ASSOCIATED CORPORATIONS WITH REFERENCE TO THE INCOME TAX ACT

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I. *Introduction.*

The principles governing the taxation of corporate income in Canada have been subject to extensive changes over the last few years. Until 1949, there was a flat rate of tax levied on all corporate income, and the periodic statutory amendments before this time were concerned only with changing the percentage rate of tax that was to be imposed on these gains. Gradually, this rate was increased during the quarter-century preceding 1949, until it reached thirty per cent. But in that year, Parliament showed a concern over the development of small business in this country. During his budget speech in the Spring of 1949, the Minister of Finance said:

> My own belief is that small business should be encouraged and it seems to me that a useful way to do this is to lower the tax and take less out of the funds they need for growth and expansion.[1]

Of course, there were other factors that may have supported the imposition of a dual tax rate. It cannot be denied that a much greater majority of the voters were not to be found holding interests in the large corporations, but rather in the many small businesses strewn across the country. Moreover, even though a tax increase of only three per cent was sought to be imposed on the larger corporations, and even though a considerably lower rate was to be levied on small businesses, the new scheme was expected to increase corporate tax revenue. In fact, the Minister estimated a gain of $8,000,000.00 for the 1950-51 fiscal year under this

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[1] (1949), 88 House of Commons Debates 1798, quoted by J. R. Petrie, Some Aspects of Recent Corporation Income Tax Legislation in Canada. Canadian Tax Foundation Bulletin, November 1950, at p. 1.

system. Seven months later, he revised this estimate and predicted a gain of thirty eight million dollars, an even greater revenue increase than was first expected.[2]

Whatever the reasoning, Parliament amended the Income Tax Act in 1949[3] so as to provide for two rates of corporate income tax which benefitted smaller companies. Thus, a tax of ten per cent was levied on taxable corporate income up to $20,000.00 and thirty-three per cent on the excess of $20,000.00.

It is easy to see that there was an immediate tendency for a larger corporation to be divided into several smaller ones so as to take advantage of the lower tax rate. Parliament anticipated this and attempted to cope with the situation by instituting legislation whereby these several smaller corporations that were formed as such merely to avoid the higher tax rate were to be treated as one entity for taxation purposes, that is, they were "associated".

But unlike the United States,[4] Canadian courts have endorsed the English rule of law whereby a taxpayer is entitled to manage his business affairs in such a manner as to avoid a higher taxation rate legally if he chooses a method of operation that does not fall within the strict wording of the tax-imposing statutes:[5]

> Tax avoidance, or tax planning, is an inevitable reaction to the rule that the letter of the law prevails. Such practices, if honestly and frankly carried out, are not illegal or improper, and have the sanction of the courts.[6]

This quotation is not meant to suggest that each time a person formed several businesses under separate corporate heads that he did so with the primary purpose of avoiding taxation. For example, where a person owned a shoe-lace factory and a restaurant, it was more feasible, economically, to incorporate each business enterprise separately.

During the past twelve years, however, the resourcefulness of many taxpayers has been such that they have been able to

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[2] *Ibid.*, at p. 2. [3] S.C., 1949 (2nd sess.), c. 25.

[4] American courts will look to the main purpose of a certain transaction, such as the incorporation of a company and if it is primarily used for tax avoidance means, the machinery thereby set up by the transaction will be ignored and the full tax rate imposed on a liberal interpretation of the taxing statute. See *Gregory* v. *Helvering* (1935), 393 U.S. 465.

[5] The classic statement setting forth this rule appears in *Partington* v. *A.-G.* (1869), 21 L.T.R. 370 at p. 375 and endorsed in numerous Canadian cases, such as *Curran* v. *Minister of National Revenue* (1959), 59 D.T.C. 1247.

[6] See William M. Carlyle, Associated Corporations: Some Observations (1960), 8 Can. Tax J. 369, at p. 370.

"outflank the letter of the law"[7] on numerous occasions. This resulted in fairly constant amendments to the Income Tax Act[8] in order to keep up with the new tax avoidance schemes that developed and finally culminated in the present section 39 of the Act. This section, coupled with subsections (5), (6), (8) and (9) of section 139 have brought some new and rather confusing aspects into the law of taxing associated corporations. But Mr. F. R. Irwin, Director of the Taxation Division of the Department of National Revenue, said:

> My thesis is that this transformation in the law is more a tribute to the ingenuity of taxpayers rather than to any love for words or complexity on the part of the government. . . .[9]

1. *History of section 39 prior to January 1st, 1961*

Upon the introduction of the dual taxation rate in 1949,[10] Parliament was concerned over the fact that an incentive was created to split larger corporations into smaller ones so as to avoid the thirty-three per cent rate. Some limitations and rules were instituted so as to provide for "related" corporations.[11] What was then section 36(4), stated that:[12]

> . . . one corporation shall be deemed to be related to another in a taxation year if, at any time in the year (a) it, directly or indirectly, controls the other (b) it is, directly or indirectly, controlled by the other (c) both corporations are controlled, directly or indirectly, by the same person.

Where two or more corporations were related under the rules, they were treated as one, and their corporate income was lumped together so that the higher tax rate could not be avoided.

Mr. Irwin points out that ". . . it is interesting to note . . . that the first simple set of rules introduced in 1949 used the test of control. . . . The criticism of these rules which seemed to carry the most weight at the time was that they discouraged the formation of new companies which depended upon capital furnished by existing corporations or by individuals who controlled one or more companies".[13] And so, in 1950, a new set of rules for determining whether corporations were "related" was provided for by legislation.[14] This amendment was of considerable significance in that the basic test of control was replaced with one of ownership, this

[7] *Ibid.*, at p. 371.
[8] R.S.C., 1952, c. 148, as am. up to July 13th, 1961.
[9] Canadian Tax Foundation, Conference Report (1960), p. 44.
[10] *Supra*, footnote 3.
[11] The term "associated" was not used until a few years later.
[12] *Supra*, footnote 3. [13] *Supra*, footnote 9. [14] S.C., 1950, c. 40.

ownership test being restricted to seventy per cent ownership of the issued common shares of a corporation. The amendment was made retroactive to 1949.

