Shareholder's Agreements: Selected Tax Issues

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INTRODUCTION

There are a plethora of tax issues that can arise in connection with shareholders agreements. Only a selected number of issues are discussed in this paper. The private corporation environment has been assumed and the issues addressed have an *inter vivos* focus, rather than *post mortem* planning. Control issues, paragraph 251(5)(b) of the *Income Tax Act*[1], and the effect of the preferred share rules are analysed in the context of a shareholders agreement.

Control Concerns

(a) De Jure Control

Any discussion of income tax issues, the concept of control and shareholders' agreements must inevitably start with the Supreme Court of Canada decision in *Duha Printers (Western) Ltd. v. The Queen*[2]. The *Duha* decision has been the subject of much commentary but it is worthwhile to summarize the facts and the decision below both to note what the case decided and what it did not.

(i) The Duha Decision

Duha was essentially a loss utilization transaction. The loss company was Outdoor Leisure Land of Manitoba Ltd. ("Outdoor"), a Manitoba corporation which was a wholly-owned subsidiary of Marr's Leisure Holdings Inc. ("Marr's"). Marr's was controlled by a husband and wife, Mr. and Mrs. Marr. The profitable corporation was Duha Printers (Western) Ltd. ("Duha"), a corporation controlled by Mr. Duha. Mr. Duha was not related to either of Mr. or Mrs. Marr.

Marr's acquired apparent voting control of Duha by the following steps.

- By Articles of Amendment, a special class of preferred shares of Duha was created and designated as Class "C" preferred shares. The Class "C" preferred shares carried the right to one vote per share provided that the voting right would cease upon the death or transfer of the share. Each Class "C" preferred share was redeemable by the corporation with the consent of the holder or, in the event that the shares were transferred, redeemable without requiring the consent of the holder.

- Marr's subscribed for 2,000 Class "C" preferred shares at the price of $1.00 per share or $2,000.00 in the aggregate. As a result, Marr's owned shares of Duha carrying the right to 55.71% of the voting rights attached to all shares in the capital of Duha.

- On the same day as the above acquisition of shares, all of the shareholders of Duha entered into an agreement described as a "unanimous shareholders' agreement" which provided that the affairs of the corporation were to be managed by a board of three directors elected by the shareholders and composed of four possible nominees being Mr. Duha, Mrs. Duha, Mr. Marr or Mr. Paul Quinton. Apparently, Mr. Quinton was a friend of both Mr. Duha and Mr. Marr and had previously served as a director of a predecessor corporation to Duha. The agreement in question also restricted the transfer of shares without the consent of the majority of directors; prohibited any shareholder from transferring or otherwise encumbering its shares in any manner; and further provided that new shares could only be issued with the unanimous consent of the existing shareholders.

- On the day following the above (i.e., after Marr's acquired shares entitling it to greater than 50% of the voting rights of Duha), Duha purchased all the issued and outstanding shares of Outdoor (the loss company) from Marr's for a nominal consideration of $1.00.

- On the following day, Duha and Outdoor amalgamated. Upon the amalgamation, the shares of Outdoor were cancelled and the shareholders of the amalgamated corporation were the same as the shareholders of Duha (pre-amalgamation) and holding the same number and class of shares as prior to the amalgamation.

- Subsequently, the shareholders elected Mr. Duha, Mrs. Duha and Mr. Quinton as the three directors of the amalgamated corporation.

The exit to the loss structure was implemented in the following calendar year.

- The Class “C’ shares of Duha owned by Marr’s (being the shares which gave Marr’s apparent voting control of Duha) were redeemed for the redemption price of $2,000.00 at the beginning of the following calendar year.

- The unanimous shareholders’ agreement was terminated shortly thereafter and Mr. Quinton resigned as a director of the corporation.

For income tax purposes, Duha (the amalgamated corporation) deducted the non-capital losses of Outdoor in computing its taxable income. The Minister disallowed those losses on the basis that Marr’s did not control Duha prior to its amalgamation with Outdoor.

The taxpayer relied upon paragraph 256(7)(a). From a technical perspective, if subparagraph 256(7)(a)(i)[3] applied at the time that Duha acquired all of the issued and outstanding shares of Outdoor, then Duha was deemed not to have acquired control of Outdoor and as a result, the loss streaming rules in subsection 111(5) would not have applied. Subparagraph 256(7)(a)(i) required that Duha be related to Marr’s immediately prior to the acquisition of the shares of Outdoor, and Duha and Marr’s would be related to each other at that time if Marr’s controlled Duha.[4] Thus, an analysis of the meaning of control became critical to the outcome of the case, including the relevance of the unanimous shareholder agreement entered into by the shareholders of Duha.

Iacobucci, J. held that for purposes of the Act, control referred to *de jure* control and not *de facto* control. He referred to the following oft-cited passage from *Buckerfield’s Limited v. M.N.R.*[5]:

> “I am of the view, however, that in Section 39 of the Income Tax Act [the former section dealing with associated companies], the word “controlled” contemplates the right of control that rests in the 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.”

Iacobucci, J. elaborated and explained that the *de jure* control test is an exercise in determining the person who has “effective control” of the corporation:[6]

> “However, it must be recognized at the outset that this test is really an attempt to ascertain who is in effective control of the affairs and fortunes of the corporation. That is, although the directors generally have, by operation of the corporate law stature governing the corporation, the formal right to direct the management of the corporation, the majority shareholder enjoys the indirect exercise of this control through his or her ability to elect the board of directors. Thus, it is in reality the majority shareholder, not the directors per se, who is in effective control of the corporation.”

Further, Iacobucci, J. stated that it was appropriate to look beyond the shareholders' register to constating documents for purposes of this exercise, but not to consider every legally binding arrangement between shareholders. The judgment made a distinction between contractually binding agreements which are not constating documents and legally binding provisions within a constating document. A unanimous shareholder agreement was held to constitute a constating document and therefore was relevant for purposes of determining *de jure* control of a corporation.

The agreement in *Duha* was a unanimous shareholder agreement because of the restriction on the ability of the directors to issue additional shares. New shares could only be issued by the directors with the unanimous consent of all shareholders. On the facts of the case, Iacobucci, J. held that the provisions of the particular unanimous shareholders' agreement did not result in the loss of *de jure* control by Marr's. In other words, while the inability to issue new shares from treasury without unanimous shareholders' approval constituted a restriction on the powers of the directors to manage the business and affairs of the corporation, it was not considered to be so severe that Marr's lost the ability to exercise effective control over the affairs of the corporation.

(ii) What is a Unanimous Shareholder Agreement?

Duha drew a distinction between a unanimous shareholder agreement and something other than a unanimous shareholder agreement. Unanimous shareholder agreements were introduced into Canadian corporate law approximately 30 years ago with the enactment of the Canada Business Corporations Act[7] following the recommendation of the Dickerson Report[8]. Virtually all of the modern Canadian business corporations statutes contain such a concept and with substantially similar definitions. The rationale for this recommendation, as explained by the relevant commentary in the Dickerson Report, was to overrule jurisprudence where an agreement among shareholders purporting to bind them in their capacity as directors was held to be an unlawful attempt to fetter the exercise of directors' discretion.[9] However, the potential scope of a unanimous shareholder agreement as permitted in the various corporate statutes goes beyond overruling such caselaw. As one author put it[10]:

> "Simply stated, the unanimous shareholder agreement allows the shareholders to strip the directors of their managerial powers without going through the time-consuming procedure of giving notice of and convening a shareholders' meeting to remove the directors from the board. The effect is instantaneous. The unanimous shareholder agreement does not remove the directors from their positions. It simply removes the powers that go with the position of director, to the extent set out in the agreement."

The relevant provisions in the Ontario Business Corporations Act[11] are as follows:

1(1) **"unanimous shareholder agreement"** means an agreement described in subsection 108(2) or a declaration of a shareholder described in subsection 108(3);

108(2) A written agreement among all the shareholders of a corporation or among all the shareholders and one or more persons who are not shareholders may restrict in whole or in part the powers of the directors to manage or supervise the management of the business and affairs of the corporation.

Thus, the statutory requirements are simple and without formality[12]: (a) a written agreement; (b) all shareholders[13] must be a party to the agreement provided that persons who are not shareholders may also be a party[14]; and (c) a restriction on the powers of the directors to manage or supervise the business and affairs[15] of the corporation. It is the last mentioned requirement which is critical to constitute the agreement as a unanimous shareholder agreement as it is more than simply an agreement among all shareholders as to the manner in which they will exercise their voting rights. The latter (which is also provided for in the OBCA[16]) is not a unanimous shareholder agreement notwithstanding that all shareholders may be a party.[17] Only if the above three requirements are satisfied will a unanimous shareholder agreement be constituted. Thus, there may be agreements which were not intended to operate as unanimous shareholder agreements which in fact constitute unanimous shareholder agreements[18] and conversely, a shareholders agreement may contain a declaration or statement of intention therein, i.e., that it is intended to be a unanimous shareholder agreement, yet fail to meet the above requirements and therefore not operate as a unanimous shareholder agreement.

Under the OBCA, directors are charged with managing or supervising the management of the business and affairs of the corporation.[19] However, the statute does not elaborate what may constitute a restriction of the powers of the directors to manage or supervise the management of the business and affairs of a corporation sufficient to qualify an agreement among shareholders as a unanimous shareholder agreement. In his discussion of the unanimous shareholder agreement as a constating document, Iacobucci, J. alluded to “major issues facing a corporation: corporate structure, issuance of shares, declaration of dividends, election of directors, appointment of officers, and the like”[20] as the items addressed in such an agreement. In *Duha*, the agreement in question restricted the ability of the directors to issue new shares and this was sufficient to support unanimous shareholder agreement characterization. It has been suggested that the statutory requirement for a restriction on the powers of the directors may be interpreted liberally by the courts to qualify an agreement as a unanimous shareholders agreement and not require a restriction that would, at common law, have been regarded as a fetter of directors’ discretion.[21] For example, in *Sportscope Television Network Ltd. v. Shaw Communications Inc.*[22], the court noted the following in determining that the agreement in question constituted a unanimous shareholder agreement:

- one of the shareholders was entitled to bring a non-voting participant to a meeting of the board of directors – which the court considered was something which could not be ordinarily done without the approval of the directors.

- there were restrictions on the transfer of shares, subject to a 90% shareholder approval requirement.

- there was a mandated director’s resignation if a shareholder disposed of its shares.

- the representatives of the two major shareholders on the board of directors had to be present to constitute a quorum at directors’ meetings and any directors’ resolution required their approval.

Some may argue that the mere requirement of shareholder consent to a resolution of the board of directors represents a restriction on the powers of the directors and therefore any agreement signed by all shareholders with such a requirement constitutes a unanimous shareholders' agreement.

The OBCA specifically provides that a unanimous shareholder agreement may override certain statutory provisions. Where these provisions deal with actions or decisions falling within the realm of directors' powers, it may be inferred that an agreement which makes use of the override constitutes a restriction on the power of the directors to manage and supervise the affairs and business of the corporation. For example, the OBCA provides that the issuance of shares may be subject to a unanimous shareholder agreement[23]:

> Subject to the articles, the by-laws, any unanimous shareholder agreement and section 26, shares may be issued at such time and to such persons and for such consideration as the directors may determine.

Since the issuance of shares is a directors' prerogative, if a written agreement signed by all of the shareholders restricts the issuance of shares by the directors, this should constitute a restriction on the power of the directors to manage the affairs of the corporation and thus qualify the agreement as a unanimous shareholder agreement. There was such a restriction in the agreement in *Duha*. Other examples of OBCA provisions which effectively contemplate that a unanimous shareholder agreement may restrict certain powers otherwise expressly reposed on directors by statute include:

- restrict or remove the powers of the directors to declare dividends[24]
- restrict or remove the powers of the directors to make by-laws[25]
- restrict or remove the powers of the directors to appoint officers[26]
- restrict or remove the powers of directors to fix remuneration of directors, officers and employees[27]
- restrict or remove the deemed borrowing powers of the directors and their ability to delegate same[28]
- provide for the procedure at meetings for shareholders[29]

It must be recognized however that the mere existence of a unanimous shareholder agreement may not change *de jure* control or rather, cause a majority shareholder (who might otherwise be considered to enjoy *de jure* control) to lose same. This was succinctly stated by Iacobucci, J. in *Duha*:[30]

> …the simple fact that the shareholders of a corporation have entered into a USA does not have the automatic effect of removing *de jure* control from a shareholder who enjoys a majority of the votes in the election of the board of directors. Rather, the specific provisions of the USA must alter such control as a matter of law. But to what extent must these powers be compromised before the majority shareholder can be said to have lost *de jure* control over the company?

> In my view, it is possible to determine whether *de jure* control has been lost as a result of a USA by asking whether the USA leaves any way for the majority shareholder to exercise effective control over the affairs and fortunes of the corporation in a way analogous or equivalent to the power to elect the majority of the board of directors (as contemplated by the *Buckerfield*'s test).

