity can gain multiple access to the small

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[6] 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.

[7] An amendment in 1954 altered the wording from "related" to "associated": SC 1953-54, c. 57, section 9.

[8] SC 1963, c. 21, section 26, enacting section 138A.

[9] Supra footnote 4, at 712.

[10] Ibid., at 711-12.

[11] SC 1970-71-72, c. 63, section 256.

[12] Canada, Department of Finance, *Summary of 1971 Tax Reform Legislation* (Ottawa: the department, June 1971), 38.

[13] Canada, Department of Finance, 1988 Budget, Budget Papers, Notice of Ways and Means Motion To Amend the Income Tax Act, February 10, 1988, clause (1).

business deduction which provides special low tax rates for active business income of Canadian-controlled private corporations below $200,000 a year.[14]

In the pages that follow, we will examine the associated corporation rules as they have been for the last decade, as well as the related common law developments. We begin with the concept upon which the legislation was first founded, the concept of control.

THE CONCEPT OF CONTROL

Central to the theme of the associated corporation rules is the concept of control. For the purpose of these rules, there are three definitions of control: deemed, de facto, and de jure. The first two, deemed and de facto, are statutorily defined under subsections 256(1.2) and (5.1) respectively. The third, de jure, is not statutorily defined and has evolved through case law. Examination of each of these concepts follows, with particular emphasis on the developments that have taken place over the last decade or so.

De Jure Control: The Early Years of Share Register Control

The concept of de jure control was addressed in *Buckerfield's Ltd. et al. v. MNR*.[15] In what has become a landmark decision, the Exchequer Court said:

> [T]he word "controlled" contemplates the right of control 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. See *British American Tobacco Co. v. I.R.C.*, [1943] All E.R. 13, where Viscount Simon, L.C., at page 15 says:
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>> The owners of the majority of the voting power in a company are the persons who are in effective control of its affairs and fortunes.[16]

The concept of de jure control, being the power to elect the board of directors (that is, greater than 50 percent of the voting shares), was upset by three subsequent decisions of the Supreme Court of Canada. In these three cases, it was held that de jure control can exist without a shareholder's having the requisite number of votes to elect the board.

The first of these cases was *Oakfield Developments (Toronto) Ltd. v. MNR*.[17] This case extended the definition of de jure control to include the right to wind up a corporation where the persons or group of persons holding such a right receive the majority of the assets upon windup.

In the same year as *Oakfield*, the decision in *Donald Applicators Ltd. v. MNR*[18] extended the definition of de jure control beyond the current ability to elect the board. The decision introduced the element of determining

[14] Canada, Department of Finance, *Tax Reform 1987: Income Tax Reform* (Ottawa: the department, June 18, 1987), 131.

[15] 64 DTC 5301 (Ex. Ct.).

[16] Ibid., at 5303.

[17] 71 DTC 5175 (SCC).

[18] 71 DTC 5202 (SCC), aff'g. 69 DTC 5122 (Ex. Ct.).

who ultimately controls in the long run where normal powers of the directors have been usurped or where the corporate articles or bylaws can be amended so that powers of the directors are neutralized.

The last case in this trilogy was *The Queen v. Imperial General Properties Limited*.[19] The issue in this case was very similar to that in *Oakfield*. As in *Oakfield*, the court looked at the participation rights of the shareholders upon a windup. Also, the court again looked at the concept of de jure control in the long run. Mr. Justice Estey stated:

> Neither is the court constrained to examine those rights in the context only of their immediate application in a corporate meeting. It has long been said that these rights must be assessed in their impact "over the long run."[20]

Post Imperial Properties: De Jure Control and the Outside Agreement

Mr. Justice Estey's comments in *Imperial Properties* created a climate of confusion and uncertainty as to whether legal control for the purposes of the associated corporation rules could be supplied using either the de jure or the de facto definition or some blurred combination of the two. The confusion arose particularly from this statement by Mr. Justice Estey:

> It has been said that control for these purposes concerns itself with *de jure* and not *de facto* considerations. . . . Such a distinction, while convenient to express as a guide of sorts in assessing the legal consequences in factual circumstances, is not, as we shall see, an entirely accurate description of the processes of determination of the presence of control in one or more shareholders.[21]

This is admittedly a shift from the strict interpretation of the rules determining control set out in 1964 in *Buckerfield's*. The courts have been asked to clarify the exact nature of that shift in a number of cases since *Imperial Properties*.

The majority of the de jure case law in the last dozen years has dealt with the argument that the results of applying the control provisions will be altered when there are agreements among shareholders that impair, reduce, or otherwise vary the prima facie voting rights as set out in the articles of association.

In *Harvard International Resources Limited*,[22] for example, the taxing authority (here the provincial treasurer of Alberta) used Mr. Justice Estey's words in *Imperial Properties* to argue for control to associate two

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[19] 85 DTC 5500 (SCC).

[20] Ibid., at 5503.

[21] Ibid., at 5502.

[22] *Harvard International Resources Limited v. Provincial Treasurer (Alberta)*, 93 DTC 5254 (Alta. QB). The arrangements seen in *Harvard International* are now addressed by the constructive share ownership rules in paragraph 251(5)(b) and subsection 256(1.4). See the discussion in the text under the heading "Subsection 256(1.4): The 'Options and Rights' Rule."

corporations for the purpose of calculating the Alberta royalty tax credit in the circumstances of the case. (The Alberta Corporate Income Tax Act provides that part XVII of the federal Act—the "interpretation" part where subsection 256(1) is found—will apply.) During the taxation years in question (1984 and 1985), Centipede Energy Ltd. ("Energy") owned all of the 150 voting preferred shares in Centipede Holdings Ltd. ("Holdings"); at the same time, over 99.3 percent of Holdings' 100 voting common shares were owned by Harvard International Resources Limited (HIRL), with Energy owning the remaining 0.7 percent as an undivided interest. Energy provided management services to Holdings pursuant to a partnership agreement with HIRL. A second agreement entitled Holdings, in the event that Energy were to withdraw its management services, to force upon Energy the redemption of Holding's preferred shares and/or the repurchase of Holding's common shares at 90 percent of their then fair market value. The provincial treasurer argued that, although the requisite share ownership to elect the board of directors of Holdings lay with Energy "as per the share register," HIRL enjoyed de facto control of Holdings "in the long run." The right (through its control of Holdings under the provisions of the two agreements) to strip Energy of the control that Energy otherwise had in Holdings meant that "Energy was always looking over its shoulder as a result of the power given to HIRL to terminate Energy's services." The treasurer took the position that "in the present circumstances, control exists with the company with the velvet hammer over Energy resulting in effective control, control in the real sense being exerted by HIRL."[23] Control could be exercised by HIRL's removing Energy from the picture and assuming control over Holdings by itself.

Mr. Justice Hutchinson of the Alberta Court of Queen's Bench did not accept this reading of the ratio in *Imperial Properties*, which, by his interpretation, did not allow for looking to any outside agreements entered into between shareholders to establish de facto control:

> I do not believe that Estey, J. intended to move outside of the boundaries of the test of *de jure* control. . . .
>
> I believe that what Estey, J. was seeking throughout his decision was to establish where *de jure* control of the respondent lay through the incorporating documents and by-laws of the respondent *Imperial General Properties*. . . .
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> In the present case, *de jure* control of the appellant rested with Energy's ownership of 150 voting preferred shares. The respondent's argument that HIRL maintained control over Holdings through its unexercised right to force Energy to cause its shares to be redeemed or repurchased by Holdings, is an argument that *de facto* control existed and not *de jure* control. It was a right that was never exercised, presumably because HIRL did not wish to exercise such rights in any event. It was a right that is not to be found within the confines of Holdings' charter and by-laws where the real test of *de jure* control must be found.[24]

[23] *Harvard International*, supra footnote 22, at 5263.

[24] Ibid., at 5265.

The issue of "outside agreements" arose once again in *Alteco Inc. v. The Queen*,[25] where the court was again asked to look for de jure control beyond the share register. The appellant, Alteco Inc., owned 51 percent of a numbered Saskatchewan company ("387"). The remaining 49 percent was owned by N Ltd. The appellant and N Ltd. had entered into what was described as a "joint venture agreement" for the incorporation and set out a number of terms with regard to its structure and operation, including a provision for a five-person board of directors and a requirement that three of those directors be designated by N Ltd. The agreement also provided that the directors were to act as representatives of the contracting parties and always to vote and act in accordance with the terms of the agreement.

The Tax Court of Canada held that "the appellant did not control 387" because "in spite of the fact that the appellant owned 51 per cent of the voting shares of 387, it was not in a position to alter the board of directors the composition of which had been agreed to by it."[26] This decision, although not involving a question of association, raised issues that appear, to some extent, to be inconsistent with each other as well as with other case law on the test for de jure control.[27] The result turned on the finding that the "joint venture agreement" enjoyed the status of a "unanimous shareholder agreement" under the Saskatchewan Business Corporations Act (BCA), which, quite typically, defined (in section 140(2)) a "unanimous shareholder agreement" as

> an otherwise lawful written agreement among all the shareholders of a corporation . . . that restricts, in whole or in part, the powers of the directors to manage the business and affairs of the corporation.

The court had no trouble giving the agreement in question this status despite a number of unusual factors: the agreement was not dated; it was not signed;[28] and no written notice of its execution had been filed as required by the Saskatchewan BCA. The court's willingness to award the agreement the status of a "unanimous shareholder agreement" was tempered by the following comment:

> However, I have not been referred to any provision of the B.C.A. or to any case law that persuades me to conclude, as urged by appellant's counsel, that a unanimous shareholder agreement is "on par with the articles of association." It is noted that 387 is not a party to the agreement and therefore

[25] [1993] 2 CTC 2087 (TCC).

[26] Ibid., at 2103.

[27] The case involved the tax relationship of "arm's length" rather than association. The appellant had claimed an allowable business investment loss within the meaning of paragraph 38(c) with respect to a debt owed to it by 387; the deduction had been disallowed on the basis that 387 and the appellant did not deal at arm's length. The issue became one of "control" because the Act provides in paragraph 251(1)(a) that related corporations are deemed not to deal at arm's length, and the definition of "related" further provides that a corporation and a person who controls the corporation are related.

[28] A signed, dated agreement was said to exist but was never located.

> has no contractual obligation to comply with what the shareholders thereunder want to do.[29]

It is unclear whether the ratio in *Alteco* is consistent or at odds with the position that it is within "the confines of [the corporation's] charter and by-laws where the real test of *de jure* control must be found." On the one hand, *Alteco* succeeds in finding control in an agreement which, if one accepts its legal status as a unanimous shareholder agreement, would then be considered to be part of the constating documents of the corporation (although, in this case, anyone interested in purchasing shares would have no notice of the existence of the agreement since it had not been registered). On the other hand, the court makes a point of saying that the agreement does not enjoy the same legal status as the articles of association and seems to attach some legal importance to the fact that the corporation itself was not bound by it.

