Tax Topics

Report No.: 2461-2462

Date: May 22, 2019

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

- –Michael Goldberg, tax partner, Minden Gross LLP[1]

Special thanks to Caroline Elias, associate at Minden Gross LLP, for her assistance in reviewing earlier versions of the Series and to Joan Jung, tax partner at Minden Gross LLP, from whose presentations and papers I've borrowed liberally. All errors and omissions are my own.

Parts 1 and 2 of this Series reviewed what is meant by control for purposes of the *Income Tax Act* (Canada) (the "Act") and reviewed some of the key tax implications of control under the Act.[2]Part 2 of the Series also considered the tools required to determine *de jure* control ("DJC") with an emphasis on the impact of unanimous shareholdrs agreements ("USAs") on DJC. In this the third and final instalment of the Series, we'll consider the tools required to determine *de facto* control ("DFC") with an emphasis on the impact of ordinary shareholders agreements on DFC. In addition, we'll also review the income tax impacts of paragraph251(5)(b) on the exit provisions that are commonly found in many shareholders agreements.

TOOLS TO DETERMINE DFC

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

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

SHAREHOLDERS AGREEMENTS AND DFC

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

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

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

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

Multiview

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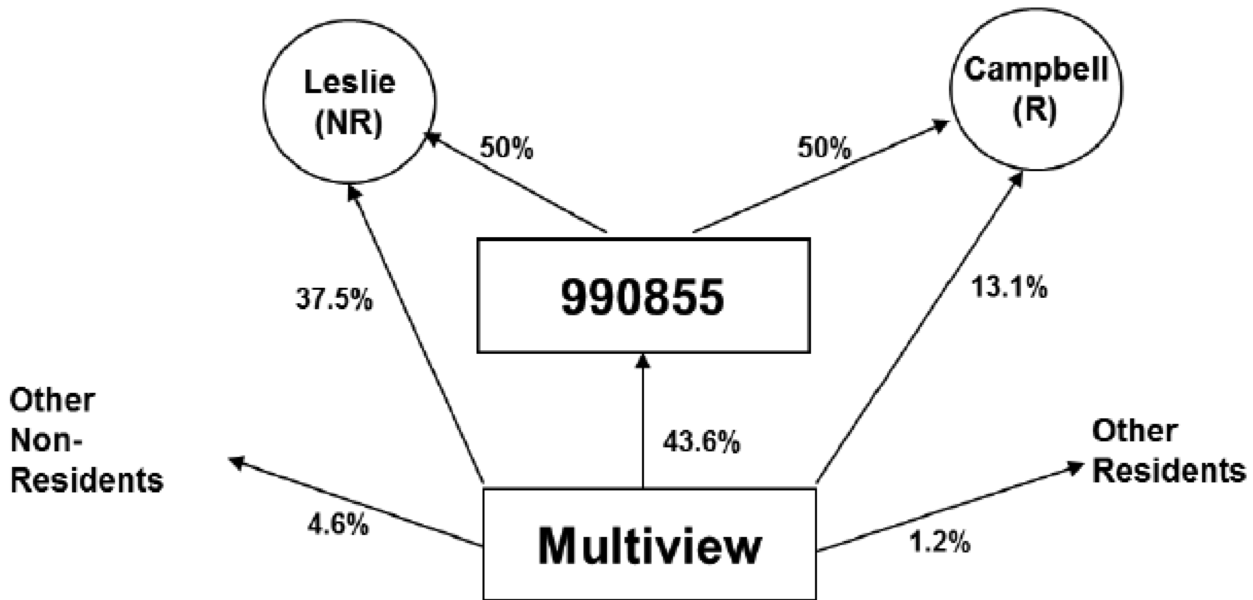
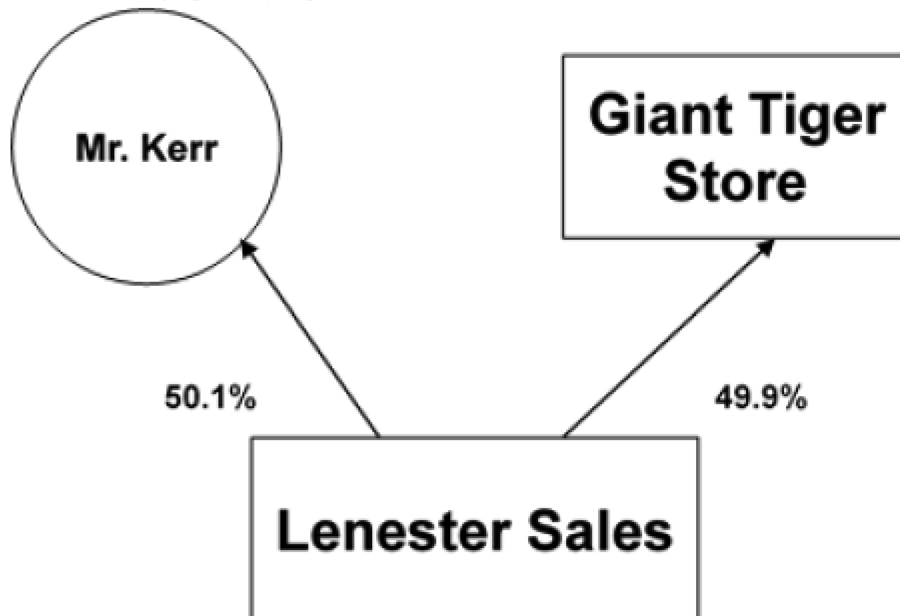
The share structure in *Multiview* is graphically reproduced below.