Other writers[31] have commented on the unique position of the unanimous shareholder agreement and its function in the determination of *de jure* control. If one examines the restrictions on directors' powers which the OBCA expressly contemplates may be imposed by a unanimous shareholder agreement (some of which are listed above), it is arguable that including any one restriction in a unanimous shareholder agreement that requires unanimous shareholder approval should not result in loss of "effective control" by the majority voting shareholder. However, this analysis clearly becomes a matter of degree if more directors' powers are "shifted" to the shareholder level pursuant to the unanimous shareholder agreement and require shareholder unanimity. For example, in *Donald Applicators Ltd. v. MNR*[32], the Exchequer Court suggested that the authority of directors had only been "slightly restricted or modified" by provisions in the corporation's articles of association which prohibited the issuance of shares without unanimous shareholder consent and provided for mandatory distribution of profits which thereby restricted the directors' authority to accumulate profits. Thurlow, J. did not think that these restrictions imposed "any serious effect" on the authority of the directors and as a result did not consider that this affected control by the shareholders.[33] By analogy, it may be that moving these two powers (i.e., issuance of shares and declaration of dividends) to the shareholders by means of a unanimous shareholder agreement and requiring unanimous consent of shareholders may not cause a majority voting shareholder to lose *de jure* control.

At the other end of the spectrum is an example given by the Canada Revenue Agency[34] in *Interpretation Bulletin* IT-64R4[35]. Where the constating documents of a corporation required unanimous consent by all holders of voting shares of all shareholders resolutions, the holder of the majority of the voting shares was not considered to have *de jure* control of the corporation.

Alteco Inc. v. The Queen[36] should also be considered in an analysis of the provisions of a unanimous shareholder agreement and *de jure* control. *Alteco* was referred to in *Duha*. In this case, Alteco Inc. held 51% of the issued and outstanding shares of 581387 Saskatchewan Ltd. ("387") and National Record Distributors Ltd. ("National") held the remaining 49% of the issued and outstanding shares. 387 operated a record/audio retail store franchise. National and Alteco entered into an agreement which set out capitalization and lending requirements for 387. The agreement (which the Court found to be a unanimous shareholder agreement) also provided that shares could not be transferred without the prior consent of the other shareholder and a right of first refusal. The agreement fixed the number of directors at five, set out the names of the directors and provided that these directors could not be changed with the unanimous consent of shareholders. Any vacancy in the board of directors would be filled by unanimous resolution of the remaining directors. Unanimous shareholder consent was also required to change the number of directors and to change the capital of the corporation. The evidence showed that of the five persons listed in the agreement as directors: two were designated by Alteco and three were designated by National. The issue in the case was whether Alteco controlled 387 as this was relevant to Alteco's claim for an allowable business investment loss. The Court held that Alteco did not control 387. While the Court recognized that Alteco held 51% of the voting shares of the corporation, the critical finding was that it could not alter the composition of the board of directors and it had agreed to a board where three individuals had been nominated by the minority shareholder. In *Duha*, Iacobucci, J. referred to this circumstance as guaranteeing the minority shareholder a majority of the representation on the board of directors.

Both *Duha* and *Alteco* looked at a unanimous shareholder agreement from the perspective of whether it caused a majority voting shareholder to lose *de jure* control. In *Duha*, the answer was no. In *Alteco*, the answer was yes and it is implicit in the decision that it was therefore the minority (49%) shareholder who had *de jure* control. If the agreement in *Alteco* was not a unanimous shareholder agreement (e.g. because the statutory requirements were not complied with[37]), then based on *Duha*, such agreement would not be relevant to an analysis of *de jure* control. However, as described below, the agreement may evidence *de facto* control by one shareholder or perhaps that the two shareholders constitute a group which controls (*de jure*) the corporation.

(b) De Facto Control

If an agreement among shareholders does not qualify as a unanimous shareholder agreement, then it is not relevant for purposes of determining *de jure* control of the corporation.[38] Although not containing any restrictions on the powers of the directors to manage the corporation, an agreement among shareholders (referred to herein for purposes of simplicity as an "ordinary shareholder agreement") may deal with their rights and arrangements *inter se*, such as:

- voting rights amongst the shareholders[39]
- representation on the board of directors and quorum requirements
- super-majority or unanimity requirements with respect to changes to the articles of the corporation
- preemptive rights – right to acquire more shares if the corporation chooses to issue additional shares
- shareholder obligations to capitalize by debt or equity
- divorce provisions whether voluntary or involuntary, upon death or *inter vivos*
- dispute resolution

An ordinary shareholder agreement may be relevant for other provisions of the Act. In particular, it has long been the administrative view of the CRA that such an agreement is relevant for purposes of determining *de facto* control. It is listed in *Interpretation Bulletin* IT-64R4[40] as one of the general factors which the CRA considers may be used in determining whether *de facto* control exists.

The concept of *de facto* control is set out in subsection 256(5.1) which was an amendment to the legislation as a result of the extensive changes to the associated corporation rules in 1988. Subsection 256(5.1) states as follows:

(5.1) Control in fact

> For the purposes of this Act, where the expression “controlled, directly or indirectly in any matter whatever,” is used, a corporation shall be considered to be so 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, except that, where the corporation and the controller are dealing with each other at arm’s length and the influence is derived from a franchise, licence, lease, distribution, supply or management agreement or other similar agreement or arrangement, the main purpose of which is to govern the relationship between the corporation and the controller regarding the manner in which a business is carried on by the corporation is to be conducted, the corporation shall not be considered to be controlled, directly or indirectly in any manner whatever, by the controller by reason only of that agreement or arrangement.

The expression “controlled, directly or indirectly in any manner whatever” as defined above is notably used in the definition of “Canadian-controlled private corporation” (a “CCPC”) in subsection 125(7); the definition of “excluded corporation” in 127.1(2) in respect of the refundable investment tax credit; the particular definition of the word “control” as that applies for purposes of the affiliated persons rules in section 251.1; the associated corporation rules in section 256 and various other provisions including anti-avoidance provisions.[41] This expression is not used in subsection 249(4) being the taxation year end triggered by control of a corporation being acquired by a person or group of persons, nor is it used in the loss streaming rule in subsection 111(5).

There have been a number of relatively recent cases dealing with *de facto* control and they have been summarized elsewhere.[42] Some of these cases have included an ordinary shareholder agreement and for that reason, are commented on below. However, it is inevitable that *de facto* control cases are highly fact based and thus limited guidance may be taken from them.

As a preliminary matter, although no shareholder agreement was involved, it is helpful to note the manner in which the *de facto* control test was articulated by the Federal Court of Appeal in *Silicon Graphics Ltd. v. The Queen*[43]. In *Silicon Graphics*, the taxpayer’s claim in respect of scientific research and experimental development expenditures was disallowed on the basis that the corporation was not a CCPC in the taxation years in question. At that time, the definition of CCPC in subsection 125(7) read as follows:

> “Canadian-controlled private corporation” means a private corporation that is a Canadian corporation other than a corporation controlled, directly or indirectly in any matter whatever, by one or more non-resident persons, by one or more public corporations (other than a prescribed venture capital corporation) or by any combination thereof.”

In *Silicon Graphics*, the corporation was listed on NASDAQ and accordingly its shares were widely held in its 1992 and 1993 taxation years. In particular, the corporation had over 8 million issued and outstanding common shares (as of January 31, 1993) and during the relevant period, the number of shareholders ranged from 136 to 305 with a majority of such shareholders being non-resident. Both *de jure* control and *de facto* control issues were litigated. With respect to the issue of *de jure* control, the Court held that such control required a “common connection” among the shareholders so that a simple aggregation of non-resident shareholders would not result in such non-residents having *de jure* control of the corporation.[44] Accordingly, the issue of *de facto* control had to be considered. On the facts, Sexton, J. A. noted that there was no evidence of any agreement or common connection among the shareholders influencing the manner in which shares were to be voted. With respect to the issue of *de facto* control, Sexton, J. A. stated as follows:[45]

> The case law suggests that in determining whether *de facto* control exists it is necessary to examine external agreements; shareholder resolutions; and whether any party can change the board of directors or whether any shareholders' agreement gives any party the ability to influence the composition of the board of directors.
>
> It is therefore my view that in order for there to be a finding of *de facto* control, a person or group of persons must have the clear right and ability to effect a significant change in the board of directors or the powers of the board of directors or to influence in a very direct way the shareholders who would otherwise have the ability to elect the board of directors.

Sexton, J. A. held that no evidence had been adduced to illustrate that the non-resident shareholders (who apparently did not act collectively and may not have even known the identity of others) exercised *de facto* control over the corporation.

In the above excerpt, Sexton, J. A. referred to two cases, *International Mercantile Factors Ltd. v. The Queen*[46] and *Multiview Inc. v. The Queen.*[47] They are discussed below together with the recent case of *The Queen v. Lenester Sales Ltd.*[48] All these cases involved some form of shareholder agreement with a control issue.

In *International Mercantile*, the issue was whether the corporate taxpayer was a CCPC in its 1979-82 taxation years so as to be eligible for small business deduction. In particular, the question was whether it was "controlled, directly or indirectly in any manner whatever" by one or more public corporations.[49] Although *International Mercantile* predated subsection 256(5.1), it is noteworthy as it was cited in support of Sexton, J. A.'s *de facto* control test as reproduced above, presumably because of the shareholder agreements involved.

International Mercantile had experienced some financial difficulties and Eric Bissell had been retained originally as a consultant. Subsequently, a contract was entered into between International Mercantile and Bissell & Bissell Enterprises Inc. ("B & B") being a company controlled by Mr. Bissell, by means of which B & B offered his services to manage the affairs of International Mercantile. Under this management agreement, business expansion and projects outside of the ordinary course of business were subject to the prior approval of the board of directors of International Mercantile and the corporation had the option to terminate the arrangement without notice upon payment of an effective penalty equal to one-third of the annual fee. As part of these arrangements, Mr. Bissell, or his corporation was offered shares such that he would hold 50% of the voting rights. As a result, the shares of International Mercantile were as follows:

- shares representing 50% of the aggregate voting rights and 75% of the equity were held by two public corporations, Charter Industries Ltd. ("Charter") and Hamilton Group Ltd. ("Hamilton")
- shares representing 50% of the aggregate voting rights and 25% of the equity were held by a private corporation, Rieris Holdings Ltd. ("Rieris"), a corporation controlled by Eric Bissell

Charter, Hamilton and Rieris entered into a shareholder agreement which, among other things, provided that:

- no shares of International Mercantile could be issued without the unanimous consent of Rieris, Charter and Hamilton (apparently to ensure that Rieris would retain its relative equity and voting position)
- the shareholder agreement shall be terminated upon the termination of the management agreement (which as described above could be terminated by International Mercantile at its sole option upon payment of an effective penalty)
- in the event of termination of the shareholder agreement as a result of the termination of the management agreement, Charter and Hamilton were required to purchase Rieris' shares of International Mercantile in equal proportions.

The shareholder agreement itself contained no provisions dealing with the election of directors of International Mercantile. The evidence was that there was no agreement as to the representation of each shareholder on the board of directors although apparently the directors were reappointed each year by unanimous vote. In the taxation years in question, the board of directors comprised five individuals: Mr. Bissell, two individuals who were considered to be nominees of Charter and two individuals who were considered to be nominees of Hamilton. The Letters Patent of International Mercantile stated that a 60% vote was required to remove a director from office prior to the end of his term. Also, the by-law of International Mercantile contemplated an annual shareholders meeting at which the board of directors would be elected provided that the existing directors would remain in office until successors were elected.

On a *de jure* control analysis and with reference to the decisions in *Oakfield Developments (Toronto) Limited v. MNR*[50] and *The Queen v. Imperial General Properties Limited*,[51] the Court determined that the corporation was not a CCPC on the basis that it was controlled directly or indirectly by one or more public corporations, i.e., Charter and Hamilton. The Court noted that Rieris could take no step to cause any change in the composition of the board of directors given that the shareholder agreement was silent on this point, the removal of directors required a 60% vote and the by-law of the corporation stated that if a new board was not elected (which could only be done by majority vote), then the existing board would remain. As a result, the Court held that Charter and Hamilton had "legal and effective control" of the corporation. In effect, although the shareholders agreement preserved the deadlock in voting rights, there was no deadlock at the directors' level.

In *Multiview*, the issue was whether the corporation was a CCPC so as to qualify for the refundable investment tax credit. In the taxation year in issue, 43.6% of the issued and outstanding shares of Multiview were held by 990855 Ontario Inc. and the shares of that numbered company in turn were held equally by John Leslie (a non-resident) and Duncan Campbell (a resident). In addition, John Leslie (the non-resident) also directly owned 37.5% of the shares of Multiview and Duncan Campbell (the resident) directly owned 13.1% of the shares of Multiview. There were other Canadian resident shareholders (as to 1.2% and other non-resident shareholders (as to 4.6%). John Leslie (the non-resident) and Duncan Campbell entered into a letter agreement. None of the other shareholders of Multiview were apparently parties to this letter agreement. Few details were available. The letter agreement provided that both individuals would have equal representation on the board of directors and that both individuals had to be present to constitute a quorum for any directors meeting. The taxpayer's submission to the CRA (as reproduced in the judgment) refers to the two individuals having "a clear oral agreement with each other to the effect that all decisions regarding Multiview or the numbered company would be made on an equal basis by them" which oral agreement was presumably intended to be reflected in the letter agreement.

