CONTROL: WHO, HOW, WHAT, WHEN AND WHY?

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INTRODUCTION

• Introduction to some of the provisions of the Income Tax Act (“Act”), CRA technical interpretations, and related jurisprudence dealing with the meaning of control for the purposes of their potential application in the charitable context

• This presentation is intended to provide a quick summary of the rules as a resource tool – a “primer”

• Discussion would be incomplete without also considering meaning of “related” and the non-arm’s length (NAL) concept
WHY?

- Over the past year, there have been a number of important changes to tax rules affecting many aspects of operations of charities in Canada.
- On July 18, 2005, the Department of Finance released legislative proposals to amend the Act which consolidates and further amends previously proposed amendments introduced in 2002, 2003 and 2004.


- Recent Conservative Budget commitment to eliminate capital gains tax on gifts of publicly traded securities – any new “self-dealing” rules for private foundations are also likely to deal with “control.”
These recent changes have increased the complexity of the regime within which registered charities and their donors operate.

Many of the changes stem from the Department of Finance’s intention to curtail abusive tax shelter schemes involving charitable donations.

Result – importation of “stealth” anti-avoidance concepts from commercial context which may be problematic.

WHAT?

What types of relationships are relevant?

- Arm’s length
- Control
- Associated/Acting in Concert
1. Arm’s Length

- Related persons are deemed not to be dealing with each other at arm’s length – paragraph 251(1)(a)

- Factual non-arm’s length – it is a question of fact whether persons not related to each other are dealing with each other at arm’s length – paragraph 251(1)(c)

See IT-419R2: Meaning of Arm’s Length

- Related persons include (251(2)):
  - Individuals connected by blood, marriage, common-law partnership or adoption
  - A corporation and a person that controls the corporation, a member of a related group of persons that control or any person related thereto
  - Two corporations controlled by the same person, group of persons, ...
  - “Controlled” for the purposes of these provisions is de jure/legal control
• Factual Non-Arm’s Length:
  – With respect to unrelated persons, paragraph 251(1)(c) provides that it is a question of fact whether they deal at arm’s length.
  – CRA generally refers to the following criteria for determining whether unrelated persons are dealing with each other at arm’s length:
    ▪ Was there a common mind which directs the bargaining for both parties
    ▪ Were the parties acting in concert without separate interests,
    ▪ Was there de facto control

2. Control (legal or de jure control)
• Not defined in the Act
• Usual definition is set out in Buckerfield’s Ltd. et al. v. M.N.R., 64 D.T.C. 5301 (Ex.Ct.):
  “the 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 an election of the Board of Directors.”

See IT-64R: Corporations: Association and Control
• Commonly referred to as legal or *de jure* control

• Concept refined since 1964 to take into consideration other significant rights contained in corporate statutes and constating documents, e.g. unanimous shareholder agreements, powers on wind-up or dissolution

• Includes indirect control - a person who controls one corporation will also control any corporation controlled by it

• Unclear how this will apply to non-share capital corporations

  – HSC was an Ontario non-share capital corporation which was engaged in and earned a profit from medical research
  – Its members were its 12 directors
  – At no time was the majority of the directors appointed by or connected to the Hospital for Sick Children and/or its Foundation
  – Profits and assets on dissolution were to be distributed to the Hospital and/or Foundation
  – Start-up funding from the Hospital and/or Foundation of $3,000,000 loan
• Example (cont’d)
  – Issue: Whether HSC was controlled directly or indirectly (pre-256(5.1) by the Hospital or its Foundation for the purpose of eligibility for refundable investment tax credits
  – At the time, “controlled directly or indirectly” meant *de jure* control
  – The Court could find “no valid reason not to apply the concepts of control developed in the decided cases for share corporations to a corporation without shares. The persons who control the non-share corporation are the members who in turn appoint the directors.”
  – No *de jure* control, maybe factual control

3. Factual Control

• Subsection 256(5.1) provides that when the expression “controlled directly or indirectly in any manner whatever” is used “a corporation will be considered to be controlled by another corporation, person or group of persons (in this subsection referred to as the “controller”) at any time where, at that time, the controller has any direct or indirect influence that, if exercised, would result in control in fact of the corporation.”
• IT-64R4 CRA describes what it considers to be relevant in determining whether *de facto* control exists, as follows:

  ¶ 21. De facto control goes beyond de jure control and includes the ability to control “in fact” by any direct or indirect influence. De facto control may exist even without the ownership of any shares. It can take many forms, e.g., the ability of a person to change the board of directors or reverse its decisions, to make alternative decisions concerning the actions of the corporation in the short, medium or long term, to directly or indirectly terminate the corporation or its business, or to appropriate its profits and property. The existence of any such influence, even if it is not actually exercised, would be sufficient to result in de facto control.