In 1994, the Tax Court of Canada again considered the effect of an agreement between shareholders on the determination of control. In *Couvre-Plancher Zénith Ltée v. MNR*,[30] the taxpayer corporation appealed the minister's reassessment, which had disallowed the small business deduction for the years 1984 and 1985. Two unrelated persons, L and S, were the shareholders of Zénith in those years. In 1982, L had granted to S a priority and exclusive right to purchase all the Zénith shares; pursuant to the exercise of the option, S became the owner of all but one of the shares. The agreement further provided that until the whole of the selling price had been paid, the one share would remain with L, who would be one of the two directors. S had exclusive authority for the day-to-day operations, but all decisions of the board, as well as all shareholders' decisions, were to be made unanimously. The minister took the position that Zénith was controlled by S and therefore was associated with a second corporation controlled by S (in which neither L nor any person related to him had ever held an interest). This position relied on the contention[31] that S

> owned the majority of the voting shares of the capital stock of the appellant so that it controlled the latter despite the restrictions contained in the agreement concerning the exercise of voting rights prior to full payment of the price of the shares.[32]

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29 Supra footnote 25, at 2103.

30 [1995] 2 CTC 2857 (TCC). The arrangements seen in *Zénith* are now addressed by the constructive share ownership rules in paragraph 251(5)(b) and subsection 256(1.4). See the discussion in the text under the heading "Subsection 256(1.4): The 'Options and Rights' Rule."

31 The respondent argued that, in the alternative, paragraph 251(2)(b) applied to deem S, who held the right to purchase all the shares of the appellant's capital stock and/or control its voting rights, to have had the same position in relation to the control of the appellant as if it had owned the shares.

32 Supra footnote 30, at 2862-63.

The appellant argued that

> one must now take into account not only the ownership of the majority of the voting shares and the other rights conferred on the shareholders by the articles of incorporation, but also the rights that might be attributed to them by other documents, more particularly by agreements among shareholders.[33]

Among the cases relied upon were *Imperial Properties* and *Alteco*.

The appeal failed as a result of two findings. First, the court found that the agreement in question was not a "unanimous shareholders agreement,"[34] but rather

> a private agreement governing the terms and conditions of a sale on shares and providing protection for the vendor until the price agreed upon has been fully paid. It is binding only on the contracting parties and those who adhered to it, of whom the appellant was not one.[35]

Second, the court, finding the ratio in *Harvard International* most persuasive, said this about control:

> While it must be admitted that the notion of control was broadened from the decision in *Buckerfield's*, *supra*, until that by the Supreme Court in *Imperial General Properties*, *supra*, it is nevertheless true, in my view, that only with the aid of a corporation's articles of incorporation, its by-laws *or an agreement binding on it*, including a unanimous agreement, can one ultimately determine who has control over such a corporation within the meaning of paragraph 256(1)(a) [emphasis added].[36]

Although the court in *Zénith* seems to have adopted the *Alteco* notion that control can be found within the confines of a unanimous shareholder agreement, the cases differ on whether there also exists a prerequisite that the agreement in question be binding upon the corporation. As well, it is unclear whether the courts in the two cases are working with the same definition of a unanimous shareholder agreement.[37] The ambiguity is increased in *Zénith* when the court refers to finding control "within the context of the rights arising from *the corporate structure*"[38] without any clear definition of what "corporate structure" includes.

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[33] Ibid., at 2864.

[34] Interestingly, one of the reasons for this conclusion was the date of the agreement (which was prior to the corporation's continuance.) Recall that in *Alteco*, the agreement was undated.

[35] Supra footnote 30, at 2866.

[36] Ibid., at 2867.

[37] In *Zénith*, the governing legislation was the Quebec Companies Act, RSQ, c. C-38, section 123.91: "The shareholders, if all of them consent thereto and make a written agreement to that effect, may restrict the powers of the directors." The Saskatchewan BCA definition was provided earlier in the text of this article. In both cases, the essence appears to be the same—that is, a restriction is imposed on the normal statutory powers of directors to manage the business and affairs of the corporation.

[38] Supra footnote 30, at 2867.

The scope of scrutiny under the de jure test and, in particular, the effect of an agreement among shareholders were before the courts again in *The Queen v. Duha Printers (Western) Ltd.*[39] The taxpayer, Duha ("D Ltd."), had claimed a deduction for the non-capital losses of Outdoor Leisureland ("O Ltd."), a corporation with which it had amalgamated. The issue was whether D Ltd. was controlled by M Inc., the same person that had controlled O Ltd. "immediately before" the share acquisition through which the two corporations (D Ltd. and O Ltd.) amalgamated. If so, no acquisition of control took place and the taxpayer was entitled to the loss deduction claimed. The scheme was described by the Federal Court of Appeal as "extremely complicated"; however, the control issue was quite straightforward. Two days before the amalgamation occurred, M Inc. acquired the majority of the voting shares of D Ltd., which had previously been wholly owned by the Duha family, to whom M was in no way "related" for tax purposes. That same day, the shareholders of D Ltd. entered into an agreement whose effect was to ensure a majority of Duha family nominees on the three-person board of directors as well as to restrict the transfer of shares. A simultaneous amendment to the articles to prohibit the issuance of any new voting shares without unanimous shareholder consent had the effect of "galvanizing" the voting structure. As a result of these circumstances, and others, the majority of the court concluded that "M Inc. did not control D Ltd." The result was reached by way of a clear finding that the agreement restricted the powers of the board of directors of D Ltd. to manage the business of the corporation and was, therefore, a "unanimous shareholder agreement" as defined by the Manitoba Corporations Act. As such, "it must be read with the corporation's charter and by-laws in order to determine the issue of control."[40]

The judgment of Mr. Justice Linden, who concurred in the result, seemed at times to suggest more far-reaching considerations and once again to cloud the distinction between de jure and de facto control:

> In determining issues of corporate control, the Court will look to the time in question, to legal documents pertaining to the issue, and to any actual or contingent obligations affecting the voting rights of shares. These factors are simply facts with legal consequences, so that the distinction between *de jure* and *de facto* control is not as stark as it once was. . . . Transactions must be assessed in the context in which they appear and with "an eye to commercial and economic realities."[41]

Mr. Justice Linden's reference to *Alteco* as an illustration of the principle that "if majority ownership does not allow for real legal control over a company, the *de jure* test of control will not have been met"[42] could be taken to suggest that anything other than "share register control" can only be control that is de facto in nature.

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[39] [1996] 3 CTC 19 (FCA).

[40] Ibid., at 21 (headnote).

[41] Ibid., at 41.

[42] Ibid., at 44.

The most recent judicial statement on de jure control relies on the decision in *Duha*; however, it fails to shed any light on the issue of outside agreements. In *The Queen v. W. Ralston & Co. (Canada) Inc.*,[43] 50 percent of the voting rights in the taxpayer corporation were held by members of the Cohen family, but neither the remaining common shareholders nor the preferred shareholders were related to any of the Cohen group. The minister's position, reminiscent of the "velvet hammer" argument in *Harvard International*, suggested that control was in fact in the hands of the Cohens, who could, if they so chose, direct the operation of the company.[44] The Federal Court was clear in its position that for the taxation years in question (1970-1974), "[i]t is a well-settled principle that the test for determining control within the meaning of the above provisions is *de jure* and not *de facto* control by the shareholders."[45] One of the facts that made *Ralston* a clear-cut case for Mr. Justice Pinard was the absence of any external agreements. Having referred to the need to determine "control by the shareholders based on the corporate structure,"[46] and citing *Imperial Properties* for the principle that "the test must depend on the constitution of the company,"[47] Mr. Justice Pinard observed, "[t]he case at bar does not involve any sophisticated class of shares *or instruments binding on shareholders and/or directors alike* which must be considered in assessing control [emphasis added]."[48] At the same time, the court's obiter comments on the issue of external agreements again fail to provide any clear guidance as to exactly what criteria an agreement must satisfy before it will provide the situs for de jure control. Mr. Justice Pinard described the *Duha* decision in these terms:

> [I]t appears that the overriding consideration for the Federal Court of Appeal was the corporate structure of the impugned companies and the legal rights which flowed therefrom and the existence of binding agreements which gave the shareholders clear and unequivocal rights in law: . . . . Any binding instrument, therefore, must be reckoned in the analysis if it affects voting rights.[49]

We are still left with at least the following questions:

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[43] [1996] 3 CTC 346 (FCTD).

[44] Counsel for the minister argued that the Cohen group controlled the defendant by reason of (1) the possibility of a deadlock at the shareholders' level in electing the directors, and the doctrine of "holding over"; (2) the right of the board of directors to issue the unallotted common shares to the Cohen group, in order to break any deadlock; (3) the right of the board of directors to redeem the preferred shares; and (4) the right to apply for a judicial windup. These grounds were rejected on the basis that in fact the directors had no such right since they were prohibited by law from acting for one group of shareholders only, or that any of these events was a question of fact and not of right.

[45] Supra footnote 43, at 352.

[46] Ibid.

[47] Ibid., at 353.

[48] Ibid., at 354.

[49] Ibid., at 353.

• Exactly which parties must the agreement bind?

• If the agreement is not "on par with articles of association," where does its status lie?

• Must the agreement meet all requirements of the relevant corporations statute for a "unanimous shareholder agreement"?

De Facto Control

It is clear from the preceding discussion that the courts struggled for some time with the need to give legal recognition to the concept of "control in fact." Subsection 256(5.1) now legislates, for the purposes of the Act, a definition of de facto control. Pursuant to this provision, which now applies wherever the words "controlled directly or indirectly or in any manner whatever" are used in the Act, de facto control will exist where "the controller has any direct or indirect influence that, if exercised, would result in control in fact of the corporation." The intent of the provision, as stated by the Department of Finance, was

> that corporations will be associated when control can be exercised in any manner whatever, including circumstances where control in fact exists by reason of a person having any direct or indirect influence.[50]

So far, we have seen only one judicial application of subsection 256(5.1), in the case of *Société Foncière D'Investissement Inc. v. The Queen*,[51] which is discussed below. Before *Société Foncière*, however, the Tax Court of Canada took the opportunity to discuss the effect of the introduction of subsection 256(5.1). In *HSC Research Development Corp. v. The Queen*,[52] the issue of control arose in the context of HSC, a charitable corporation without share capital, which sought refunds of investment tax credits claimed in 1986, 1987, and 1988. The minister disallowed 60 percent of the claim on the basis that HSC was an "excluded corporation," defined by subsection 127.1(2) as a corporation "controlled directly or indirectly, in any manner whatever," by a person exempt from part I tax. Although the result in the case appears to have narrow application, the court gave some interesting answers regarding statutory interpretation, which might have some broader significance.