The Tax Court of Canada held that Multiview was not controlled directly or indirectly in any manner whatever by John Leslie. In particular, the Court noted the lack of a casting vote and stated:[52]

> "For no time did any shareholder agreement provide that Leslie possessed a casting vote in 990855 Ontario Inc. nor did Leslie possess any other mechanism that would result in him controlling the voting shares of 990855 Ontario Inc."

In this case, although the agreement apparently provided for equal representation on the board of directors by both individuals such that the non-resident had a negative veto over directors' decisions (as indeed did the resident individual), this was not considered sufficient influence to result in control in fact of the corporation.

The *de facto* control test as articulated in *Silicon Graphics* was applied in *Lenester Sales* which involved an associated corporations reassessment. The CRA reassessed on the basis that a franchisee was controlled directly or indirectly in any manner whatever by the franchisor and therefore associated with another franchisee. Although the tail-end of subsection 256(5.1) contains exclusionary language for what is sometimes referred to as the "franchise exemption", the Federal Court of Appeal declined to express an opinion on whether this exemption applied but otherwise affirmed the Tax Court of Canada decision on the basis that the franchisor did not have control in fact of the franchisee.

In *Lenester Sales*, the franchisor was Giant Tiger Store Limited ("GTS"). It was the person which the Minister considered had control in fact of the taxpayer. The relationship between the taxpayer and GTS included a franchising license agreement, a shareholders agreement and a lease. In this case, the taxpayer operated a retail store under a franchising license from GTS. The taxpayer also leased space from GTS. In the taxpayer's 1997 taxation year, its shares were held as to 501 shares by Russell Kerr (the operator of the particular retail outlet) and as to 499 shares by GTS. The shareholders agreement provided for the following:

- Mr. Kerr was hired by the taxpayer as an employee and was required to devote his full time and attention to such position with remuneration to be determined from time to time by the board of directors.
- the board of directors was comprised of two individuals: one as a nominee of GTS and one as a nominee of Mr. Kerr. The shareholders agreed to vote their shares to effect this result. There was no provision for a casting vote.
- There was a shotgun buy-sell arrangement.

In the Tax Court of Canada judgment, Bowman, A. C. J. T. C. noted that there was "nothing unusual" about the franchise agreement or the lease. Bowman, A. C. J. T. C. quoted the test of *de facto* control from *Silicon Graphics* as reproduced above and held that on the facts, GTS did not have the rights contemplated by that test. In other words, he considered that GTS did not have the right to effect a significant change in the board of directors of *Lenester Sales* or their powers, or to influence in a direct way Mr. Kerr, being the 51% shareholder who would otherwise have the ability to elect the board of directors. In addition, Bowman, A. C. J. T. C. also stated that if the broader interpretation of *de facto* control (i.e., economic dependence; day-to-day operation control) as set out by other caselaw applied, he nonetheless considered that GTS had no such direct or indirect influence so as to result in control in fact. Further, Bowman, A. C. J. T. C. considered that the franchise exemption in subsection 256(5.1) would have applied.

The *International Mercantile*, *Multiview, and Lenester Sales* cases may be summarized in the following manner (overlaying a *de facto* control test to the facts in *International Mercantile*):

- a shareholder agreement which recognizes deadlocked voting rights but which effectively "permits" greater representation on the board of directors by one group (i.e., the public corporations) than the other may result in a finding that the public corporations control, directly or indirectly in any manner whatever, the taxpayer corporation in *International Mercantile.*

- a shareholder agreement which recognized deadlocked voting rights between a resident and non-resident and which provided for equal representation on the board of directors by each of them led to a finding that a non-resident did not control directly or indirectly in any manner whatever the taxpayer corporation in *Multiview*.

- a shareholder agreement where there was a 51%:49% split in voting rights but which provided that each shareholder would have equal representation on the board of directors did not lead to a finding that a minority shareholder controlled, directly or indirectly in any manner whatever, the taxpayer corporation in *Lenester Sales*.

In a two shareholder situation, where there is equal representation on a board of directors, each of the two persons can exercise influence by virtue of a negative veto as all directors' resolutions therefore require the consent of both directors. In *Multiview*, the non-resident therefore had a negative veto at the director's level. Similarly, in *Lenester Sales*, GTS (the franchisor) had a negative veto at the director's level although it was only a 49% shareholder. Based on these cases, it appears that a veto right at the director's level may not constitute *de facto* control, i.e., negative control may not be *de facto* control. It should be noted that in neither *Mutiview* nor *Lenester Sales* was any person given a casting vote.

The foregoing appears to accord with the CRA's administrative position. In a response to a question regarding veto rights in a shareholder agreement[53], the CRA replied as follows:

> The fact that a shareholder has veto rights over the merging or dissolution of a corporation, changes to its articles of incorporation or by-laws, the issuing of additional shares, or the purchase of shares in a corporation does not automatically mean in itself that the shareholder has control in fact of the corporation.
>
> A shareholder who is the only person with veto rights over all the operations of a corporation could have control in fact of the corporation. However, this depends as well on all the other relevant facts. If all the shareholders in a corporation have veto rights over its operations, the

veto rights of one of the shareholders could not in themselves give that shareholder control in fact.

It should be noted however (as was noted by Bowman, A. C. J. T. C. in the Tax Court of Canada decision in *Lenester Sales*) that a broader test of *de facto* control has appeared in other caselaw (notably in *Mimetix Pharmaceuticals Inc. v. The Queen*[54] and *Transport M.L. Coutoure Inc. and 9044-2807 Quebec Inc. v. The Queen*[55]) whereby operational control and economic dependency were considered rather than the narrower test in *Silicon Graphics*. Accordingly, notwithstanding that deadlock by virtue of mutual veto may not result, in and of itself, in *de facto* control, other factors as considered pursuant to the broader principles referred to above it may lead to a different result.[56]

(c) Group of Persons

The CRA has stated a number of times that the existence of a shareholder agreement would not always be *prima facie* evidence that the shareholders that are party to the agreement constitute a group of persons.[57] This is not relevant for purposes of the associated corporation rules given the special rule in paragraph 256(1.2)(a) which deems any two or more persons owning shares in the capital stock of a corporation to constitute a group. However, it is relevant for other purposes, notably the deemed year end upon acquisition of control of a corporation by a person or group of persons pursuant to subsection 249(4) and the loss streaming rules in subsection 111(5).

The prerequisites to constitute a group were outlined most recently by the Federal Court of Appeal in *Silicon Graphics.* Sexton, J.A. stated the requirement that there be a "sufficient common connection" between the individual shareholders which might include a voting agreement, an agreement to act in concert or family or business relationships. On the facts of the case, Sexton, J.A. indicated that there was no evidence that the non-resident shareholders would "vote as a block in the election of directors" or in other important matters related to the control of the company. Recall however that this was a case involving hundreds of shareholders who may not have known the identity of other shareholders.

The required "common connection" seems easiest to find in a family situation. Sexton, J.A. indicated that business relationships may also suffice. Could this be the business relationship documented in a shareholder agreement? The following suggestions can be gleaned from a selection of caselaw which did not involve shareholders agreements. All of the below cases dealt with an associated corporation issue, i.e., whether two corporations were controlled by the same group of persons.

- In *Regal Wholesale Ltd. v. The Queen*[58], the Federal Court – Trial Division held that an aunt and nephew were a group and noted that they "earn their livelihood from the same business ventures", in addition to being part of a family group.
- In *Vina-Rug (Can.) Ltd. v. MNR*[59], the Supreme Court of Canada noted that the non-family individual who was held to be part of the group controlling the corporation, attended and voted at all shareholders' and directors' meetings and at all relevant times, all resolutions were passed unanimously.

- In *S. Madill Ltd. v. MNR*[60] , the shareholders of a manufacturing company and a sales company (which sold the products of the other company on an exclusive basis) were considered to be a group. They were, to some degree, directors and officers on a criss-cross basis but the evidence clearly showed that one individual was the managing directors and ran the day to day operations of the manufacturing company and another individual did likewise for the sales company. The Court found that the four individuals had a "community of interest and concern in the operation" of both companies.

- In *Express Cable T.V. Ltd. v. MNR*[61] two corporations were assessed as being associated on the basis of being controlled by the same group of persons. It was determined that there was community of interest between certain shareholders because all were involved in the television production business, and some of the shareholders in question provided services to each of the corporations in question.

It should be evident from the above that the required common connection does not seem to be overly stringent or onerous.

In 1996, the CRA set out its administrative position regarding a "group of persons" in Income Tax Technical News no. 7:[62]

> Recently we were asked to clarify our position concerning when persons would be considered to be a group that has acquired *de jure* control of a corporation, particularly in the context of a closely-held corporation.
> It remains our view that it is a question of fact whether persons who own the majority of voting power in a corporation constitute a group that has *de jure* control of the corporation. Two or more persons who become the owners of a majority of the voting shares of a corporation will generally be considered to have acquired control of the corporation where there is an agreement amongst them to vote their shares jointly, where there is evidence that they act in concert to control the corporation, or where there is evidence of their intention to act in concert to control the corporation. A group of persons would be regarded as acting in concert when the group acts with considerable interdependence in transactions involving a common purpose. A common link or interest between members of a group is required to ensure that an acquisition of control is the result of a jointly decided action, rather than a mere fortuitous event.
> Although the requirement to act in concert is relevant in determining whether a group of persons controls any corporation, it is also our view that certain presumptions are appropriate in the case of closely-held corporations. For example, in a closely-held situation, the fact that shareholders jointly adopt mutually advantageous measures is an important indicator of acting in concert. Furthermore, it is our view that in almost all cases where the voting power in a corporation is equally divided between two shareholders, the corporation will be controlled by the group consisting of the two shareholders. In order to rebut this presumption of control by the group, it would be necessary to show that no one is controlling the corporation and that the decision-making process in the corporation is effectively deadlocked. In our view, this

> would be very unusual; however, an example might be where the two shareholders cannot agree on how to run the corporation and have consequently applied to a court for an order authorizing the dissolution of the company.

The above administrative position suggests a lower threshold in the case of a closely held corporation. Shareholders of a private corporation commonly enter into shareholders agreements to govern the management of the business and set policy. The leading case on shareholders agreement and the fettering of directors' discretion is *Ringuet v. Bergeron*[63]. While this was not a tax case, Judson, J.'s statement as reproduced below aptly recognizes that shareholders might combine to act together and this could be the purpose of the shareholder agreement:[64]

> "It is no more than an agreement amongst shareholders owning or proposing to own the majority of the issued shares of a company to unite upon a course of policy or action and support the officers whom they elect. … Shareholders have the right to combine their interest in voting powers to secure such control of a company and to ensure that the company will be well managed by certain persons in a certain manner."

If shareholders of a closely held private corporation "unite upon a course of policy or action" and evidence same by a shareholders agreement, would they become a group of persons? The shareholders may be earning their livelihood from the same business venture; they may sometimes vote unanimously to carry out certain corporate action and they certainly will have a common interest in the operations of the corporation. These were items noted in the selection of caselaw referred to above. It has been said that the existence of a common goal should not be equated with having a common interest.[65] When shareholders enter in to a shareholders agreement, it is not uncommon that they will agree upon representation on the board of directors and particularly that each shareholder may be entitled to a certain number of nominees.[66] In this regard, the shareholders agreement may typically contain a covenant by each shareholder to vote their shares so as to carry out the terms of the shareholders agreement. In this limited fashion, one might argue that the shareholders will therefore have acted jointly. Further, a shareholders agreement may differentiate between major decisions and other decisions and provide for differing voting thresholds. Major decisions (as listed in the agreement) might require unanimity amongst shareholders or, perhaps, merely the consent of the two or more shareholders who combined achieve a certain voting percentage (obviously, in excess of a simple majority). Query whether such provisions, or rather the fact that the shareholders act in accordance with such provisions, might also cause them to be regarded as acting jointly and therefore constitute a group.

