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PART 3: SHAREHOLDERS AGREEMENTS, THE ACT AND THE NON-SPECIALIST ADVISOR: THE IMPACT OF CONTROL

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Parts 1 and 2 of this Series reviewed what is meant by control for purposes of the *Income Tax Act* (Canada) (the "Act") and reviewed some of the key tax implications of control under the Act.² Part 2 of the Series also considered the tools required to determine *de jure* control ("DJC") with an emphasis on the impact of unanimous shareholders agreements ("USAs") on DJC. In this the third and final instalment of the Series, we'll consider the tools required to determine *de facto* control ("DFC") with an emphasis on the impact of ordinary shareholders agreements on DFC. In addition, we'll

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² Unless otherwise noted, defined terms in this article have the meaning designated in the first instalment of the Series.

also review the income tax impacts of paragraph 251(5)(b) on the exit provisions that are commonly found in many shareholders agreements.

Tools To Determine DFC

The nature of items that can impact DFC is extremely broad since the determination is, as clarified by new subsection 256(5.11), required to take into account all relevant factors. The terms of shareholders agreements, including those agreements that are not USAs, can often play a significant factor when making DFC determinations.

Although the tax implications of DJC are broader than those of DFC, the tax implications of DFC are still extremely far-reaching.³ Moreover, due to the fact-based nature of DFC determinations, the ability for the terms of shareholders agreements, regardless of whether or not the agreements are USAs, to impact DFC is far more insidious.

Shareholders Agreements and DFC

Some of the terms in a typical shareholders agreement that can contribute to a determination of DFC include:

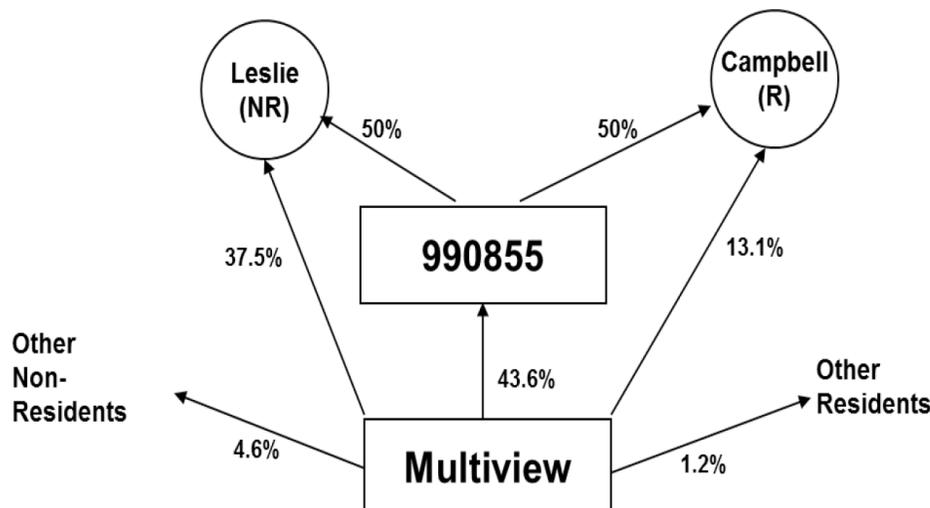
- nominee or representation arrangements;
- casting vote;
- quorum requirements; and
- veto or other consent requirements for certain resolutions.

Two cases, *Multiview Inc. v. the Queen* ("Multiview")⁴ and *The Lenester Sales v. The Queen* ("Lenester"),⁵ both of which involved a review of the impact of ordinary shareholders agreements on DFC, are discussed below to illustrate how, if at all, the terms of shareholders agreements can impact DFC.

In both cases the issue was whether a person who directly or indirectly controlled less than a majority of votes might enjoy DFC of the respective underlying corporation as a result of the terms in each respective shareholders agreement.

Multiview

The share structure in *Multiview* is graphically reproduced below.



In *Multiview*, the question was whether Multiview Inc. was a CCPC because it was controlled directly or indirectly in any manner whatever by Leslie, a non-resident. Leslie was a direct 37.5% shareholder of Multiview Inc., but he was also a 50% shareholder of 990855 Ontario Inc. ("855"), a holding company that owned a 44% block of Multiview Inc. If Leslie could have been considered to have DFC over 855, then together with his direct shareholdings in Multiview Inc.