While there were various minor changes in the following ten-year period, which dealt largely with varying the two taxation rates, the two most significant amendments were passed in 1951.[15]

Firstly, ownership of the shares was deemed to be ownership whether it was direct or indirect. Secondly, two or more corporations, each of whose shares were owned to the extent of seventy per cent or more by persons "not dealing at arm's length", would not be deemed "related" to one another unless one of the individuals owned shares in each of the corporations.

Later, the word "associated" was substituted for "related" and section 36 became section 39. By 1960, the Act imposed a tax of twenty one per cent on taxable corporate income up to the first $25,000.00, and fifty one per cent on the excess income.[16]

Immediately prior to the final amendment which was passed in 1960[17] but not to take effect until January 1st, 1961, the rules for determining whether corporations were associated were laid out in subsections (4), (5) and (6) of section 39, the effects of which were as follows:

> ... corporations were deemed to be associated with one another if any of the following circumstances existed at any time in the taxation year:
> (a) if one of them owned 70% or more of the issued common shares of the other;
> (b) if at least 70% of the issued common shares of each corporation was owned by one person or two or more persons jointly;
> (c) if at least 70% of the issued common shares was owned by persons not dealing with each other at arms length, one of whom owned at least one share of each corporation;
> (d) if they were both associated with the same corporation; or
> (e) if 70% or more of the issued common shares of one of them was owned directly or indirectly by a combination of two or more other corporations which were associated with one another.[18]

2. *Circumstances and problems that arose with reference to corporate taxation up to December 31st, 1960*

There were several aspects of the Income Tax Act which caused considerable concern among legal authorities in the ten-year period from 1950-1960. This was largely due, perhaps, to an un-

[15] S.C., 1951 (1st sess.), c. 51.
[16] These rates include the three per cent imposed by the Old Age Security Act, R.S.C., 1952, c. 200, as am.
[17] S.C., 1960, c. 43.
[18] CCH Canadian Limited pamphlet on Associated Corporations in Canada (1961), p. 7.

certainty of vital terms that were not defined and which, at times, seemed incomprehensible.

The "not-at-arms-length" concept was an important test to be applied in determining whether two or more corporations were associated; yet the term was nowhere defined in the Act. Any one of several meanings could be attached to the expression. Furthermore, the basic principle of this test met with constant disfavour among taxpayers, accountants and lawyers for the whole ten-year period in question. For example, related persons were "deemed"[19] to be not at arms length to one another in their dealings. Whereas Canadian courts have not been consistent with this judicial definition of the word deemed, the Income Tax Appeal Board began to take the attitude that the word was to be interpreted as being "conclusively considered"—an irrebuttable presumption permitting "no exception or elasticity".[20] Yet, it was often true that a family group incorporated a series of companies primarily to facilitate various business enterprises and to assist younger family members, with no intention to avoid taxes. However, the "not-at-arms-length" concept has little or no effect in the present sections dealing with corporate association,[21] and a more detailed discussion of the term would be beyond the scope of this analysis.

There was uncertainty as to the meaning of terms and rules governing the relatedness of one individual to another, which still exists today to a large degree, and which will be dealt with in the following discussion.

Moreover, despite these rules and their complexities, it was still easy for an individual or a group to divide a large corporation into several smaller ones, even within family groups, so as to skirt the Act with straightforward clarity. One of the major reasons for this was that while the seventy per cent ownership rule was probably passed in 1950 because it was "regarded as a reasonable alleviation of the earlier rule based on more than 50% ownership",[22] it is clear that it was not based on any mathematical formula. There were numerous instances where, even though these smaller corporations gave up thirty-one per cent of their ownership interest

[19] Carlyle, *op. cit.*, footnote 9, p. 43 *et seq.*, outlines some of these criticisms. Moreover, the Canadian Institute of Chartered Accountants regularly sent a letter to the Minister suggesting that this rule be cleared from ambiguity and unfairness.

[20] *No. 25* v. *M.N.R.* (1951), 51 D.T.C. 345.

[21] *Op. cit.*, footnote 9, p. 43 *et seq.*, discusses this aspect. A very thorough analysis of the anomalies of the "not-at-arms-length" concept is given by Dr. F. E. LaBrie, The Uncertainties of Tax Planning (1960), 9 Chitty's L. J. 114, at p. 177.

[22] *Ibid.*, p. 45.

to a minority, so as not to fall within the seventy per cent rule, not only did the minority receive corporate profits to the extent of their interest, but in addition, the major shareholders saved considerable money themselves. The CCH publication on *Associated Corporations in Canada* uses the following example to issustrate this very point.[23]

Corporation A controlled three wholly owned subsidiary corporations B, C and D. Tax might have been computed as follows:

Corporation	Taxable Income	Tax Rate	Tax	Ownership	Net
A	$200,000	50%	$100,000	100%	$100,000
	25,000	21	5,250	100	19,750
B	20,000	50	10,000	100	10,000
C	15,000	50	7,500	100	7,500
D	20,000	50	10,000	100	10,000
	280,000		132,750		147,250

Assume that an employee (*e.g.*, the general manager) of each of corporations B, C and D acquired a 31% interest in the corporation by which he was employed. Tax might thereafter be computed as follows:

Corporation	Taxable Income	Tax Rate	Tax	Ownership	Net
A	$200,000	50%	$100,000	100%	$100,000
	25,000	21	5,250	100	19,750
B	20,000	21	4,200	69	10,902
C	15,000	21	3,150	69	8,177
D	20,000	21	4,200	69	10,902
	280,000		116,800		149,731

Despite the fact that corporation A's interest in corporations B, C and D had been reduced from 100% to 69%, it was still possible to enjoy a saving of $2,481 a year, and the balance of the tax saving ($13,469) would accrue to the employees who held a minority interest. . . . In fact, businesses have been broken into as many as twenty-three component corporations.