In a 1990 technical interpretation[67], the question was whether there was an acquisition of control for purposes of subsections 111(5) and 249(4) in the following circumstances. There were two 50:50 unrelated shareholders – A and B. One of them, B, sold his 50% interest to unrelated person – C. A and C proposed to enter into a shareholders agreement containing a buy-sell provision effective upon death, bankruptcy or permanent disability of either of them; a right of first refusal; pre-emptive rights; a shotgun clause; and a restriction on the powers of the directors regarding share transfers, the issuance or acquisition of shares and declaration of dividends. Each shareholder was to have equal representation on the board of directors. In addition, no shareholder had the power to cause the winding up of the corporation. (By virtue of the clause that restricted the power of directors regarding share transfers and the issuance of shares and declaration of dividends, the shareholder agreement in question likely was a unanimous shareholder agreement although this was not mentioned in the technical interpretation.) In the CRA response, the requirement for a common link or interest as prerequisite to constituting a group was referred to. The CRA stated that the terms of the shareholder agreement did not result in *de jure* control of the corporation being acquired by either shareholder. However, the response did not specifically state whether the terms of the agreement, in and of themselves, might cause the two shareholders to be considered a group. The response discussed the requirement of common link or interest and the group issue was raised as a result, it seems a reasonable inference that the shareholders agreement, in and of itself, was not a sufficient common link or interest.[68]

The control considerations where there is a shareholders agreement which is not a unanimous shareholder agreement can be rationalized as follows. Based on *Duha*, it is clear that one considers a unanimous shareholder agreement in determining *de jure* control of a corporation. Thus if there is a majority voting shareholder, unless the terms of the unanimous shareholder agreement causes him/her to not have effective control over the corporation, such majority voting shareholder should have *de jure* control. If one shareholder was not a party to the agreement or it otherwise failed the statutory requirements for a unanimous shareholder agreement, then its terms should not be relevant to determination of *de jure* control, but could be relevant in determining whether the majority shareholder and others constitute a group of persons. The group of persons could have *de jure* control of the corporation. Thus, it seems that a shareholders agreement which is not a unanimous shareholders agreement may nonetheless be relevant in *de jure* control analysis, but in a roundabout way.

Exit Provisions and Paragraph 251(5)(b)

A unanimous shareholder agreement or an ordinary shareholder agreement most likely contain “divorce” provisions which may provide for the purchase and sale of a shareholder’s interest in the corporation by the other shareholders or perhaps the corporation itself under certain circumstances (whether voluntary or involuntary and whether precipitated by possible third party sale, death or marital problems). In its simplest form, this might be an option or a right by one shareholder to acquire the shares of another shareholder. But for paragraph 251(5)(b), such an option or right would not be relevant for purposes of determining *de jure* control of a corporation. This is illustrated by the decision in *Rous & Mann Press Ltd. v. MNR*[69] in which the right of certain individuals to subscribe for voting shares in a number which would have caused them to have a majority of the voting rights was not considered relevant to a determination of control as the “mere ability to acquire control is quite different from actually having control”.[70] Subsequently, the predecessor to subparagraph 251(5)(b)(i) was enacted.

Paragraph 251(5)(b) applies for purposes of the definition of CCPC and also for purposes of subsection 251(2). Thus, it applies for purposes of determining whether a person and a corporation are related and therefore whether they are deemed to be non-arm’s length. However, in numerous provisions where “related persons” or a non-arm’s relationship is a prerequisite, the statute expressly provides that such relationship is to be determined without reference to paragraph 251(5)(b). Typically, these are anti-avoidance provisions. For example:

- Subsection 17(13) provides an extended definition of controlled foreign affiliate purposes of section 17 only. Where two Canadian resident corporations are related (otherwise then because of a right referred to in paragraph 251(5)(b)), a corporation that is a controlled foreign affiliate of one corporation is deemed to be a controlled foreign affiliate of the other corporation.

- Subparagraph 80.01(6)(a)(ii) defines a “specified obligation” for purposes of the debt parking rules. Where an obligation was acquired by the holder from another person who was not related to the holder at the time of acquisition or conversely who was only related to the holder because of paragraph 251(5)(b), such obligation is a “specified obligation”.

- Paragraph 186(4)(b) is the extended definition of control for Part IV tax purposes. A payer corporation is connected with a particular corporation if the payer corporation is controlled (otherwise then by virtue of a right referred to in paragraph 251(5)(b)) by the particular corporation at the particular time.

Paragraph 251(5)(b) does not apply for purposes of the loss streaming rules in subsection 111(5) nor to trigger a taxation year end pursuant to subsection 249(4) upon an acquisition of control.[71] Paragraph 251(5)(b) does not apply for purposes of the associated corporation rules. However, there is a similar provision in the associated corporation rules being subsection 256(1.4) which is virtually identical to subparagraphs 251(5)(b)(i) and (ii).

The wording of paragraph 251(5)(b) is broad and is best reproduced:

> (5) Control by related groups, options, etc.
>
> For the purposes of subsection (2) and the definition “Canadian-controlled private corporation” in subsection 125(7),
>
> > (b) 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 contingently,
> >
> > > (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,
> > >
> > > (ii) to cause a corporation to redeem, acquire or cancel any shares of its capital stock owned by other shareholders of the corporation, the person shall, except where the right is not exercisable at that time because the exercise thereof is contingent on the death, bankruptcy or permanent disability of an individual, be deemed to have the same position in relation to the control of the corporation as if the shares were so redeemed, acquired or cancelled by the corporation at that time;

Only subparagraphs (i) and (ii) are reproduced above. Subparagraph 251(5)(b)(iii) refers to the acquisition or control of voting rights in respect of shares and subparagraph 251(5)(b)(iv) refers to causing the reduction of voting rights in respect of shares.

Notwithstanding the apparent breadth of paragraph 251(5)(b), the CRA has had a longstanding administrative position that such provision will not typically apply to a right of first refusal or a shotgun arrangement and the below appears in the current version of *Interpretation Bulletin* IT-419R2:[72]

> Although the wording in paragraph 251(5)(b) may be broad enough to include almost any buy-sell agreement, this paragraph will not normally be applied solely because of:
>
> (a) a “right of first refusal”, or
> (b) a “shotgun arrangement” (i.e. an arrangement under which a shareholder offers to purchase the shares of another shareholder and the other shareholder must either accept the offer or purchase the shares owned by the offering party) contained in a shareholder agreement.

Historically, it appears that the CRA’s administrative position stemmed from a view that a right of first refusal did not confer a right to acquire a share but rather was an option to acquire a right to acquire a share and the CRA’s administrative prerequisite that the parties have a clear right or obligation. The following was stated in 1979:[73]

1979, Q.38 – Control under Paragraph 251(5)(b).

Does the Department interpret and apply paragraph 251(5)(b) literally, no matter how remote the right of an optionee or other party to acquire shares of a company may be?

Department's Response

Although the wording in paragraph 251(5)(b) may be broad enough to include almost any "buy-sell" agreement, it is the Department's practice not to apply this paragraph unless both (or all) parties clearly have either a right or an obligation to buy or sell, as the case may be.

Shareholder agreements commonly referred to as "the right of first refusal" are considered not to confer a right to acquire a share but rather an option to acquire a right, in certain future circumstances, to acquire a share.

It is also our practice not to apply paragraph 251(5)(b) of the Act to a "shotgun agreement" (a shareholder offers to purchase the shares of another shareholder and the other shareholder must either accept the offer or purchase the shares owned by the offering party).

Although the exclusion of a right of first refusal and shotgun from the operation of paragraph 251(5)(b) has survived multiple versions of the relevant Interpretation Bulletin, the current version of *Interpretation Bulletin* IT-419R2 omits the description of a right of first refusal as "an option to acquire a right, in certain circumstances, to acquire a share". Also omitted is the statement that it is not the CRA's practice to apply paragraph 251(5)(b) unless "both (or all) parties clearly have either a right or obligation to buy or sell, as the case may be".[74] It is understood[75] that the omission of these words was intentional and while the administrative concession remains for a right of first refusal and a shotgun arrangement, the requirement that both parties have a clear right or obligation to buy or sell, as the case may be, is no longer the administrative practice.

The extent of the legal fiction created by the operation of the deeming role in paragraph 251(5)(b) was illustrated in *Couvre-Plancher Zenith Ltée. v. MNR*[76] where Mr. Sorel or his controlled corporation, Roger Sorel Tapis Inc. ("RST") had an option to acquire all the issued and outstanding shares of the taxpayer corporation from a Mr. Longtin, an unrelated person. Under the terms of the option arrangement, Mr. Sorel or RST upon exercise would become the owner of all but one of the issued and outstanding shares and would become the owner of the final share upon full payment. The arrangement contemplated payment of the purchase price over the course of five years and the parties agreed that during that period, both individuals would be represented on the board of directors with unanimity required for directors' decisions. Further, until Mr. Sorel or RST had paid one-half of the purchase price, shareholders' decisions also had to be unanimous. RST exercised the option. The corporation was reassessed to deny it the benefit of the small business deduction in its 1982 and 1983 taxation years on the grounds that it was associated with RST. Less than one-half of the purchase price had been paid in the taxation years in question. The Minister was successful in its first argument that because RST owned a majority of the voting shares of the taxpayer corporation, it controlled such corporation "in the long run" notwithstanding the restrictions in the agreement regarding the deadlocked voting rights prior to full payment of the purchase price. This was based on the position that the agreement could be ignored because it was not binding on the corporation. However, the Court also considered the application of paragraph 251(5)(b) and held that this provision applied because of the contingency arrangement regarding the final share notwithstanding the actual voting restrictions which existed. In other words, Mr. Sorel was deemed to be in the same position in relation to control as if he owned that share; he would own that share if full payment had been made and if so, there would be no voting restrictions.

The divorce or exit provisions of a shareholder agreement commonly take one of the following forms:

- Right of First Refusal – This is probably the most common form of divorce or exit provision. Prior to selling shares to a third party, the exiting shareholder is required to offer his/her shares to the remaining shareholders. The right may be triggered by the exiting shareholder actually obtaining a prior bona fide arm's length third party offer. The remaining shareholders then have the option (for a stipulated time period) to purchase such shares on the same terms and conditions, failing which the exiting shareholder is free to accept the third party offer.
- Right of First Offer – This is sometimes referred to as a "soft" right of first refusal. The distinction between this and first mentioned right of refusal is whether the exiting shareholder first has an offer from a third party. Where the agreement contains a right of first offer, the first step is that the exiting shareholder offers to sell his/her shares to the remaining shareholders on the terms and conditions as set out in the offer. If the remaining shareholders do not accept this offer, then the exiting shareholder is free to sell his/her shares to a third party purchaser on no less favorable terms and typically within a stipulated period. As a matter of drafting, some shareholders agreements do not distinguish between a "hard" right of first refusal and the right of first offer and refer to both as simply a right of first refusal.
- Shotgun – One shareholder offers to buy the shares of the other shareholder and at the same time offers to sell his/her shares on the terms and conditions as set out in the offer. A variation of this involves an auction procedure whereby the shareholder puts his/her shares up for auction and the other shareholders can bid for shares. A reserve price may be set and there could be obligations to sell at the highest bid or a right to decline all bids.
- Puts and Calls – A put, being the right of a shareholder to require his/her shares to be purchased and a call whereby a shareholder is subject to having his/her shares purchased at the option of others may be included in the shareholder agreement to deal with certain triggering events. These may include the excluded events set out in paragraph 251(5)(b) being the death, bankruptcy or permanent disability of an individual.[77] However, the triggering events can be broader and could include cessation of employment; debtor-creditor issues less than bankruptcy such as seizure of shares; the making of a claim by a shareholder's spouse or other triggering event under relevant matrimonial legislation; a shareholder's breach of the shareholder agreement which, depending on the terms of the agreement, may include events such as encumbering shares or a change of control of a corporate shareholder or failing to contribute capital. The CRA has indicated that it will not extend its administrative treatment for a right of first refusal or shotgun arrangement to other types of triggering events operative upon marital breakdown or a loan default.[78]
- Tag-along or Piggy-back Right – These provisions require that if the shareholder wishes to sell to a third party, the remaining shareholders can require that their shares be sold to the same purchaser on the same terms and conditions.

- Drag-along or Carry-along Right – Under this provision, if a shareholder receives an offer from a third party for the purchase of his/her shares which he proposes to accept, he/she can require the remaining shareholders to sell their shares to such purchaser on the same terms and conditions.

If the language of paragraph 251(5)(b) is applied to each of the above exit provisions, assuming “A” and “B” are the two shareholders of a corporation where A is the shareholder who desires to exit, then these provisions could be expressed as:

- Right of First Refusal – *B will have a right under contract to acquire A’s shares, contingent upon A receiving a third party offer.* This seems to fit within the wording of paragraph 251(5)(b) but if one relies upon the CRA’s administrative position, then this provision should not, in and itself, operate to deem B to own A’s shares of the corporation for purposes of related person or CCPC analysis.
- Right of First Offer – *B will have a right under contract to acquire A’s shares, contingent upon A making an offer to him.* On its face, this seems to fit within the wording of paragraph 251(5)(b) and if so, it is necessary to argue that the CRA’s administrative position regarding a right of first refusal includes a right of first offer since the rights amongst the parties are the same although the sequence is slightly different and nomenclature is different. It can also be argued that this scenario is not different from any hypothetical willing vendor scenario. In other words, any recipient of an offer made by a vendor has a right under contract to acquire shares; such right is contingent upon the vendor making an offer but it is unknown whether the vendor will choose to make an offer to that person. The argument is that such a broad interpretation of paragraph 251(5)(b) could potentially sweep any possible recipient of an offer within its net. There is a distinction between the right of first offer and the hypothetical willing vendor. A must make an offer to B if A wishes the freedom to sell to third parties and therefore the possibility of B receiving such an offer and having such rights under contract is greater than the hypothetical willing vendor and the world scenario. Paragraph 251(5)(b) does not however speak to the likelihood that a contingency will occur.
- Shotgun – *At any time of B’s choosing, B has a right under a contract to acquire A’s shares upon certain terms and at the same time, has the obligation to sell his/her shares to A on the same terms.* This seems to fit within the wording of paragraph 251(5)(b) and therefore one must rely on the CRA’s administrative position.
- Put – *B has the right (obligation) to acquire A’s shares, contingent upon A choosing to exercise his/her put right.* This seems to fit within the wording of paragraph 251(5)(b).
- Call – *B has the right to acquire A’s shares, contingent upon B choosing to exercise his/her call right.* This seems to fit within the wording of subparagraph 251(5)(b).
- Tag-along or Piggyback Right – B has the right to sell his/her shares on the same terms to the same person to whom A is selling his/her shares. This does not fit within the wording of paragraph 251(5)(b).

