

# UNANIMOUS SHAREHOLDER AGREEMENTS AND CCPC STATUS

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A corporation that qualifies as a "Canadian-controlled private corporation" ("CCPC")<sup>1</sup> is entitled to preferential tax treatment under various provisions of the Act, including under the "small business deduction"<sup>2</sup> and the "refundable investment tax credit",<sup>3</sup> as are its shareholders and employees, for example under the capital gains exemption<sup>4</sup> or the employee stock option rules.<sup>5</sup> The organizing principle of CCPC status is the absence of control by disqualifying persons such as non-residents or public corporations. Thus, where disqualifying persons hold a majority of the shares of a corporation, shareholders may seek to structure their investment in the corporation so as to preserve CCPC status. This might be achieved by having the corporation issue voting shares to qualifying persons and non-voting shares to disqualifying persons, or separate classes of shares to qualifying and disqualifying persons the terms of which confer on the holders of that class, voting as a group, a fixed number of votes. Addressing control of a corporation in the share terms is not always acceptable from a business perspective, however, and can prove inflexible and cumbersome. For this reason, shareholders will often look to a unanimous shareholder agreement ("USA") in circumstances where disqualifying persons have a majority interest in a corporation, since it is a relatively flexible tool for allowing investors to establish the terms of their investment in the corporation *inter se*, including with respect to control.

Recently, however, CRA has indicated that in many circumstances it will not consider a USA to be effective in establishing *de jure* control for CCPC purposes. This article discusses these recent CRA views and considers the merits of CRA's position.

## **Definition of CCPC**

CCPC is defined in subsection 125(7) as a "private corporation" other than a corporation described in any of paragraphs (a) to (d).<sup>6</sup> Paragraphs (a) and (b) of the definition deal with the issue of control.<sup>7</sup>

Under paragraph (a), a corporation is not a CCPC if it is controlled, directly or indirectly in any manner whatever, by one or more non-resident persons, public corporations (other than a prescribed venture capital corporation), corporations a class of the shares of which is listed on a designated stock exchange or any combination of such persons or corporations.<sup>8</sup> Paragraph (a) is concerned with both *de jure* and *de facto* control by a disqualifying person or group of disqualifying persons.<sup>9</sup>

Under paragraph (b), a corporation is not a CCPC where it would be controlled by a hypothetical person if that person owned all of the shares owned by any disqualifying person. Paragraph (b) was introduced to override *Silicon Graphics Ltd. v. The Queen*,<sup>10</sup> in which a widely-held corporation with a majority of non-resident shareholders was found to be a CCPC on the basis

that the shareholders did not have a common connection and so could not act together to control the corporation. Paragraph (b) is concerned only with *de jure*, and not *de facto*, control.<sup>11</sup>

Subsection 251(5) provides a number of additional rules for purposes of the definition of CCPC, including deeming rules requiring a person's control of a corporation to be determined as if certain rights in respect of the shares of the corporation were exercised, including rights to acquire shares, to cause shares held by other shareholders to be redeemed, to acquire voting rights in respect of shares or reduce the voting rights held by other shareholders.

### **USAs and *de jure* Control**

The starting point for control in Canada is the decision of the Exchequer Court in *Buckerfield's Ltd. v. MNR*,<sup>12</sup> which held that *de jure* control consists of the control that rests in the ownership of such a number of shares as carries with it the right to a majority of the votes in the election of a board of directors. This basic principle has been elaborated and expanded in a number of subsequent cases to the effect that the determination of *de jure* control requires more than a mere inquiry into the share register.<sup>13</sup> In *Duha Printers (Western) Ltd. v. Canada*<sup>14</sup> the Supreme Court of Canada reiterated this position, holding that it is necessary to read the share register in light of the relevant corporate legislation and the constating documents of the corporation and that a USA is to be included among the constating documents. The Court was clear that only an agreement that meets the relevant statutory requirements for a USA could be considered for purposes of *de jure* control: generally, an agreement between all of the shareholders of a corporation that restricts in whole or in part the powers of the directors.<sup>15</sup> An ordinary shareholder agreement might be relevant for *de facto* control, but cannot be considered a constating document and so cannot affect *de jure* control.