These methods are also considered preferable because employer-employee relations were considerably bettered and were often used as incentives to managers of branch offices. It should also be noted that the majority shareholders did not lose their control of the corporations. Not only were they able to retain sixty-nine per cent of the issued common shares, but their voting majority could be increased by the issuance of preference shares with accelerated voting rights. Moreover, preference shares with varied dividend payments, or agreements to buy back the issued

[23] (1961), pp. 8 and 9.

common shares, were also employed as devices to retain a great deal of power in the majority.[24] Of course, all of these advantages, financial and otherwise, were derived at the expense of the government.

> . . . there was evidence that the pastime of dividing companies was becoming increasingly popular . . . the number of companies ran into several hundreds and the revenue into millions. . . . The loophole had to be closed.[25]

In 1959, the Minister of Finance issued a warning that something would have to be done if the present trend continued. In 1960, the warning materialized into the form of an amendment of the Income Tax Act and hence our present section 39.[26]

II. *The Effect of the Income Tax Act with Reference to Associated Corporations as of January 1st, 1961.*[27]

> Prior to the current amendment, the test in determining whether corporations were associated or not was based on the *ownership* of 70% or more of the common shares of the corporation. *Corporate control* is now the principal catalyst, which will precipitate the finding of associated status. The new rules will not apply until after December 31, 1960, and before then, anyone concerned must unscramble his eggs if he has relied on or enjoyed the benefit of the ownership test, and must find a new recipe for serving up separate 21% portions. . . .[28]

Whereas the major change in the new section 39 is that the concept of control is now to be used as the test for associated corporations, there were other changes as well. The "not-at-arms length" doctrine no longer applies to this section. New rates have been introduced in subsections (1) and (2) of section 39; that is, while the percentage figures of eighteen percent and forty-seven per cent[29] remain the same, the dividing line between the dual rates has been set at $35,000.00, instead of the previous figure of $25,000.00. Before getting into a more detailed discussion of the new amendments, a brief glance at the rules for resolving associated status may be of some assistance at this time.

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[24] *Op. cit.*, footnote 9, p. 46. [25] *Ibid.*

[26] *Supra*, footnote 17.

[27] It should be noted that there are several qualifications and exceptions to the discussion that follows, namely, when dealing with personal corporations, investment companies, non-resident owned investment corporations, foreign business corporations and charitable corporations. See *op. cit.*, footnote 18, p. 6 in this regard.

[28] Carlyle, *op. cit.*, footnote 6, at p. 371.

[29] Or twenty-one per cent and fifty per cent when considering the Old Age Security Act.

1. *The rules*

If any of the following circumstances are present at any time[30] in a taxation year one corporation will be associated with another. Thus, where:

(a) "One of the corporations controlled the other;"[31]

Example:

Corporation A owns fifty per cent plus one of the voting shares of corporation B. Corporations A and B are associated.

(b) "Both of the corporations were controlled by the same person or group of persons;"[32]

Examples:

(i) X owns fifty per cent plus one of the voting shares in each of corporations A and B. Corporations A and B are associated.

(ii) X and Y own fifty per cent plus one of the voting shares in each of corporations A and B. Corporations A and B are associated.

Further discussion will tend to show that some degree of uncertainty may arise in the application of this rule.

(c) "Each of the corporations was controlled by one person and the person who controlled one of the corporations was related to the person who controlled the other, and one of those persons owned directly or indirectly one or more shares of the capital stock in each of the corporations;"[33]

Example:

X and Y are brothers. X controls corporation A by owning more than fifty per cent of the voting shares and Y similarly controls corporation B. X owns one share in corporation B. Corporations A and B are associated.

It will be noted at this point that the Act does not make any distinction as to the type of share that X may own in his brother's corporation. Presumably, any type of share will suffice, which illustrates the importance of owning even one director's qualifying share in a corporation, even though that share may be devoid of almost all privileges, including voting rights.

The rules for determining whether or not two persons are

[30] S. 39(5) has been operative since 1949. Sub-s. (4), (4a), (6) and (6a) apply only if the circumstances referred to existed after December 31st, 1960.

[31] Income Tax Act, *supra*, footnote 8, s. 39(4) (a).

[32] *Ibid.*, s. 39(4)(b).

[33] *Ibid.*, s. 39(4)(c).

"related" for purposes of the Act are laid out in subsections (5), (6), (8) and (9) of section 139. This section will be dealt with to some degree under the following headings.

The reference to indirect ownership of shares is thought not to apply to the piercing of a corporate veil so as to find that X, as owner of corporation A "indirectly" owns the shares of corporation B because these shares are directly owned by corporation A. Rather, indirect ownership refers to the power to look behind a trust or through a nominee to see who, in fact, owns the shares in question. Further discussion on indirect ownership will ensue.