- Drag-along or Carry-along Right – A has the right to cause B to sell to the same third party on the same terms as A's sale. This does not fit within the wording of paragraph 251(5)(b).

Preferred Share Regime

The preferred share rules must also be addressed in a discussion of shareholder agreements. The preferred share rules have been the subject of much commentary in various Canadian Tax Foundation papers.[79] The below is not intended to be a detailed discussion but rather, intended only to highlight issues that may derive from a shareholders agreement and limited to term preferred share and taxable preferred share analysis. These rules may apply to common shares in a private corporation environment – a typical situation for a shareholders agreement. The potential application of these rules derives in part from the reference in the definition of each such share in subsection 248(1) to not only the terms or conditions of shares but also "any agreement in respect of the share" or "any agreement relating to the share". That could include a shareholder agreement as the words "in respect of" have been interpreted to be "words of the broadest possible scope" and "probably the widest of any expression intended to convey some connection between two related subject matters"[80]. The below discussion assumes that the shares are not grandfathered.

(a) Term Preferred Share Concerns

Term preferred share characterization is relevant in certain circumstances to dividend deductibility pursuant to subsection 112(1). The relevant portion of subsection 112(2.1) reads as follows:

> No deduction may be made under subsection (1) or (2) in computing the taxable income of a specified financial institution in respect of a dividend received by it on a share that was, at the time the dividend was paid, a term preferred share, other than a dividend paid on a share of the capital stock of a corporation that was not acquired in the ordinary course of the business carried on by the institution.

To paraphrase, a specified financial institution may not deduct in computing taxable income, a taxable dividend received by it on a term preferred share, subject to an exemption for a dividend paid on a share that was not acquired in ordinary course of business carried on by the institution. Thus, the two prerequisites are: (a) the dividend recipient must be a specified financial institution; and (b) the dividend must be paid on a term preferred share, with an exemption applicable to shares acquired outside the ordinary course of business.

The first prerequisite as described above is that the dividend recipient be a specific financial institution. The term "specified financial institution" is defined in subsection 248(1) in potentially broader terms than expected. While a bank, a credit union and insurance corporation are specifically listed as a "specified financial institution", paragraph (e) and (g) of such definition truly expand the scope of the definition. Paragraph (e) refers to:

> "a corporation whose principal business is the lending of money to persons with whom the corporation is dealing at arm's length or the purchasing of debt obligations issued by such persons or a combination thereof"

and paragraph (g) includes as a "specified financial institution" any person that is related to any corporation listed in any of paragraphs (a) to (f) of the definition (referred to herein as a "Paragraph (g) SFI"). It should be noted that for this purpose, there is no express exclusion of paragraph 251(5)(b).[81] While the requirement of arm's length dealing in paragraph (e) of the definition may effectively exempt internal financing corporations within a related group of corporations, it seems possible that a corporation (which may not be a venture capital entity or an entity whose ordinary business includes the lending of money) may engage in activity consisting of lending to arm's length persons or acquiring debt obligations issued by arm's length persons. This could be a limited number of loans or the purchase of publicly available debt instruments. While it may not be clear that such a corporation is earning income from business as opposed to earning income from property, the rebuttable presumption (based on *Canadian Marconi Company v. MNR*[82]) is that a corporation earns income from business.[83] Further factual analysis would be required. If such a corporation falls within paragraph (e) of the definition, then any related corporation may be a Paragraph (g) SFI. Thus, a corporation may unexpectedly be a specified financial institution.

The second prerequisite to the application of subsection 112(2.1) is that the dividend be paid on a term preferred share. There is a lengthy definition of term preferred share in subsection 248(1). Of particular concern in the private corporation shareholder agreement milieu are subparagraphs (a)(i) to (iii) of the definition which are reproduced below:

> (a) under the terms or conditions of the share, <u>any agreement relating to the share</u> or any modification of those terms or conditions or that agreement,
>
> (i) the <u>owner thereof may cause the share to be</u> redeemed, <u>acquired</u> or cancelled (unless the owner of the share may cause the share to be redeemed, acquired or cancelled by reason only of a right to convert or exchange the share) or cause its paid-up capital to be reduced,
>
> (ii) the issuing <u>corporation or any other person</u> or partnership is or may be <u>required to redeem, acquire or cancel,</u> in whole or in part, the share (unless the requirement to redeem, acquire or cancel the share arises by reason only of a right to convert or exchange the share) or to reduce its paid-up capital,
>
> (iii) the issuing <u>corporation or any other person</u> or partnership provides or may be <u>required to provide any form of guarantee, security or similar indemnity or covenant</u> (including the lending of funds to or the placing of amounts on deposit with, or on behalf of, the holder thereof or any person related thereto) <u>with respect to the share</u>.
>
> [emphasis added]

Certain divorce provisions in a shareholder agreement may arguably satisfy the requirements in subparagraphs (a)(i) or (ii) of the term preferred share definition. Specifically, if under the terms of the shareholder agreement, a shareholder has the right to cause the share to be acquired or cancelled, or the issuing corporation or other person may be required to acquire such shares, then such shares may constitute term preferred shares. For example, it appears that a put right would satisfy subparagraph (a)(i) of the term preferred share definition. The CRA has taken an expansive reading of these requirements and has suggested that piggy-back rights may fall within the wording of subparagraphs (a)(i) or (ii) of the definition[84] and shotgun buy-sell arrangements may be a form of guarantee or security with respect to the share as referred to in subparagraph (a)(iii) of the definition.[85]

Citibank Canada v. The Queen[86] dealt with the interpretation of the words "any form of guarantee, security or similar indemnity or covenant" as those words appear in subparagraph (a)(iii) of the definition. The issue was whether a formula (in the terms and conditions of certain preferred shares) which permitted shares to be converted into common shares provided the taxpayer with "any form of guarantee, security or similar indemnity or covenant” with respect to those shares. As it was acknowledged by the Minister that there was some ambiguity in the disputed words, the Federal Court of Appeal (following the interpretative rule set out in *Corporation Notre-Dame de Bon-Secours v. Communauté Urbaine de Québec*[87]*)* found that as a matter of statutory interpretation, the purpose of the provision became relevant. Malone, J. A. found that the definition of term preferred share arose from a “narrow and particular context” and applied to a “specific and sophisticated segment of taxpayers”. In his view, the legislative purpose required these words to be narrowly construed and their legal and technical meaning was applicable. The words “any form of” did not indicate that a broader meaning should be given to the words “guarantee, security or indemnity” but rather that the instrument did not have to be a formal guarantee, security or indemnity; the common feature of which was that there were protections against loss.

In light of *Citibank*, subparagraph (a)(iii) of the term preferred share definition should be more narrowly interpreted. As a shotgun buy-sell arrangement does not seem to provide protection against loss (but rather provides an exit to address a deadlock situation and liquidity for only one party) its inclusion in a shareholder agreement should not, in and of itself, cause the shares to be term preferred shares by virtue of subparagraph (a)(iii). *Citibank* will not however, prevent term preferred share characterization pursuant to subparagraphs (a)(i) or (ii) but supports narrower interpretation given the context and purpose of these rules.

If the shares subject to exit arrangements in a shareholders agreement constitute term preferred shares and the particular shareholder is a specified financial institution, subsection 112(2.1) will not apply if the share was not acquired in ordinary course of business of such shareholder.[88] In connection with the term preferred share rules, there has been one reported case interpreting this expression: *Societé D’Investissements Desjardins v. MNR*[89]*. Desjardins* illustrated that the determination of whether a particular transaction or acquisition of shares was or was not in the ordinary course of business of the institution was a fact specific analysis. Tremblay, T.C.J. stated:[90]

> [T]his provision was clearly enacted to avoid the improper use by lending institutions of shares similar to loans the dividends on which were tax free while the interest on the sums loaned had to be included in the income of these corporations. The malice rule that emerges from this provision is accordingly the abuse of this tax free transaction. However, an exceptional situation that might at a pinch be described as accidental should not suffer from application of the principal in subsection 112(2.1) of the Act.

The Court also cited with approval a paper by Geoffrey Dyer in the 1986 Corporate Management Tax Conference[91] suggesting that a corporation which constitutes a specified financial institution by virtue of being related to another specified financial institution (i.e., a Paragraph (g) SFI) should have more scope to argue that it acquired particular shares outside the ordinary course of business. Perhaps this is the exceptional circumstance referred to above. The foregoing may provide comfort for a corporation which falls with the definition of specified financial institution by virtue of being related to one, and finds that the common shares which it owns in a corporation constitute term preferred shares by virtue of certain exit arrangements in a shareholder agreement.[92]

If the “outside the ordinary course of business” exemption does not apply, other relief may be available in the case of a deemed dividend. Where a dividend is deemed to have been paid on a term preferred share pursuant to subsection 84(2) or (3), paragraph 191(4)(e) may effectively provide an exemption and render subsection 112(2.1) inapplicable. Such a deemed dividend could arise on the redemption or purchase for cancellation of the share by the corporation. Subsection 191(4) contains a concept (but not a defined term) of a “specified amount”. To the extent that the amount paid on the redemption, acquisition or cancellation does not exceed the “specified amount”, the effect of paragraph 191(4)(e) is that subsection 112(2.1) shall not apply. Therefore, the dividend deduction rule in subsection 112(1) should apply to permit the deduction of the deemed dividend. However, to the extent that the amount paid on the redemption, acquisition or cancellation exceeds the “specified amount”, the amount of the excess shall be subject to subsection 112(2.1).[93]

Subsection 191(4) requires that the terms and conditions of the share or an “agreement in respect of the share” specify an amount in respect of the share, including an amount for which the share is to be redeemed, acquired or cancelled. The CRA has stated that unless the terms and conditions of the share or an agreement in respect of the share specify a different amount for purposes of subsection 191(4), the specified amount will be the amount for which the share is to be redeemed, acquired or cancelled.[94] The specified amount cannot exceed the fair market value of the consideration for which the share was issued. Where the terms and conditions of the share are subsequently changed or an agreement in respect of the share is entered into or changed, the specified amount cannot exceed the fair market value of the share immediately before the particular time (i.e., before such change or before the agreement is entered into or changed). It has been the administrative position of the CRA that the specified amount must be an actual dollar amount; not based on a formula that relates to some other share nor subject to a price adjustment clause which might permit the amount to be adjusted.[95]

If the shares in question are preferred shares, then the redemption price (assuming that this is a fixed dollar amount and not subject to a price adjustment clause) may be the specified amount for purposes of subsection 191(4). A retractable preferred share may be a term preferred share by virtue of the retraction feature alone, without regard to any exit arrangements in a shareholders agreement.

If the shares in question are common shares and constitute term preferred shares because of exit arrangements in a shareholders agreement, it seems unlikely that any amount would be specified in the terms and conditions of the shares. Rather, it appears that the purchase price (i.e., the amount to be paid by the corporation upon the acquisition or cancellation of the shares) may have the greatest correlation to a specified amount yet it seems unlikely that this will have been described as a fixed dollar amount in the shareholder agreement. Rather, the relevant amount payable upon the exit arrangement becoming operative may likely be referenced by way of formula or by subsequent determination. This does not satisfy the CRA’s administrative views on a specified amount. Further, given the requirement that the specified amount cannot exceed the fair market value of the share immediately before the particular time (being the time the shareholders agreement was entered into), if the shares increase in value from that time to the date that the exit arrangement becomes operative, an amount less than the purchase price will have been specified and pursuant to subsection 191(5), the excess would not be exempted by subsection 191(4)[96]. Thus, paragraph 191(4)(e) may provide relief from the consequences of term preferred share characterization only in limited circumstances.

(b) Taxable Preferred Share Concerns

Assuming that the corporation and any corporate shareholder are private corporations, if the shares (subject to a shareholders agreement) constitute taxable preferred shares or short term preferred shares, Part VI.1 tax may apply. As it has been assumed that the corporate shareholder is a private corporation, any dividend received on a taxable preferred share shall be an “excepted dividend” pursuant to paragraph 187.1(c) and therefore not subject to Part IV.1 tax. Because of the dividend allowance and the substantial interest exemption (both further described below), there may be limited circumstances where Part VI.1 tax become a concern.