First, the court dealt with the question whether the courts had in any way distinguished between contexts, such as the association rules pre-1989, in which the Act used simply the word "controlled" and those in which the statutory language was "controlled directly or indirectly, in any manner whatever" (as in the definitions of "Canadian-controlled private corporation" in paragraph 125(6)(a) and "excluded corporation" in subsection 127.1(2)). Judge O'Connor concluded that "[d]ecisions of the

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50 Canada, Department of Finance, *Explanatory Notes to Legislation Relating to Income Tax* (technical notes to Bill C-139) (Ottawa: the department, June 1988), subclause 193(1).

51 [1996] 3 CTC 2537 (TCC).

52 [1995] 1 CTC 2283 (TCC).

courts . . . interpreting provisions of the Act containing such words have interpreted them in an identical manner, that is, by applying the concept of *de jure* control."[53]

Second, in rejecting the argument that subsection 256(5.1) represented simply a statutory clarification of the fact that the jurisprudence had moved away from legal control to factual control, the court in *HSC* stated:

> The conclusion that the enactment of subsection 256(5.1) effected a change in the law is also supported by the wording of the provision and its effective date. Unlike a number of provisions in the Act . . . which begin with the words "for greater certainty," subsection 256(5.1) begins with the words "for the purposes of this Act" . . . the expression "controlled, directly or indirectly in any manner whatever shall be considered. . . ." If the drafters intended to merely clarify the meaning of the phrase "controlled directly or indirectly in any manner whatever," they could have done so with clear wording. The fact that they did not is indicative of the fact that subsection 256(5.1) introduced a new concept of control.[54]

The case of *Société Foncière*, the first to apply subsection 256(5.1), provided an early and very clear indication of the breadth of the provision by finding control in fact in the hands of Paul Allain, a shareholder with 0.2 percent of the voting rights. The balance of the shares was split equally between his two adult daughters, who also served on the corporation's four-member board of directors (their father was not a director). Under resolutions adopted by the board of directors, Allain had "complete authority to manage all aspects of the corporation's commercial and financial dealings." Although the court acknowledged that the other shareholders continued to hold the power to divest him of this authority, it felt compelled to arrive at its result by the wording of the statute:

> It is hard to imagine words with a broader meaning.
>
> Apparently, the Parliament of Canada feared that the words "directly or indirectly in any manner whatever" did not go far enough. It therefore tried to reinforce their effect by means of paragraph [sic] 256(5.1).[55]

The reaction of the tax community to the introduction of the de facto control test was reflected in the submission of the CBA-CICA joint committee on taxation, which stated:

> The concept of a person having "any direct or indirect influence that, if exercised, would result in control of the corporation" is too far reaching. Even with the specific exceptions, the definition in subsection 256(5.1) is far too broad and not capable of a reasonably predictable result. This type of drafting is a major source of complexity and frustration for the tax administration and taxpayer and clearly requires modification.

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53 Ibid., at 2290.

54 Ibid., at 2296.

55 Supra footnote 51, at 2542.

> Thousands of taxpayers must deal with the very subjective test in subsection 256(5.1), forcing them to incur the cost and inconvenience of professional advice which will still leave this issue unclear for many of them.[56]

One commentator expressed his opinion on the inclusion of this provision as follows:

> Of all of the Budget changes, the introduction of the "undue influence" rules is, perhaps, the most bitter pill to swallow because of the tremendous amount of uncertainty which it is bound to create.[57]

The level of uncertainty in the tax-planning community has been somewhat reduced by Revenue Canada's publication of the general factors it finds indicative of de facto control.

> (a) the percentage of ownership of voting shares (when such ownership is not more than 50 percent) in relation to the holdings of other shareholders;
>
> (b) ownership of a large debt of a corporation which may become payable on demand (unless exempted by subsection 256(3) or (6)) or a substantial investment in retractable preferred shares;
>
> (c) shareholder agreements including the holding of casting vote [Revenue Canada has confirmed that neither the enactment of subsections 256(5.1) and (1.4) nor the amendments to paragraph 251(5)(b) will change its administrative position on shareholder agreements commonly known as "rights of first refusal" and "shotgun clauses"];
>
> (d) commercial or contractual relationships of the corporation, for example, economic dependence on a single supplier or customer;
>
> (e) possession of a unique expertise that is required to operate the business; and
>
> (f) the influence that a family member, who is a shareholder, creditor, supplier, etc., of a corporation, may have over another family member who is a shareholder of the corporation.[58]

Deemed Control

Although the 1988 amendments to the associated corporation rules were, for the most part, condemned by the tax community for adding complexity and uncertainty to the structuring of corporate groups, certain aspects of the problem were in fact simplified. For example, the combined effect of paragraphs 256(1.2)(a) and (b), dealing with control by the same group of persons, works to simplify the search for the controlling group in situations where several groups of persons may have legal control.

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[56] Joint Committee on Taxation of the Canadian Bar Association and the Canadian Institute of Chartered Accountants, *Tax Reform Cleanup: An Identification of Significant Deficiencies in Phase One of the Government's Tax Reform* (Toronto: the joint committee, March 1989), 33.

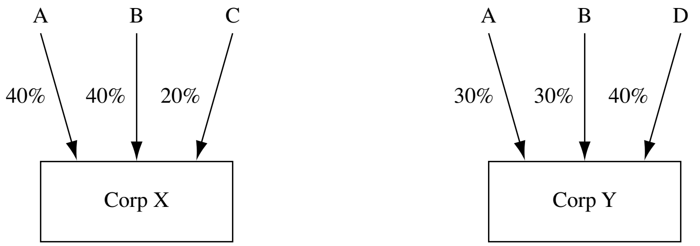
[57] Perry Truster, "Associated Corporations—II," in *1988 Ontario Tax Conference* (Toronto: Canadian Tax Foundation, 1988), tab 5, 13.

[58] *Interpretation Bulletin* IT-64R3, "Corporations: Association and Control—After 1988," March 9, 1992, paragraph 19.

In *Quincaillerie Brassard Inc. et al. v. MNR*,[59] the court was asked to determine the "controller" group from a number of possible combinations. The appellants had been denied the small business deduction for the 1980 through 1982 taxation years on the grounds that they were controlled by the same group of persons that controlled a third corporation, which had reached its $1 million cumulative deduction account. The case provides a good illustration of the ambiguities faced by the courts under the pre-1989 rules relating to control by a "group of persons."

In *Quincaillerie*, the court had to decide whether the six-member group of persons that could have legal control was the group of persons that had de facto control. Judge Tremblay held that "where several groups could possibly have legal control, the one which has *de facto* control must be chosen."[60] He went on to select as the group of persons having de facto control "the one which sets company policy that must be implemented by the board of directors."[61] He then cited the traditional common law criteria for identifying de facto control by a group over a corporation as "the presence of a common set of interests, objectives and existing relationships between a number of shareholders that could constitute a majority group."[62]

For taxation years since 1989, the courts need no longer search for "a common set of interests" among shareholders. In stark contrast to the vagueness of the de facto influence test, the deemed control provisions could be said to have reduced the uncertainty in tax planning and compliance. Paragraph 256(1.2)(a) now provides a statutory definition for what has long been a grey area in the case law, the concept of "group of persons"; paragraph 256(1.2)(b) provides for numerous controllers of the same corporation at the same time. Both provisions apply solely for the purpose of the associated corporation rules in subsection 256(1). Consider the following simple example.



A, B, C, and D are not related, and the percentages indicated represent full voting shares.

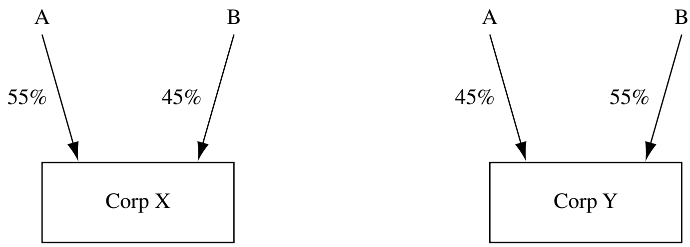
[59] 91 DTC 559 (TCC).

[60] Ibid., at 564.

[61] Ibid.

[62] Ibid.

In determining whether corps X and Y are associated, it is no longer necessary to choose from the possible combinations of controlling groups the group that in fact controls each corporation. Identification of common shareholders with shareholdings above the requisite 50 percent in both corporations is now the primary test to associate these corporations under paragraph 256(1)(b). Although for the purpose of the associated corporation rules, the concept of "group of persons" is now codified and the requirement to identify *the* controlling group is relaxed, the two issues still remain for the purpose of the test of relationship in subsection 251(2). In this area, the tax practitioner must continue to deal with a nebulous concept where "there is a surprising lack of judicial authority as to [its] precise meaning."[63] Consider this example.



Mr. A and Mr. B are not related, and the percentages indicated represent full voting shares.

For the purposes of the associated corporation rules, Mr. A and Mr. B are a group of persons that controls corps X and Y. At the same time, Mr. A alone controls corp X and Mr. B alone controls corp Y. However, for the purposes of determining whether the two corporations are related, Mr. A is the sole controller of corp X and Mr. B is the sole controller of corp Y. This result arises from the fact that the concept of "control by a person or group of persons," as found in two provisions,[64] is applied differently because one is defined by statute and the other by the courts. Corps X and Y are associated because they are both controlled by the same group of persons as required by paragraph 256(1.2)(b); however, they are not related pursuant to *Southside Car Market Ltd. et al. v. MNR*,[65] because corp X is controlled by Mr. A and corp Y is controlled by Mr. B. The court in *Southside* held that corp X and corp Y were not associated owing to the fact "that a group of persons cannot be said to control a corporation when, in fact, it is controlled by a single person."[66]

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[63] Howard J. Kellough and Peter E. McQuillan, *Taxation of Private Corporations and Their Shareholders*, 2d ed., Canadian Tax Paper no. 95 (Toronto: Canadian Tax Foundation, 1992), 6:34.

[64] For the purpose of association, paragraph 256(1)(b) applies; for related persons, subparagraph 251(2)(c)(i) applies.

[65] 82 DTC 6179 (FCTD).

[66] Ibid., at 6187.