(d) "One of the corporations was controlled by one person and that person was related to each member of a group of persons that controlled the other corporation, and one of those persons owned directly or indirectly one or more shares of the capital stock of each of the corporations;" [34]

Example:

X controls corporation A. Y (X's father), Z (X's brother) and corporation Q (also controlled by X) each own one third of the shares in corporation B. If (i) X owns one or more shares in corporation B, or (ii) if either Y, Z or corporation Q owns one or more shares in corporation A, corporations A and B are associated.

(e) "Each of the corporations was controlled by a related group and each of the members of one of the related groups was related to all of the members of the other related group, and one of the members of one of the related groups, owned directly or indirectly one or more shares of the capital stock in each of the corporations;" [35]

Example:

X and Xw (X's wife) control corporation A, D and E (children of X and Xw) control corporation B. If either (i) X or Xw owns a share in corporation B or, (ii) D or E owns a share in corporation A, corporations A and B are associated.

It should be noted that under paragraph (c) of subsection (5d) of section 139, a shareholder shall be deemed to be related to himself where he owns shares in two or more corporations. Furthermore, a "related group" is one wherein each member of that group is "related" under section 139 to every other member. A group composed of X, his brother, and X's son is not a "related

[34] *Ibid.*, s. 39(4)(d). [35] *Ibid.*, s. 39(4)(e).

group" because X's brother and X's son (uncle and nephew) are not "related" within the Act.[36]

(f) "Where two corporations are associated or deemed . . . to be associated with the same corporation at the same time, they shall, for purposes of this section, be deemed to be associated with each other."[37]

Example:

Corporation A is associated with corporation B because X controls both corporations. Corporation C is associated with corporation B because Xw (X's wife) controls corporation C and has one share in corporation B. Although corporations A and C would not otherwise be associated, since each is associated under different rules to corporation B, they are associated with each other by virtue of this section.

The above example illustrates the danger of incorporating a third company where a group has certain interests in two other corporations. The same result occurred in *No. 720* v. *Minister of National Revenue*[38] under the old provisions of section 39, but the effect would be the same today.

2. *Section 139 (5d)(b)*

At this point, it might be advisable to consider the effect of section 139(5d)(b) which, by virtue of section 39(4a)(c), applies *mutatis mutandis* to section 39 (4). Section 139(5d)(b) reads as follows:

> For the purpose of subsection (5a) . . .
> (b) a person who had a right under a contract, in equity or otherwise, either immediately or in the future and either absolutely or contingently, to, or to acquire, shares in a corporation, or to control the voting rights of shares in a corporation, shall . . . be deemed to have had the same position in relation to the control of the corporation as if he owned the shares; . . .

Consideration is given to this subsection because several writers on the subject have taken the view that the meaning of "control", as found in section 39(4), has been greatly extended. CCH Canadian Limited, in dealing with the matter, has reasoned this way:

> The circumstances in which control of a corporation may exist are broadened by virtue of section 139 (5d) which is made applicable to

[36] The rules designating relatedness are set out in the Act in s. 139(5)(6), (8) and (9), *ibid.*

[37] *Ibid.*, s. 39(5).

[38] (1960), 60 D.T.C. 446.

> section 39(4) by section 39(4a). Paragraph (b) of section 139(5d) provides . . . [as quoted above]. This provision is very broad and it would appear that, in considering the tests for control, a person will be treated as if he owned the shares in a corporation in at least the following circumstances:
> (1) if he is the beneficial owner of the shares, notwithstanding that (a) he has, in the same way, given up his voting rights, *e.g.*, pledged the shares to a bank or other lender; (2) if he has an option to acquire the shares; (3) if he is a party to a contract under which he may in some circumstances acquire the shares or control the voting rights of the shares; or (4) if he is a voting trustee of the shares under an arrangement whereby, *e.g.*, voting control of the corporation is given to a trustee, and the holders of the shares have deposited them under an arrangement whereby they receive voting trust certificates.[39]

Mr. Carlyle agrees with this line of reasoning, adding the following situations whereby section 139(5d)(b) extends the meaning of control:[40]

> (iii) a person who, under the company's constitution could on the exercise of preemptive rights acquire control;
> (iv) any contract dehors the constitution giving the right to a person to direct the voting;
> (v) substitutional voting rights contained, say in the default provisions of otherwise voting shares; . . .

Indeed, this popular view has been supported by Mr. Campbell W. Leach, C.A.,[41] Mr. Godfrey in his report to the Canadian Tax Foundation[42] and Mr. H. H. Stikeman, Q.C.[43] Each of these writers in dealing with the problem of associated corporations feels that the word "control" as found in section 39(4) has been extended by section 139(5d)(b) beyond mere legal control in two ways:

(a) Mere potential control, which is not "control" in fact or in law[44] is sufficient within the meaning of that term in section 39(4) so as to associate two or more corporations.
(b) Real or factual control (in at least those previously enumerated examples), as distinct from simply legal or apparent control, and which is determined by going beyond the share registry to find the real owners in equity, is a sufficient form of "control" within section 39(4) to associate two or more corporations.

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[39] *Op. cit*, *supra*, footnote 18, at pp. 17 and 18.
[40] *Op. cit.*, footnote 6, at p. 373.
[41] Associated Corporations (1960), 77 Canadian Chartered Accountant 547.
[42] *Op. cit.*, footnote 9, pp. 43 *et seq.*
[43] Canada Tax Service, Letter No. 58, November 25th, 1960.
[44] *Federal Commissioners of Taxation* v. *West Australian Tanners et al.* (1945), 8 A.T.D. 25.

If this view is accepted, and if legal control is extended to factual and potential control, we shall see that the powers given by section 39(4) to associate corporations are widened a great deal.