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

Lenester

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



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

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

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

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

PARAGRAPH 251(5)(*B*) EXIT ISSUES

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

Similar but not identical rules exist in subsection 256(1.4). The effect of subsection 256(1.4) is that it can associate otherwise unassociated corporations.[7]

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

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

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

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

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

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

As is highlighted in bold in subparagraph 251(5)(b)(i) above, exit mechanisms that are contingent on death, bankruptcy, or permanent disability of an individual are not caught by paragraph 251(5)(b). However, although death and bankruptcy

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are bright line events, there is no statutory definition of permanent disability. Consequently, care may be required to avoid paragraph 251(5)(*b*) when considering exit rights associated with disability situations.[10]

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

Unfortunately, the CRA's published positions provide very little analysis and, as a result, there appears to be a risk that other typical put and call rights, for example, such as are typically found in rights of first offer, could be caught by paragraph 251(5)(b).

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

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

CURRENT ITEMS OF INTEREST

TAX RELIEF FOR CANADIANS AFFECTED BY FLOODING

Recognizing the difficulties facing taxpayers affected by recent flooding, the CRA is encouraging individuals, businesses, and first-responders to request taxpayer relief online, by phone, or by filing form RC4288. Each request is considered on a case-by-case basis.

PROGRESS OF LEGISLATION

C-97, *Budget Implementation Act, 2019, No. 1*, received Second Reading in the House of Commons and is currently with the Standing Committee on Finance.

C-82, *Multilateral Instrument in Respect of Tax Conventions Act*, is currently undergoing Second Reading in the Senate.

S-6, *Canada–Madagascar Tax Convention Implementation Act, 2018*, which has already received Third Reading in the Senate, has received Second Reading in the House of Commons and has been reviewed by the Standing Committee on Finance.

SASKATCHEWAN COURT OF APPEAL UPHOLDS FEDERAL CARBON TAX

The Saskatchewan Court of Appeal released its decision today upholding the federal government's right to impose a carbon tax. In a split decision, Chief Justice Richards, writing for the majority, stated at para 164:

> Having worked through both the pith and substance of the Act and the scope of Parliament's jurisdiction in relation to greenhouse gas pricing, it is now possible to determine the validity of the Act. As explained earlier, this involves an inquiry as to whether the pith and substance of the Act comes within a head of federal authority. The answer to that inquiry is self-evident in light of the foregoing analysis. The pith and substance of the Act is about establishing minimum national standards of price stringency

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> for greenhouse gas emissions. Parliament has jurisdiction over this subject matter by virtue of the national concern branch of Peace, Order, and good Government. It follows that the Act is constitutionally valid.

And in conclusion held "The Greenhouse Gas Pollution Pricing Act is not unconstitutional either in whole or in part".

Saskatchewan's Attorney General is on record as saying prior to the release of the decision that, if the court did not hold in Saskatchewan's favour, it would be seeking leave to appeal to the Supreme Court of Canada.

CANADA TO IMPLEMENT NEW ANTI-DUMPING MEASURES FOR STEEL

The Canadian Government has announced that it intends to enact final safeguard measures for imports of heavy plate and stainless steel wire.

In October 2018, in response to the introduction by the US of tariffs on steel and aluminum products, the Canadian Government imposed provisional steel safeguard measures for a period of 200 days. The Government asked the Canada International Trade Tribunal ("CITT") to undertake an inquiry into whether final safeguards are warranted. A WTO member may take a "safeguard" action (i.e., restrict imports of a product temporarily) to protect a specific domestic industry from an increase in imports of any product which is causing, or which is threatening to cause, serious injury to the industry.