At the same time, the provisions introduced a new dimension to control, that of "fair market value control." Paragraph 256(1.2)(c) is a significant departure from the concept of control as being linked to the voting rights of shareholders. It introduces a "values test" in determining when control will be deemed to exist.[67] In determining the fair market values, all outstanding and issued shares are deemed to be non-voting.[68] The "values test" is also modified by subsection 256(1.6), whereby "term preferred shares"[69] and shares of a "specified class"[70] are deemed not to be issued and outstanding. Furthermore, this rule provides that the greater of the paid-up capital and the redemption value of these shares be treated as a liability when determining the fair market value of the remaining issued and outstanding shares (for example, for the purposes of paragraphs 256(1.2)(c) and (d)).

The CBA-CICA joint committee on taxation viewed the "values test" as problematic. The committee believed that

> the valuation problems raised by the use of the fair market value concept in subsection 256(1.2) will be significant and will result in undesirable compliance costs for both the taxpayer and the tax administration.[71]

The following example illustrates the operation of the deemed control rules, in particular, paragraphs 256(1.2)(a), (b), (c), and (g) and subsection 256(1.6).

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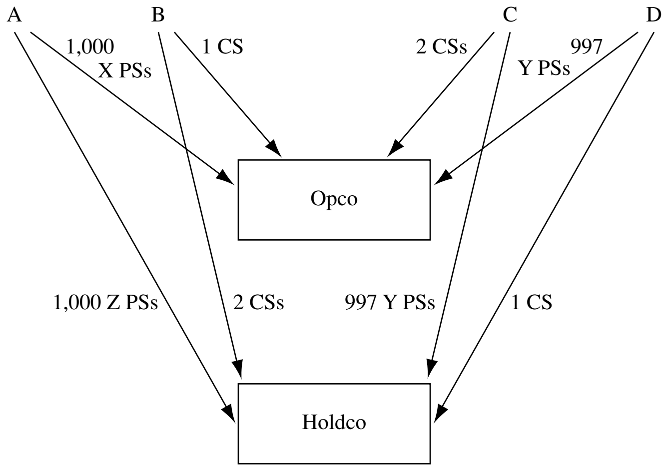
[67] In particular, this provision deems a corporation, a person, or a group of persons to control a corporation if the former corporation, person, or group owns more than 50 percent of the fair market value of all issued and outstanding shares (subparagraph 256(1.2)(c)(i)), or owns more than 50 percent of the fair market value of the common shares (subparagraph 256(1.2)(c)(ii)).

[68] Paragraph 256(1.2)(g). This deeming provision removes the difficulty in determining the value attached to minority interest discounts and voting premiums. The Department of Finance gave the following reason for including this provision: "Particularly in the case of closely held private corporations, assigning a value to such voting rights could be very difficult and result in inappropriate consequences": technical notes to Bill C-139, supra footnote 50, at subclause 193(1).

[69] Shares of a corporation in financial difficulty as defined in subsection 248(1).

[70] Subsection 256(1.1) defines "specified class." The most common type of a "specified class" of shares would be fixed-rate, fixed-amount, non-voting preferred shares issued in an estate freeze.

[71] Supra footnote 56, at 23. The committee's concern is illustrated by the following example. Assume that a father had transferred assets to a corporation in which his adult children were the common shareholders and as consideration received typical "high-low" preferred shares. If the value of the common shares fluctuated in value such that in some years they were 45 percent and in other years 55 percent of the total value of the company, then in one year but not others the father would be seen to control the corporation. That corporation could then be associated with other corporations controlled by him and not necessarily on a consistent basis.



A, B, C, and D are not related. CSs are common shares, and PSs are preferred shares. The CSs are all voting shares and have a fair market value (FMV) of $1 per share. The class X PSs are voting shares and have an FMV of $10 per share. The class Y PSs are voting shares and have an FMV of $1 per share. The class Z PSs are non-voting shares and have an FMV of $50 per share.

Analysis of the control of Opco

A owns greater than 50 percent of the FMV of all issued and outstanding shares; therefore, subparagraph 256(1.2)(c)(i) deems A to control Opco. C owns greater than 50 percent of the FMV of the CSs; therefore, subparagraph 256(1.2)(c)(ii) deems C also to control Opco. A, as a person, and C, as a person, can both control Opco at the same time by virtue of subparagraph 256(1.2)(b)(ii). Also A, with any combination of B, C, and D, can be a "group of persons," pursuant to paragraph 256(1.2)(a), that can control Opco by having greater than 50 percent of the voting shares; that is, the group has de jure control.

Analysis of the control of Holdco

A's PSs are of a "specified class"; therefore, pursuant to subsection 256(1.6), they are considered not to be issued and outstanding and the FMV, being the redemption amount of $50,000, is treated as a liability. The FMV of Holdco, then, is $1,000. As a result, B owns greater than 50 percent of the FMV of the CSs; therefore, subparagraph 256(1.2)(c)(ii) deems B to control Holdco. At the same time, C owns greater than 50 percent of the FMV of all issued and outstanding shares; therefore, subparagraph 256(1.2)(c)(i) deems C also to control Holdco.

Conclusion

Opco and Holdco are associated because C controls both.

THE CONCEPT OF SHARE OWNERSHIP

Subsection 256(1.2): The "Lookthrough" Rules

Share ownership for the purpose of associated corporations under paragraphs 256(1)(c), (d), and (e) includes both actual and constructive ownership. Three of the rules that provide a "lookthrough" rule for share ownership are contained within subsection 256(1.2). They are paragraph (d) dealing with corporations, paragraph (e) dealing with partnerships, and paragraph (f) dealing with trusts. Essentially, these paragraphs, which apply for all of the tests of association in subsection 256(1), operate to deem the person(s) having an interest in these types of intermediaries to own any shares of a corporation held by that intermediary.

Paragraph 256(1.2)(d) operates to deem shares of a corporation owned or deemed to be owned by a holding corporation, Holdco, to be owned by the shareholders of Holdco, on the basis of their fair market value percentage[72] interest in Holdco.[73] Similarly, paragraph 256(1.2)(e) provides that shares[74] held by a partnership will be deemed to be owned by each partner on the basis of his or her share of the partnership income or loss for the period under review.[75]

Paragraph 256(1.2)(f) generally provides that beneficiaries of a trust are deemed to own the shares of any corporation held by that trust. In one case, the shares are deemed to be owned by the person that transferred them to the trust. The method of attributing the shares so held depends on the type of trust used as the intermediary and is set forth in subparagraphs (i) through (iv).

Subparagraph 256(1.2)(f)(i) deems ownership of the shares held by a testamentary discretionary trust or a testamentary non-discretionary trust. Simply put, where the trust is discretionary, each beneficiary is deemed to own the shares held by the trust.[76] Where the trust is non-discretionary, the beneficiaries are deemed to own the shares held by the trust in proportion to their fair market value interest in the trust.[77]

Subparagraph 256(1.2)(f)(ii) deems ownership of shares held by an inter vivos discretionary trust, and subparagraph 256(1.2)(f)(iii) attributes the shares of an inter vivos non-discretionary trust. Each of the beneficiaries of the former is deemed to own the shares held by the trust; each of the beneficiaries of the latter is deemed to own a portion of the shares held by the trust based on the fair market value of each beneficial interest therein.

[72] In determining the fair market value percentage for a shareholder, paragraph 256(1.2)(g) and subsection 256(1.6) apply.

[73] This provision overrides the Supreme Court of Canada's decision in *Army and Navy Dept. Stores v. MNR*, 53 DTC 1185, for the purposes of section 256 only.

[74] Shares of a "specified class" and "term preferred shares" are excluded pursuant to subsection 256(1.6).

[75] Where the partnership income is nil for the period under review, it will be deemed to have been $1 million so that deemed share ownership can be applied.

[76] Clause 256(1.2)(f)(i)(A).

[77] Clause 256(1.2)(f)(i)(B).

Subparagraph 256(1.2)(f)(iv) deems ownership of the shares held by a reversionary trust as determined under subsection 75(2). The person from whom the shares were received shall be deemed to own those shares.

Subsection 256(1.3): The "Young Entrepreneur" Rule

Subsection 256(1.3) is a general rule whereby shares of a corporation that are owned by a minor child[78] of the parent are deemed to be owned by the parent. The application of this seemingly simple provision may be problematic because of the exception to the rule provided by the phrase "without a significant degree of influence by the parent" contained therein. There is little guidance as to the actual test that must be applied in order to meet the exception to parental share ownership as provided by the above phrase, which has become known as the "young entrepreneur" rule.[79] The position of the Department of Finance is that determining the degree of parental influence is not "particularly onerous or complex. Since the exception is targeted to entrepreneurship, we . . . suggest that a test based on the business affairs of the corporation is . . . appropriate."[80]

Another area that may cause difficulty in the application of subsection 256(1.3) is the deemed parental ownership of shares deemed to be owned by the minor. The question is whether shares that are deemed to be owned by the minor pursuant to the other lookthrough rules—paragraphs 256(1.2)(d), (e), and (f)—can be deemed to be owned by the parent. This question arises because subsection 256(1.3) includes only the word "owned," whereas the other lookthrough rules, which were introduced at the same time, include the phrase "owned, or deemed . . . to be owned."

The CBA-CICA joint committee on taxation had reservations on this point at the time subsection 256(1.3) was introduced and asked the Department of Finance to clarify whether or not it was its intent to attribute shares that were deemed to be owned by the minor.[81] It appears that neither the Department of Finance nor Revenue Canada views the absence of the phrase "or deemed to be owned" in subsection 256(1.3) as problematic when coupling it with the other ownership rules contained in subsection 256(1.2).[82] On two occasions, Revenue Canada has published

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[78] A minor child is one who has not attained the age of 18 years in the fiscal periods of the corporations under review. Note the extended definition of "child" in subsection 252(1).

[79] Both the explanatory notes that accompanied the budget proposing subsection 256(1.3) (Budget Papers, supra footnote 13, at 55-61) and the technical notes to Bill C-139, supra footnote 50, enacting the provision, were silent on the test to be applied in order to "fall out" of its grasp.

[80] Kellough and McQuillan, supra footnote 63, at 6:51, quote this statement as part of the response by the Department of Finance to a query by the CBA-CICA joint committee on taxation regarding the test required to meet the "young entrepreneur" rule.

[81] Supra footnote 56, at 24.

