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# Some Reflections on Corporate Control

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## PRÉCIS

La signification du contrôle d'une société a été établie en 1964 dans l'arrêt *Buckerfield's* comme étant « le droit de contrôle qui découle de la propriété d'un certain nombre d'actions donnant droit à la majorité des voix à l'élection du conseil d'administration ». Dans l'arrêt *Duha Printers* en 1998, la Cour suprême du Canada a réaffirmé le critère élaboré dans *Buckerfield's* et réglé certains problèmes découlant de son application. Et pourtant, un certain nombre de cas et de questions demeurent sans réponse.

Cet article explore certaines des circonstances dans lesquelles le résultat de l'application du critère traditionnel du contrôle de droit est incertain, comme diverses situations de contrôle simultané et l'exercice du contrôle d'une société par l'intermédiaire d'une fiducie, d'un mandataire ou d'une société de personnes. Certaines particularités de la reformulation, dans l'arrêt *Duha Printers* du critère élaboré dans *Buckerfield's* sont observées, entre autres, la nature de la convention unanime des actionnaires et la distinction entre le pouvoir de nomination et le pouvoir d'élection des administrateurs.

Finalement, l'auteur passe brièvement en revue plusieurs aspects du critère réglementaire du « contrôle de fait » qui vient s'ajouter à la règle du contrôle de droit dans certains cas et il met l'accent sur la façon dont les tribunaux ont appliqué le critère.

## ABSTRACT

The meaning of corporate control was settled in *Buckerfield's* in 1964 as “the right of control that rests in ownership of such a number of shares as carries with it the right to a majority of the votes in the election of the Board of Directors.” The *Buckerfield's* test was reaffirmed and some issues regarding its application were resolved by the Supreme Court of Canada in *Duha Printers*, in 1998. Yet there remain a number of unanswered questions and hard cases.

This article explores some of the circumstances in which the result of applying the traditional de jure control criterion is uncertain, such as various situations involving simultaneous control and the exercise of control of a corporation through a trust, agent, or partnership. Certain peculiarities of the *Duha Printers* restatement of the *Buckerfield's* test are observed. These include the nature of the unanimous shareholders' agreement and the distinction between the power to nominate and the power to elect directors.

Finally, the author briefly reviews several aspects of the statutory “control in fact” test that supplements the de jure rule in certain cases. The focus is on how the test has been judicially applied.

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Once upon a time, both family and fiscal relationships were simpler. Before 1972, the Income Tax Act referred to only two types of corporate connection, both of which relied upon "control." Corporations could be "related" to other persons, and two corporations could be "associated" with each other. The rule respecting the carryover of losses made no reference to an "acquisition of control." It was in this less complicated world that the courts grappled with and appeared to subdue the unruly concept of corporate control.

The tests for determining whether persons are related have not changed dramatically over the years. The rules governing associated corporations are still with us, although they have been subjected to extensive amendments—so extensive that a number of the questions raised in this article find distinct statutory responses in that particular context. Meanwhile, other potential corporate liaisons have emerged. Corporations may be "connected" to one another; indeed, there are several definitions of "connected," employed for different statutory purposes. Corporations may also be "affiliated," another form of relationship tailored to meet a specific statutory need. Behind each of these kinds of corporate rapport—related, associated, connected, affiliated—lurks "control." In addition, control may stand alone as a measure of "connectedness" that is relevant to determining certain income tax consequences.

It may not be immediately clear to the casual, or even the attentive, reader of today's Income Tax Act<sup>1</sup> why quite so many different types and degrees of connection need to be defined—what subtle tax policies underlie the fine distinctions. It may not be obvious in a given circumstance, for example, why corporations A and B are related but not associated, connected for purposes of part IV but not for purposes of subsection 15(2), associated but not affiliated, etc. Then there is “acquisition of control,” a notion used mainly as the test for determining whether or to what extent tax attributes survive changes in corporate ownership.

This article explores control itself. It does not encompass the many statutory provisions that extend or modify the notion of corporate control. In particular, I shall not generally refer to or discuss the various provisions directed to associated corporations in section 256 or acquisitions of control and their consequences. I will try to discern and organize in broad outline what we know, and ask some questions about what we (or at least I) do not know, regarding corporate control. This is not a work of fiscal archaeology, but some historical sensibility is, I believe, required.

## CONTROL

Control and the derivative relationships based upon it are especially, although not exclusively, employed in formulating anti-avoidance rules. A control relationship is usually a sign that certain tax benefits should be shared, deferred, or denied.

“Control” is not, of course, defined in the Act. It evidently represents some kind of relationship between a corporation and another person whereby the latter holds sway over the former. The preferred construction of the term chosen from among competing possibilities was largely settled in a series of decisions rendered in the 1960s. I do not propose to discuss all of these cases, but I would like to reflect briefly on the seminal decision of President Jaxkett in *Buckerfield's*.<sup>2</sup> It is worthwhile to consider what was actually decided in that case and why. A number of issues appear to be still unresolved 40 years on.

### Deconstructing Buckerfield's

President Jaxkett's formulation of the meaning of control has certainly withstood the test of time. It has been repeatedly accepted and adopted by the Supreme Court of Canada.<sup>3</sup> The version of the encapsulated reasons most commonly incanted in decisions of courts at all levels is this:

Many approaches might conceivably be adopted in applying the word “control” in a statute such as the *Income Tax Act* to a corporation. It might, for example, refer to

1 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as “the Act”). Unless otherwise stated, statutory references in this article are to the Act.

2 *Buckerfield's Ltd. et al. v. MNR*, 64 DTC 5301 (Ex. Ct.).

3 Initially in *MNR v. Dworkin Furs (Pembroke) Ltd. et al.*, 67 DTC 5035 (SCC), and most recently in *Duba Printers (Western) Ltd. v. The Queen*, 98 DTC 6334 (SCC).

control by “management,” where management and the Board of Directors are separate, or it might refer to control by the Board of Directors. . . . The word “control” might conceivably refer to *de facto* control by one or more shareholders, whether or not they hold a majority of shares. I am of the view, however, that in section 39 of the *Income Tax Act* [the former section dealing with associated corporations], the word “controlled” contemplates the right of control that rests in ownership of such a number of shares as carries with it the right to a majority of the votes in the election of the Board of Directors. See *British American Tobacco Co v. I.R.C.* [1943] 1 A.E.R. 13, where Viscount Simon L.C., at page 15, says:

The owners of the majority of the voting power in a company are the persons who are in effective control of its affairs and fortunes.<sup>4</sup>

Several observations may usefully be made about this text:

1. *Shareholder control.* “Control” is an ambiguous expression and might refer to one or more of several institutions of corporate governance. The decision in *Buckerfield’s* to reject management and the board of directors as the locus of control in favour of shareholders is significant. It is not self-evident and may have been dictated by a number of unspoken reasons. One factor in this choice that is expressed, but not often remarked, is statutory context. The citation above, reproduced as it normally appears in the case law, omits a sentence. President Jaccett interpolated into his reasons:

The kind of control exercised by management officials or the Board of Directors is, however, clearly not intended by section 39 when it contemplates control of one corporation by another as well as control of a corporation by individuals (see subsection (6) of section 39).<sup>5</sup>

It is not evident that the same contextual concerns apply throughout the Act wherever the word “control” is used. However, the *Buckerfield’s* test has been applied more broadly. After *Duba Printers*,<sup>6</sup> it seems no longer open to question that the shareholder level of control identified by President Jaccett is the statutory test, regardless of the context in which “control” appears (leaving aside, of course, the subsequent addition of subsection 256(5.1), to be discussed below).

2. *Legal control.* *Buckerfield’s* plumps resolutely for legal rather than factual control. President Jaccett seems to rest this choice on two previous decisions, of the English House of Lords in *British American Tobacco*<sup>7</sup> and the Privy Council in *Wrights’ Canadian Ropes*.<sup>8</sup> The latter case does seem rather firm

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4 *Supra* note 2, at 5303.

5 *Ibid.*

6 *Supra* note 3.