The CITT has now concluded that final safeguards are warranted. In response to the ruling, the Government will hold an intensive 30-day consultation with industry and workers, to determine what further protections are required.

The Government said that new measures will include a targeted review of dumping cases to boost protections through higher duties and greater flexibility for the Canada Border Services Agency to address price and cost distortions in foreign markets when determining whether dumping has occurred. The Government will also consult on the framework for the remission of the surtaxes currently imposed on imports from the US.

RECENT CASES

WHETHER BANKRUPTS HONEST BUT UNFORTUNATE BANKRUPTS ENTITLED TO DISCHARGE

Mr. Ebenal and Mrs. Ebenal operated a residential renovation services business and a hair dressing business through a numbered corporation. The Ebenals' financial difficulties began in 2013 when Mr. Ebenal discovered that his pension had been embezzled and his savings had been lost. When the Ebenals made assignments into bankruptcy for the first time on January 24, 2018, Mr. Ebenal's tax debt amounted to $218,168 in tax plus $200,568 in penalties and interest, and Mrs. Ebenal's tax debt amounted to $216,532 plus $195,668 in penalties and interest. The Minister opposed the Ebenals' application to the Court of Queen's Bench for Saskatchewan for a discharge on the grounds that both bankruptcies were tax driven and that there was surplus income available for the creditors.

The Ebenals' application was granted. There is a presumption that a bankrupt who fails to pay income tax owing is a dishonest debtor (see, for example, *Re Lattery* 2018 SKQB 281). In the present proceedings, however, the Ebenals rebutted this presumption in the absence of any evidence of their dishonesty, and in fact they did not know that they had earned the amount leading to the CRA assessments in issue. The Ebenals were, therefore, honest but unfortunate bankrupts who were entitled to a discharge. As a result, Mrs. Ebenal was discharged after serving a one-day suspension, and Mr. Ebenal was discharged on the condition that he pay a $217 fee owing to the Trustee.

¶50,205

Ebenal (Re)

2019 DTC 5044

APPEAL FROM DENIAL OF CAPITAL GAINS DEDUCTION ON SHARE

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As part of a series of transactions, a share disposition took place during the 2008 taxation year, resulting in a gain of $14,386,399. Of that gain, $9,221,643 was allocated to a family trust of which the taxpayer and his family members were beneficiaries. The taxpayer then claimed a capital gains deduction in relation to the gain that had been allocated to him. That deduction was denied on assessment and the taxpayer appealed to the Tax Court of Canada. The Tax Court dismissed his appeal, finding that the requirements of section 110.6 of the *Income Tax Act* (the "Act"), on which the appellant's claim for a capital gains exemption relied, had not been met. An appeal from the Tax Court decision was then taken to the Federal Court of Appeal.

The appeal was dismissed. The Federal Court of Appeal first noted that the Tax Court had found that the criteria set out in section 110.6 of the Act were not met, and that the gain realized on the share disposition therefore did not qualify for the capital gains deduction. The appellate Court was therefore required to assess whether the Tax Court erred in such determination and it concluded that it had not. The Tax Court's decision required it to interpret various contracts and such interpretation, as a question of mixed fact and law, was reviewable on a standard of palpable and overriding error, a highly deferential standard of review. The appellate Court reviewed the terms of those contracts before concluding that there were too many inconsistencies in the documents to support a finding that the Tax Court had made a palpable and overriding error in the conclusions it reached, based on its review of those documents and the other evidence before it. The appellant had failed to establish that the Tax Court committed any error in making its findings and his appeal was therefore dismissed, with costs.

¶50,204

Gillen v. The Queen

2019 DTC 5043

WHETHER APPELLANT'S MOTION FOR SUMMARY JUDGMENT TO BE ALLOWED

The appellant brought a motion for summary judgment in her appeal, based on the respondent's failure to serve a Reply to the Notice of Appeal within the required five-day period. The respondent then brought a cross-motion seeking to extend the deadline for service of that Reply to the date on which it was actually served. The respondent had filed the Reply with the Court prior to the required deadline but had, through oversight, failed to serve the appellant.