By way of summary, Part VI.1 tax consequences are as follows:

- Tax is imposed upon the dividend payer at the rate of either 25% or 40% on the amount of the dividend paid on a taxable preferred share (other than an “excluded dividend”) in excess of the corporation’s dividend allowance for the year. The lower 25% rate applies unless the corporation has elected to pay Part VI.1 tax at the higher 40% rate.

- In the case of short term preferred shares, tax is imposed on the dividend payer at the rate of 66 2/3% of the dividend (other than an “excluded dividend”) in excess of the corporation’s dividend allowance for the year. It has been proposed that this rate be reduced to 50%.[97]

- The corporation (dividend payer) is entitled to a deduction pursuant to paragraph 110(1)(k) equal to 9/4 of the Part VI.1 tax. The July 18, 2005 Draft Legislation has proposed that this be changed to a deduction equal to three times the Part VI.1 tax (applicable to the 2003 and subsequent taxation years). The effect of the paragraph 110(1)(k) is to provide a full credit of the Part VI.1 tax, assuming that the dividend payer is subject to a combined federal and provincial income tax rate of 44.44% in the particular year. The proposed amendment will produce a full credit based on an assumed combined federal and provincial rate of 33.3%. To the extent that the corporation cannot use the paragraph 110(1)(k) deduction in the year in which the Part VI.1 tax liability arises, this deduction shall result in a non-capital loss of the corporation subject to the usual carryover rules.

- There is a mechanism in subsection 191.3 whereby the corporation (dividend payer) may transfer the Part VI.1 tax liability and resultant paragraph 110(1)(k) deduction to a related corporation.

The dividend allowance of a corporation as provided in subsection 191.1(2) is equal to $500,000.00 (pro-rated for short taxation years). This allowance is reduced to the extent that the corporation and associated corporations have paid dividends (other than excluded dividends) in excess of $1,000,000.00 on taxable preferred shares in the immediately preceding calendar year.

An “excluded dividend” is not subject to Part VI.1 tax. The term “excluded dividend” is defined in subsection 191(1) and while there are various seemingly specialized categories, perhaps the most commonly relied upon exemption is found in paragraph (a) of the definition. This provides that a dividend paid by a corporation to a shareholder that had a substantial interest in the corporation at the time the dividend was paid is an “excluded dividend”. The requirements for a substantial interest are set out in subsection 191(2). A shareholder can have a substantial interest in a taxable Canadian corporation on the following basis:

- if the shareholder is related (otherwise than by reason of a right referred to in paragraph 251(5)(b)) to the corporation at the particular time, or
- the shareholder owns shares that represent 25% or more of the "votes and value" and either
    - 25% or more (on a fair market value basis) of the shares of the corporation that are not taxable preferred shares or
    - 25% or more (on a fair market value basis) of each class of shares of the corporation

For the above purposes, there is a look-through test so that a shareholder is deemed to own any shares owned by a related person (other than a person related by virtue of paragraph 251(5)(b)). There are more stringent prerequisites for substantial interest in the case of a shareholder which is a partnership or trust.[98]

By virtue of the dividend allowance and the substantial interest exemption, there may be limited circumstances in which Part VI.1 tax becomes an issue in the private corporation environment. One such circumstance may be a redemption of shares. It is possible that a deemed dividend arising by virtue of a redemption or purchase of shares for cancellation may exceed the corporation's dividend allowance for the year. Subsection 191(4) may theoretically provide relief from Part VI.1 tax consequences in respect of a subsection 84(2) or (3) deemed dividend. If its prerequisites are met, the amount of the dividend deemed to have been paid on the redemption, acquisition or cancellation of a share is deemed to be an "excluded dividend" for purposes of Part VI.1 tax and an "excepted dividend" for purposes of Part IV.1 tax. In other words, if subsection 191(4) applies, there is no Part VI.1 or Part IV.1 tax liability in respect of the particular dividend. However, as previously discussed, the application of subsection 191(4) requires that the terms or conditions of the share or the agreement in respect of the share "specify an amount in respect of the share". Where the shares are common shares, it seems unlikely that any such amount will have been specified in the terms and conditions of the shares. As described previously, it has been the CRA's administrative position that a specified amount for this purpose is a fixed dollar amount, not subject to adjustment nor fixed by formula. It seems unlikely that a shareholder agreement with exit provisions including purchase for cancellation of shares would refer to a fixed amount. Thus, it appears that subsection 191(4) may be of limited assistance.

The above has described generally described Part VI.1 tax consequences together with exemptions which may apply in the private corporation context. However, as a preliminary matter, Part VI.1 tax may only apply if dividends are received on taxable preferred shares. Without purporting to delve into the complexities of the definition of "taxable preferred share" in subsection 248(1), common shares which are subject to a shareholder agreement with exit provisions may constitute taxable preferred shares for the following reasons:

- <u>Liquidation Entitlement</u>: Such shares may be considered to have a fixed, minimum or maximum liquidation entitlement as described in subparagraph (b)(ii) of the taxable preferred share definition. In particular, subparagraph (b)(ii) of the definition refers to a share where by reason of the terms or conditions of the share or any agreement in respect of the share to which the corporation or a person non-arm's length with corporation[99] is a party, it may reasonably be considered that the amount that the shareholder is entitled to receive on a liquidation or on the redemption, acquisition or cancellation of the share is, by way of formula or otherwise fixed, limited to a maximum or established to be not less than minimum. Although this is sometimes referred to as the "liquidation entitlement", subparagraph (b)(ii) is worded broadly enough to encompass not only amounts received upon the dissolution of the corporation but also amounts received upon an acquisition of the share. It should be noted that there is an exclusion embedded in subparagraph (b)(ii) itself where the requirement to redeem, acquire or cancel the share arises only in the event of the death of the shareholder, including for this purpose, a shareholder of a shareholder, e.g. death of the individual shareholder of a corporate shareholder. However, the use of the word "only" may preclude reliance upon this exclusion, as exit arrangements may have multiple triggering events, in addition to death.

- Guarantee Agreement: Subparagraph (b)(iv) of the taxable preferred share definition contemplates a guarantee arrangement – defined therein as a "guarantee agreement". Specifically, the share may be a taxable preferred share if, by reason of the terms or conditions of the share or any agreement in respect of the share to which the corporation or a person non-arm's length to the corporation is a party, any person (other than the corporation) is obligated to effect any undertaking, including any guarantee, covenant or agreement to purchase or repurchase the share which is given to ensure that any loss which the holder may sustain by virtue of the ownership or disposition of the shares is limited or to ensure that the holder will derive earnings by reason of the ownership of his share. There is broad language with respect to the obligation – "either absolutely or contingently, and either immediately or in the future".

A retractable preferred share is likely a taxable preferred share, by virtue of the retraction right and without regard to any provisions of a shareholder agreement. However, an exit arrangement in respect of common shares would presumably set the price which an exiting shareholder may receive. This may not be a fixed dollar amount and therefore may not be a "specified amount" for purposes of subsection 191(4) but subparagraph (b)(ii) of the taxable preferred share definition contemplates that the amount may be set "by way of formula or otherwise". It may therefore be argued that pursuant to the shareholder agreement, the amount which the shareholder is entitled to receive on the redemption, acquisition or cancellation of the share is fixed or subject to a maximum or minimum, by way of formula or otherwise.. Such shares may therefore fall within subparagraph (b)(ii) of the taxable preferred share definition.

The exit arrangements may also fit within subparagraph (b)(iv) of the taxable preferred share definition and while the *Citibank* decision may be of assistance in limiting the meaning of the word "guarantee", the wording of subparagraph (b)(iv) is both broader and more specific than the "any form of guarantee, security or similar indemnity or covenant…with respect to the share" language found in the term preferred share definition. Subparagraph (b)(iv) specifically refers to an agreement to purchase or repurchase the share and this phrase is not restricted to arrangements in the nature of a guarantee since it is not preceded by the use of the word "similar". It is however necessary that such agreement be give to ensure that any loss which the holder may sustain by virtue of owning the shares is limited or to ensure that the holder will derive earnings. These are questions of fact[100]. In the context of the guaranteed preferred share rule in subsection 112(2.2) which uses similar wording, the CRA indicated that a put option would be considered to be a "guarantee agreement" (as used therein) but also noted that it was a question of fact whether such put option results in limiting loss on the shares or ensuring that the person derives earning by reason of ownership of the shares.[101]

The subparagraph (b)(ii) liquidation entitlement or the subparagraph (b)(iv) guarantee agreement must exist by reason of the terms and conditions of the share, or any agreement in respect of the share to which the corporation, or a person non-arm's length to the corporation, is a party. The above discussion has assumed that in the case of a common share subject to a shareholders agreement, the liquidation entitlement and guarantee agreement derive from the shareholders agreement and not the terms and conditions of the common shares. It should be noted that paragraph (b) of the taxable preferred share definition does not apply to any agreement, but rather only an agreement to which the corporation or a non-arm's length person is a party. Therefore, it may be prudent to consider whether these taxable preferred share concerns may be addressed by choice of party to the shareholder agreement. If one of the shareholders is non-arm's length to the corporation, and that shareholder is a party to the agreement, this line of thought becomes irrelevant. However, if all shareholders are arm's length to the corporation, then one should determine whether it is necessary for the corporation to be a party. It is not mandatory that the corporation itself be a party to a shareholders agreement except where the exit provisions contemplate a corporate repurchase of shares. In that case, it seems preferable to have a direct covenant from the corporation. However, the shareholders agreement likely contains a compliance provision enforceable against the parties. Specifically, the agreement may provide that each shareholder shall vote and take all necessary steps to ensure that all terms of the agreement are carried out. If the corporation is not itself a party to the shareholders agreement, a shareholder might nonetheless be able to enforce an exit covenant involving the corporation, perhaps by seeking some form of equitable relief as against the other shareholders (each of whom is a party to the agreement). In the case of a unanimous shareholder agreement, a statutory compliance order is possible.[102]

Paragraph (f) of the taxable preferred share definition provides two exceptions which may be of assistance. These are based on: (i) a 60 day closing requirement; or (ii) a fair market value acquisition price. If applicable, as the agreement is to be read without reference to the portion where a person agrees to acquire the share, the exit arrangement is effectively excised from the agreement for purposes of applying the taxable preferred share definition. As a result, neither the liquidation entitlement concept in subparagraph (b)(ii) nor the guarantee arrangement concept in subparagraph (b)(iv) should apply.

(i) <u>60 day Closing Requirement</u>: This exception requires that the share be acquired within 60 days after the agreement is entered into with an acquisition price not exceeding the greater of the fair market value at the time the agreement was entered into and the fair market value at the time of acquisition. If the agreement in question is the shareholders agreement, it seems unlikely that this exception may apply given the 60 day requirement. While it is likely that the operation of the exit clause leads to a second agreement (i.e., offer and acceptance results in a contract) which may (depending on the particular shareholders agreement) close within 60 days thereafter, the excision would therefore apply only to the second agreement. Specifically, only the second agreement would therefore be read without reference to the part where a person agreed to acquire shares and thus, the second agreement may therefore not fit within subparagraphs (b)(ii) or (iv) of the taxable preferred share definition. However, the shareholders agreement itself would not be so excised as the acquisition would not presumably close within 60 days of signing the shareholders agreement and therefore, the parameters of subparagraph (f)(i) would not be met.

(ii) Fair Market Value Acquisition Price Requirement: This requirement is satisfied if the agreement provides that the shares shall be purchased for an amount that does not exceed the fair market value of the shares at the time of acquisition. The acquisition price may also be determined by reference to the assets or earnings of the corporation provided that this method of computation is reasonable, i.e,, where that "may reasonably be considered to be used to determine an amount that does not exceed the fair market value of the share at the time of acquisition". In either case, there is a fair market value benchmark and the agreement itself is not considered evidence for this purpose notwithstanding that it may be an agreement with an arm's length person.

CONCLUSION

A shareholders agreement is a useful and commonly used commercial document to set out the objectives of individual shareholders, protect their rights and provide for the governance and management of the corporation. Each of these commercial objectives has related tax issues, and a selection of such issues has been analysed in this paper.

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[1] R.S.C. 1985 (5th supp.) C.1, as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this paper are to the Act.

[2] 98 DTC 6334 (SCC).

[3] For the taxation years in issue in *Duha*, the relevant portion of subparagraph 256(7)(a)(i) read as follows:

> 256(7) For the purposes of subsections 66(11) and (11.1), 87(2.1), 88(1.1) and (1.2) and section 111
>
> (a) where shares of a particular corporation have been acquired by a person after March 31, 1977, that person shall be deemed not to have acquired control of the particular corporation by virtue of such acquisition if that person
>
> (i) was, immediately before such share acquisition, related (otherwise than by virtue of a right referred to in paragraph 251(5)(b)) to the particular corporation.

[4] See paragraph 251(2)(b)(i).

[5] 64 DTC 5301 (Ex. Ct.) at.p. 5303.

[6] *Duha*, supra note 2, paragraph 36.

[7] S.C. 1974-75-76, c. 33, now R.S.C. 1985, c. C-44 (the "CBCA").