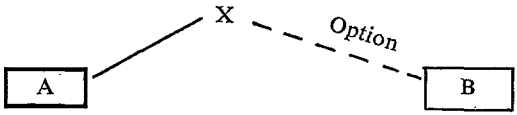
However, it is submitted that section 139(5d)(b) *may* have been extended much further than is warranted under a careful reading of the Act. It is significant that each of the four previously mentioned writers, in discussing this aspect, has omitted the words that precede paragraph (b) in section 139(5d), and which state that paragraph (b) applies, "for the purposes of subsection (5a)..." of section 139. Subsection (5a) of section 139 deals solely with "related persons" and sets down rules whereby individuals or corporations are to be deemed related to one another. Section 139(5a) is, in turn, applicable to section 39(4), but obviously, only with respect to relationship. In other words, can it not be argued that section 139(5d)(b) applies only to the expressions of "control" that appear within section 139(5a) for relationship determination, but not to the expression of "control" within section 39(4) which determine association?

Section 139(4a)(c) reads that "subsection (5d) of section 139 is applicable *mutatis mutandis*". The definition of *mutatis mutandis* is fairly standard, and Jewitt's *Dictionary of English Law*[45] defines the term as meaning, "with necessary changes in points of detail". The question which may not be too certain at this time is whether the words preceding paragraph (b) of section 139(5d), "For the purpose of subsection (5a) . . ." of section 139, are a mere detail that can be disregarded. If so, of course, paragraph (b) applies directly to the expression of "control" that appears in section 39(4). However, if these words are not to be considered as "unessential detail"[46] but an integral part of paragraph (b), then while paragraph (b) applies directly to section 39(4), it does so only with respect to relatedness and not to the expression of control. Rather, the reference to control would only go so far as section 139(5a) directly, which in turn would affect section 39(4).

There are two other factors that might be noted in section 39(4), each of which supports one of the two different views set out above. Firstly, it may be said that since paragraphs (a) and (b) of that subsection deal with relatedness, this infers that the whole subsection, including paragraph (c), refers only to relatedness within section 39(4). However, the second point to notice is that section 139(5a) is made applicable to section 39(4) by virtue of section

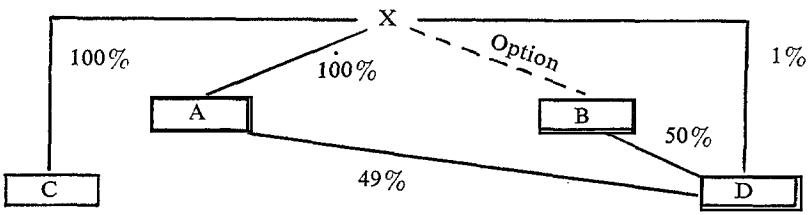
[45] (1959), p. 1203.
[46] See Radins Law Dictionary (1959), p. 214.

39(4a)(a). Presumably, then, section 139(5d)(b), which also applies to section 139(5a), would apply to section 39(4) without specific reference by paragraph (c) of section 39(4a). Therefore, it can be argued that paragraph (c) would have no purpose unless it was put there to give section 139(5d)(b) direct effect to the expression of control in section 39(4). Nevertheless, it is suggested that some argument can be made as to the real effect of section 139(5d)(b). To illustrate, suppose that X has control of corporation A and an option to acquire the controlling voting shares of corporation B.



While CCH Canadian and Messrs. Carlyle, Leach, Godfrey and Stikeman would argue that corporations A and B are associated, it is suggested here that possibly the most that can be said is that (a) X and corporation B are *related*; and (b) that corporations A and B are *related* by virtue of sections 139(5a) and 139(5d)(b) — but corporations A and B are *not* associated. Can it be said that section 139(5d)(b) applies directly to "control" in section 139(5a), but has no direct application to "control" in section 39(4)?[47]

However, it is true that section 139(5d)(b) will have some effect on section 39(4), even if only indirectly. If in the preceding example, X also controlled corporation C, and corporations A and B (which are now related) controlled corporation D, and if either (a) X owned one or more shares in corporation D (as illustrated below); or (b) corporation A or B owned one or more shares in corporation C, then, undoubtedly, corporations C and D would be associated by virtue of section 39(4)(d), even if section 139(5d)(b) does not directly apply to "control" in section 39(4).



[47] It should be noted that two or more corporations may be related to each other without being associated.

It does appear that Parliament's intention was to extend the meaning of control within section 39(4) by section 139(5d)(b). Therefore, while it is submitted that this aim may not have been accomplished, it should be noted that this wide interpretation might, in fact, be attached to control for association purposes in a court of law, and the circumstances that will give rise to such control as laid out by CCH Canadian[48] and Mr. Carlyle[49] should be kept in mind.

There are other observations and criticisms that may be made with reference to section 139(5d)(b), some of which may tend to water down the intended effect of that subsection even further, despite the fact that it may merely apply to section 139(5a).

It might be noted that the word "person" appears in section 139(5d)(b) only in its singular form. The Supreme Court of Canada held that the singular term "person" as it then appeared did not include "persons" in the plural.[50] This *obiter* was based on the wording of section 127(5) of the Act dealing with the not-at-arms-length concept (since amended) wherein "a person" and "one of several persons" were used as two distinct terms. Hence, the Supreme Court reasoned that, despite the Interpretation Act[51] which declares that words in the singular include words in the plural, the term "person" could not mean more than one person.

Perhaps a similar issue might arise here in that section 139(5d) refers to a "related group", a "group" and to "a person". If so, it may be somewhat doubtful whether two persons or a "group" of persons fall within the meaning of paragraph (b) so as to relate or associate two corporations whose controlling shares are likely to be sold to a "group" under an option or a contract. The Crown would likely argue that each "person" within such a group who has a potential right to control the voting shares shall be deemed to own the shares. Nevertheless, if the controlling interest potentially lies with a group, it could be argued that the deemed ownership cannot be imputed to a group *collectively* so as to give them "control" within section 139(5a) or section 39(4).