7 *British American Tobacco Co. v. IRC*, [1943] 1 All ER 13 (HL).

8 *Minister of National Revenue v. Wrights’ Canadian Ropes* (1946), 2 DTC 927 (PC).

authority for the point. The question under the relevant statutory provision of the Canadian Income War Tax Act was whether a company “controlled directly or indirectly” another company, and Lord Greene MR evidenced no hesitation in deciding that “the admission signed on behalf of both parties . . . to the effect that Wrights held only 49.86 per cent of the shares of the Respondents is conclusive that it did not.”<sup>9</sup> It is noteworthy that neither the precedents nor *Buckerfield’s* itself employs the expression “legal control” (let alone the Latinism “de jure”) or suggests any particular contrast with factual control. Nonetheless, *Buckerfield’s* is the standard authority for the de jure test. The preference for a legal over a factual criterion, not only in the context of associated corporations but throughout the Act, has been confirmed and entrenched in decades of consistent application. To such validation has been added the implicit authority of Parliament, through the addition of de facto control in subsection 256(5.1) as a distinct measure of corporate relationship.

3. *Assumptions*. It is always dangerous to extract legal maxims from judicial decisions, especially such sibylline pronouncements as the control test in *Buckerfield’s*. The case addressed a specific, and relatively straightforward, factual situation. The court’s formulation of the meaning of control rests on a number of unstated assumptions. For example, there was no reason in that case to consider whether the board of directors did have the legal right to manage the business and affairs of the corporation. Nor were there any legal or factual impediments to the exercise of votes by the majority shareholders.
4. *Group of persons*. *Buckerfield’s* required a determination of whether control rested with a “group of persons” consisting of two corporations. President Jackett concluded that the word “group” in this expression included any number of persons from two to infinity. However, it is not evident from the tight reasons for judgment whether he meant to suggest that the test was merely mathematical or also implied some form of connection among the putative members. The issue appears not to have been advanced by counsel as a reason to reject group control.

*Duba Printers* presents a ringing endorsement of President Jackett’s judicial formula and has, to some extent, supplanted the earlier decision as the locus classicus for the meaning of control.<sup>10</sup> The following discussion reflects some of the many questions to which the Supreme Court of Canada did not provide a complete or satisfying answer. There are still a number of unresolved hard cases ahead of us.

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9 Ibid., at 929.

10 There are many useful commentaries on the *Duba Printers* decision. The most insightful, in my view, is provided by one of the (losing) counsel: Roger Taylor, “The Supreme Court of Canada: Principles of Adjudication of Tax-Avoidance Appeals from Stubar to Shell Canada,” in *Report of Proceedings of the Fifty-First Tax Conference*, 1999 Conference Report (Toronto: Canadian Tax Foundation, 2000), 17:1-53.

## How Thick Is the Bright Line?

The legacy of *Buckerfield's* is generally considered to be a simple and certain definition of corporate control. However, the underlying premise upon which the reasons for judgment of Justice Iacobucci in *Duba Printers* are based does not seem to exclude entirely the possibility of subtlety:

Thus, *de jure* control has emerged as the Canadian standard, with the test for such control generally accepted to be whether the controlling party enjoys, by virtue of its shareholdings, the ability to elect the majority of the board of directors. 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 statute 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. This was expressly recognized by Jackett, P. when setting out the test in *Buckerfield's*. Indeed, the very authority cited for the test was the following dictum of Viscount Simon, L.C., in *British American Tobacco Co. v. Inland Revenue Commissioners*, [1943] 1 All E.R. 13, at p. 15:

The owners of the majority of the voting power in a company are the persons who are in effective control of its affairs and fortunes.

Viewed in this light, it becomes apparent that to apply formalistically a test like that set out in *Buckerfield's*, without paying appropriate heed to the reason for the test, can lead to an unfortunately artificial result.<sup>11</sup>

It is often difficult to reconcile broad judicial statements of principle with their application, even in the very decision in which they are enunciated, and *Duba Printers* may be such a case. The passages quoted above confirm that the ultimate question is “Who is in effective control of the affairs and fortunes of the corporation?” and caution that the *Buckerfield's* criterion should be applied not formalistically but with regard to this principle. It would not be surprising if this introductory description of the legal test were seen by government counsel to be more encouraging than the ensuing result.

Because of the remarkable taxpayer victory in *Duba Printers*, there may be a temptation to ignore the admonition with which the Supreme Court of Canada opened its analysis. That could be a mistake. A change in the *Duba* facts might possibly lead a court to invoke the “substance” comments of Justice Iacobucci.

## Control “in the Long Run”

*De jure* control rests with the shareholder or shareholders who meet the *Buckerfield's* test “in the long run.” This proposition was established by Justice Thurlow in

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11 *Duba Printers*, supra note 3, at paragraphs 36 to 37.

*Donald Applicators*<sup>12</sup> shortly after President Jackett enunciated the basic test, and it was affirmed by the Supreme Court of Canada in that case and more recently in *Duba Printers*.

*Donald Applicators* dealt with a clever ownership structure concocted precisely, and admittedly, to avoid associated corporation status. The scheme rested on a division of voting powers. One shareholder, Saje Management Limited, held in respect of each of 10 corporations all the shares of a class that did not carry a majority of the votes in the election of the board of directors, but did provide sufficient voting power to do almost anything else.

Here, in the case of each appellant company, Saje Management Limited as the holder of 498 Class B shares had ample voting power, not merely to pass or to defeat any ordinary resolution (other than one electing directors), but to pass or defeat any special resolution or any extraordinary resolution that might be proposed. That shareholder thus had the voting power to change the articles of the company. As I see it, it had the power to repeal Article 55 and any other article conferring upon the directors authority to bind the company, and thus to reduce the directors to the status of errand boys, while reserving all decision making power not specifically conferred on the directors by the statute or by the memorandum of association for the shareholders as a whole, or of Class B shares only, in general meeting. It had the voting power to remove the directors from office. It had as well the voting power to pass a special resolution to eliminate the need for unanimous consent of all shareholders to the issue of additional shares and to vest in the Class B shareholders authority to issue additional Class A shares in sufficient numbers to outvote the two shares held by the Nassau residents. . . .

A shareholder who, though lacking immediate voting power to elect directors, has sufficient voting power to pass any ordinary resolution that may come before a meeting of shareholders and to pass as well a special resolution through which he can take away the powers of the directors and reserve decisions to his class of shareholders, dismiss directors from office and ultimately even secure the right to elect the directors is a person of whom I do not think it can correctly be said that he has not *in the long run* the control of the company.<sup>13</sup>

The italicized expression was lifted from the very passage of the reasons for judgment in *British American Tobacco* upon which President Jackett had relied in *Buckerfield's*.

Justice Thurlow thought it necessary to have regard to the shareholder's legal right under the articles, not to elect the directors, but rather to implement an intermediate step that would put it in the position to do so (or to emasculate or dismiss them). This is a kind of indirect control in a temporal sense. A shareholder that can, by exercising legal powers vested in it under the constating documents of the corporation, put itself in effective control, in *Buckerfield's* control, should be regarded as having de jure control already.

12 *Donald Applicators Ltd. et al. v. MNR*, 69 DTC 5122 (Ex. Ct.); aff'd. 71 DTC 5202 (SCC).

13 *Ibid.*, at 5126 (Ex. Ct.) (emphasis in original).

It is important to distinguish control in the long run from control in fact. Having regard to its extraordinary voting power, the controlling shareholder in *Donald Applicators* may well have been in an immediate position to influence the election of the board of directors; but, as observed in *Duba Printers*, its de jure control position arose not from any such influence but from the legal rights granted under the corporate charter. Control in the long run is a legal, not a factual, potentiality. This doctrine is not so much an extension as a restatement of the *Buckerfield's* test. A majority shareholder faced with a defiant board of directors also has only potential control, in that the shareholder must follow the corporate mechanics of calling a meeting and replacing the board in order to exercise its legal rights. This shareholder, who meets the strict terms of the *Buckerfield's* test of share ownership, also exercises control "in the long run."