[8] Robert W. V. Dickerson, John L. Howard and Leon Getz, *Proposals for a New Business Corporations Law for Canada*, (Ottawa: Information Canada. 1971). Commonly known as the Dickerson Report after the name of one of the authors.

[9] Paragraph 299 of the Dickerson Report commented on the recommendation for subsection 11.14(2) of the draft Canada Business Corporations Act in Volume II of the Dickerson Report which was largely adopted to become what is now subsection 146(2) of the CBCA.

> 299. The common law rule is generally stated to be subject to the qualification that the agreements must be for a lawful purpose (*Motherwell v. Schoof, supra*), and this is generally tested by reference to whether the agreement purports to bind the parties to it not merely *qua* shareholders, but also *qua* directors. Thus, in *Motherwell v. Schoof*, part of such an agreement which purported to dictate the manner in which the parties would act in exercising their powers as directors was struck down as an invalid attempt to fetter the exercise of their discretion. This is doubtless a sound principle in a case where all shareholders are not parties to the agreement, but there is authority for the view that even an agreement to which all shareholders are parties is subject to the same limitation: *Atlas Developments Co. Ltd. v. Calof & Gould* (1963) 41 WWR 575. This seems unnecessarily rigid, and accordingly s. 11.14(2) in effect reverses the decision in that case. Note that, under subsection (2), all the shareholders can enter into an agreement with a non-shareholder by which he has exclusive power to manage the affairs of the corporation. There is some doubt as to how far directors may go in divesting themselves of management powers under existing law, and this provision is designed to clarify the law on the point.

Motherwell v. Schoof, [1949] 4 DLR 812 (SCC), involved an agreement between two shareholders to vote their shares so as to elect each other as directors and to submit shareholder matters to arbitration if necessary. However, the agreement also purported to bind them in their capacity as directors to vote as provided therein and to submit directors' decisions to arbitration if necessary. The agreement was severed by the Court and the portion fettering the discretion of directors was held invalid.

[10] Bruce W. Welling, *Corporate Law in Canada* (2nd ed. 1991), p.482. Similarly broad language has been used by other commentators. See, e.g., Disney, Michael., "The Unanimous Shareholder Agreement: A Promise Unfulfilled?", 8 Corporate Structure, Finance and Operations, ed. Sarna (Toronto: Carswell, 1995), p.83 at p. 88.

> "It permits shareholders to agree to take over the powers of the directors entirely, thereby eliminating the fundamental corporate law distinction between the roles and powers of directors and shareholders."

[11] R.S.O. 1990, c. B16, as amended (the "OBCA").

[12] The existence of a unanimous shareholder agreement may but need not, be noted by legend on the corporation's share certificates. It is typical to do so thereby causing a transferee to bound by its provisions pursuant to subsections 56(3) and 108(4) of the OBCA.

[13] Note that the requirement speaks to all shareholders and not only voting shareholders.

[14] Commonly, the corporation itself is a party to the agreement.

[15] It seems evident that "business" and "affairs" are intended to be distinct. The term "affairs" is defined in subsection 1(1) of the OBCA with reference to internal relationships among the corporation, directors, officers and shareholders:

> "affairs" means the relationships among a corporation, its affiliates and the shareholders, directors and officers of such bodies corporate but does not include the business carried on by such bodies corporate."

[16] This is sometimes referred to as a pooling agreement. See subsection 108(1) of the OBCA which states:

> "A written agreement between two or more shareholders may provide that in exercising voting rights the shares held by them shall be voted as therein provided."

[17] In contrast, it appears that under Alberta *Business Corporations Act*, R.S.A. 2000, c. B-9, the statutory requirements for a unanimous shareholder agreement may be different and such an agreement may be constituted without restriction on the powers of the directors to manage the business of the corporation since that is only one of the matters that may be provided for in the agreement. It appears that merely dealing with shareholder rights will suffice. In this statute, a unanimous shareholder agreement is defined in subsection 1(jj) as follows:

> 1(jj) "unanimous shareholder agreement" means
> (i) a written agreement to which all the shareholders of a corporation are or are deemed to be parties, whether or not any other person is also a party, or
> (ii) a written declaration by a person who is the beneficial owner of all the issued shares of a corporation,

that provides for any of the matters enumerated in section 146(1);

> 146(1) A unanimous shareholder agreement may provide for any or all of the following:
> (a) the regulation of the rights and liabilities of the shareholders, as shareholders, among themselves or between themselves and any other party to the agreement;
> (b) the regulation of the election of directors;
> (c) the management of the business and affairs of the corporation, including the restriction or abrogation, in whole or in part, of the powers of the directors;
> (d) any other matter that may be contained in a unanimous shareholder agreement pursuant to any other provision of this Act.

[18] The OBCA does not require that the agreement expressly state that it is intended to be a unanimous shareholder agreement. Some corporate statutes contain a requirement to file notice of the execution or termination of a unanimous shareholder agreement. See, e.g., Saskatchewan *Business Corporations Act*, R.S.S. 1978, c. B-10, subsection 140(5); *Corporations Act* (Manitoba), C.C.S.M. c. C225, subsection 140(6); *Corporations Act* (Newfoundland), R.S.N.L. 1990, c. C-36, subsection 245(5).

[19] Subsection 115(1) of the OBCA.

[20] *Duha*, supra note 2, paragraph 78.

[21] Michael Disney, "Shareholder Agreements: Organization, Management and Governance Issues", in Shareholders Agreements 2002 (Law Society of Upper Canada) at p. 2-11. Welling, supra note 10, p. 483-4 seems to suggest otherwise:

> First, a unanimous shareholder agreement should be structured to define some realm of corporate decision-making that is to be stripped from the board of directors and transferred to the shareholders. The nature of the agreement is to specify certain endeavors concerning which the directors will be rendered powerless, rather than to express a shareholder consensus as to a particular course of action the corporation is to pursue. This is not what some practitioners currently think of as a unanimous shareholder agreement. However, it seems an inevitable conclusion when one recalls that the effect is to catapult each shareholder into a director's role *vis-à-vis* certain defined subject matters. If each shareholder then owes the corporation the same types of equitable duties as a director would, then each shareholder *qua* acting director will be obliged to make up his mind afresh as he is confronted by each new problem within the scope of the agreement. He cannot agree in advance as to how he will decide because he will have inherited the director's obligation to decide each issue as *then* appears to be to the corporate advantage. Far from being free, as a shareholder, to contract, sell, or give away his precious vote, each shareholder *qua* acting director will be caught by the rule in *Motherwell v. Schoof*: he who owes a fiduciary obligation (here, each shareholder, because of the unanimous shareholder agreement) cannot fetter his discretion; he is required to remain free to vary his opinion as seems to him to suit the occasion and the person (here, the corporation) to whom the duty is owed. In short, a unanimous shareholder agreement is an agreement by 100 per cent of the shareholders setting out certain areas of corporate endeavor in which the directors' power is to be limited; it is not a binding agreement as to how each of the shareholders will exercise his judgment in the future when voting on corporate affairs.

[22] 46 B.L.R. (2d) 87 (OCJ).

[23] Subsection 23(1) of the OBCA.

[24] Subsection 38(1) of the OBCA.

[25] Subsection 116(1) of the OBCA.

[26] Section 133 of the OBCA.

[27] Section 137 of the OBCA.

[28] Subsections 184(1) and (2) of the OBCA.

[29] Section 97 of the OBCA.

[30] *Duha*, supra note 2, paragraphs 81-2.

[31] See Robert Lee, "Shareholders' Agreements: Subtle Aspects relating to Control," in *Report of Proceedings of the Fifty-Sixth Tax Conference*, 2004 Conference Report (Toronto: Canadian Tax Foundation, 2005), 15:1-18 and Robert Couzin, "Some Reflections on Corporate Control", (2005) vol. 53, no. 2 *Canadian Tax Journal* 305-332.

[32] [1969] CTC 98 (Exchq. Ct.), affirmed [1971] CTC 402 (SCC).

[33] There were two classes of shares. There were two (2) issued and outstanding Class A shares which had the exclusive right to vote for the election of directors. There were 498 issued and outstanding Class B shares which carried full voting rights except in the election of directors. The Class B shareholder was held to have control "in the long run" because it could pass any ordinary resolution at a shareholder meeting and pass a special resolution to change the articles of the company.

[34] Referred to herein as the CRA.

[35] "Corporations: Association and Control", August 14, 2001, paragraph 18. The example in this paragraph referred to such a provision being included in the articles of incorporation, but presumably also the position is the same if such provision is included in any constating document, including a unanimous shareholder agreement.

[36] [1993] 2 CTC 2087 (TCC). This was a decision under the informal procedure.

[37] There was an argument made that the agreement was ineffective because the statutory requirement for filing notice of a unanimous shareholder agreement was not complied with. The Court did not accept this argument. One clear OBCA requirement is that all shareholders be a party. Therefore, if a non-voting shareholder is not a party, the OBCA requirements for a unanimous shareholder agreement are not satisfied.

[38] Given Iacobucci, J.'s use of the qualifier "generally", perhaps there may be particular circumstances where an agreement among shareholders which is not a unanimous shareholders agreement may nonetheless be considered. See *Duha*, supra note 2, paragraph 59:

> "As I have already indicated, agreements among shareholders, voting agreements and the like are, <u>as a general matter</u>, arrangements that are not examined by courts to ascertain control. In my view, this is because they give rise to obligations that are contractual and not legal or constitutional in nature."

In *Duha*, reference was made to two cases in which Iacobucci, J. held that the courts properly considered external documents (i.e., documents other than constating documents). *MNR v. Consolidated Holding Company Limited*, 72 DTC 6007 (SCC) and *The Queen v. Lusita Holdings Ltd.*, 84 DTC 6346 (FCA) are both cases that involved examination of trust instruments to determine the limitations on the trustees' power to vote shares. This was also pointed out in Lee, supra note 31, p.15:17.

[39] As contemplated in subsection 108(1) of the OBCA.

[40] *Interpretation Bulletin* IT-64R4*,*supra note 35, paragraph 23:

> 23. Whether a person or group of persons can be said to have *de facto* control of a corporation, notwithstanding that they do not legally control more than 50 per cent of its voting shares, will depend on each factual situation. The following are some general factors that may be used in determining whether *de facto* control exists:
> (a) the percentage of ownership of voting shares (when such ownership is not more than 50 per cent) 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 a casting vote;
>
> (d) commercial or contractual relationships of the corporation, e.g., 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.
>
> Although the degree of influence in (f) is always a question of fact, close family ties (between parents and children or between spouses) especially lend themselves to the development of significant influences. Generally, these persons must demonstrate their economic independence and autonomy before escaping presumptions of fact which apply to related persons. However, with respect to siblings, unless the facts indicate otherwise, generally one sibling would not be considered to have influence over another.
>
> In addition to the general factors described above, the composition of the board of directors and the control of day-to-day management and operation of the business would be considered.

See also CRA document no. 9203565 dated May 14, 1992 (pre-dating *Duha*) which stated that such an agreement may be a determining factor in ascertaining whether a person or persons has *de facto* control of a corporation pursuant to subsection 256(5.1).

[41] For example, the expression “controlled, directly or indirectly in manner whatever” appears in

- subsection 24(2) relating to cessation of business by an individual which is thereafter carried on by the spouse or a corporation “controlled directly or indirectly in any manner whatever” by the individual
- limitations on the capital gains reserve in paragraph 40(2)(a)
- limitations on the replacement property rules in respect of capital property in paragraph 44(7)(b)
- subsection 95(6), an anti-avoidance provision applicable to foreign affiliates and certain non-resident corporations.

[42] See Tax for the Owner-Manager, Volume 4, Number 4 October 2004 and Catherine A. Brayley, “Curent Cases of Interest to Owner-Managers and their Advisors”, 2003 Ontario Tax Conference p. 7:1-15.

[43] 2002 DTC 7112 (FCA).

[44] The Court also considered the argument that subsection 125(7) as it was then worded did not import a group concept but rather, related to ownership only. The Court held that the use of the word “control” connoted such group concept. Subsequently, the definition of CCPC was amended by S.C. 1998, c.19 to provide that all shares held by a non-resident person shall be deemed to be owned by a single non-resident person for purposes of the CCPC definition.

[45] Ibid, paragraphs 66-7.

[46] 90 DTC 6390 (FCTD), affirmed 94 DTC 6365 (FCA).

[47] 97 DTC 1489 (TCC).

[48] 2004 DTC 6461 (FCA), affirming 2003 DTC 997 (TCC).

[49] As *International Mercantile* involved a reassessment for 1979-1982 taxation years, subsection 256(5.1) was not yet enacted. However, at that time, the expression "controlled, directly or indirectly in any manner whatever" was used directly in the definition of CCPC. Specifically, CCPC was then defined in paragraph 125(6)(a) as follows:

> (a) "Canadian-controlled private corporation" – "Canadian-controlled private corporation" means a private corporation that is a Canadian corporation other than a corporation controlled, directly or indirectly in any manner whatever, by one or more non-resident persons, by one or more public corporations (other than a prescribed venture capital corporation) or by any combination thereof.

