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COMMENT

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GREATER CERTAINTY WHEN ASSESSING "DE FACTO" CONTROL

The concept of control is used throughout the Income Tax Act and is an essential test that is used to determine if one corporation is associated with another. In very general terms, corporations are associated if one corporation controls another "directly or indirectly in any manner whatever" or there is common control of the corporations. Certain tax rules and restrictions apply to corporations that are associated. For example, associated corporations must share one small business deduction, which means that only $500,000 of active business income across the entire group of associated corporations is subject to the low tax rate.

There are two ways that control can exist – de jure control and de facto control. De jure control means control in law - holding sufficient shares and votes to elect the majority of the corporation (i.e., more than 50 per cent of the votes). De facto control looks at control in fact, such as the ability to influence the election of the board of directors. The notion of control can be complex, particularly with jurisprudence where the courts have provided new interpretations in grey areas.

A decision earlier this year by the Federal Court of Appeal in the case of McGillivray Restaurant Ltd. v. Canada has an interesting outcome with respect to the concept of de facto control worthy of review. The case first rose on appeal by the taxpayer, McGillivray Restaurant Ltd,(McGillivray) to the Tax Court of Canada (TCC) following a CRA assessment restricting the taxpayer's ability to claim the full small business deduction.

A brief overview of the facts before the TCC in a November 2014 decision is as follows:

- McGillivray was incorporated in 2005, based on professional advice.
- Gordon Howard was the first and only director, president and secretary of McGillivray throughout its existence.
- Ruth Howard, Gordon's long-time spouse, subscribed at nominal cost for 76 per cent of the common shares of McGillivray, while Gordon subscribed for the remaining 24 per cent. There was no shareholder agreement.
- McGillivray, with Ruth as the majority shareholder and Howard as a minority shareholder, was one of three Keg restaurants operating under a franchise arrangement in Winnipeg. Howard was the sole shareholder of two other corporations (GRR and MorCourt) that owned two other Keg restaurants. As well, he was operations director and general manager for all three restaurants.
- Gordon thought the 76 per cent ownership by Ruth resulted in the independence of McGillivray from the other corporations Gordon owned (GRR and MorCourt) and that Ruth's approval was not required for decision-making. There was agreement between Gordon and Ruth that she would not be involved in any aspect of the McGillivray business to the point documents were not signed at the advisor's office but, as the case suggests, more likely taken home for her to sign.

Ruth held 76 per cent of the shares so had de jure control of McGillivray by virtue of her shareholdings. However, the question remained as to whether Gordon had de facto control of McGillivray. In simple terms, the TCC considered the issue of whether the three Keg restaurants, which McGillivray was one of, were "controlled, directly or indirectly in any manner whatever, by the same person or group of persons?" The issue of control was in respect of the years 2007, 2008, and 2009. When looking at the concept of de facto control, the TCC's conclusion rested on the issue of "who had effective control of the affairs and fortunes of the corporation."

In this case, the TCC looked at the concept of de facto control as "economic controlling influence, control of day-to-day operations, controlling of the corporation's fortune's by making all decisions, economic influence to exert pressure and who signs all the cheques." Applying this criterion, the TCC concluded Ruth's involvement was negligible, while Gordon controlled all issues thereby resulting in Gordon having de facto control of McGillivray.

The taxpayer appealed the TCC's decision to the Federal Court of Appeal (FCA). In March 2016, the FCA reaffirmed the TCC's decision that Gordon did have de facto control of McGillivray but arrived at this conclusion for different reasons. The FCA disagreed with the TCC's analysis that the test for de facto control is based on operational control.

The FCA asserted that de facto control should be based on factors that help to determine "whether a person or group of persons has effective control, by means of an ability to elect the board of directors of a corporation." This should be limited to the ability to affect the board of directors or influence shareholders who have that right or ability. The FCA concluded that to incorporate operational control issues into the analysis would lead to subjectivity resulting in the potential for unpredictable results.

The FCA reaffirmed the TCC's interpretation that there was an "unwritten agreement" between Ruth and Gordon that allowed Gordon to act as the sole director of McGillivray. The FCA found that as long as Ruth permitted Gordon to continue in the role as sole board member, he retained sufficient influence as is contemplated in the issue of de facto control.

The outcome of this FCA decision is helpful to taxpayers as it provides a practical approach with a greater degree of certainty than in the recent past when analyzing the possible existence of de facto control in business situations. Control of business operations or day-to-day management is no longer a factor in the analysis of de facto control. The ability to affect a corporation's board of directors, or influence shareholders who have that right or ability, is the key consideration in the analysis of de facto control. It is important to keep in mind that there does not need to be a written agreement in order for de facto control to apply.