Like the admonition in *Duba Printers* to recall the origins of the *Buckerfield's* test in "effective control," the epithet "in the long run" reminds us that legal control is not always what, or where, it may appear to be at first blush.

### The Factual Dragon Slain

*Duba Printers* firmly rejected any incursion of factual elements into the determination of corporate control. Earlier jurisprudence of the Supreme Court of Canada had led some observers to wonder whether factual ingredients had leached into the application of the *Buckerfield's* test.

I would be tempted to go further than did Justice Iacobucci with respect to the Supreme Court of Canada's previous decisions in *Oakfield Developments*<sup>14</sup> and *Imperial General Properties*.<sup>15</sup> In *Oakfield Developments*, the putative controller held 50 percent of the voting power in connection with the election of the board of directors through its ownership of common shares; the other 50 percent was attached to fixed-dividend preferred shares. The common shareholder also had the legal power to demand the winding up of the corporation, on which it would receive virtually all the assets. This (right? fact?) was considered sufficient to justify a finding of de jure control.

*Imperial General Properties* extended the same principle to a circumstance in which the putative controller held 90 percent of the common shares but there was a 10 percent common shareholder who also held preferred shares. The voting power was, again, split 50-50, although not between two classes of shares. The power to wind up the company was still considered decisive.

Justice Wilson wrote a strong dissent in *Imperial General Properties* in which she expressed the view that *Oakfield Developments* had been wrongly decided. Her observation is quoted in *Duba Printers*, although the court did not go so far as to adopt it in preference to the majority and so reject outright the decision in *Oakfield*

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14 *Oakfield Developments (Toronto) Ltd. v. MNR*, 71 DTC 5175 (SCC).

15 *The Queen v. Imperial General Properties Limited*, 85 DTC 5500 (SCC).

*Developments*. It preferred the softer route of denying the applicability of both of the earlier decisions to the situation at hand.<sup>16</sup>

There is a fundamental difference between these cases and the *Donald Applicators* affirmation of control in the long run. While there is a temporal element of long-run control in *Oakfield Developments* and *Imperial General Properties*, with respect Justice Wilson correctly perceived that what might or could occur over that long run was a factual event—obtaining the assets—and not legal control. While the Supreme Court of Canada has not expressly overturned these prior decisions, they are, in my view, of doubtful authority post-*Duba*.

### Simultaneous Control

Is there an exclusion principle in corporate control? That is, does or should the conclusion that a certain person or group of persons controls a corporation prevent any other person or group of persons from having de jure control of the corporation at the same time? There are a number of quite different situations that may give rise to simultaneous control, and the answers may vary.

### Tiers of Corporations

To start with what many thought was an easy case, consider the situation where control is exercised indirectly through an interposed holding corporation. It has been accepted since *Vineland Quarries*,<sup>17</sup> decided shortly after and in intended confirmation of *Buckerfield's*, that control may be exerted indirectly in such a circumstance. However, one cannot actually achieve this reasonable result through a fundamentalist reading of President Jackett's words, since the second-tier controller does not own any shares of the corporation it purportedly controls. Indeed, the language of Justice Cattanach in *Vineland Quarries*, read with several decades of hindsight, might seem to permit a certain invasion of factual considerations into de jure control. Be that as it may, the proposition is both well accepted and intuitively correct. The person in ultimate control controls the second-tier subsidiary because it controls the first-tier subsidiary. This conclusion could be justified by control "in the long run," and it sits well with the notion of "effective control" that grounds the *Buckerfield's* test.

But does such ultimate control deprive the intermediate entity of de jure control of the first-tier corporation? The judicial response to this question, which undoubtedly came as a surprise to many and not only within the Canada Revenue Agency (CRA), was affirmative. In *Parthenon Investments*,<sup>18</sup> the Federal Court of

16 For what it is worth, *Oakfield Developments*, *Imperial General Properties*, and control through the power to wind up the corporation continue to be cited post-*Duba* in *Interpretation Bulletin* IT-64R4 (Consolidated), "Corporations: Association and Control," paragraph 14.

17 *Vineland Quarries and Crushed Stone Ltd. v. MNR*, 66 DTC 5092 (Ex. Ct.); aff'd. 67 DTC 5283 (SCC).

18 *Parthenon Investments Limited v. MNR*, 97 DTC 5343 (FCA).

Appeal determined that in an A—B—C vertical situation, A and A alone controls C. The person who literally meets the *Buckerfield's* test for control of C, B, is forced out of the picture by the ultimate control vested in A. In the particular circumstances of that case, A was a Canadian resident and B a non-resident, and the issue was whether C qualified as a Canadian-controlled private corporation (CCPC). The decision to deny control status to the interposed non-resident might seem, at first blush, reasonable from a policy perspective.<sup>19</sup> In any event, such elimination of intermediate control produced clearly unacceptable results elsewhere in the Act and was reversed by legislation. Subsection 256(6.1) preserves (or restores) simultaneous de jure control of a corporation at successive tiers of ownership.<sup>20</sup> Paragraph (a) of that provision addresses the situation where the tested corporation is controlled by a single corporation, itself controlled by a person or group of persons, while paragraph (b) addresses the situation where the tested corporation is controlled by a person or group of persons that includes a corporation itself controlled by some other person or group of persons.

### *Control in the Long Run*

A quite different simultaneous control question might arise where control “in the long run” is in issue. In the particular situation considered in *Donald Applicators*, for example, Justice Thurlow concluded that the shareholder with the right to amend the articles was in control. It was not relevant, and therefore not considered, whether this necessarily deprived the apparent controller, the person holding the shares with the right to elect the directors, of that status. In *Duba Printers*, Justice Iacobucci, accepting the proposition that the extensive powers of the shareholder in *Donald Applicators* gave it control in the long run, contrasted that situation with the case before him:

However, as shall be seen, the question of control “in the long run” does not arise in the instant case, as the majority shareholder group retained the *immediate* voting power to elect directors.<sup>21</sup>

That is a curious statement. Where a person is found to have control in the long run, some other person may have “immediate” voting power to elect directors. It is, of course, possible that apart from the alleged long-run controller, no one controls. However, it is also possible that one shareholder has control in the long run while another owns shares carrying a majority of the votes in electing the board.

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19 If the small business deduction is an incentive for Canadian-controlled enterprises, it seems appropriate that it be available where the ultimate controller is Canadian. However, this ignores the complexities of the shareholder-corporation integration system and the interaction with bilateral tax conventions.

20 There is a parallel amendment in subsection 256(6.2) dealing with de facto control.

21 *Duba Printers*, supra note 3, at paragraph 44.

In the fact situation in *Donald Applicators*, Justice Thurlow found that Saje Management, the holder of the special shares, had control of each of the 10 corporations that had issued the shares. That was sufficient to resolve the issue in the case, which was whether those corporations were associated with each other. Since the planners had hoped that control would instead be found to rest with the owners of the common shares, they had taken the precaution of causing those shares to be issued by each corporation to two unrelated individuals (chosen from among the Nassau solicitor, his partner, and employees), never using the same pair twice. But what if a single individual had owned the common shares of one of the corporations? Would that corporation have been associated with another controlled by that individual? The simultaneous control question is whether, in the words of *Duba Printers*, the person with the immediate voting power to elect directors can also be said to control. Is there such a thing as control “in the short run”?

My predilection would be to conclude that the person with the “short-run” control does not control at all. To revert again to *Donald Applicators*, if the 10 appellants were associated because they were all controlled by Saje Management Limited, the holder of the special shares, then I find it illogical to suggest that they were also controlled by whoever happened to own the common shares, even though those shares did carry the right to elect a majority of the board of directors. This is not “immediate” but apparent control, ousted by the power of the special shareholder.

This issue does not seem to have been considered directly in the case law. Arguably, my conclusion is inconsistent with *Duba Printers*, or at least with the dictum referred to above. If so, then that conclusion is wrong, whether or not it is correct.