The mere existence of a USA will not, of course, have the automatic effect of removing *de jure* control from a shareholder who holds a majority of the voting shares. Rather, it is necessary to determine whether the USA leaves any way for the majority shareholder to exercise effective control over the corporation in a way equivalent to the power to elect the majority of the board of directors.<sup>16</sup>

### **USAs and Paragraph (a) of the Definition of CCPC**

In a technical interpretation dated December 7, 2009,<sup>17</sup> CRA considered the following fact situation. A corporation governed by the OBCA, Opco, has three shareholders, one of whom, a non-resident corporation, holds a majority of the voting shares. The shareholders enter into a USA providing, *inter alia*, that each shareholder is entitled to appoint a specified number of directors. Under the USA, the non-resident shareholder cannot appoint a majority of the directors of Opco, on which basis the taxpayer took the position that the non-resident shareholder did not have *de jure* control. Since the other two shareholders of Opco were not disqualifying persons, the taxpayer took the position that Opco was a CCPC.

CRA rejected the taxpayer's position, taking the view that the reallocation of the power to appoint directors in a USA cannot alter *de jure* control. The basis for this view is that, in CRA's opinion, only the provisions of the relevant corporate statute that are made expressly subject to a USA can be modified by a USA for purposes of determining *de jure* control. In other words, if

the relevant section of the OBCA does not contain the words "subject to any unanimous shareholder agreement", its statutory effect cannot be altered by a USA. Subsection 119(4) of the OBCA deals with the election of directors and does not contain the requisite language. Hence, in CRA's view, the provisions of the USA that deal with the appointment of directors are merely aspects of a private agreement between the shareholders and not part of the constating documents of the corporation.

CRA's position with respect to paragraph (a) is not that a USA can never be relevant to *de jure* control, only that it is not effective with respect to voting control. Presumably CRA would consider a USA that stripped the directors of all of their powers (however impractical this might be for the management of the corporation) to be effective in overriding the ability of a majority shareholder to control the corporation.

A number of observations may be made about CRA's position. First, *Duha* nowhere suggests that some provisions of a USA are to be considered part of the corporation's constating documents and that some are not. On the contrary, the Court's conclusion that a USA is to be treated "as part of the corporate constitution, along with and equivalent to the articles of incorporation and the by-laws" suggests that, like the articles and by-laws, it is to be considered in its entirety.<sup>18</sup> The Court comes to its view, in part, based on the fact that for purposes of a court ordered remedy a breach of a USA is statutorily on par with a breach of the OBCA or the articles or by-laws of the corporation and that the provisions of a USA can be enforced against the corporation or its directors regardless whether they are parties to the agreement.<sup>19</sup> There is no suggestion, in *Duha* or the OBCA, that liability in this regard applies to some parts of a USA and not others. It would be odd indeed if a document all of the provisions of which were on par with the articles and by-laws for purposes of statutory liability was only selectively relevant for purposes of control.

Second, even if CRA were correct that a USA is only selectively relevant, the election of directors is in fact subject to the provisions of a USA under the OBCA. While CRA is correct to note that subsection 119(4) of the OBCA (which provides that directors are to be elected by the shareholders at the annual shareholder meetings) does not make reference to USAs, paragraph 97(a) of the OBCA does. Under paragraph 97(a), all questions put before a shareholders' meeting are to be determined by majority vote, subject to, *inter alia*, a USA.

Third, and most importantly, *Duha* expressly states that a USA can affect *de jure* control by limiting the voting rights of a majority shareholder. The Court provides the following summary of what is to be considered in determining *de jure* control:

- (a) the corporation's governing statute;
- (b) the share register of the corporation; and
- (c) *any specific or unique limitation on either the majority shareholder's power to control the election of the board or the board's power to manage the business and affairs of the company, as manifested in either;*
  - (i) the constating documents of the corporation; or

(ii) *any unanimous shareholder agreement.*<sup>20</sup>

While the USA in *Duha* did not contain a restriction on voting control, this fact situation was considered in *Alteco Inc. v. Canada*.<sup>21</sup> In that case the Tax Court held that a USA under which the minority shareholder of a corporation was guaranteed the ability to appoint a majority of the board of directors was effective in causing the majority shareholder not to have *de jure* control. Given the decision in *Alteco* and the statements in *Duha*, it is difficult to see how CRA's position could prevail.