One may also find on an examination of paragraph (b) that there is ambiguity in some of its terms. While it seems that legal control with subsection (5a) is extended to potential and factual control in some respects, the question may arise as to how far this extension may be effected. Thus, whereas it is clear that the phrase

[48] *Supra*, footnote *18*. [49] *Supra*, footnote 6.
[50] *Army and Navy Department Stores* v. *Minister of National Revenue* (1953), 53 D.T.C. 1185.
[51] R.S.C., 1952, c. 158, s. 31(j).

". . . a right under contract, in equity, or otherwise . . ." imputes control to mean a right to control voting shares under a contract, what does the term "in equity" mean? Could this paragraph be interpreted as meaning that a trustee may be "deemed" to control a corporation under a trust agreement, and also that the beneficiary can be "deemed" to control through deemed ownership of the same shares "in equity", if he has a contingent right to acquire the shares absolutely at some future time?

What does the term ". . . or otherwise . . ." mean? Does it have any effect whatsoever under our strict interpretation rules, and if so, what is its effect? The word "deemed" is also used, but it has never been defined adequately in a court of law, as we shall see later. Therefore, one may ask whether a person who has a right to control is "deemed" without consideration to the true facts and without recourse to rebuttal, to own the shares. Or does the word "deemed" simply imply a presumption that may be rebutted by evidence?

A major criticism of the subsection is put forth by Dr. LaBrie:[52]

> Some extension is given to the meaning of "control" by s. 139(5d)(b). Such . . . rights may exist either immediately or in the future and may be either absolute or contingent. The unfairness of treating future and contingent rights to shares, or to vote shares as tantamount to present ownership of shares seems somewhat far-reaching. This fact tempts us to construe these extensions as intended to apply to the acquisition of shares and to the control of the voting rights of shares rather than to the existence of the right entitling the holder to acquire or to control voting rights. Suppose, for example, a beneficiary under a will was given a right to shares contingent on his surviving his brothers and sisters. To treat such a person as owning the shares seems manifestly unjust. It would seem to be of the essence of this statutory provision that the right be presently existing and that only its exercise by acquisition or by control may be contingent or absolute, immediate or future. To speak of a person having contingently a right to shares seems somewhat contradictory.

Presumably, these comments and criticisms were confined merely to the application of paragraph (b) of section 139(5a), as Dr LaBrie was not dealing with "associated corporations" when the above quoted passage was written. However, this comment is still applicable to associated corporations directly if extended effect is given to the term "control" within section 39(4). One final observation may be made in this regard. It would appear that Parliament intended to put teeth into the control test by virtue of paragaph (b), but that if it has failed to do so, an amendment

[52] *Op. cit.*, footnote 21, at pp. 187-188.

is likely forthcoming. Therefore, as I proceed to deal with control later in this article with reference to association, the discussion will treat section 139(5d)(b) as if it would, in fact, apply to section 39(4) directly.

3. *Saving provisions*

Subsections (6) and (6a) of section 39 are saving provisions designed to give some relief in certain situations where two or more corporations are "associated" by section 39(4) despite the fact that there is no economic association whatever. A common example is one in which corporation A requires money in order to get its operations started. X, who controls corporation B, is a man of means and is willing to loan corporation A the required funds. But as security for his investment, X desires a controlling interest in corporation A until such time as it establishes itself and is in a position to repay the loan. Under section 39(4), corporations A and B would be associated even though there is obviously little relation to each other. Section 39(6) alleviates such a situation, but with a rather considerable limitation in that this saving provision applies only to arms length transactions. This is discriminatory to family groups where it is quite common for a father to want to give his son a start in his own business, and quite natural for the father to withhold the controlling shares unto himself as security until the matter is taken in hand by the son. Yet, even though the son's corporation may have no economic association with the father's business, if the father controls a corporation of his own, the two will be associated and section 39(6) will be of no assistance.

After section 39 was amended in 1960, it was realized that where a trust company was appointed as executor and trustee of two or more wholly unrelated estates which had a corporation within each estate, the two or more corporations would be associated under section 39(4). In an attempt to rectify this rather ridiculous situation, subsection (6a) was added in the summer of 1961. This second saving provision states that where two corporations are controlled by the same trustee as executor, and would thus be associated by section 39(4), they are deemed not to be associated where: [53]

(a) that trustee or executor did not acquire control of the corporations as a result of one or more trusts or estates created by the same individual or two or more individuals not dealing with each other at arms length, and

[53] *Supra*, footnote 8.

(b) that the trust or estate . . . arose only upon the death of the individual creating the trust or estate . . . .

One might wonder why a serious limitation was also placed on this saving provision in that it applies only where a trust arises upon the death of the individual creating it. Thus, it would appear that where several individuals completely separate and unknown to one another, choose to create a trust to be administered by the same trust company, and where those trust properties consist of corporations, each of the corporations would be associated where the trusts are not to take effect on the deaths of these individuals.

There is a further criticism of subsections (6) and (6a) of section 39 in that the circumstances which may involve the application of the saving provisions must be ". . . established to the satisfaction of the Minister . . .". Mr. Carlyle points out that this is "a retrograde step . . . a discretionary power that appears unnecessary, inasmuch as the question is one of fact capable of determination in a court of law".[54]

While it is admitted that at least a step in the right direction was taken when the saving provisions were enacted, it is remarkable that a more careful analysis was not made by the Minister at the time these provisions were being considered so as to give more substantial relief to the unfair and even ludicrous "associations" that may arise under section 39(4).