### *Embedded or Embracing Groups*

A third possible simultaneous control issue relates to concentric circles of ownership. The simplest example arises where one individual holds a majority of the shares. Can a group of which that individual is a member (however one decides to define “group”) also be in control at the same time? The judicial answer is “no.”<sup>22</sup> One might question whether this is a sensible answer. However, given the language of *Buckerfield’s*, it is a conclusion that Justice Cattanach found inescapable.

Does the same logic apply where no individual controls? What if group A controls a corporation and all the members of group A are members of the larger group B, which would, apart from the simultaneous control question, be considered to control? Alternatively, what if group A and group B are distinct, with or without overlapping membership? Can both control at the same time?

Paragraph 251(5)(a) of the Act provides, for the limited purposes of determining whether persons are related and for the definition of “Canadian-controlled private corporation,” that where a related group is in a position to control a corporation, it shall be deemed to be a related group that controls the corporation

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22 *Southside Car Market Ltd. et al. v. The Queen*, 82 DTC 6179 (FCTD).

whether or not it is part of a larger group by which the corporation is in fact controlled. This deeming rule resolves one issue but leaves open several others:

1. Is it a proper inference that, in the situation described in that paragraph, both the smaller group *and* the larger group control?
2. Can more than one overlapping related group control at the same time?
3. What about contexts other than those addressed in subsection 251(5)?
4. What about unrelated groups?

The first question appears to be answered in the affirmative by the very text of paragraph 251(5)(a). Thus, at least in the situations to which the paragraph is addressed, control by a larger related group may coexist with control by an embedded related group, thereby providing a different answer than if a single member of a related group held sufficient voting shares to control. It is not obvious why this should be the case.

The second question also seems to find an affirmative answer in the statutory text, since any embedded related group in a position to control is deemed to be in control, specifically to be “a” related group that controls.<sup>23</sup>

The more interesting and difficult questions are the third and the fourth. Is there a negative implication that, for purposes other than the CCPC definition and the meaning of related persons in section 251, the embedded related group would not have control? Or is it the larger group that would not have control? And, of the broadest practical importance, what is the situation of unrelated groups?

Consider the situation where A and B form a group of persons that controls corporation XYZ. Suppose that, but for that fact, one would conclude that A, B, and C form a group of persons that controls XYZ. Is the latter conclusion foreclosed by the control that A and B are in a position to exercise? And, in this circumstance, assuming the requisite tests for forming a group of persons are met, would the groups consisting of (A and C) and (B and C) also control? I would be inclined to answer “yes” to both questions. There is some oblique authority for the proposition that both a smaller and a larger group can control simultaneously, thereby preventing taxpayers from escaping the consequences (association in that case) by claiming that control by the smaller group precludes control by the larger.<sup>24</sup> As for the permutations among the potential control groups, this seems a necessary consequence of accepting embedded control groups. There is no a priori basis for preferring A and B over any other pair (at least not on the facts as I have stated them).

It has been suggested that where more than one group of persons could have de jure control, the group that has de facto control should be awarded the prize.<sup>25</sup> I am

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23 The CRA considers this to be a clear result of paragraph 251(5)(a). See IT-64R4 (Consolidated), supra note 16, at paragraph 28.

24 See *Express Cable Television Ltd. v. MNR*, 82 DTC 1431 (TRB).

25 *Quincaillerie Brassard Inc. et al. v. MNR*, 91 DTC 559, at paragraph 4.03.2 (TCC).

not convinced that the jurisprudence establishes such a rule; and even if earlier cases suggested it, I doubt it could survive the strict rejection of factual control in *Duba Printers*.

More judicial guidance on this subject would undoubtedly be welcome.

### ***Simultaneous Ownership Under Paragraph 251(5)(b)***

Two different persons can not only be in control of the same corporation at the same time; they can, in a sense, even own the same shares of the corporation simultaneously under the deeming provision of paragraph 251(5)(b).

Suppose X owns all of the shares of corporation ABC and Y has a right to acquire the shares as described in that provision. Paragraph 251(5)(b) deems Y to be in the same position in relation to the control of ABC as if he owned the shares that are factually owned by X, for purposes of applying the CCPC definition or determining relationship under section 251. The provision does not deem X *not* to own the shares. Indeed, it has nothing to do with the tax position of X or the relationship between X and ABC. Its target is the relationship between Y and ABC.

Therefore, if the determination of any tax consequence under the Act depends on whether X controls ABC, Y's rights are irrelevant. Paragraph 251(5)(b) effectively allocates control to Y without removing it from X.<sup>26</sup>

This provision applies only for the limited purposes of determining related-person status and the definition of a CCPC. However, subsection 256(8) extends its ambit to various acquisition-of-control provisions in certain tax-avoidance circumstances. Thus, a person with a paragraph 251(5)(b) right to acquire shares may be deemed to have acquired control of a corporation even though the grantor of the right has not relinquished such control.

### **The Unanimous Shareholders' Agreement**

A unanimous shareholders' agreement (USA) is defined in the Canada Business Corporations Act as "[a]n otherwise lawful written agreement among all the shareholders of a corporation, or among all the shareholders and one or more persons who are not shareholders, that restricts, in whole or in part, the powers of the directors to manage, or supervise the management of, the business and affairs of the corporation."<sup>27</sup> The law declares such an agreement to be valid, thereby reversing

26 *Economy Home Builders of Windsor Ltd. v. MNR*, 65 DTC 302 (TAB), and the appendix to the reasons for judgment of President Jockett in *Viking Food Products Ltd. v. MNR*, 67 DTC 5067 (Ex. Ct.).

27 Canada Business Corporations Act, RSC 1985, c. C-44, as amended (herein referred to as "the CBCA"), section 146(1). The Quebec definition is somewhat different, although seemingly to similar effect: "The shareholders, if all of them consent thereto and make a written agreement to that effect, may restrict the powers of the directors." Companies Act, RSQ, c. C-38, section 123.91. See also article 310 of the Civil Code of Québec, SQ 1991, c. 64, as amended (herein referred to as "CCQ"). Ontario's legislation states, "A written agreement among all the

the common-law rule that the board of directors may not be prevented from exercising its statutory right and duty to “manage, or supervise the management of, the business and affairs of a corporation”<sup>28</sup> by private agreement.

The decision of the Supreme Court of Canada in *Duba Printers* removed any doubt that, having regard to the statutory recognition of this particular type of agreement, it should be regarded as a “constating document” on a par with the articles of incorporation and bylaws for the purpose of determining de jure control. On the other hand, an otherwise similar (or, indeed, identical) agreement that does not meet the statutory definition is not to be taken into consideration for this purpose.

There is a logical oddity in the special status afforded the USA. The statutory definition, and the reason for such a definition, is related to the otherwise exclusive authority of directors to manage the corporate business. It has nothing to do with the rights of shareholders inter se or, more particularly, with the rights of shareholders relating to the election of directors. A USA can and often does address such matters, but these can be set out in a valid and enforceable agreement that is not a USA.<sup>29</sup> It may seem strange that the restriction of the powers of directors is the feature that permits other unrelated provisions of the agreement, namely, those dealing with the election of the directors, to be taken into account in determining de jure control, especially since the very restriction of the directors’ powers might make one wonder why the ability to elect them should continue to be the litmus test for “effective control.”

Before USAs were a gleam in the legislator’s eye, the implications of a restriction on the powers of directors did attract judicial consideration, from Justice Thurlow in the *Donald Applicators* case. In that case, the restriction was in the articles. Justice Thurlow puzzled over what its impact should be and concluded that, in a proper case, it might cause one to look elsewhere than in the direction indicated by *Buckerfield’s*:

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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.” Business Corporations Act, RSO 1990, c. B.16, as amended, section 108(2). The definition applied in other provinces may be different.