The appellant's motion was dismissed and the respondent's cross-motion allowed. The Tax Court of Canada first noted that Rule 21(1) of the *Tax Court of Canada Rules* (Informal Procedure) provides that failure to comply with the Rules shall not render any proceeding void unless the Court so directs, giving the Court discretion to deal with the irregularities in "such manner and on such terms as in the opinion of the Court, the circumstances of the case require". The Court noted that the appellant had brought her motion despite having obtained a copy of the Reply from the Court two days after the deadline and having refused the respondent's offer to provide an electronic copy pending service of the Reply, which it indicated would be done "forthwith". The Court held that the appellant had not provided any factual basis to suggest that she had been prejudiced in any way as a result of the respondent's short delay in serving the Reply, and found that the motion for summary judgment was totally without merit. The Court was satisfied that the respondent had acted immediately to cure the default and that any prejudice suffered by the appellant relating to costs incurred in bringing the motion were "self-inflicted and totally unnecessary". In the Court's view the appellant's actions in bringing the motion and causing the respondent to have to respond and to bring its cross-motion were "extremely unreasonable". The appellant's motion for summary judgment was disallowed and the respondent's cross-motion for an extension of time was allowed. The appellant was ordered to pay the respondent the costs of the motion in the amount of $250, within 30 days.

¶50,203

Jackson v. The Queen

2019 DTC 1052

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WHETHER CASCADING ASSESSMENTS UNDER SECTION 160 BASED ON VALID ORIGINAL ASSESSMENT

Section 160 assessments were issued against a family trust and the beneficiaries of such trust. The trust was the sole shareholder of a holding company which was itself the sole shareholder of two other companies. An assessment with respect to the 2010 taxation year had been issued for one of those companies. That assessment went unpaid and section 160 assessments were therefore issued against the holding company, the family trust, and its beneficiaries. The trust and the beneficiaries appealed from the section 160 assessments, arguing that the underlying assessment against the company was made in error.

The appeals were dismissed. The Tax Court of Canada held that, in order for section 160 to apply, it was necessary that a transfer of property had taken place, that such transfer was made to a non-arm's length person, that the transfer was made for less than fair market value consideration, and that the transfer was made by a person who owed tax in respect of the year in which the transfer was made, or some prior year. Where all four tests were met, then the transferee was liable to pay an amount equal to the lesser of the amount owed to the Minister by the transferor or the shortfall in the consideration. The appellants had acknowledged that the first three tests were satisfied, but argued that the underlying assessment which identified tax owed by the transferor was wrong and that no tax was owed by the company at the relevant time. The Court held that the validity of the section 160 assessments rested on the correctness of the underlying assessment, that the burden of showing that assessment to be erroneous lay with the appellants, and that they had failed to meet that burden. The Court reviewed the evidence provided by the appellants with respect to the underlying assessment and concluded that they had failed to provide the necessary documentary evidence on which their arguments relied, although claiming to be in possession of such documents. The Court therefore drew an adverse inference from that failure. It found as well that the witness on whom their case rested lacked credibility. Their appeal from the section 160 assessments was therefore dismissed.

¶50,202

Ansems v. The Queen

2019 DTC 1051

INTERNATIONAL NEWS

FRENCH COURT AGAIN REJECTS GOOGLE TAX BILL

The Paris Administrative Court of Appeals on April 25, 2019 upheld an earlier administrative court decision in favor of Google regarding back taxes dating back to 2005.

In July 2017, the administrative court in Paris ruled Google did not owe €1.1 billion (US$1.3 billion) in back taxes said to be due for the period 2005 to 2010, because it did not have a permanent establishment in France.

The basis of the French Government's challenge to Google's tax position was that it paid minimal corporate tax in France despite deriving substantial revenues in the country during the period in question. It says that Google's French income was routed to Ireland, where corporate tax is 12.5 per cent, to avoid paying French corporate tax.

In reaching the verdict, judges agreed with the opinion of an administrative court adviser, who decided in June 2017 that Google was not liable for the €1.1 billion back tax bill because the company did not have a sufficiently large physical presence in France. Further, the French subsidiary was found to lack autonomy from the Irish headquarters.

The Paris Administrative Court of Appeals released five judgments on April 25: No. 17PA03065, No. 17PA03066, No. 17PA03067, No. 17PA03068, and No. 17PA03069.

MEXICO URGED TO UNDERTAKE AMBITIOUS TAX SYSTEM REFORMS

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In its new Economic Survey for Mexico, the OECD urged Mexican authorities to more comprehensively reform the corporate and personal income tax systems and value-added tax. In particular, it has called for Mexico to lower headline rates, which are high by international comparison, by broadening the bases for each tax.

The OECD notes that a narrow tax base and high tax evasion rates limit the resources to finance needed infrastructure investment and policies to reduce poverty and inequality. It urges the Mexican authorities to develop a comprehensive tax reform package for implementation in the medium term.