**USAs and Paragraph (b) of the Definition of CCPC**

The determination whether a corporation is disqualified from being a CCPC by virtue of paragraph (b) of the CCPC definition is a two-step process. First, all shares of the corporation that are owned by disqualifying persons are attributed to a single hypothetical person. Second, a determination is made whether this hypothetical person would control the corporation.<sup>22</sup>

In a series of statements in 2008 and 2009, CRA expressed the view that while a USA is relevant for the first step (by virtue of paragraph 251(5)(b)) it is not relevant for the second step. It has provided two justifications for this view. First, CRA looks to the statement of the Federal Court of Appeal in *Silicon Graphics*<sup>23</sup> that paragraph (b) provides that "mere ownership of shares by a majority of non-residents would be sufficient to constitute non-resident control".<sup>24</sup> Second, CRA argues that since the hypothetical person is not, and is not deemed to be, a party to the USA, the USA is irrelevant for purposes of determining whether the hypothetical person has *de jure* control of the corporation, so that the determination under paragraph (b) is a strictly arithmetic one.<sup>25</sup>

CRA's first argument is hardly determinative. *Silicon Graphics* was not concerned with a USA or paragraph (b). Rather, it concerned the application of paragraph (a) and considered paragraph (b) (which had been added to the definition to override the decision of the Tax Court in the same case and which did not apply for the taxation years at issue) solely as part of an exercise in statutory interpretation in respect of paragraph (a). In this context, the Court's comment cannot be expected to have any meaningful jurisprudential value.

The second argument goes to the always vexing problem of deeming rules: if something is deemed to be, what is the extent of the legislative fiction of its existence? Paragraph (b) provides only that control be determined as if each share owned by a disqualifying person were owned by the hypothetical person. While no mention is made of the conditions of ownership (such as restrictions imposed by a USA), the deeming rule is surely not intended to exclude the conditions imposed by the articles and by-laws of the corporation or the governing legislation. It would appear to go against the principle in *Duha* to take into account some, but not all, of the constating documents of the corporation in determining this hypothetical control.

Put another way, it seems unlikely that Parliament intended that a USA should be relevant for purposes of paragraph (a) but not paragraph (b). For example, assume that 100,000 voting shares of a corporation are owned by a single disqualifying person entitling that person to over 50% of the votes, but that person's power to elect the board or otherwise control the affairs of the corporation is limited by a USA. That person would not be considered to have *de jure* control of

the corporation. However, if CRA's position with respect to paragraph (b) is correct, if that person held 99,999 voting shares and another disqualifying person held a single share, then the USA would not be relevant. It is not clear what policy objective would be served by such a distinction.<sup>26</sup>

## **Conclusions**

While CRA appears to have developed a dislike of USAs in the CCPC context, its positions on the matter are not particularly strong. Nevertheless, given the attention CRA is giving to USA arrangements, practitioners may consider using other methods for managing investments by disqualifying persons in CCPCs. Where a USA is used, care should be taken to ensure that, in the words of the Supreme Court in *Duha*, the USA does not leave "any way for the majority shareholder to exercise effective control over the affairs and fortunes of the corporation".<sup>27</sup> This would include rights under paragraph 251(5)(b). For example, special voting provisions, call rights, a right to amend or terminate the USA or to alter the number of directors would all need to be considered in light of paragraph 251(5)(b) and the general effectiveness of the USA with respect to *de jure* control.

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<sup>1</sup> Defined in subsection 125(7) of the *Income Tax Act*, RSC 1985, c. 1 (5th Supp.), as amended (the "Act"). All statutory references are to the Act unless otherwise indicated.