28 CBCA section 102(1).

29 It has been observed that a USA, unlike a private agreement that is not a USA, is enforceable by way of a restraining or compliance order under section 247 of the CBCA: “If a corporation or any director, officer, employee, agent, auditor, trustee, receiver, receiver-manager or liquidator of a corporation does not comply with this Act, the regulations, articles, by-laws, or a unanimous shareholder agreement, a complainant or a creditor of the corporation may, in addition to any other right they have, apply to a court for an order directing any such person to comply with, or restraining any such person from acting in breach of, any provisions thereof, and on such application the court may so order and make any further order it thinks fit.” In this respect, a USA is “special.” However, note that section 247 does not provide for such an order against a shareholder acting in that capacity (for example, voting his or her shares).

Thus, while in an ordinary situation control may reside in the voting power to elect directors such power to choose directors in my opinion would not afford control of a company in which, by the memorandum and articles, the directors have been shorn of authority to make decisions binding upon the company and such decisions had been reserved for the shareholders in general meeting. If, therefore, in an ordinary situation control of a company rests in the voting power to elect directors but in the suggested situation does not rest in such voting power it seems to me that when the situation is not ordinary the question of *de jure* control of the company must be resolved as one of fact and degree depending on the voting situation in the particular company and the extent and effect of any restrictions imposed by the memorandum and articles on the decision making powers of the directors.

The statement of the President of this Court in *Buckerfield's* case, . . . when he said, "I am of the view, however, that in section 39 of the *Income Tax Act*, the word 'controlled' contemplates the right that rests in ownership of such a number of shares as carries with it the right to a majority of the votes in the election of the board of directors" should, I think, be read and understood as applying to a case where the directors when elected have the usual powers of directors to guide the destinies of the company.<sup>30</sup>

This interesting and intelligent observation was obiter because Justice Thurlow found that the powers of the directors in the case at bar were not so severely restricted as to require such a re-examination of the control test. However, the very language of the definition of a USA invites one to reflect on his dictum. In the extreme, if the USA "restricts in whole" the powers of the directors, on what basis can one justify looking for control in the ownership of shares that carry a majority of the votes in their election? But, in that case, where *would* one look?

The related curiosity of the *Duba Printers* decision to have regard to USAs but to no other "external" agreements is that it puts considerable pressure on the analysis of shareholders' agreements to determine whether they do, indeed, restrict the powers of the directors. Such an analysis was critical in the case, and the bar seems to have been placed rather low. The required minute legal analysis is intended to smoke out provisions that have nothing to do with the definition of *de jure* control and, as just noted, could actually point in another direction entirely. The greater the restrictions on the directors, the less relevance, one might have thought, should be accorded the ownership of the shares that carry the right to elect them.

### **Nomination Versus Election Rights**

On its face, the *Buckerfield's* test considers only the right to vote and not the right to choose for whom one is allowed to vote. This is not a metaphysical distinction but a very practical one. It is not at all unusual to find that the articles of incorporation or a shareholders' agreement (USA or not) restricts the range of choice of the individuals or categories of individuals who may or must be chosen as directors.

Where the restriction on how the voting shareholder may cast his or her vote is contained in a private agreement that is not a USA, the power of nomination is

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30 *Supra* note 12, at 5125 (Ex. Ct.).

irrelevant under the *Duba Printers* doctrine. Justice Iacobucci seemed equally untroubled where such power was expressed in a USA:

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 nor 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.<sup>31</sup>

On the facts, the Supreme Court of Canada decided that the restricted universe of nominees under the provisions of the particular USA did not provide a basis for doubting the location of *de jure* control because of the precise identity of the permitted directors (although one might have thought this a factual matter irrelevant to legal control). However, the citation immediately above suggests that, as a matter of principle, the specification of a slate of potential nominees should not affect this determination.

It may seem strange that restrictions in the constating documents regarding who may be elected to the board are irrelevant to legal control. In the extreme case, suppose that X holds 49 percent of the voting shares, Y holds 51 percent, and the articles provide that the sole director will be X or his nominee. Could one seriously contend that Y has “effective control”?<sup>32</sup> There are many variations in practice, and it is far from clear in what cases (if any) nomination powers, fixed lists, or other restrictions on the effective freedom to vote for directors may be relevant to *de jure* control.

### Group of Persons

Like so much else about corporate control, it is surprising that 40 years after *Buckerfield's* we are still not entirely sure what constitutes a “group of persons.” That case did enlighten us regarding the math: two or more persons constitute a “group.” It was always clear that merely adding together the voting shares held by any possible “group” would provide an unworkable definition of control. In a widely held public corporation, virtually any trade could constitute an acquisition of control by a new group under such an approach.

One might therefore have expected the case law to clarify early on that a group of persons could be formed only with some kind of defined linkage. There are such statements in the jurisprudence,<sup>33</sup> but only in the 2002 decision of the Federal

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31 *Duba Printers*, supra note 3, at paragraph 54.

32 These facts are a more extreme version of those considered in *Alteco Inc. v. The Queen*, [1993] 2 CTC 2087 (TCC), a decision distinguished rather than disturbed by the Supreme Court of Canada in *Duba Printers*.

33 *Yardley Plastics of Canada Ltd. v. MNR*, 66 DTC 5183 (Ex. Ct.), reached this conclusion relying on “effective control” and “control in the long run.” The trial decision in *Vina-Rug (Canada)* (sub nom. *Floor & Wall Covering Distributors Ltd et al. v. MNR*), 66 DTC 5373 (Ex. Ct.); aff’d.

Court of Appeal in *Silicon Graphics* was the matter addressed head-on and, it seems, resolved.<sup>34</sup> In that case, the phrase “group of persons” was not considered, since the statutory control test at issue was the definition of “Canadian-controlled private corporation,” which referred to control by one or more public corporations or non-residents. Indeed, it was this difference in wording that led the CRA to question the need for a common connection, a principle it had accepted administratively in interpreting the “group of persons” control tests in the Act. Speaking for a strong and unanimous bench, Justice Sexton unequivocally held that a common connection *is* necessary to justify a finding of control and that no such connection existed among the numerous and dispersed non-resident shareholders.<sup>35</sup> The CRA accepts that the same reasoning applies to the expression “group of persons.”<sup>36</sup>

Alas, the definition and the source of the “common connection” required to form a group are not nearly as clear as the requirement to find one. Justice Sexton in *Silicon Graphics* merely stated in the negative that there was no evidence adduced that would suggest that the non-resident shareholders would vote as a block. What might such evidence be?

The USA, being a constating document relevant to de jure control, is evidently one place to look. However, the question of whether shareholders act in concert or have a common connection is not a legal but a factual inquiry. This is not backsliding toward de facto control. There may be facts that are relevant to deciding whether a group exists, which group could then be found to be in legal control of a corporation, and seeking out such facts is not tantamount to substituting a factual control test. After all, the identity of the voting shareholders is also a fact. It appears, therefore, that a private agreement that would be verboten in deciding legal control could be relevant in deciding whether the parties to that agreement are likely to act in concert. The provisions of such an agreement may constitute a connection that justifies considering certain shareholders to constitute a group, able and likely to exercise effective control in the long run. Nor need the common connection be restricted to agreements. It could, presumably, be deduced from conduct or from a business or family relationship. However, I would resist certain CRA presumptions, such as the inference of a common connection between 50-50 shareholders absent a deadlock.<sup>37</sup>

Unfortunately, there is quite a distance between the multitude of non-resident shareholders who do not even know each other and do not form a group (*Silicon*

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68 DTC 5021 (SCC), suggested that a “common connection” was required. While the Supreme Court of Canada affirmed the result, it is not evident that any “common connection” was relevant to its decision. To the contrary, the reasons for judgment can be read as accepting the purely mathematical approach.

34 *Silicon Graphics Limited v. The Queen*, 2002 FCA 260.

35 *Ibid.*, at paragraphs 36 to 37.

36 *Income Tax Technical News* no. 25, October 30, 2002.

37 *Income Tax Technical News* no. 7, February 21, 1996.

*Graphics*), and two siblings with a USA prescribing that they shall vote together on everything, who evidently do. The grey area is unacceptably large for such a fundamental concept.