[82] The Department of Finance amended subsection 256(1.3) (Bill C-18; given royal assent December 17, 1991; SC 1991, c. 49) to remove deemed ownership of shares by a group of persons of which the parent was a member. It did not, at that time or subsequently, consider it necessary to clarify this question.

its views on this issue in response to taxpayer queries.[83] In both cases, which dealt with scenarios wherein shares in a corporation were held by trusts whose beneficiaries included minor children, Revenue Canada took the position that the shares owned by the trust were first attributed to the children (paragraph 256(1.2)(1)(f)) and then again attributed from the children to the parent (subsection 256(1.3)). When asked directly whether this result was the one intended, Revenue Canada responded:

> We agree that the provisions of paragraph 256(1.2)(f) and subsection 256(1.3) will apply to deem the two corporations described in the hypothetical situation outlined in your letter to be associated with each other. We are, however, unable to conclude that this is an unintended result. On the contrary it appears that it was the intention of Parliament, as explicitly expressed in the provisions of paragraph 256(1.2)(f) and subsections 256(1) and 256(1.3) of the Act, that if the conditions of those provisions are met such corporations shall be deemed to be associated for the purposes of the Act.[84]

Subsection 256(1.4): The "Options and Rights" Rule

Subsection 256(1.4) is the last provision that deems share ownership under the associated corporation rules. Paragraph 256(1.4)(a) provides that, where a person or group of persons has a right to acquire shares or to control the voting rights of shares, that person or group of persons is deemed to own the shares. Further, if the shares to which the right refers are not issued (as is the case for employee stock options), they will be deemed to be issued and outstanding. An exception to the above is provided where the right is not exercisable until the death, bankruptcy, or permanent disability of the individual from whom the right was received. These exceptions accommodate inter vivos buy-sell arrangements as well as survivorship agreements.

A further exception to the "options and rights" rule is provided by administrative practice. Revenue Canada will not invoke this provision unless there is a right or obligation to buy or sell, thus excluding rights of first refusal and shotgun arrangements.[85]

Paragraph 256(1.4)(b) provides that, subject to the same exceptions found in paragraph 256(1.4)(a), where a person has the right at any time to cause a corporation to redeem, acquire, or cancel any shares of its capital stock owned by other shareholders of the corporation,[86] that person

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[83] See Revenue Canada document no. 9219885, August 21, 1992, and document no. 9328745, March 4, 1994.

[84] Revenue Canada document no. 9219885, supra footnote 83.

[85] IT-64R3, supra footnote 58, at paragraph 37.

[86] Where the "right" referred to in this provision is not part of a shareholders' agreement, Revenue Canada may have difficulty in applying it. The authority to redeem, acquire, or cancel shares normally resides with the board of directors. Invocation of this provision implies that the individual can control the voting behaviour of the board, and it appears that this would be de facto control as envisioned under subsection 256(1.5). Kellough and McQuillan, supra footnote 63, at 6:54-55.

shall be deemed at that time to have had the same position in relation to control of the corporation and ownership of shares of its capital stock as if the shares were redeemed, acquired, or cancelled by the corporation.

DEEMED ASSOCIATION

Where it is still possible to structure corporate groups so as to avoid the expanded technical rules, the tax practitioner formulating such a structure must consider the possibility that the corporations within that group may be *deemed* to be associated under the anti-avoidance provision now contained in subsection 256(2.1). Subsection 256(2.1) provides that, where one of the main purposes for the separate existence of the corporations is to reduce the tax otherwise payable, the corporations will be deemed to be associated with each other in the taxation year. The provision, for all intents and purposes a continuation of its predecessor, subsection 247(2),[87] operates in the following manner. Revenue Canada infers, from an analysis of the facts of the particular case, that a main reason for the separate existence of two or more corporations is to reduce the tax otherwise payable. The onus of disproving this inference lies on the taxpayer. The taxpayer must prove that the tax reduction arising from the structure of the corporate group is merely incidental and not one of the main reasons for the structure. A practitioner asked to advise a client who has been reassessed under this provision must make it clear that it is the client as taxpayer who bears the onus of disproving Revenue Canada's inference.

Notice that the tax considerations need only play *a* main part in the corporate structure. To establish that tax reduction was not *the* primary motive will not suffice. The second obstacle facing the taxpayer preparing a defence is to predict what weight the courts will give to the specific facts of the case, and more important, what facts, if any, could be presented that might lead to a favourable judgment. The approach set out in *The Queen v. Covertite Limited* has been most frequently cited:

> To succeed, the taxpayer must: a) disprove the facts assumed by the Minister in reaching his conclusion; or b) convince the Court that the inferences drawn by the Minister from the facts assumed were unreasonable and unwarranted; or c) add further facts capable of changing the whole picture and leading to different inferences pointing to the conclusion that the other reasons alleged have actually been prevalent.[88]

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[87] The pre-1989 legislation required a ministerial direction for the deeming provision to apply. This requirement was eliminated, suggesting a resulting increase in use by Revenue Canada. In addition, there is no longer the negative test imposed on the taxpayer of establishing that the separate existence of the corporations is not solely for the purpose of carrying on the business in the most effective manner. This change simply codified a judicial interpretation (*Krag-Hansen et al. v. The Queen*, 86 DTC 6122 (FCA)) of former paragraph 247(2)(a). Neither of these changes was expected to alter the provision's thrust or the assessing actions of Revenue Canada.

[88] 81 DTC 5353, at 5355 (FCTD).

In an earlier article,[89] we reviewed all reported Canadian court cases dealing with the deemed association rules in an attempt to identify factors that recur in the courts' consideration. Although it is not possible to conclude what arguments will always be sufficiently compelling to an individual judge, our analysis pointed to three significant factors. If taxpayers can satisfy the court that

1) they were unaware of the tax advantages of non-association,

2) stated objectives (for example, estate planning or limitation of liability) were best achieved by the impugned corporate structure, and

3) the controlling shareholder of the original corporation did not continue to be the directing mind of the second corporation,

their chances for a successful challenge of a deemed association assessment will be significantly increased.

These results reflected the deemed association case law up to March 1991. A review of the cases reported in the seven years since the completion of our analysis does not indicate a change in the law or in the types of fact situations that attract litigation under subsection 256(2.1). The most recent decision of *Hughes Homes Inc. et al. v. The Queen*,[90] for example, considered two corporations; one was owned by husband and wife, Mr. and Mrs. Hughes, together, and the other was wholly owned by Mrs. Hughes. The corporations were held not to be associated. Tax Court Judge McArthur cited the same three recurring factors:

1) The taxpayers were unaware of resulting tax savings: "I find credible the Appellants' witnesses' statements that they were not aware of the rules of association under the Act and that Lopa was incorporated without any tax advice."[91]

2) The impugned corporate structure made sense given other stated objectives: "Lopa was incorporated so that Mrs. Hughes would be able to protect her endeavours from any business risks that exist for Hughes Homes or any risks resulting from Mr. Hughes' personal guarantees."[92]

3) The two corporations were not under a single directing mind: "[W]hile [Mrs. Hughes] operated a business that complemented her husband's activities, the scope of her activities were [sic] adequately separate and distinct."[93]

The combination of de jure, de facto, and deemed, as three dimensions of control whereby corporations may become associated, casts a wide and

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[89] Maureen Donnelly and Allister Young, "Deemed Association Cases: Probative Factors in a Predictive Model" (1992), vol. 40, no. 2 *Canadian Tax Journal* 363-83.

[90] 98 DTC 1082 (TCC).

[91] Ibid., at 1084.

[92] Ibid., at 1085.

[93] Ibid., at 1084.

perhaps overlapping net. For example, the reassessment of Société Foncière, discussed above, could as easily have been pursued as a typical scenario for deemed association in the absence of a codified test for de facto control.

It has also been suggested that the introduction of the general anti-avoidance rule (GAAR) made deemed association redundant. In response to that suggestion by the CBA-CICA joint committee on taxation, the Department of Finance predicted that "at some point in the future, after practitioners and Revenue Canada, Taxation have had a chance to gain some practical experience with the GAAR, subsection 256(2.1) could be targeted for repeal."[94] It appears that a decade of GAAR experience has not yet brought us to that point.

SUBSECTION 256(1): ASSOCIATED CORPORATIONS—THE TECHNICAL RULES

The five technical rules of associated corporations found within subsection 256(1) are dependent upon one or more of the concepts of relationship, control, and share ownership. These five technical rules can be reduced to the following two general rules:

1) corporations with common control are associated,[95] and

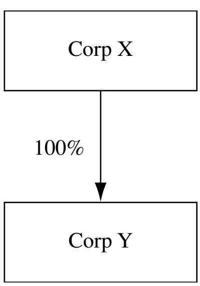
2) corporations with one or more related shareholders are associated if the related shareholder(s) own(s) at least 25 percent of each corporation.[96]

Examples of Application of the Technical Rules[97]

The preamble to subsection 256(1) states, "For the purposes of this Act, one corporation is associated with another in a taxation year if, at any time in the year."

The First General Rule

> **Paragraph 256(1)(a):** one of the corporations controlled, directly or indirectly in any manner whatever, the other.



[94] Supra footnote 63, at 6:71.

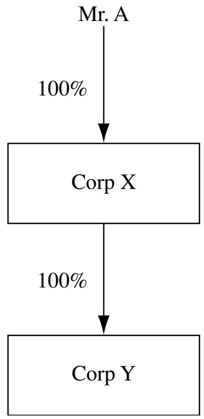
[95] Paragraphs 256(1)(a) and (b).

[96] Paragraphs 256(1)(c), (d), and (e).

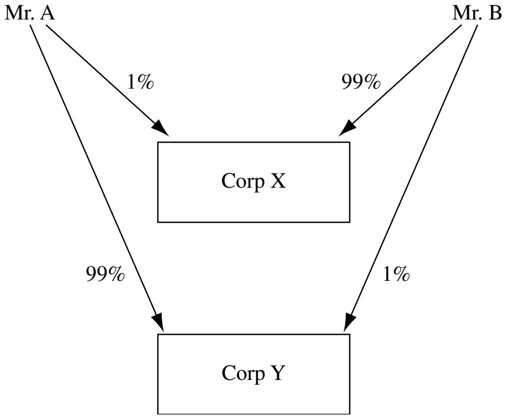
[97] Unless otherwise indicated, in the examples that follow, all shares are common shares of the same class.

Corp X controls corp Y; therefore, they are associated. Although ownership is shown as 100 percent of shares, all that is required is that corp X control corp Y on either a de jure or a de facto basis.

Paragraph 256(1)(b): both of the corporations were controlled, directly or indirectly in any manner whatever, by the same person or the same group of persons.



Mr. A controls corp X. At the same time, Mr. A also controls corp Y through his control of corp X.[98] Corp X and corp Y are controlled by the same person, Mr. A; therefore, they are associated.



Mr. B has de jure control of corp X; Mr. A has de jure control of corp Y. At the same time, Mr. A and Mr. B as a "group of persons" (paragraph 256(1.2)(a): two or more persons who own shares of the corporation) have deemed control pursuant to paragraph 256(1.2)(b), of corps X and Y. Corps X and Y are associated because they are controlled by the "same group of persons."

[98] *Vineland Quarries and Crushed Stone Ltd. v. MNR*, 67 DTC 5283 (SCC), established this concept of indirect control.