• In *Silicon Graphics Ltd. v. H.M.Q.*, [2002] 3 C.T.C. 527, the Federal Court of Appeal found that in order for the controller to have *de facto* control it must have the clear right and ability to effect a significant change in the board of directors or their powers or to directly influence the shareholders who would otherwise have the ability to elect the board.
Other decisions emphasizing factors such as economic interdependence, whether the decision-making power rests somewhere other than with those with *de jure* control, operational control, close familial ties (albeit unrelated)

Subsection 256(8.1) provides that for the purposes of the acquisition of control rules a non-share capital corporation is deemed to have a single class of shares owned by the members in a proportion that the Minister deems reasonable—does this rule apply?

WHO?

- Who are the key actors/players when determining issues of control and arm’s length?
  - Individual directors/trustees or officers
  - Corporations
  - Individual and corporate donors
  - Intra-charity
WHERE?

1. New Definitions of Charitable Organizations and Public Foundations

- The definitions of charitable organizations and public foundations have been amended by replacing the “contribution” test with a “control” test.

- The rationale for amending the definitions is to permit charitable organizations and public foundations to receive large gifts from donors without concern that they may be deemed to be a private foundation.

- The previous “contribution” test meant that where more than 50% of the capital of a charity was contributed from one donor or donor group then the charity would be deemed to be a private foundation subject to more stringent activity and disbursement obligations.

- The new “control” test means that while a donor may donate more than 50% of the capital of a charity, the donor or donor group cannot exercise control directly or indirectly in any manner over the charity or be in a non-arm’s length relationship with 50% or more of the directors or trustees of the charity.
• As a result of the introduction of a “control” test, the convoluted business rules in relation to “control” will become applicable as a result of the phrase “controlled directly or indirectly in any manner whatever”

• Charities will now need to be careful that they do not unwittingly become designated as a private foundation instead of either a charitable organization or public foundation

2. New definition of “enduring property”

• New definition includes five-year gifts received by a charitable organization from another registered charity 50% of the board of which deal at arm’s length with each member of the board of the recipient organization
3. Revocation for Public and Private Foundations

- Paragraphs 149.1(3)(c) and (4)(c) provide that the registration of a charitable foundation may be revoked if it acquires control of any corporation.
- However, subsection 149.1(12) provides a special rule for determining whether control has been acquired.

4. Undue Benefit – subsection 188.1(5)

- Gifts other than to qualified donee
- The amount of any “rights, income, property or resources” paid, payable, assigned or otherwise made available to member or trustee of the charity, or a person who contributed more than 50% of the capital of the charity, or a person who deals not at arm’s length with such a person or the charity
5. Eligible Donee – Subsection 188(1.3)

- New interim sanctions and penalties - sanctioned charities can transfer the amount of tax or penalty to CRA or to another arm’s length charity (eligible donee)
- more than 50% of directors of the recipient charity must deal at arms length with all directors of the sanctioned charity

6. Amount of Advantage – Subsection 248(32)

- Broad definition includes:
  - The total value of all property, services, compensation, use or other benefits
  - To which the donor, or a person not dealing at arms length with the donor
  - Has received or obtained or is entitled to receive (either immediately or in future)
  - As partial consideration of or in gratitude of the gift or that is in any other way related to the gift
7. Donation Tax Shelter Rules

- Rules arising from donation tax shelter schemes prescribing “deemed fair market value” of cost
- New provisions also require a “look-back” to see if the property had been acquired within the 3 or 10 years by a non arm’s length person and if so then the “deemed fair market value” applies to the person – subsection 248(36)
- New rules do not apply if a shareholder has transferred property to a controlled corporation in exchange for shares and the shares are donated, or a rollover transaction to a corporation for the same purpose of donating shares.

8. Definition of Non-Qualifying Security

- Detailed rules in subsections 118.1(13) to (19) regarding gifts of shares or debt obligations of a corporation that the donor does not deal with at arm's length

9. Definition of Non-Qualified Investment

- A non-qualified investment is a share, right to acquire a share or debt owing to a private foundation by a person who does not deal at arm's length with the foundation or a corporation controlled by the foundation – defined in 149.1(1)
• Also, provisions dealing with charities which “act in concert” in order to avoid disbursing funds – paragraph 149.1(4.1)(b) and subsection 188(4)

• Associated charities – subsection 149.1(7) provides that the Minister may designate charities to be associated, but this does not necessarily mean “associated” within the meaning of subsection 156(1)

HOW?

• How are the control and arm’s length rules used in provisions related to charities?