FINANCIAL LITERACY LEADS TO BETTER OUTCOMES

Financial literacy and retirement planning tend to go hand-in-hand; both subjects capture media headlines and are the focus of a great deal of government attention. Financial literacy refers to the set of skills and knowledge that allows individuals to make well-informed and effective decisions with respect to their financial resources, including earning, managing and investing money. Retirement planning is the process of preparing financially for the type of lifestyle individuals desire after their working years. This includes accumulating adequate savings during one's working years to afford a particular lifestyle and managing those funds during the accumulation and post-retirement phase. There is a growing sense that stronger financial literacy leads to better retirement planning.

In late June, federal Finance Minister Bill Morneau announced that he and his provincial counterparts had reached an agreement in principle to enhance the Canada Pension Plan (CPP), a significant element of Canada's public pension system. The phased-in design changes to the CPP include increasing the upper earnings limit to $82,700 by 2025 (currently $54,900), with the income replacement level increasing to one-third of income (currently one-quarter). To finance these objectives, employer and employee plan contributions will be subject to a series of increases over a seven year period beginning January 1, 2019.

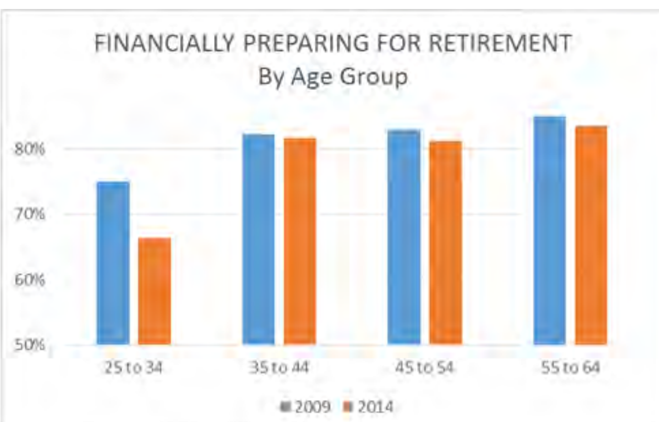
As plans are underway to strengthen the public portion of Canadian's retirement resources, Statistics Canada recently issued a new report that looks at how well Canadians are preparing for retirement along with perspectives on the relationship between financial literacy and retirement planning. The 2014 survey captured data from individuals, ages 25 to 65, within Canada's labour force – employed and unemployed. The report, released in March of this year, provides some interesting statistics based on four age bands: 25 to 34, 35 to 44, 45 to 54, and 55 to 64.

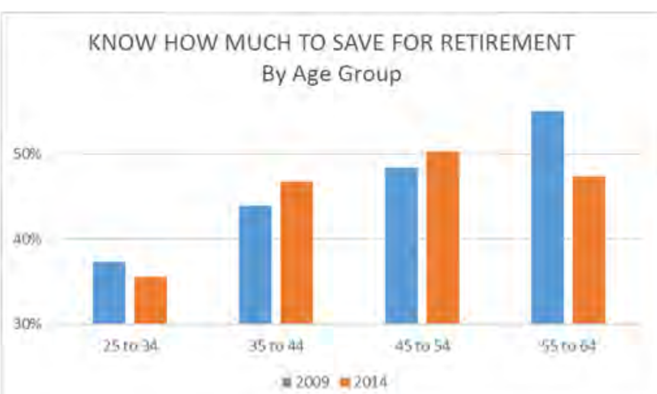
Seventy-eight per cent of those surveyed indicated they were preparing financially for retirement, although only 45 per cent indicated they knew how much they needed to save. Of particular interest is the group of individuals ages 55 to 64. Within this group there was a significant decline, from 56.8 per cent in 2009 to only 47.4 per cent in 2014, when asked if they knew how much to save to fund their retirement. Two of the other three age categories, 35 to 44 and 45 to 54, experienced slight increases, 2.8 and 1.9 per cent respectively, when asked if they knew how much to save, while ages 25 to 35 dropped slightly.

Looking at the youngest generation in the study, more than one-third of people ages 25 to 34 indicated they know how much to save but the number who are actually saving for retirement declined from 75 per cent in 2009 to 66.3 per cent in 2014.