It recommends that this should include broadening the VAT base by cutting exemptions and abolishing reduced rates while compensating low-income taxpayers with subsidies. The standard VAT rate in Mexico is 16 per cent, slightly above the average in Latin America (15.4 per cent), but lower than the OECD average of 19.3 per cent, the report notes. However, the revenue from VAT compared to its theoretical revenue is the lowest among OECD countries due to a narrow VAT base, with only around 40 per cent of domestic consumption being subject to the standard rate, on top of low levels of voluntary compliance, it adds.

Other recommendations include that Mexico should increase the progressivity of personal income tax by lowering the income threshold for the top rate and further cutting back tax allowances or converting them into tax credits. Further it calls on the authorities to create a nationwide property register and consider the use of blockchain for property tax administration. Revenues from property taxes amount to just 0.3 per cent of GDP, against the OECD average of 1.9 per cent.

The report says a key challenge is to reduce reliance on oil revenues. The new government took office on December 1, 2018. In January 2019, the Government introduced measures to stimulate economic activity along the US border. Under the changes, eligible taxpayers can apply for a refund that lowers their CIT rate to 20 per cent and the headline VAT rate to 8 per cent from 16 per cent.

The OECD noted that, at 30 per cent, the statutory corporate tax rate is high by international standards and well above the OECD average of 24 per cent. However, effective tax rates are lower due to accelerated depreciation on investments in buildings and machinery, and below the median in a sample of OECD and G20 economies.

The report says:

> Overall, Mexico would benefit from an in-depth review of its tax system that would take all these objectives into account. The government acknowledges these challenges and is working on strategies to address them. In the near term, this involves improving the tax administration and reducing regulatory loopholes which facilitate tax evasion and avoidance. In the second half of the Executive's term, the government intends to undertake a comprehensive tax reform aimed at increasing the progressivity of tax policy, enhancing tax revenue, and reducing price distortions.

FRANCE TO FLESH OUT TAX CUT PLANS IN JUNE

French Prime Minister Edouard Philippe announced on April 30, 2019 that plans for reductions in personal and corporate income tax will be released by the Government in June 2019.

The announcement comes after President Emmanuel Macron pledged recently to introduce €5 billion (US$5.6 billion) worth of tax cuts in response to the yellow vest protests.

Macron said that he would "significantly" reduce income tax, with the tax cuts to be funded in part by the removal of tax loopholes for companies.

In his presentation, Philippe also revealed that proposals for reform of the unemployment insurance system will also be presented in June. Additionally, this month, the Court of Auditors will be tasked with studying the extent to which taxes are being evaded in France, with the court to submit new anti-tax avoidance proposals to the Government in October 2019.

Footnotes

[1] Michael Goldberg, tax partner, Minden Gross LLP, MERITAS law firms worldwide, and founder of "Tax Talk with Michael Goldberg", a quarterly conference call about current, relevant, and real life tax situations for professional advisors who serve high net worth clients.

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[2] Unless otherwise noted, defined terms in this article have the meaning designated in the first instalment of the Series.
[3] See Part 1 of the Series for a review of the tax implications of DJC and DFC.
[4] 97 DTC 1489 (TCC).
[5] 2004 DTC 6461 (FCA).
[6] For example, *Silicon Graphics*, 2002 DTC 7112 (FCA), at paras 66-67.
[7] This Series will generally not discuss subsection 256(1.4). Numerous authors have written on subsection 256(1.4), including Ron Dueck and Stephanie Daniels "Update and Review of the Related, Affiliated, and Associated Rules: Overlaps, Differences, and Their Significance," (2014) 10:1 Canadian Tax Foundation.
[8] *Income Tax Act* (Canada), s. 251(5)(b).
[9] As set out in CRA doc No 2011-0429411C6 (November 29 2011), each person is considered to exercise paragraph 251(5)(*b*) rights independently. This should be contrasted from the approach taken in subsection 256(1.4). In that provision the CRA treats all rights as having been exercised simultaneously (CRA document no. 2003-0048571C6 (December 2 2002)).
[10] For more on CRA's views about the meaning of permanent disability see CRA document no. 5-9404 (April 20 1990), CRA document no. 9106955 (December 31 1992), and CRA document no. 1991-160 (October 1991).
[11] See CRA Folio S1-F5-C1, "Related Persons and Dealing at Arm's Length" (November 24 2015) at para 1.28; CRA Interpretation Bulletin IT-64R4 (cancelled), "Corporations: Association and Control" (November 1 2004) at para 37. Reference to "clear" rights or obligations that were originally found in Q.38 to the 1979 Revenue Canada Round Table has not found its way into CRA's currently published administrative positions.
[12] Joan Jung, "CCH Webinar: Shareholder Agreements" (Webinar delivered at Wolters Kluwer Online, 20 November 2018) [unpublished].

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