<sup>2</sup> Subsection 125(1).

<sup>3</sup> Section 127.1.

<sup>4</sup> Subsection 110.6(2.1).

<sup>5</sup> Subsection 7(1.1) and paragraph 110(1)(d.1).

<sup>6</sup> "Private corporation" is defined in subsection 89(1) generally as a Canadian resident corporation other than a "public corporation" or a corporation controlled by one or more public corporations. A "public corporation" is defined generally as a Canadian resident corporation a class of the shares of which is listed on a "designated stock exchange" (defined in subsection 248(1)) in Canada, that made a valid election to be a public corporation or that was a public corporation and has not made a valid election to cease to be a public corporation.

<sup>7</sup> Paragraph (c) provides that a corporation a class of shares of which is listed on a designated stock exchange is not a CCPC. Paragraph (d) deals with the election in subsection 89(11) not to be a CCPC for purposes of the eligible dividend rules and other limited purposes.

<sup>8</sup> Referred to herein as "disqualifying persons".

<sup>9</sup> Generally, *de facto* control will be found where the person or group has influence sufficient to determine the composition of the board of directors of the corporation or to control the board's decision-making power, subject to certain express exceptions in subsections 256(5.1) and (6). See *Taber Solids Control (1998) Ltd. et al. v. The Queen*, 2009 DTC 1899 (TCC) for a useful discussion of *de facto* control.

<sup>10</sup> 2002 DTC 7112 (FCA).

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<sup>11</sup> CRA confirmed that paragraph (b) looks only to *de jure* control at the CRA Roundtable at the 2009 Annual Conference of the Canadian Tax Foundation, question 8(a).

<sup>12</sup> 64 DTC 5301 (Ex. Ct.).

<sup>13</sup> See, for example, *Donald Applicators Ltd. v. MNR*, 66 DTC 5124 (Ex. Ct.), aff'd 71 DTC 5202 (SCC), *Oakfield Developments (Toronto) Ltd. v. MNR*, 71 DTC 5175 (SCC) and *The Queen v. Imperial General Properties Limited*, 85 DTC 5500 (SCC).

<sup>14</sup> 98 DTC 6334 (SCC).

<sup>15</sup> See, for example, section 108(2) of the *Business Corporations Act* (Ontario) ("OBCA"), RSO 1990, c. B.16.

<sup>16</sup> *Supra* footnote 14, paras. 81 and 82.

<sup>17</sup> CRA Document 2009-0314351I7(E). See also Technical Interpretation, CRA Document 2009-0343331I7(F), dated December 22, 2009.

<sup>18</sup> *Supra* footnote 14, para. 61.

<sup>19</sup> *Ibid.*, para. 68.

<sup>20</sup> *Ibid.*, para. 85. Emphasis added.

<sup>21</sup> [1993] 2 CTC 2087 (TCC).

<sup>22</sup> See *Sedona Networks Corporation v. The Queen*, 2007 DTC 5359 (FCA) at para. 2.

<sup>23</sup> *Supra* footnote 10.

<sup>24</sup> *Ibid.*, para. 45. CRA articulates this view in Technical Interpretation, CRA Document 2008-0265902I7(F), dated May 6, 2008.

<sup>25</sup> Technical Interpretation, CRA Document 2008-0265901I7(F), dated February 27, 2008 and the CRA Roundtable, 2009 Canadian Tax Foundation annual conference, question 8(b).

<sup>26</sup> It seems equally unlikely that paragraph (b) was intended to apply in circumstances where there is only one disqualifying person, such that a corporation may succeed under paragraph (a) by virtue of a USA but fail under paragraph (b). CRA would appear to agree, indicating that it takes the decision in *Perfect Fry Company Ltd. v. The Queen*, 2007 DTC 588 (TCC), aff'd 2008 DTC 6471 (FCA) to stand for the principle that paragraph (b) will not apply where a single person owns all of the disqualifying shares. See Technical Interpretation, CRA Document 2007-0253591I7(E), dated March 18, 2008.

<sup>27</sup> *Supra* footnote 14, para. 82.