The Second General Rule

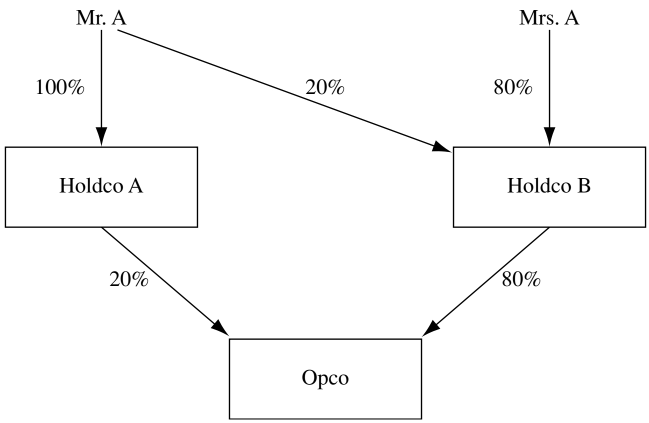
In order to determine association under paragraphs 256(1)(c), (d), and (e), the following three-step process is suggested:[99]

- Step 1: determine who controls (is/are the controller(s) of) each corporation, bearing in mind the concept of control for purposes of the associated corporation rules.

- Step 2: determine if the controller(s) has (have) at least 25 percent of the non-specified share ownership in each corporation.

- Step 3: determine the relationship, if any, of the person or group of persons that controls each corporation (the controller(s)).

> **Paragraph 256(1)(c):** each of the corporations was controlled, directly or indirectly, in any manner whatever, by a person and the person who so controlled one of the corporations was related to the person who so controlled the other, and either person owned, in respect of each corporation, not less than 25 percent of the issued shares of any class, other than a specified class, of the capital stock thereof.



Mr. A and Mrs. A are married.

Step 1: Controllers
Holdco A is controlled by Mr. A. Opco is controlled by Mrs. A, since she controls Holdco B, which controls Opco.

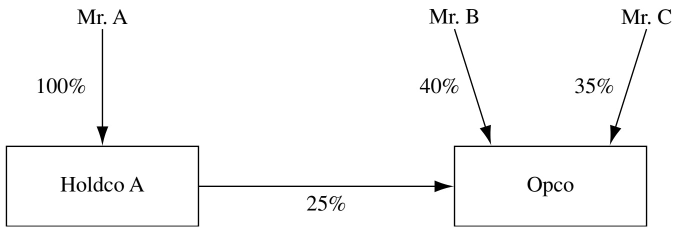
[99] A literal interpretation of these paragraphs suggests a four-step process: (1) identifying controllers, (2) determining relationships, (3) determining 25 percent cross-ownership, and (4) identifying a specified class of shares. The three-step process presented is a more efficient approach because it determines the requisite cross-ownership before the more difficult determination of relationships among the controllers. That is, the "indispensable element" required for these provisions to apply is the much easier share ownership. Furthermore, the fourth step of determining a specified class of shares is combined with the first step of the proposed three-step process. Given that "specified shares" will affect the determination of the controllers, they must be identified in step 1.

Step 2: At least 25 percent cross-ownership in each corporation
Mr. A owns 100 percent of Holdco A. Mr. A is deemed to own 36 percent of Opco, 20 percent through Holdco A and 16 percent (that is, 20 percent of 80 percent) through Holdco B pursuant to paragraph 256(1.2)(d). Mr. A therefore owns not less than 25 percent of the shares of any class in both corporations. Mrs. A is deemed to own 64 percent (that is, 80 percent of 80 percent) of Opco indirectly through Holdco B pursuant to paragraph 256(1.2)(d), the lookthrough provision.[100]

Step 3: Relationship of the controllers
Mr. and Mrs. A are related by marriage pursuant to paragraph 251(2)(a).

Conclusion:
Holdco A and Opco are associated by virtue of paragraph 256(1)(c).[101]

Paragraph 256(1)(d): one of the corporations was controlled, directly or indirectly in any manner whatever by a person and that person was related to each member of a group of persons that controlled the other corporation, and that person owned, in respect of each corporation, not less than 25 percent of the issued shares of any class, other than a specified class, of the capital stock thereof.



Mr. A and Mr. B are brothers; Mr. C is Mr. B's 21-year-old son.

Step 1: Controllers
Holdco A is controlled by Mr. A. Opco is controlled by several groups of persons including Mr. A and Mr. B. Pursuant to paragraph 256(1.2)(a), Mr. A and Mr. B are a "group of persons." Furthermore, pursuant to subparagraph 256(1.2)(b)(ii), Mr. A and Mr. B can be considered the "group of persons" that controls Opco notwithstanding that Opco can also be controlled by other groups of persons made up of Mr. A, Mr. B, and Mr. C.[102]

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100 Mrs. A would also be considered to control Opco through her control of Holdco B, pursuant to the decision in *Vineland*, supra footnote 98.

101 Whenever corporations are associated under paragraph 256(1)(c), they will also be associated under paragraph 256(1)(d); therefore, paragraph 256(1)(c) can be repealed (as long as paragraph 256(1)(d) is modified to reflect "a person" as well as "a group"). For example, Holdco A is controlled by one person, Mr. A, and Opco is controlled by the "group of persons," Mr. A and Mrs. A. Mr. A is deemed to own 20 percent of Opco through Holdco A and 16 percent of Opco through Holdco B. Mrs. A owns 64 percent of Opco through Holdco B; thus, the group of Mr. and Mrs. A owns 100 percent of Opco. Mr. A owns 100 percent of Holdco A and 36 percent of Opco. Mr. A is related to each member of the "group of persons" that controls Opco, to himself by subsection 256(1.5), and to Mrs. A by paragraph 251(2)(c). Holdco A and Opco also are associated pursuant to paragraph 256(1)(d).

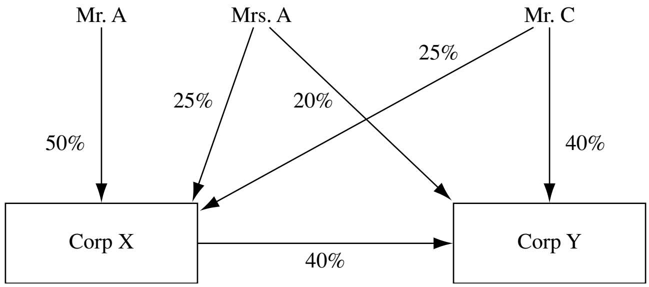
102 Other possible controlling "groups of persons" are (1) Mr. A and Mr. C; (2) Mr. B and Mr. C; (3) Holdco A, Mr. B, and Mr. C; and (4) Holdco A and Mr. C.

Step 2: At least 25 percent cross-ownership in each corporation
Mr. A owns 100 percent of Holdco A. Mr. A is deemed to own, through Holdco A, 25 percent of Opco pursuant to paragraph 256(1.2)(d).

Step 3: Relationship of the controllers
Since Mr. A and Mr. B are brothers, they are related by blood connection (as defined in paragraph 251(6)(a)) pursuant to paragraph 251(2)(a). Mr. A is related to himself pursuant to subsection 256(1.5). Mr. A is therefore related to each member of the group of persons, Mr. A and Mr. B, that controls Opco.

Conclusion:
Holdco A and Opco are associated by virtue of paragraph 256(1)(d).

Paragraph 256(1)(e): each of the corporations was controlled, directly or indirectly in any manner whatever, by a related group and each of the members of one of the related groups was related to all of the members of the other related groups, and one or more persons who were members of both related groups, either alone or together, owned, in respect of each corporation, not less than 25 percent of the issued shares of any class, other than a specified class of the capital stock thereof.



Mr. A and Mr. C are brothers, and Mrs. A is the wife of Mr. A.

Step 1: Controllers
Corps X and Y are each controlled by related groups. Corp X is controlled by the related group of Mr. A and Mrs. A. Corp Y is controlled by the related group of Mrs. A and Mr. C.

Step 2: At least 25 percent cross-ownership in each corporation
The related groups of both corporations own collectively not less than 25 percent of the shares of any class in both corporations.[103]

Step 3: Relationship of the controllers
Mr. and Mrs. A and Mr. C are related. Mr. and Mrs. A are related by marriage pursuant to paragraph 251(2)(a). Mr. A and Mr. C are related by blood connection (as defined in paragraph 251(6)(a)) pursuant to paragraph 251(2)(a). Mrs. A and Mr. C are related by blood connection (as defined in paragraph 251(6)(a) and the extended meaning of brother and sister found in paragraphs 252(2)(a) and (d)) pursuant to paragraph 251(2)(a). Mr. and Mrs. A and Mr. C are also related to themselves pursuant to subsection

[103] Mr. A is deemed to own 20 percent (that is, 50 percent of 40 percent) of the shares of corp Y through his 50 percent ownership of corp X pursuant to paragraph 256(1.2)(d).

256(1.5). Each member of the related group that controls corp X is related to all of the members of the related group that controls corp Y.

Conclusion:
Corps X and Y are associated pursuant to paragraph 256(1)(e).

SUBSECTION 256(2): THE "TRANSITIVITY" RULE

Subsection 256(2) provides that where two corporations that are not otherwise associated are each associated with a "third corporation" at the same time, they are deemed to be associated with each other.

Subsection 256(2) does not apply to deem two corporations to be associated where the third corporation is not a Canadian-controlled private corporation (CCPC) at that time[104] or where the third corporation is a CCPC and it elects in prescribed form on an annual basis not to be associated with both of the other two corporations. If the third corporation makes the election, it is precluded from claiming the small business deduction for the year in which the election is made.[105]

THE SAVING PROVISION

Subsections 256(3) through (6) provide that, where certain conditions are met, corporations that are otherwise associated shall be deemed not to be associated for the purposes of the Act. Generally, these provisions apply when the association is considered temporary or incidental.

Subsections 256(3) and (6) will disassociate corporations where the minister is satisfied that both of the following two conditions are met:

1) there is an enforceable agreement or arrangement whereby, upon the occurrence of an expected event, the controller will cease to have control and control will be acquired by a person or group of persons that is at arm's length with the controller; and

2) the purpose for which the corporation is controlled is to safeguard the rights or interests of the controller in respect of outstanding indebtedness or redeemable shares.

Subsection 256(4) applies when the controller is a trustee or executor of a trust and the minister is satisfied that

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[104] "Canadian-controlled private corporation" is defined in subsection 125(7). This exception codifies the decision in *Holiday Luggage Mfg. Co. Inc. v. The Queen*, 86 DTC 6601 (FCTD). In that case, the court ruled that two CCPCs were not associated with each other as a result of their each being associated with a US corporation at the same time.