## Trusts

A trust is a relationship, not an entity. But the liability for tax on trust income must be fixed on someone. The double-barrelled approach adopted in the Act is to deem references to the trust to be references to the trustee but, at the same time, to consider the trust to be an individual in respect of the trust property, without affecting the trustee's own tax liability.<sup>38</sup> Complex rules then determine whether the trust income is taxed in the hands of the trust (that is, the trustee in his or her capacity as such) or the beneficiaries.

This treatment leaves the question of corporate control up in the air in the case where shares of a corporation form part of the trust corpus. The fact that the taxation of trust income is determined as if the trust were an individual tells us nothing about what happens to the liability of the corporation in these circumstances.

Two separate questions need to be answered in determining corporate control where shares are held in trust. The first is whether the trustee, as registered holder of the shares, is the "owner" within the meaning of the *Buckerfield's* test.<sup>39</sup> The obvious alternative would be to look, instead, to the trust beneficiaries who have "beneficial ownership" of the trust property. The second question arises if one decides to stop the analysis at the level of the trustees. In that case, the issue is how one unravels the relationship between or among multiple trustees, as determined under the trust indenture or will.

The most informative decision on the subject is still *Consolidated Holding*,<sup>40</sup> rendered only a few years after *Buckerfield's*. The Supreme Court of Canada confronted a textbook problem. Consolidated was controlled by the two Gavin brothers. The shares of a second company were so distributed that, in order to constitute a control group, a block of shares held by Consolidated would have to be aggregated with another block held by the estate of the Gavins' late father. The executors and trustees of the estate were the two Gavins plus Montreal Trust. A majority of trustees could bind the third. The court did locate control with the trustees, but insisted on looking behind the share registry to the terms of the trust in order to determine how that control could be exercised:

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38 Subsections 104(1) and (2).

39 Companies acts used to provide that a corporation "is not bound to see to the execution of a trust, express, implied or constructive, in respect of shares of the company." Canada Corporations Act, RSC 1970, c. C-32, section 37(1). Section 51(4) of the CBCA is more generic but to similar effect: "A corporation is not required to inquire into the existence of, or see to the performance or observance of, any duty owed to a third person by a registered holder of any of its securities or by anyone whom it treats, as permitted or required by this section, as the owner or registered holder thereof."

40 *MNR v. Consolidated Holding Co. Ltd.*, 72 DTC 6007 (SCC).

In determining whether a group of persons controls a company, it is not sufficient in the case of trustees who are registered as shareholders to stop the inquiry at the register of shareholders and the Articles of Association. It is necessary to look to the trust instrument to ascertain whether one or more of the trustees have been put in a position where they can at law direct their co-trustees as to the manner in which the voting rights attaching to the shares are to be exercised.

From the point of view of the company, apart from protective provisions, trustee shareholders must vote as a unit. If they are not unanimous, the shares cannot be voted. In this event, the control would be in “Consolidated,” the two shareholders of which are the two Gavin trustees. Merely to look at the share register is not enough when the question is one of control.

The problem here is not solved by a decision that a company is not bound to see to the execution of trusts to which its shares are subject or that it may take the vote of the first named trustee on its share register. These are merely protective provisions in favour of the company and do not touch the question of control. Here, if one looks at the facts as a whole, one finds that the two Gavins, by combining, can control the vote of the estate shares. They already control the voting of “Consolidated.” In this case, therefore, both corporations are controlled by the same group of persons, namely the two Gavins. They are, in the words of Abbott J. in *Vina Rug (Canada) Ltd. v. Minister of National Revenue*, (1968) S.C.R., 193 at 197 [68 DTC 5021 at 5023],

in a position to control at least a majority of votes to be cast at a general meeting of shareholders.<sup>41</sup>

Therefore, the Gavins controlled both companies.

This approach to determining who controls a corporation when shares of the corporation are held in trust requires two steps:

1. Look, as usual, to the register of shareholders. There, presumably, one finds the names of the trustees or some other reference to the trust.
2. Then look at the trust deed to determine how decisions are made. Different control results may follow if, for example, the trust instrument stipulates unanimous or majority decision making.

As trust deeds are not constating documents of a corporation, one may ask whether this approach is still valid after *Duba Printers*. The answer is “yes.” Justice Iacobucci did not take issue with *Consolidated Holding* but instead offered a distinction between trust deeds and other external documents:

A trust imposes upon the trustee a fiduciary obligation to act within the terms of the trust instrument and for the benefit of the beneficiary. That is, the trustee is not free to act other than in accordance with the trust document, and if the trust document imposes limitations upon the capacity of the trustee to vote the shares then these must accordingly be taken into account in the *de jure* control analysis. By contrast, any

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<sup>41</sup> *Ibid.*, at 6008.

limitations which might be imposed by an outside agreement are limitations freely agreed to by the shareholders, and not at all inconsistent with their *de jure* power to control the company. In other words, limitations on the voting powers of trustees must be seen as limitations on their capacity as free actors in the circumstances. No such limitations encumber the ordinary shareholder in his or her exercise of *de jure* control, even if an outside agreement exists to limit actual or *de facto* control.<sup>42</sup>

The distinction is subtle. It is true that a trustee is bound by fiduciary obligations, but why are these qualitatively different from the contractual obligations that may bind a shareholder under a private agreement? Perhaps the fact that the institution of the trust affects property rights as well as personal obligations is relevant. It is, perhaps, also relevant that the remedy for breach would likely be specific performance rather than damages; however, the same could be said for a number of “external agreements.”

In any event, the *Consolidated Holding* rule survives.<sup>43</sup> The result may be inconvenient. For example, where a majority of the voting shares of a corporation are held in trust, substituting one arm’s-length trustee for another seems to constitute an acquisition of control. It would be easy enough to multiply the strange examples, from the definition of “controlled foreign affiliate” to the affiliation of trustees and corporations held in trust. One might have expected to find statutory rules to temper the rigour of the *Consolidated Holding* test in the case of trusts established for purposes of providing security to a lender or arising on death, or, more generally, to deal with professional trustees. Indeed, there are rules of this sort, but they apply only to the case of association and *de facto* control.<sup>44</sup>

The CRA has not been particularly generous in offering administrative relief. In fact, it has opined that where the trustees of a trust controlled the voting rights of a majority of the shares of a corporation prior to the distribution of those shares to unrelated beneficiaries, there would be an acquisition of control.<sup>45</sup> The CRA has also reasoned that two trusts with the same trustee are the same “person” for purposes of the definition of “affiliated persons” in section 251.1, so that corporations controlled by such trusts are necessarily affiliated.<sup>46</sup> The latter position has proved

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42 *Duba Printers*, supra note 3, at paragraph 49.

43 Although ironically, in the context of associated corporations in which it was devised, a different rule now applies that effectively establishes beneficiary control: paragraph 256(1.2)(f).

44 See subsections 256(3), (4), (5), and (6). Subsection 256(6) refers, in its preamble, to circumstances in which a corporation would be regarded as controlled, directly or indirectly in any manner whatever, by a person or partnership. This is a reference to *de facto* control and subsection 256(5.1). However, where the conditions of subsection 256(6) are met, dealing essentially with security arrangements, “the controlled corporation is deemed not to have been controlled by the controller at the particular time.” Arguably, this rule could therefore apply to prevent *de jure* control.

45 CRA document no. 9208175, May 28, 1992.

46 CRA document no. 2000-0046075, February 18, 2002.

unworkable and will be reversed legislatively.<sup>47</sup> However, it is illustrative of the problems that are likely to arise from identifying the trust with the trustee when determining control.