³ See Part 1 of the Series for a review of the tax implications of DJC and DFC.

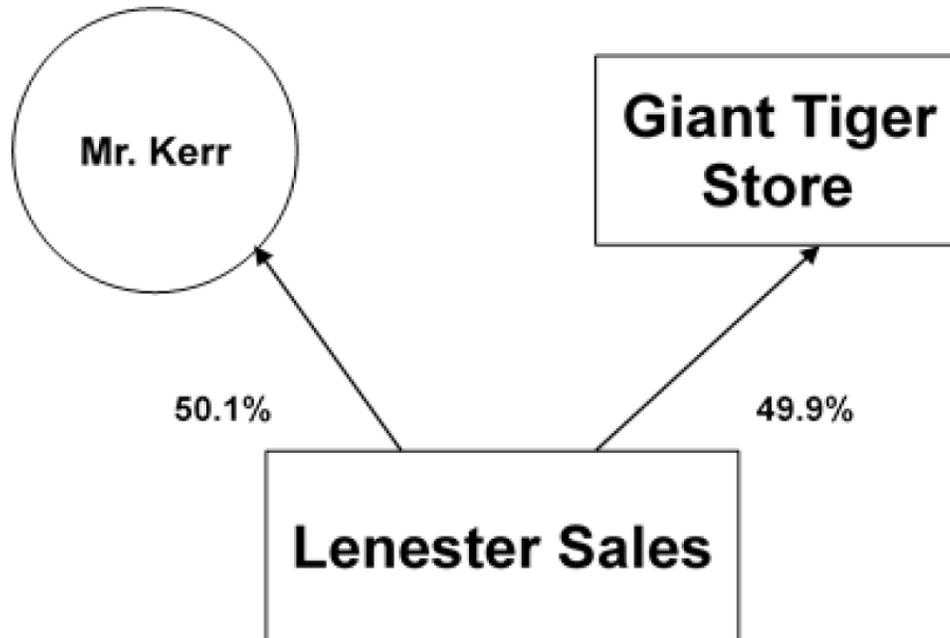
⁴ 97 DTC 1489 (TCC).

⁵ 2004 DTC 6461 (FCA).

he would have also been considered to have DFC over Multiview Inc.

Lenester

The share structure in *Lenester* is graphically reproduced below.



In *Lenester*, the issue was whether Giant Tiger Stores Limited ("Giant Tiger"), the 49.9% shareholder of Lenester Sales Ltd. ("Lenester Sales.") had DFC of Lenester Sales. If Giant Tiger had DFC over Lenester Sales then the two corporations would have been associated and Lenester Sales would have lost its small business deduction.

In both of these cases the respective shareholders agreements governing Multiview Inc. and Lenester Sales, respectively, provided for equal representation on the board of directors of each respective corporation and did not provide any shareholder with a casting vote.

Thankfully, because the Courts have consistently held that where a shareholders agreement results in a deadlocked board of directors DFC cannot exist,⁶ in both of these cases, the respective shareholders agreements were not found to impact DFC.

Once again, while the terms of shareholders agreements may inadvertently create negative tax issues, it is worth keeping in mind that purposeful planning by careful advisors could be employed to arrange for DFC or avoid DFC in appropriate circumstances.

Paragraph 251(5)(b) Exit Issues

As mentioned briefly in Part 1 of the Series, the exit provisions in shareholders agreements can create negative tax consequences due to the potential interaction of paragraph 251(5)(b) with the exit provision rights. More specifically, depending on the nature of the exit provision rights, paragraph 251(5)(b) could deem a person to control a corporation that otherwise would not be controlled by that person with the result that the corporation would be deemed to be related and acting at non-arm's length with the person. The provision might also cause the corporation to lose its CCPC status.