III. *Section 39(4). Terms and Extent of Application.*

As noted previously, associated corporate status is determined by the rules set out in subsection (4) of section 39. It is, therefore, important to understand more fully the meaning of the terms that are used within that subsection, and perhaps the more important of these are the concepts of "person", "owned directly or indirectly", "related", "group" and "controlled". Some of these words and phrases are defined within the Act itself, others are not. In the latter case, reference must be made to other sources for assistance, such as the common law. Indeed, the most important of these terms, that of "control" is nowhere defined by the Act, and it will be seen that this concept may have some rather confusing aspects.

1. *"Person"*

The word "person" should not be interpreted merely as meaning an individual human being. Section 139(1)(ac) describes the term as follows:

[54] *Op. cit.*, footnote 6, at p. 374.

> "person", or any word or expression descriptive of a person, includes any body corporate and politic, and the heirs, executors, administrators or other legal representatives of such person, according to the law of that part of Canada to which the context extends.

To illustrate, section 39(4)(b) states that two corporations will be associated with each other where "both of the corporations were controlled by the same person . . .". If the controlling "person" was a corporation, there would be an association of the first two corporations.

2. *Ownership, "directly or indirectly"*

The concept of ownership of shares is no longer the basic factor in associating corporations, having been replaced by the control test. However, share ownership is an important element to be considered where related persons as groups are involved, as set out in paragraphs (c), (d) and (e) of subsection 4 of section 39.

Corporations are distinct entities from one another,[55] even though the same person or persons may own shares in two or more such corporations. Moreover,

> . . . the person who accepts the shares does not own the property of the company. . . . The property of the corporation is its own property and not the property of its shareholders.[56]

As Mr. Leach points out:[57]

> The most popular misconception about indirect ownership of shares is that if individual A owns the shares of company X which owns shares of company Y, then A indirectly owns the shares of company Y. This, of course, is not so, since the courts have held that the corporate veil cannot be pierced to establish indirect ownership. Indirect ownership of shares exists more commonly where shares are held for the benefit of a person by a trustee or nominee.

To illustrate the importance of this principle, consider its effect on the following examples.

Example 1:

H and W are husband and wife. H owns and controls corporation A. Corporation B is then created wherein all of the voting shares are owned by W, but which shares are of little value. H owns preference shares in corporation B which are lucrative and represent the real wealth of corporation B. Under section 39(4)(c), corporations A and B are associated (keeping in mind

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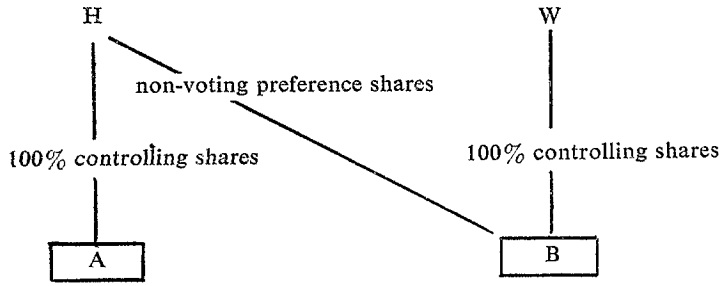
[55] *Hartford Accident & Indemnity Co.* v. *Millson's et al.* (1939), 44 Que. P.R. 170.

[56] *Re Corlet Estate*, [1939] 3 W.W.R. 83 (Alta.).

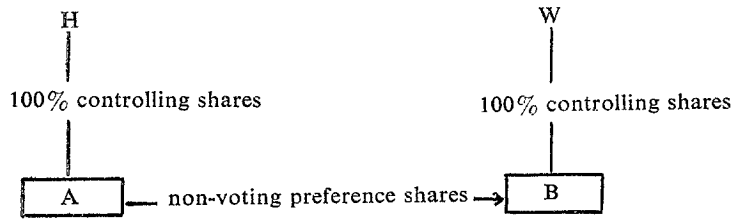
[57] *Op. cit.*, footnote 4, at p. 549.

that no distinction is made as to the type of shares that H need own in his wife's corporation so as to associate them).



Example 2:

Suppose that the facts are the same as above except that H instead of owning the preference shares in corporation B directly, arranges his affairs so that his own corporation, A, owns those shares. Since the corporate veil will not be pierced so as to establish H as an owner of shares in corporation B, the two corporations will not be associated even though, practically speaking, the same result has been effected.



Similarly, H may use the device of incorporating a holding company to own the preference shares in corporation B so as to avoid association.

Having eliminated the piercing of a corporate veil to find indirect ownership, regard should be given to the circumstances wherein such ownership will, in fact, be found, namely, by looking through a trustee or nominee. The better view seems to be that while the meaning of "ownership" has considerable elasticity,[58] ownership is to be regarded as true ownership and not merely the apparent ownership that is evidenced by a corporation's share

[58] This was implied in *Disher-Winslow Products Ltd.* v. *Minister of National Revenue* (1952), 52 D.T.C. 27, at p. 28 when citing *Wynne Dalby* (1913), 30 O.L.R. 67.

register.[59] Later discussion will contrast this method with that of finding "control" of a corporation. Although a person may be registered as the owner of shares in a corporation, if he holds them merely as a trustee or nominee of another person, the courts will find that the beneficiary, and not the trustee or nominee, is the true "owner". Furthermore, it does not appear that duality of ownership will enter into the picture. In other words, it cannot be said while the beneficiary owns the shares "indirectly", his trustee owns the same shares "directly".[60] The word "direct" does not apply to trust relationships, but rather to circumstances where a person owns shares directly for his own benefit.