### Agency

No one suggests that large public corporations are controlled by brokerage firms or CDS (the Canadian Depositary for Securities) in whose name shares are commonly registered. Why not? The corporate law, as noted above, dispenses a corporation from any requirement to inquire into the existence of, or see to the performance or observance of, any duty owed to a third person by a registered shareholder. That should apply to contracts of agency as well as trusts. Nonetheless, the Act generally disregards agents in favour of principals, and this rule appears to apply to corporate control. The CRA baldly states:

The owners of shares of a corporation are considered to be those persons who are the beneficial owners of such shares. This is the case even if the shares are registered in the corporation's share register in the name of another person or persons such as a nominee or bare trustee.<sup>48</sup>

This conclusion probably rests on the assumption that, as a matter of law, the beneficial owner can control the voting behaviour of the registered owner. In effect, the “ownership” of shares to which the *Buckerfield's* test refers is taken to mean beneficial ownership. But that statement is too broad, given the treatment of trusts. The beneficiaries of a trust are, after all, the quintessential “beneficial owners.” However, unlike an agent, the trustee has not just legal title but also administrative powers that cannot, as a matter of the general law, be challenged or controlled by beneficiaries. The agent, on the other hand, is normally bound to do what the principal directs. The property rights may or may not be held in trust, but the power to determine the manner in which shares held by an agent are voted remains with the principal.

Treating the principal rather than the agent as the controller is sensible and in keeping with both the admonition of *Duba Printers* against formalism and the principle of control “in the long run.” However, while the agency relationship may be imposed by law,<sup>49</sup> more often it is established by contract, so that in order to look

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47 See Canada, Department of Finance, *Legislative Proposals, Draft Regulations and Explanatory Notes Relating to Income Tax* (Ottawa: Department of Finance, September 2004), clause 38.

48 IT-64R4, *supra* note 16, at paragraph 15.

49 For example, the CRA has maintained the position that since paragraph 128(2)(a) provides that a trustee in bankruptcy is deemed to be the agent of the bankrupt for all purposes of the Act, there is no change in control of a corporation when a controlling individual makes an assignment or is discharged from bankruptcy. See “Revenue Canada Roundtable—Income Tax” (1994) vol. 7, no. 2 *Canadian Petroleum Tax Journal* 129-47, question 23, at 144-45.

behind the agent as registered holder of the shares, one must have regard to that contract. Presumably, the agency agreement must fall into the category of exceptional instruments, such as trust indentures, that escape the injunction against taking “external agreements” into account in determining de jure control. One fears that as the category of exceptions expands, the coherence of the rigorous test falters.

As a footnote, it may be observed that in most circumstances, the rights of the principal, unlike those of a beneficiary of a trust, would fit within the deeming provision of paragraph 251(5)(b).<sup>50</sup> But of course that provision extends to only a limited class of control determinations required under the Act.

## Partnerships

Like a trust or agency relationship, a partnership (or at least a partnership formed under provincial law in Canada)<sup>51</sup> is not a “person” for purposes of the Act. The solution chosen for subjecting partnership income to tax might be regarded as an extension or codification of the agency rule. Subsection 96(1) provides that the income of a member of a partnership is computed as if the partnership were a separate person resident in Canada and this notional person’s income or loss were income or loss of the partner to the extent of his or her share thereof. This provision does not apply for the purpose of computing the income of a corporation whose shares are partnership property. It provides no guidance where the question relates to the control of such a corporation. If a majority of the voting shares of a corporation are partnership property, who controls the corporation?

If the test for corporate control were based on economic participation, one might reasonably establish a test that would look to the relative interests of the partners in the partnership property.<sup>52</sup> However, the *Buckerfield’s* philosophy is premised on voting control, not economic interest. Perhaps, by analogy to the treatment of trusts in *Consolidated Holding*, one should look instead to the partnership agreement and determine which combination(s) of partners can legally determine how the shares held in partnership may be voted. Where the partnership agreement does not specifically address this matter, the partners share equally in the capital and profits of the business, and decisions such as how to vote any shares that are partnership property are made by a majority of the partners.<sup>53</sup> In many cases, however, some partners are more equal than others, and partnership decision making is regulated by the agreement, perhaps on a basis of relative partner capital accounts, and sometimes

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50 The right of a beneficiary was held not to be a paragraph 251(5)(b) right in *The Queen v. Lusita Holdings Limited*, 84 DTC 6346 (FCA).

51 *Interpretation Bulletin* IT-90, “What Is a Partnership?” February 9, 1973, paragraph 1. With respect to Quebec partnerships, see CCQ article 2188.

52 Paragraph 256(1.2)(e), the statutory solution chosen for purposes of determining association where shares are held by a partnership, is based on just such a test.

53 See, for example, the Partnerships Act, RSO 1990, c. P.5, as amended, sections 24(1) and (8); and CCQ articles 2202 and 2216.

with special rules regarding certain decisions. The logic would, however, persist that the internally agreed methodology for deciding how the shares held in partnership are voted should determine who controls the corporation. Continuing along this path, one would naturally conclude that in the case of a limited partnership, the general partner(s) is (are) the person (or group of persons) controlling the voting of any shares of a corporation held in partnership, unless the partnership agreement provides otherwise. For example, the agreement might require some particular mechanism of approval by the limited partners.

The preceding paragraph sets forth one solution to the problem of corporate control by partners of a partnership. It may be justified as an extension of the *Consolidated Holding* decision to partnerships provided that a partnership agreement is another exceptional document, like a trust deed, that is not a mere external agreement disregarded in determining de jure control. The law governing partnerships does regulate, to some extent, the rights of partners with respect to partnership property and, to this extent, it may be said to affect matters of property rights as well as mere contractual obligations. However, one could contend that the partnership agreement does no more than bind the partners to behave in a certain way with respect to the corporate shares held in partnership and, in this respect, is no different from a shareholders' agreement that is not a USA.

The control analysis based on the partners' rights under the agreement might be justified by the principle of agency, discussed immediately above. "Every partner is an agent of the firm and of the other partners for the purpose of the business of the partnership."<sup>54</sup> This could be a basis for effectively disregarding the partnership and examining the rights of the partners.

Suffice it to say that the question of control by a partnership remains an unresolved or at least untested issue. Surprisingly so, I might say, given the number of corporations controlled by or through partnerships.

## FACTUAL CONTROL

This article deals mainly with broad questions regarding corporate control in the legal sense. However, the discussion would be incomplete without consideration of a few interpretive issues relating specifically to de facto control.

In 1988, the Department of Finance took a bold step. It effectively reversed the *Buckerfield's* line of cases in favour of a different test of corporate control in certain provisions of the Act. It was apparently decided that the de jure test was subject to undue manipulation. Therefore, for purposes of the definition of "associated corporations" and certain other anti-avoidance regimes,<sup>55</sup> a new factual test was prescribed in subsection 256(5.1).

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54 Partnerships Act, supra note 53, sections 6 and 7; and CCQ articles 2208 and 2215.

55 A useful list is to be found in the Department of Finance explanatory notes that accompanied the introduction of subsection 256(5.1): Canada, Department of Finance, *Explanatory Notes to Legislation Relating to Income Tax* (Ottawa: Department of Finance, June 1988), subclause 193(3).

## Legislative Design

Before addressing specific issues of interpretation, it is appropriate to take note of the following drafting points:

1. The Department of Finance chose an odd method to distinguish those cases in which the new *de facto* test would be applied from those in which the case law test of *de jure* control would remain undisturbed. The drafters observed that the Act sometimes used the word “control” without modification and sometimes added the qualifier “directly or indirectly in any manner whatever.” Most, although not all, of the latter group of provisions referred to circumstances coinciding with those in which Finance wished to apply its new *de facto* test. Therefore, with a bit of refinement, we have the current rule that where this qualifier appears, the reader is directed to the statutory rule in subsection 256(5.1), and where it does not, the case law test of *de jure* control continues to govern.
2. Does “control in fact,” the expression adopted in subsection 256(5.1), supplant or supplement legal control? The explanatory notes accompanying the introduction of subsection 256(5.1) suggested that the new provision expanded rather than replaced the meaning of control.<sup>56</sup> There is implicit judicial authority for that view.<sup>57</sup>
3. The core of the statutory definition is expressed as a hypothetical: the purported controller “has any direct or indirect influence that, *if exercised*, would result in control in fact.” The possession of direct or indirect influence is, however, actual and not potential. The same principle effectively applies to *de jure* control. The person who owns the majority of the voting shares controls the decision to exercise the voting control.
4. Subsection 256(5.1) does not actually define “control in fact.” It merely determines when control in fact is to be used as the test for corporate control. The subsection does restrict whatever meaning the case law or ordinary language might afford “control in fact” if that general meaning could include circumstances that are not based on “direct or indirect influence,” although it is hard to construct examples where factual control would not involve “influence.”