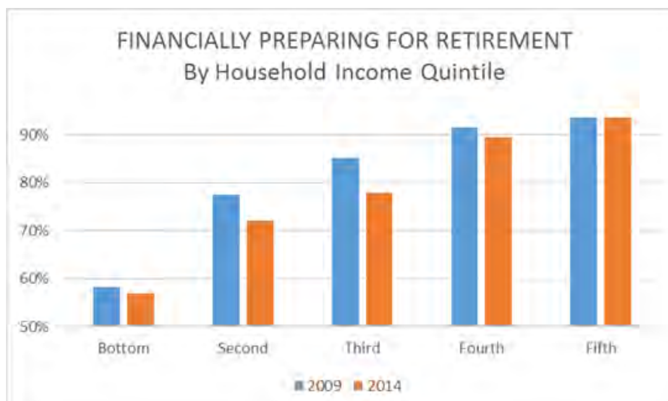
The survey also analyzed the results based on household income divided into five categories (quintiles). As would be expected, those with the highest household income were the most financially prepared for retirement and 62.5 per cent of the group indicated they knew how much to save. These numbers were quite consistent between the 2009 and 2014 surveys.

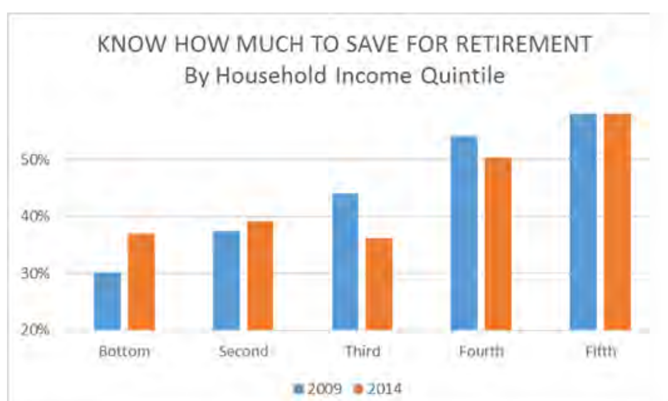
In general terms, there seems to be a slight drop across all households, except the top quintile, as to who is preparing financially for retirement. Household incomes in the third and fourth quintiles indicated less knowledge about how much to save when comparing the 2009 and 2014 results. No explanation for these variations is offered by the study, but theories could include a shift away from employment pension plans in general and, more specifically, the shift away from defined benefit pension plans that provide a pre-determined amount of retirement income.





Data source: Financial Literacy and Retirement Planning, Statistics Canada, March 23, 2016



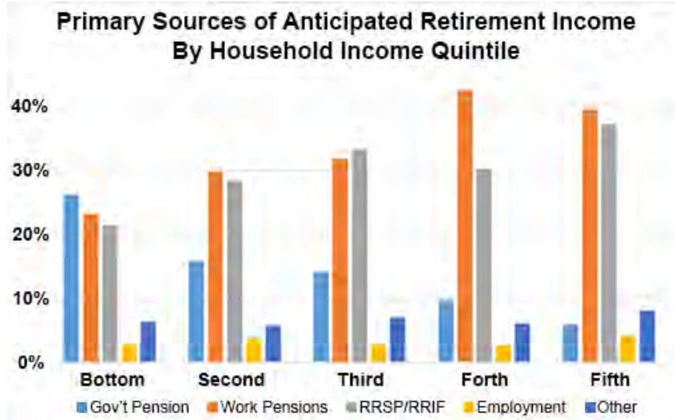


Data source: Financial Literacy and Retirement Planning, Statistics Canada, March 23, 2016

As is evident from the report, older, higher household income individuals are more likely to be preparing for retirement and are confident with their knowledge of how much to save. However, there appears to be a growing sense of uncertainty by the older, middle household income group with respect to how much is enough. This might be attributable to the fact that higher-income individuals are generally less reliant on public retirement programs, whereas the middle-income have a greater reliance and sense of uncertainty with respect to the reliability of public programs in the future.

The survey asked respondents what sources of income they were including in their retirement income planning:

- Over 90 per cent included government pensions (CPP, QPP, OAS) and RRSPs.
- Almost 70 per cent included workplace pensions.
- About 50 per cent indicated their plan included earnings from part-time work during retirement.
- About 30 per cent said they would have to sell something.
- Only about 20 per cent reported that they were including inheritance in their planning.



Data source: Financial Literacy and Retirement Planning, Statistics Canada, March 23, 2016

Planning is the key to achieving one's goals and objectives. Public programs such as the CPP are certainly components of many Canadian's retirement income plans. However, an enhanced CPP does not alter the need for Canadians to develop strong financial literacy skills and focus on retirement planning goals.

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