[50] 71 DTC 5175 (SCC).

[51] 85 DTC 5500 (SCC).

[52] *Multiview*, supra note 47, p. 1493.

[53] CRA document no. 2000-0038085, October 6, 2000. See also *Interpretation Bulletin* IT-64R4, paragraph 16. A casting vote can be exercised in either a shareholders' meeting or in a directors' meeting. See CRA document no. 9216045, August 12, 1992 which dealt with a casting vote by a director where the shareholder agreement provided that the chairman of the board of directors should have a casting vote and further that the chairman must be a particular shareholder's nominee. Note that a casting vote could be provided for in the by-law of the corporation rather than a shareholders agreement.

[54] [2003] 3 CTC 72 (FCA), affirming [2002] 1 CTC 2188 (TCC).

[55] 2003 DTC 817 (TCC).

[56] See *Income Tax Technical News* no. 32, July 29, 2005, "Control in Fact: Impact of Recent Jurisprudence" where in the CRA acknowledged the narrower test enunciated in *Silicon Graphics* and the broader test in other cases but simply reiterated that the "shopping list" of criteria in paragraphs 21 and 23 of *Interpretation Bulletin* IT-64R4 remain valid criteria. Although pre-dating the Federal Court of Appeal decision in *Silicon Graphics* and the *Mimitix* and *Transport M.L. Coutoure* cases, in CRA document no. 1999-9914177, June 16, 2000, in a discussion relating to the expression "controlled, directly or indirectly in any manner whatever", the CRA referred to "any agreements entered into between the corporation and its shareholders as to how the business of a corporation will be carried on", in addition to the rights of shareholders in paragraph 17 of IT-64R3 [note: now paragraph 21 of IT-64R4] and the factors outlined in paragraph 19 of IT-64R3 [note: now paragraph 23 of IT-64R4].

[57] See question 12 of the 1991 Revenue Canada Round Table and CRA document no. SE91_205.206, September 4, 1991.

[58] [1976] CTC 276 (FCTD).

[59] [1968] CTC 1 (SCC), paragraph 8.

[60] [1972] CTC 47 (FCTD).

[61] [1982] CTC 2447 (TRB).

[62] February 21, 1996, "Control by a Group – 50/50 Arrangement".

[63] [1960] S.C.R. 672 (SCC).

[64] Ibid, p. 684.

[65] *H.T. Hoy Holdings Ltd. v. The Queen*, 97 DTC 1180 (TCC) at p.1185.

[66] In *Duha*, supra note 2, Iacobucci, J. held that the *de jure* control test did not require examination of nominees [at paragraph 54]:

> "In any event, however, the major concern of the *de jure* test is to ascertain which shareholder or shareholders have the voting power to elect a majority of the directors. The test neither requires or permits an inquiry into whether a given director is the nominee of any shareholder, or any relationship or allegiance between the directors and the shareholders."

[67] CRA document no. AC59494, March 19, 1990.

[68] Based on the administrative position as later set out in Income Tax Technical News no. 7, supra note 62, presumably the CRA would consider these two 50:50 shareholders to constitute a group.

[69] 53 DTC 326 (Tax Appeal Board).

[70] Ibid, p.330. Current subparagraph 251(5)(b)(i) was first enacted as subsection 139(5d) by S.C. 1953-4, c. 57, s. 31, but without the exemptions for rights whose exercise is contingent on the death, bankruptcy or permanent disability of an individual.

[71] Subject to the anti-avoidance rule in subsection 256(8).

[72] *Interpretation Bulletin* IT-419R2, "Meaning of Arm's Length", June 8, 2004, paragraph 17.

[73] See question 38, 1979 Revenue Canada Round Table.

[74] *Interpretation Bulletin* IT-419R2, paragraph 17 compared to *Interpretation Bulletin* IT-419R, August 24, 1995, paragraph 13. Reference may also be made to CRA document no. 2003-0004255, April 29, 2003 being question 10 at the Conference for Advanced Life Underwriting (2003) wherein the CRA stated that its administrative position had not changed in reference to a specific question regarding the then concern that "old" paragraph 13 of IT-419R may be deleted. The CRA response was that it was planning only to amend paragraph 13, not delete it. The CRA also noted that the administrative position was limited to such rights in a shareholders agreement only.

H.T. Hoy Holdings, supra note 65 is an interesting case to note. The case involved a subsection 55(2) reassessment in respect of the taxpayer's 1986 – 88 taxation years. The taxpayer argued that subsection 55(2) did not apply to certain deemed dividends because the taxpayer and its two corporate shareholders were non-arm's length. One argument which the taxpayer put forth was that paragraph 251(5)(b) – as it then read – was applicable so as to cause Cloutier Inc. (the shareholder without majority voting shares) to be related to the taxpayer corporation. In this case, Parkway Chevrolet Oldsmobile Canada Inc. ("Parkway") transferred most of its operating assets to Plaza Chevrolet Oldsmobile Cadillac Inc. ("Plaza") in consideration of Class B, D and E shares. Immediately thereafter, Parkway and Cloutier Inc. entered into a unanimous shareholders agreement whereby Cloutier Inc. became the holder of Class A and C shares. However, Parkway retained over 99% of the voting rights of Plaza. The unanimous shareholders agreement provided for the redemption of the Class B, D and E shares held by Parkway "in a certain order and according to various valuation mechanisms". Parkway and H.T. Hoy Holdings Ltd. amalgamated. It should be noted that for the taxation years in issue, subparagraph (ii) of paragraph 251(5)(b) was not yet in force. In rejecting the application of paragraph 251(5)(b), the Tax Court of Canada stated that Cloutier Inc. "did not have an unrestricted right under contract to acquire the appellant's shares in Plaza". It appears that because subparagraph (ii) of paragraph 251(5)(b) was not yet in force, the taxpayer's argument could have been rejected on the basis of *Arctic Geophysical Ltd. v. MNR* 68 DTC 5013 (Ex. Ct.). However, there was no express reference thereto. The Court noted that the redemption was contractual and that Cloutier Inc. could not exercise the redemption arbitrarily. However, it is the use of the word "unrestricted" which is curious. Query whether this was intended to indicate that a paragraph 251(5)(b) right should not be subject to contingencies or other limitations notwithstanding the breadth of the words. Contrast

CRA document no. 2002-0133675, January 7, 2003 wherein the CRA expressed its view that rights subject to the operation of multiple contingent events nonetheless fell within paragraph 251(5)(b) and subsection 256(1.4). Note that the taxpayer's argument in *H.T. Hoy* would not be available today as paragraph 251(5)(b) has expressly been made inapplicable for purposes of determining whether two persons are related in section 55 pursuant to subparagraph 55(5)(e)(iv).

[75] Based on a verbal discussion with a Rulings officer.

[76] [1995] 2 CTC 2857 (TCC). The Court considered the agreement between the shareholders and held that it was a unanimous shareholder agreement. This case pre-dated the Supreme Court of Canada decision in *Duha*.

[77] Note that the individual referred to in paragraph 251(5)(b) need not be the shareholder or, indeed, a person with any connection to the corporation in question.

[78] CRA document nos. 9033975, January 6, 1992; 9214360, May 27, 1992; 9515635, September 20, 1995.

[79] For example, see David Downie and Tony Martin, "The Preferred Share Rules: An Introduction", in *Report of Proceedings of the Fifty-fifth Tax Conference,* 2003 Conference Report (Toronto: Canadian Tax Foundation, 2004), 52:1-28; and Evelyn P. Moskowitz, "The Preferred Share Rules: Yes, They Can Apply To You!" in *Report of Proceedings of the Forty-ninth Tax Conference*, 1997 Conference Report (Toronto: Canadian Tax Foundation, 1998) 9:1-47; and Donald M. Sugg, "Preferred Share Review: Anomalies and Traps For The Unwary" in *Report of Proceedings of the Forty-fourth Tax Conference,* 1992 Conference Report (Toronto: Canadian Tax Foundation, 1993) 22:1-31.

[80] *Nowegijick v. The Queen* 83 DTC 5041 (SCC), at p.5045.

[81] Subsection 256(6) provides an exemption for purposes of the Act where a corporation (referred to therein as the "controlled corporation") would be regarded as having been controlled or controlled, directly or indirectly in any manner whatever, by another person. If it is established that such control exists to safeguard indebtedness owing to the controller or safeguard the interest of the controller in respect of an investment in shares and there is an enforceable agreement whereby upon the happening of a reasonably foreseeable event, the controlled corporation will cease to be so controlled, then the controlled corporation is deemed not to be so controlled. It should be noted that subsection 256(6) applies not only to *de facto* control but also *de jure* control.

[82] 86 DTC 6526 (SCC) at p.6529.

[83] *Canada Trustco Mortgage Company v. MNR* 91 DTC 1312 (TCC) suggests that the threshold may be rather low. While the issue in the case involved an "active business" test, the Court found that income from a mortgage portfolio was income from an active business where the taxpayer did not maintain an office and had no employees and its mortgage portfolio was administered by others.

[84] See question 15 of the 1991 Revenue Canada Round Table.

[85] CRA document no. SE91_081.082, September 23, 1991.

[86] 2002 DTC 6876 (FCA), affirming 2001 DTC 111 (TCC). For an analysis of the meaning of "guarantee", see Alan M. Schwartz and Catherine Rosebrugh, "The Interpretation of Legal Terms Undefined in Tax Legislation: Guarantee and Novation", *in Report of Proceedings of the Fifty-fourth Tax Conference,* 2002 Conference Report, (Toronto: Canadian Tax Foundation, 2003) 37:1, 18-26.

[87] [1994] 3 SCR 3 (SCC).

[88] For a thorough survey of statutory provisions, judicial interpretation and CRA administrative statements regarding the expression "in the ordinary course of business", see Guy Fortin and Melanie Beauliu, "The Meaning of The Expressions: In The Ordinary Course of Business" and "Directly or Indirectly", in *Report of Proceedings of the Fifty-fourth Tax Conference*, 2002 Conference Report (Toronto: Canadian Tax Foundation 2003), 36:1-37.

[89] 91 DTC 373 (TCC).

[90] Ibid, paragraph 87.

[91] Ibid, paragraph 89 citing Geoffrey J.R. Dyer, "Preferred Share Financing", in *Income Tax Considerations Corporate Financing*, 1986 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1986), p. 25-26.

[92] It should be noted that in CRA document no. 2001-0079985, November 13, 2001, CRA stated that where a specified financial institution invests in term preferred shares of a related corporation, such shares would generally be considered to have been acquired in the ordinary course of business, unless such shares were acquired in the course of reorganization and are redeemed quickly or if those shares are issued on the incorporation of a wholly owned subsidiary where the proceeds of sale of the shares constitute permanent capital of the subsidiary.

[93] Pursuant to subsection 191(5).

[94] See question 20 of the 1989 Revenue Canada Round Table and CRA document no. 9309585, April 16, 1993.

[95] Ibid.

[96] A second agreement may be entered into once the triggering event has occurred at which time the purchase price would be known with specificity. For example, the shareholders agreement may set out the parameters of the corporate repurchase, including presumably the method by which the purchase price shall be calculated. The shareholders agreement also likely contains procedural clauses relating to the closing of any repurchase or other exit arrangement, including closing deliveries. Thus, the shareholder and the corporation could enter into a closing agreement which, among other things, could specify the amount to be paid upon cancellation of the share. However, if the share was, immediately before the particular time, i.e., immediately before the second agreement, a term preferred share, subparagraph 191(4)(e)(i) shall apply to deny the exemption otherwise available. In other words, entering into a second agreement does not assist where the first agreement (being the shareholders agreement) already caused the shares to be term preferred shares.

[97] Pursuant to draft legislation released on July 18, 2005 and proposed to be applicable to dividends paid by a corporation in its 2003 and subsequent taxation years. See Canada, Department of Finance, *Draft Legislation and Explanatory Notes re: Non-Resident Trusts and Foreign Investment Entities, Reimbursement of Crown Charges and Technical Amendments* (the "July 18, 2005 Draft Legislation").

[98] See paragraph 191(3)(d) which provides that only partnerships or trusts whose members or beneficiaries, as the case may be, meet certain requirements may have a substantial interest in a corporation. Specifically, in the case of a partnership, all members must be related to one another and in the case of a trust, all beneficiaries (other than registered charities) must be related to one another. An extended definition of "related" applies in the latter case.

[99] Referred to in the definition as a "specified person" and defined in paragraph (h) of the taxable preferred share definition.

[100] For example, see *Brown v. The Queen* 2003 DTC 5298 (FCA), where the right of a partner to retract his partnership unit was held to be for the purpose of reducing loss which the partner might sustain by reason of being a member of the partnership.

[101] See CRA document no. 9407695, April 19, 1994. Similar to subparagraph (b)(iv) of the taxable preferred share definition, the guaranteed preferred share rule in subsection 112(2.4) refers to a person being obligated, either absolutely or contingently, to effect an undertaking, including "any guarantee, covenant or agreement to purchase or repurchase" the shares.

[102] Pursuant to section 253 of the OBCA.