• Example: Application of definitions of charitable organizations and public foundations
  – Public share capital corporation provides start-up funding ($20 million) for foundation in year 1 (“Contributor”)
  – Members are the directors (5 directors)
  – Beyond appointing the initial directors, the corporation has no further authority to appoint the directors
  – Letters patent provide that no profit is payable to the members and that the assets remaining on dissolution are to be distributed to registered charities with similar objects
• Definition of “public foundation” includes the following:

Re. arm’s length:

c) more than 50% of the directors, trustees, officers or like officials of which deal at arm's length with each other and with

(i) each of the other directors, trustees, officers and like officials of the organization,

(ii) each person described by subparagraph (d)(i) or (ii), and

(iii) each member of a group of persons (other than Her Majesty in right of Canada or of a province, a municipality, another registered charity that is not a private foundation, and any club, society or association described in paragraph 149(1)(l)) who do not deal with each other at arm’s length, if the group would, if it were a person, be a person described by subparagraph (d)(i), and

• What type of relationship is at issue? Arm’s length

• Who are we looking at? 50% of directors, trustees, officers or like officials of the foundation

vs

(i) Each other and other directors, trustees, officers or like officials

(ii) Contributor or persons who do not deal at arm’s length with the Contributor

(iii) Group of persons making contribution (does not apply here)
(i) The Board

- Are 3 of the directors unrelated to each other and factually at arm’s length with each other?
- These 3 directors must also be unrelated to and factually at arm’s length with the remaining 2 directors?
- What about officers and like officials? Does this include the executive director?

(ii) The Contributor

- Are 3 of the directors unrelated to and factually at arm’s length with the Contributor and persons at arm’s length with the Contributor?
- Since the Contributor is a corporation, the rules in paragraph 251(2)(b) apply – but note reference in (d) to “if the organization were a corporation”
- Essentially, the directors of the foundation will be unrelated to the Contributor corporation if they do not control (de jure) the corporation or are unrelated to any person or group of persons that controls the corporation
Since the Corporation is a public corporation, its shares are likely widely held and we can assume, for the purposes of the example, that no person or group of persons controls the corporation and that the directors are unrelated to the Contributors.

But, are they factually at arm’s length with the Contributor?

- economic ties
- “acting in concert”

Re. Control:

(d) that is not, at the particular time, and would not at the particular time be, if the organization were a corporation, controlled directly or indirectly in any manner whatever

(i) by a person (other than Her Majesty in right of Canada or of a province, a municipality, another registered charity that is not a private foundation, and any club, society or association described in paragraph 149(1)(l)),

(A) who immediately after the particular time, has contributed to the organization amounts that are, in total, greater than 50% of the capital of the organization immediately after the particular time, and
(B) who immediately after the person's last contribution at or before the particular time, had contributed to the organization amounts that were, in total, greater than 50% of the capital of the organization immediately after the making of that last contribution, or

(ii) by a person, or by a group of persons that do not deal at arm's length with each other, if the person or any member of the group does not deal at arm's length with a person described in subparagraph (i);

• What type of relationship? Control (de jure and/or factual)
• Who are we looking at? The relationship between the foundation and the Contributor
• The foundation cannot be controlled by
  (i) the Contributor
  (ii) persons or group of persons not at arm’s length with the Contributor
• Legal control: Does the Contributor have sufficient votes to control the majority of the Board? Not likely since the directors are the members and appoint themselves

• Factual control:
  – Does the Contributor have any direct or indirect influence that, if exercised, would result in control in fact of the corporation?
  – Economic interdependence?
  – Who is in the "driver’s seat?"
  – Operational control?

WHEN?
• Each provision will have its own relevant time for determining the issue of arm’s length or control

• New definitions:
  – continuous determination with respect to arm’s length
  – Determine control issue at particular time of large contribution
CONCLUSION

- The application of the rules concerning “control” in the charitable context is unclear, since these rules are premised upon application to commercial arrangements in a business context rather than for registered charities

- Donors, directors and officers of registered charities and their advisors will need to carefully review these rules when establishing charitable organizations and public foundations involving a major donor or when receiving a donation from a major donor who contributes more than 50% of the capital of a charity in order to ensure that the charity in question will not inadvertently be caught by these rules

- The current relationships between entities in multiple corporate structures should also be reviewed in order to assess whether the application of the control and arm’s length concept may have an undesirable effect, particularly where the boards of directors of various related organizations are composed of substantially the same individuals
RESOURCE MATERIALS

- For more information see Charity Law Bulletins #73, #76 and #77 at www.charitylaw.ca
- IT-419R2: Meaning of Arm’s Length
- IT-64R: Corporations: Association and Control

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