[105] This result is accomplished by deeming its business limit to be nil. A separate election must be made each time two corporations wish to be disassociated. Revenue Canada has set out the appropriate procedures in response to numerous taxpayer queries. See, for example, Revenue Canada document numbers 9305985, November 5, 1993; 9238527, May 19, 1993; 9119985, January 20, 1992; 9127155, December 9, 1991; and ACC9579, June 26, 1990. In the opinion of Revenue Canada, this election applies only for the purposes of section 125 (see Revenue Canada document no. 9308765, June 16, 1993).

• the trustee or executor did not acquire control as a result of one or more trusts created either by the same individual or by individuals not dealing at arm's length, and

• the particular trust or estate arose on the death of the individual creating it.

Where a corporation controls another corporation only as a trustee, subsection 256(5) will deem them not to be associated with each other unless a settlor of the trust either controlled or was a member of a related group that controlled the corporation acting as the trustee.

A STEP-BY-STEP APPROACH

Although complex, the technical rules for associating corporations can be reduced to a logical, step-by-step approach. The decision-tree on the facing page is one example.[106]

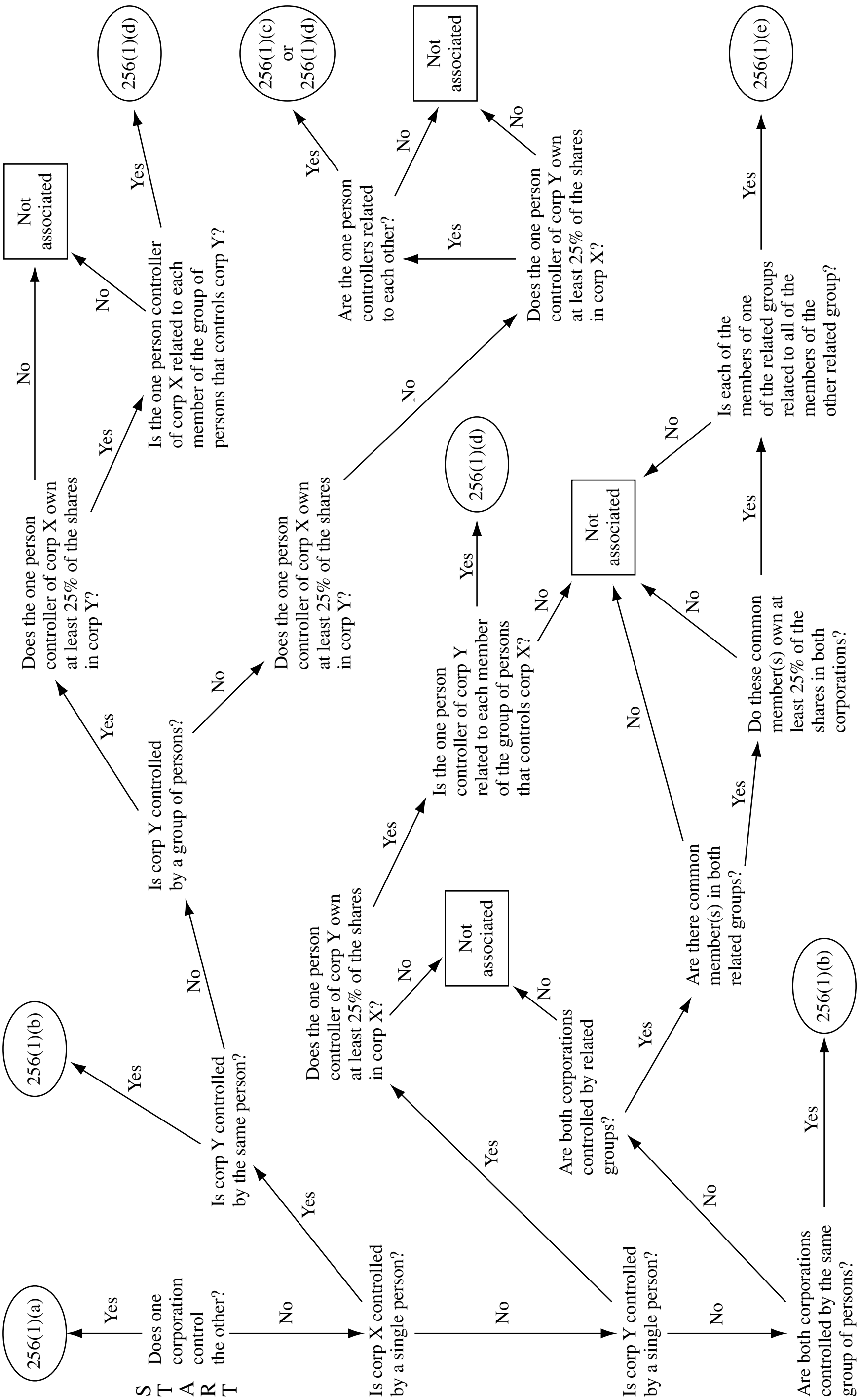
WHEN IS A GROUP NOT A GROUP? THE NEW CONCEPT OF AFFILIATION

On April 26, 1995, the Department of Finance released proposed amendments relating to the transfer of unrealized losses. The department cited the need for simplification as well as the curtailment of loss transfers among members of corporate groups.[107] Although these rules apply outside the corporate context,[108] this article will restrict its discussion to those provisions that deal with transfers between corporations. The general thrust of these anti-avoidance rules remains essentially the same—that is, to thwart the crystallization of specific types of losses until the property that gave rise to the loss leaves the corporate group. The most significant proposed changes relate to the circumstances in which, and for

[106] For a computerized example, see Maureen Donnelly and Allister Young, "The Tax Expert and the Expert System: A Demonstration Using the Associated-Corporation Rules," in *Report of Proceedings of the Forty-Seventh Tax Conference*, 1995 Conference Report (Toronto: Canadian Tax Foundation, 1996), 47:1-34.

[107] Canada, Department of Finance, "Backgrounder," accompanying Draft Amendments to the Income Tax Act, the Income Tax Application Rules, the Canada Pension Plan, the Children's Special Allowances Act, the Customs Act, the Old Age Security Act, the Unemployment Insurance Act and a Related Act, April 26, 1995. References to proposed provisions of the Act are to this draft legislation.

[108] For example, the amendments to the superficial loss rules provide a stop-loss rule for capital losses realized on a transfer by an individual to an affiliated person. For further discussion, see Edward A. Heakes, "New Rules, Old Chestnuts, and Emerging Jurisprudence: The Stop-Loss Rules," in the 1995 Conference Report, supra footnote 106, 34:1-22; Gregory T.W. Bowden, "The Impact of the Stop Loss Rules on Estates and Buy-Sell Agreements," in *1995 British Columbia Tax Conference* (Toronto: Canadian Tax Foundation, 1995), tab 2; and Lincoln K. Schreiner, "Corporate Stop Loss Rules—Some Changes," ibid., tab 3.


START
Does one corporation control the other?
Yes
256(1)(a)
No
Is corp X controlled by a single person?
Yes
Is corp Y controlled by the same person?
Yes
256(1)(b)
No
Is corp Y controlled by a group of persons?
Yes
Does the one person controller of corp X own at least 25% of the shares in corp Y?
No
Not associated
Yes
Is the one person controller of corp X related to each member of the group of persons that controls corp Y?
Yes
256(1)(d)
No
Not associated
No
Does the one person controller of corp X own at least 25% of the shares in corp Y?
No
Does the one person controller of corp Y own at least 25% of the shares in corp X?
No
Not associated
Yes
Are the one person controllers related to each other?
Yes
256(1)(c) or 256(1)(d)
No
Not associated
No
Is corp Y controlled by a single person?
Yes
Does the one person controller of corp Y own at least 25% of the shares in corp X?
No
Not associated
Yes
Is the one person controller of corp Y related to each member of the group of persons that controls corp X?
Yes
256(1)(d)
No
Not associated
No
Are both corporations controlled by the same group of persons?
Yes
256(1)(b)
No
Are both corporations controlled by related groups?
No
Not associated
Yes
Are there common member(s) in both related groups?
No
Not associated
Yes
Do these common member(s) own at least 25% of the shares in both corporations?
No
Not associated
Yes
Is each of the members of one of the related groups related to all of the members of the other related group?
No
Not associated
Yes
256(1)(e)

how long, losses are to be in tax limbo[109] within the corporate group and to the definition of the corporate group itself.

The proposed amendments to the stop-loss rules adding the term "affiliated person" bring a new dimension to the concept "corporate group." As was the case with the amendments to the associated corporation rules, this term as proposed will both broaden and at the same time narrow membership in corporate groups for specific purposes.

In the context of the stated goal of simplification, one commentator[110] suggests that the proposed amendments do manage to "harmonize" the stop-loss rules generally, because they now apply in all instances following transfers of "loss" properties among affiliated persons. On the other hand, the introduction of the term "affiliated persons" may in fact add to the complexity of planning and compliance as they relate to loss utilization within a corporate group.

The addition of the term "affiliated persons" to the dimension of the corporate group is symptomatic of the frustration encountered in the search for tax simplification. This frustration is increased when the same concept or term takes on different definitions depending on the situation to which it is being applied. The concept "corporate group" exists in several forms with several purposes: to ensure that members transact at fair market values ("related"), share the small business deduction ("associated"), and retain losses with the transferor ("affiliated"). Of the three terms defining corporate groups—related, associated, and affiliated—affiliated would, on the one hand, have the most restricted membership and, on the other hand, open membership to others excluded from the related and associated categories.

Affiliation Versus Association

Scope of the Relationship

The current stop-loss rules in subsections 85(4) and (5.1) apply generally when losses are realized on transfers by a person or partnership to a corporation where, immediately thereafter, the corporation is controlled by the taxpayer, by the taxpayer's spouse, or by the controller of the taxpayer. The definition of affiliated persons continues to restrict the application of the stop-loss rules to corporate groups as narrowly defined

[109] Losses on transfers of property by a corporation, trust, or partnership (the transferor) after April 26, 1995 to an affiliated person (the transferee) will remain with the transferor until the earliest of a number of triggering events. The loss is recognized generally at the earliest of the time the property leaves the affiliated group, the emigration of the transferor, the change in tax status of the transferor, the change of the transferred property from business use to some other use, the acquisition of control of a transferee corporation, and the winding up of the transferee corporation. Proposed paragraphs 13(21.2)(e) and 40(3.4)(b).

[110] Jerald Wortsman, "Changes to Stop-Loss Rules Intended To Eliminate Unacceptable Tax Avoidance" (1996), vol. 3, no. 3 *Corporate Structures and Groups* 148-56.

above, in that the only relationship that will affiliate two individuals continues to be the spousal relationship.[111] This is a very small subset of the relationships between individuals that will effect corporate association. Recall that paragraphs 256(1)(c), (d), and (e) will associate corporations whose controllers are in any way related for tax purposes.