Similar but not identical rules exist in subsection 256(1.4). The effect of subsection 256(1.4) is that it can associate

⁶ For example, *Silicon Graphics*, 2002 DTC 7112 (FCA), at paras 66-67.

otherwise unassociated corporations.⁷

To illustrate the breadth of paragraph 251(5)(b), the provision is partially reproduced below:⁸

where at any time a person has a right under a contract, in equity or otherwise, either immediately or in the future and either absolutely or contingent

- i. to, or to acquire, shares of the capital stock of a corporation or to control the voting rights of such shares, the person shall, **except where the right is not exercisable at that time because the exercise thereof is contingent on the death, bankruptcy or permanent disability of an individual**, be deemed to have the same position in relation to the control of the corporation as if the person owned the shares at that time. [emphasis added]

When applicable, paragraph 251(5)(b) will deem "a person"⁹ to actually hold corporate securities and rights in which the person only has contingent interests, and, as mentioned above, depending on the nature of those rights this deeming rule could impact CCPC status and/or the persons who are related and non-arm's length with a corporation.

Some provisions that are commonly found in shareholders agreements to control or regulate shareholder exits are:

- shotgun rights;
- rights of first refusal;
- tag along or piggy back rights;
- drag along rights;
- put/call options;
- mandatory buy-out rights; and
- pre-emptive rights.

On their face, some of the rights listed above such as shotgun rights, rights of first refusal, and put/call options would appear to engage paragraph 251(5)(b) if the exercise of the rights could put the holder in a position to control the corporation.

As is highlighted in bold in subparagraph 251(5)(b)(i) above, exit mechanisms that are contingent on death, bankruptcy, or permanent disability of an individual are not caught by paragraph 251(5)(b). However, although death and bankruptcy are bright line events, there is no statutory definition of permanent disability. Consequently, care may be required to avoid paragraph 251(5)(b) when considering exit rights associated with disability situations.¹⁰

Even with these bright line exceptions, there are still many other situations where paragraph 251(5)(b) could be applicable to ordinary exit provisions in shareholders agreements. Fortunately, in addition to statutory relief for death, bankruptcy, and permanent disability, the CRA has offered a bit of administrative relief from the broad wording of paragraph 251(5)(b). In particular, the CRA's longstanding position is that it will not apply paragraph 251(5)(b) to rights of first refusal or shotgun arrangements.¹¹

Unfortunately, the CRA's published positions provide very little analysis and, as a result, there appears to be a risk that

⁷ This Series will generally not discuss subsection 256(1.4). Numerous authors have written on subsection 256(1.4), including Ron Dueck and Stephanie Daniels "Update and Review of the Related, Affiliated, and Associated Rules: Overlaps, Differences, and Their Significance," (2014) 10:1 Canadian Tax Foundation.

⁸ *Income Tax Act* (Canada), s. 251(5)(b).

⁹ As set out in CRA doc No 2011-0429411C6 (November 29 2011), each person is considered to exercise paragraph 251(5)(b) rights independently. This should be contrasted from the approach taken in subsection 256(1.4). In that provision the CRA treats all rights as having been exercised simultaneously (CRA document no. 2003-0048571C6 (December 2 2002)).

¹⁰ For more on CRA's views about the meaning of permanent disability see CRA document no. 5-9404 (April 20 1990), CRA document no. 9106955 (December 31 1992), and CRA document no. 1991-160 (October 1991).

¹¹ See CRA Folio S1-F5-C1, "Related Persons and Dealing at Arm's Length" (November 24 2015) at para 1.28; CRA Interpretation Bulletin IT-64R4 (cancelled), "Corporations: Association and Control" (November 1 2004) at para 37. Reference to "clear" rights or obligations that were originally found in Q.38 to the 1979 Revenue Canada Round Table has not found its way into CRA's currently published administrative positions.

other typical put and call rights, for example, such as are typically found in rights of first offer, could be caught by paragraph 251(5)(b).

A useful summary of CRA's positions regarding the application of paragraph 251(5)(b) and subsection 256(1.4) is reproduced below:¹²

Buy-sell Provision	Can s. 251(5)(b) or s. 256(1.4) apply
Right of first refusal	Rely on CRA administrative position
Shotgun	Same
Put right	Arguable, see CRA document no. 900351 (April 30, 1990). When does a "right" exist — only when the person exercises the put?
Call right	Yes
Tag along	No
Drag along	No

¹² Joan Jung, "CCH Webinar: Shareholder Agreements" (Webinar delivered at Wolters Kluwer Online, 20 November 2018) [unpublished].

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