## Control of What?

The fundamental interpretive issue relating to subsection 256(5.1) arises precisely from the lack of any definition of the expression “control in fact.” When the provision was enacted, the Department of Finance indicated that it was intended to reflect “what is often referred to as *de facto* control.”<sup>58</sup>

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56 Ibid.

57 The Federal Court of Appeal deemed it appropriate to decide both *de jure* and *de facto* control in *Silicon Graphics*, *supra* note 34.

58 *Supra* note 55, at subclause 193(3).

From 1964 to 1988, “control” under the Act (with or without the qualifiers “directly or indirectly” and “in any manner whatever”) meant *de jure* control. The notion of factual control did make its way into the case law, albeit in a different context. It was not the test applied to a statutory requirement of corporate control, but rather one of the circumstances in which corporations might be found not to be dealing at arm’s length in fact. That case law addresses a distinct problem, and although the analysis may sometimes incorporate *de facto* control, it does not provide a great deal of guidance that is useful in the context of subsection 256(5.1).

That subsection has focused the judicial mind on the problem. In particular, two responses emerged in decisions of the Tax Court of Canada as to the essential structure of factual control. In some cases, the court has linked *de facto* control with the *Buckerfield’s* test, suggesting that the aim of subsection 256(5.1) was to identify those forms of influence that, if exercised, would permit someone other than the person owning a majority of the voting shares to change or determine the composition of the board of directors (what I will call “board control”). The competing view is that factual control resides in the person who has the ability to manage the business and affairs of the corporation in the place of the directors (“operational control”).

This issue has now been considered on three occasions by the Federal Court of Appeal. Justice Sexton in *Silicon Graphics* came down on the side of board control:

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.<sup>59</sup>

The other two decisions, *Transport Couture*<sup>60</sup> and *Lenester Sales*,<sup>61</sup> are ambiguous or indecisive on this point. In the former, Justice Noël accepted the dictum of *Silicon Graphics* cited above but then elided to the operational control upon which the trial judge had relied:

It is not possible to list all the factors which may be useful in determining whether a corporation is subject to *de facto* control (*Duba Printers*, [1998] 1 S.C.R. 795, para. [38]). However, whatever factors are considered, they must show that a person or group of persons has the clear right and ability to change the board of directors of the corporation in question or to influence in a very direct way the shareholders who would otherwise have the ability to elect the board of directors (*Silicon Graphics*, [2002]

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59 *Supra* note 34, at paragraph 67. However, in paragraph 68 of the reasons, *ibid.*, it is observed that “[t]here is no evidence that Silicon US as a creditor ever exercised operational control of Alias.” So, perhaps the decision is not entirely one-sided in this respect.

60 Sub nom. 9044-2807 *Québec Inc. v. The Queen*, 2004 FCA 23.

61 *The Queen v. Lenester Sales Ltd.*, 2004 FCA 217.

FCA 260, para. [67]). In other words, the evidence must show that the decision-making power of the corporation in question in fact lies elsewhere than with those who have *de jure* control.

The trial judge relied primarily on the operational control exercised by Transport Couture, the economic dependence on it of ML1 and ML2 and the family relations between the shareholders as a basis for concluding that Transport Couture in fact controlled ML1 and ML2. The appellant did not challenge the relevance of the factors considered by the trial judge. However, it argued that the evidence did not allow the trial judge to conclude that operational control of ML1 and ML2 was in the hands of Transport Couture or that ML1 and ML2 were economically dependent on Transport Couture.

In my view, the evidence amply supports the trial judge's decision. As he indicated at paragraph 36 of his reasons, if Transport Couture had decided not to renew its management contract and no longer to retain the services of ML1 and ML2, neither Louis-Marie Couture in the case of ML1 nor his wife in the case of ML2 would have been in a position to pursue the activities of those corporations.<sup>62</sup>

The judgment of the Federal Court of Appeal in *Lenester Sales* was delivered from the bench. Justice Evans declared the court to be agnostic on this particular point:

The Judge did not err in his selection of the legal tests for determining whether the necessary degree of control existed. After considering both the various tests found in the jurisprudence, he concluded that, whichever was adopted, the taxpayers were not "controlled" by GTS.<sup>63</sup>

At trial, Justice Bowman had, indeed, considered both tests. He appeared to prefer board control as enunciated in *Silicon Graphics*, but added that "[e]ven applying the somewhat broader interpretation suggested in some cases, . . . it is clear that GTS had no direct or indirect influence that would result in control in fact of Lenester or Sushi."<sup>64</sup>

Does this collision reflect a false dichotomy? If the board of directors exercises real control over the business and affairs of the corporation, then *ex hypothesi* no one else *could* have operational control. Control in fact in such a case, if it is to lie elsewhere than at the locus of *de jure* control, must perforce be with a person or group of persons who can, through some means other than ownership of voting shares, control the composition of the board. On the other hand, if the board has been emasculated and either cannot or does not discharge its statutory duty to manage the business, control in fact should presumably be sought where such operational control resides, or perhaps more accurately, it should be found to lie with those who either manage the business or have the power to determine who does.

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62 *Supra* note 60, at paragraphs 24 to 26.

63 *Supra* note 61, at paragraph 8.

64 *Lenester Sales Ltd. v. The Queen*, 2003 TCC 531, at paragraph 33.

## Sources of Influence

The premise of subsection 256(5.1) is that control in fact depends upon the exercise of “influence.” The source of such influence is evidently not the ownership of a majority of the voting shares, which would provide *de jure* control. So what might it be?

The exception that uses up most of the words in subsection 256(5.1), commonly referred to as “the franchise exception,” provides a hint by negative implication. The drafters presumably felt that the person described in the exclusionary language would, or at least might, have been regarded as having control in fact. Thus, a person may be in control as the result of the terms of a contract intended to govern the relationship between this person and the corporation in the nature of a franchise, lease, or distribution agreement.

Beyond this example, we are left to our own devices to figure out what might be the appropriate sources of “influence” referred to in subsection 256(5.1). The CRA’s view, not surprisingly, is expansive:

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.<sup>65</sup>

65 IT-64R4, *supra* note 16, at paragraph 23.

Cases have referred to shareholders' agreements and financing or banking arrangements, and there seems to be no reason not to consider any contractual stipulation as a potential source of influence. The administrative list above goes farther. Item (a) includes factual control associated with large but minority holdings in widely held corporations. This was one of the examples posited in the explanatory notes accompanying subsection 256(5.1).<sup>66</sup> Absent any presumptive rules,<sup>67</sup> it may be difficult to determine what level of ownership would meet this standard. Item (e) might be relevant to loan-out companies of rock stars or other circumstances in which the business of the corporation is singularly dependent on the activities of an individual who does not, however, own the majority (or any) of the voting shares. Item (f), family relationship, is delicate. Close family ties may lend themselves to acting in concert, but it is not clear why they would lend themselves to "influence." Does this mean mutual influence?

The last paragraph of the citation from the interpretation bulletin refers to influence in a kind of self-referential way. A person, it is suggested, may derive influence resulting in control in fact from the very act of exercising operational control. This may be similar to the reasoning in a Tax Court of Canada case in which one of the 50 percent owners of a corporation was also the sole director with extensive powers. That individual was considered to have the requisite influence to support the assertion of de facto control.<sup>68</sup>

To date, most of the cases have dealt with influence arising from legally enforceable agreements. Where the courts will look to determine the sources of influence remains to be seen.

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66 *Supra* note 55.

67 Compare the Investment Canada Act, RSC 1985, c. 28 (1st Supp.), as amended, section 28.

68 *Plomberie J.C. Langlois Inc. v. The Queen*, 2004 TCC 734.