Reliance on the Concept of Control

As is the case with "associated," the new notion of "affiliated" also relies on the concept of "control" when forming corporate groups. Furthermore, the de jure definition of control continues to be supplemented by the statutorily defined de facto control. The statutory definition of de facto control contained in subsection 256(5.1) applies to the current stop-loss rules because of the inclusion of the phrase "controlled directly or indirectly in any manner whatever" in both subsections 85(4) and (5.1). Proposed subsection 251.1(3) defines "controlled" as used in section 251.1 to include de facto control as defined in subsection 256(5.1).

Treatment of Group of Persons

Recall that the 1988 amendments to the associated corporation rules removed the uncertainty around the definition of "group of persons" by providing in paragraphs 256(1.2)(a) and (b) the statutory means for identifying the controlling group. Unfortunately, there is no equivalent provision in the new affiliated rules, so that the tax planner is left to the uncertainty of judicial interpretation on this point.

Drafting Style

The proposed rules for affiliation introduce a new drafting style when compared with the other statutory definitions ("associated" and "related") in the context of dealing with two corporations each of which is controlled by a different group. For example, in testing for association where two corporations are controlled by different groups, paragraph 256(1)(e) applies. The statutory language requires that the test be carried out in the following way: take *each* of the members of *either* of the groups and relate them to *all* of the members of the *other* group. In contrast, for the purposes of affiliation, the group control provision (subparagraph 251.1(1)(c)(iii)) provides for a reciprocal test: take *each* member of *each* group and affiliate with at least *one* member of the *other* group.

The situation involving two corporations, one with a lone controller and the other under group control, would fall under paragraph 256(1)(d) for the purposes of association. The provision requires the following approach: starting with the corporation with the lone controller, relate *that person* to *each member of the group* controlling the other corporation. When faced with the same scenario, the provision testing for

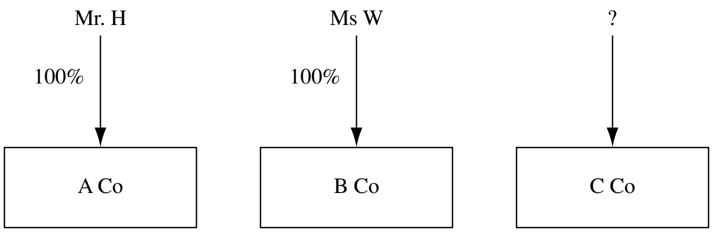
[111] Proposed paragraph 251.1(1)(a).

affiliation (subparagraph 251.1(1)(c)(ii)) requires that you start with the corporation subject to group control and affiliate *each member of the group* with *that person* who is the lone controller of the other corporation.

It remains to be seen whether these differences in form will produce any differences in substance.

Transitivity

In what may at first appear to be a significant departure from the approach taken when associating or relating corporations,[112] the proposed rules defining the relationship of affiliation do not include a transitivity rule. It is, however, unlikely that a transitivity provision would significantly increase the number of taxpayers caught in the affiliation net. Recall that affiliation between individuals is confined to the spousal relationship, and as a general rule, one is already related for tax purposes to all of those persons to whom one's spouse is related. Consider the following example using individuals as controllers.



Mr. H and Ms W are married.

A Co and B Co are affiliated under subparagraph 251.1(1)(c)(i). Consider the introduction of a third corporation, C Co. In order for C Co to be affiliated with A Co, for example, C Co would have to be controlled by Mr. H or by Ms W or by the group Mr. H and Ms W. Any of those scenarios would at the same time automatically affiliate C Co with B Co under either subparagraph 251.1(1)(c)(i) or (ii).

Providing for Deemed Ownership

In forming corporate groups for the purposes of affiliation, the proposed amendments do not provide for the deemed ownership of shares arising under options. In other words, there is no equivalent to subsection 256(1.4) or paragraph 251(5)(b), which include options and rights for the purposes

[112] Subsection 251(3) deems two corporations to be related to each other when they are both related, pursuant to subsection 251(2), to a third corporation at the same time. The major difference between subsections 251(3) and 256(2) (the transitivity rule for association) is that subsection 251(3) cannot be used more than once to string together related corporations. The ability to loop through the transitivity rule more than once for the purposes of association makes it possible to string together corporations that are not otherwise associated in order to form an associated group of companies.

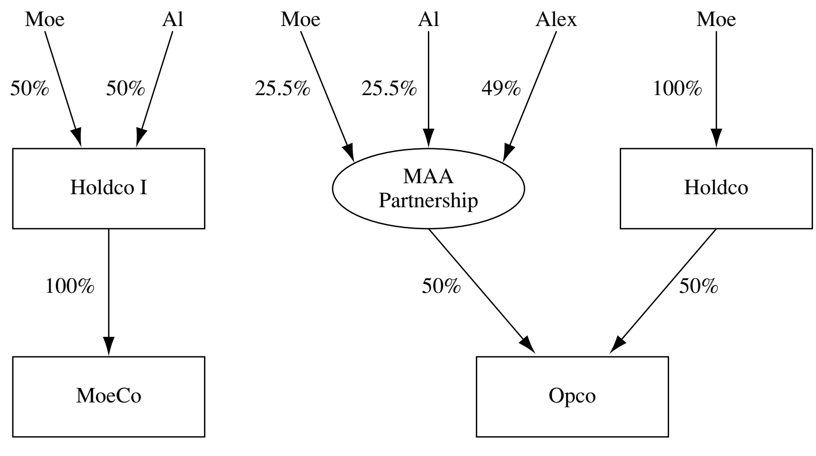
of "association" and "relatedness,"[113] respectively. The absence of such a provision narrows the scope of the affiliation net.

Partnerships as Persons

The affiliated rules have a significantly different approach to partnerships when compared with the rules for association, which treat the partnership as an intermediary or lookthrough vehicle. Proposed paragraphs 251.1(1)(e) and (f) deal specifically with affiliating partners with their partnerships and partnerships with each other. This suggests an intention to elevate the partnership to the same status as any other tax "person." It may be simply that affiliation tests take partnerships into account specifically as separate taxpayers because the stop-loss rules themselves apply equally to partnerships in the calculation of income at the partnership level under subsection 96(1); on the other hand, perhaps it is an attempt to make the taxpayer indifferent as between partnership and incorporation as a business form. On closer examination, however, it appears that the legislation is too narrowly focused to effect such a broad purpose. Consider, specifically, paragraph 251.1(1)(d), which affiliates a partnership with a corporation. It applies only when the corporation is controlled by a "group of persons" and therefore catches some partnership scenarios but not others. For example, an equal partnership of A and B would not be affiliated with a corporation wholly owned by A. The partnership would, however, be affiliated with a corporation 50 percent of whose shares were owned by each of A and B.

Affiliation Versus Association: An Example

Consider the following example where two holding companies and a partnership are used as intermediaries in the ownership of two operating companies.



[113] The constructive share ownership rules in paragraph 251(5)(b) are also applicable for the purposes of the definition of "Canadian-controlled private corporation" in subsection 125(7).

Moe and Al are married, and Alex is their daughter.

The ownership in the corporations is percentage of outstanding voting shares; the ownership given for the partnership is both current and windup income percentages.

Affiliation

Holdco I and MAA: paragraph 251.1(1)(d)
Holdco I is controlled by the group of persons Moe and Al. Moe and Al are a majority-interest group of partners of MAA. Moe and Al are affiliated with each other (paragraph 251.1(1)(a)) and also with themselves (paragraph 251.1(4)(a)).

Holdco I and Holdco: subparagraph 251.1(2)(c)(ii)
Holdco is controlled by one person, Moe, and Holdco I is controlled by the group of persons Moe and Al. Moe and Al are both affiliated with Moe (as above).

MoeCo and Opco: subparagraph 251.1(1)(c)(ii)

MoeCo is controlled by one person, Holdco I, and Opco is controlled by the group of persons Holdco and MAA. Holdco and MAA are both affiliated with Holdco I (as above).

Holdco I and MoeCo: subparagraph 251.1(1)(b)(i)
Holdco I controls MoeCo.

Holdco and MoeCo: subparagraph 251.1(1)(c)(i)
Holdco is controlled by one person, Moe, and MoeCo is controlled by one person, Holdco I. Moe, the controller of Holdco, is affiliated with Holdco I (subparagraph 251.1(1)(b)(ii)).

Opco and MAA: paragraph 251.1(1)(d)
Opco is controlled by the group of persons MAA and Holdco. MAA is controlled by the majority-interest group of persons Moe and Al. Each member of the group of persons is affiliated with at least one member of the majority-interest group of persons. MAA is affiliated with both Moe and Al (paragraph 251.1(1)(e)) because each is a "majority-interest partner" (subsection 248(1)). Holdco is affiliated with Moe (subparagraph 251.1(1)(b)(i)) and with Al (subparagraph 251.1(1)(b)(iii)). Each member of the majority-interest group of partners is affiliated with at least one member of the group of persons. Moe and Al are both affiliated with Holdco (as above).

MoeCo and MAA
MoeCo and MAA are not affiliated if Holdco I is the controller of MoeCo. However, if de jure control as determined in *Vineland*[114] is applied and Moe and Al are identified as the controllers of MoeCo, MAA and MoeCo are affiliated (paragraph 251.1(1)(d)). MoeCo is controlled by the group of persons Moe and Al, and Moe and Al are the majority-interest group of persons that control MAA. Moe and Al are affiliated (as above).

Holdco I and Opco: subparagraph 251.1(1)(c)(iii)
Opco is controlled by the group of persons MAA and Holdco, and Holdco I is controlled by the group of persons Moe and Al. MAA and Holdco are affiliated with both Moe and Al (as above).

[114] Supra footnote 98.

Holdco and Opco: subparagraph 251.1(2)(c)(ii)
Holdco is controlled by Moe, and Opco is controlled by the group of persons MAA and Holdco. Holdco is affiliated with Moe (subparagraph 251.1(1)(b)(i)), and MAA is affiliated with Moe (paragraph 251.1(1)(e)).

In the above example, MAA and Holdco are not affiliated with each other. This result can be attributed to the narrow definition under paragraph 251.1(1)(d) when a partnership is affiliated with a corporation.

If MAA Partnership were changed to MAAco, a corporation, all persons except Alex would be affiliated with each other. MAAco and Holdco would be affiliated with each other under subparagraph 251.1(1)(c)(ii).

Whether MAA is a partnership or a corporation, all persons (other than individuals) are associated with each other for tax purposes.