A distinction was made in *Disher-Winslow Products Ltd.* v. *Minister of National Revenue*[61] between owning and merely "holding" a share. Where X was the registered owner of a director's qualifying share, which he held conditionally and solely for the purpose of signing corporate cheques while the real owner was away, it was felt that X was not a "shareholder" or owner within the meaning of the Act, but merely a "holder" of the share. This view adds emphasis to the principle that only the real or beneficial owner of a share will be considered as the true owner within section 39(4).

It would appear then, that although a court will not look through a corporate entity to find ownership, it will go behind the corporate share register to find the real or beneficial ownership, distinguishing ownership from the mere holding of a share; once found, a dual ownership will not likely be imputed to someone else.[62]

3. *Relatedness*

The rules for determining whether persons or a "group" are related for purposes of section 39(4) are set out in section 139(5a). Subsections (5b) to (5d), (6), (8) and (9) of section 139 attempt to clarify and explain the meaning to be attached to the relatedness rules in subsection (5a), but Dr. LaBrie points out that these subsections do ". . . not bear up under close analysis".[63] For example, does the word "child" as used in subsections (6), (8) and (9) include persons over the age of twenty-one? What is the effect of

[59] *Peck Building Corporation* v. *Minister of National Revenue* (1960), 60 D.T.C. 493.

[60] *Army and Navy Department Stores* v. *Minister of National Revenue*, *supra*, footnote 50.

[61] *Supra*, footnote 58.

[62] Later discussion will show that this statement may be subject to modification when considering the effects of s. 139(5d) on s. 39(4).

[63] *Op. cit.*, footnote 21, at p. 181.

the marriage factor to relatedness where illegitimate children, step children, adopted children or children by dependency are involved? How far will the courts go in relating the real and foster relatives of one spouse to the real or foster relatives or both of the other spouse for purposes of the Income Tax Act? When it is also realized that provincial statutes govern the terms of relationship, the problem may lead to even further complications.

Dr. LaBrie explains that a further examination of subsections (6), (8) and (9) reveal that subsections (8) and (9) were merely taken verbatim from "the 1948 Income Tax Act, taken in turn from the earlier Income War Tax Act".[64] However, when subsection (6) was inserted in the present Act, the necessary adaptations were not made with subsections (8) and (9). The implementation of all three subsections may result in persons being related twice over or in being the "child" of a number of individuals under different rules. In other words, subsections (8) and (9) were simply not tailored to subsection (6).

It will be shown that even further confusion may arise when an attempt is made to establish relatedness between individuals and corporations, or two or more corporations, due to the fact that reliance is placed on terms such as "deemed" or "controlled", which terms are undefined and ambiguous. However, for the present, it will be sufficient to say merely that the relatedness rules are somewhat unclear and could possibly lead to future complications.[65]

4. "*Group*"

Although the word "group" is not completely defined in the Act, it seems that for the purposes of section 39(4) a "group" must necessarily mean a controlling entity within a corporation. Whereas a group of persons may constitute a legal entity in some circumstances, unless each person within that group acts with the other persons so as to exert control over a corporation, it is submitted, these persons do not constitute a "group" within section 39(4). For example, where 100 persons are the sole members of an organization having group entity or personality in law, and each of these individuals owns some shares in corporation X so that collectively they own fifty-one per cent of the voting shares, they still *may* not consist of a "group" within section 39(4), if they do

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[64] *Ibid*, at p. 183.

[65] For a complete analysis of the related rules, it is suggested that reference be made to Dr. LaBrie's article, *ibid.*, at pp. 180 *et seq.*

not act in concert with one another to control the corporation in fact.[66]

A group's numerical limits may also be of some concern. Doubt has been expressed as to whether two persons comprise a "group". However, it is suggested that the safe assumption to make at the present time is that two persons do compose a "group". Clearly, this was the intention of Parliament. It will also be noted that this assumption has been made in this analysis for the purpose of illustrative examples. But how far will the courts go in the other direction to find a "group"? Most certainly, five persons could conceivably constitute a controlling group within section 39(4). But what about fifty or 5,000? It is suggested, then, that generally speaking, the greater the number of persons within the group, the greater the task of determining "group" control, as shall be seen in the following pages.

5. "*Control*"

It may be evident to the reader by this time that the concept of control of a corporation is perhaps the most important term within section 39(4), for this is basically the test that underlies the association of corporations. While we do find definition of corporate control in sections 28(3) and 62(3a), these sections are expressly restricted to other matters and have no application to subsection (4) of section 39.[67] Therefore, the meaning of corporate control must be gleaned from other sources, the most significant of which is the common law.

As a starting point, one might adopt the classic statement of Rowlatt J. in *B.W. Noble, Ltd.* v. *The Commissioners of Inland Revenue*.[68]

> It seems to me that "controlling interest" is a phrase that has a certain well known meaning; it means the man whose shareholding in the Company is such that he is the shareholder who is more powerful than all the other shareholders put together in General Meeting. This is really what it comes to.

The clearest example of such a situation is that of a person in absolute ownership of fifty per cent plus one of a corporation's voting stock. Hence, in the *Noble* case, the owner of fifty per cent of the voting shares who, as chairman of the company, had the

[66] This statement relies on the proposition, which will be discussed under subsequent headings, that a court of law must give some regard to facts and evidence when seeking to establish group control.

[67] S. 28(3) refers to non-deductible dividends and s. 62(3a) deals with non-profit scientific research corporations, *supra*, footnote 8.

[68] (1917), 12 T.C. 926.

right to cast a tie-breaking vote, was held to have had corporate control. The Canadian case of *Rex* v. *Staples*[69] contains reasoning similar to that of Rowlatt J., but states further that control is not a negative power but a positive thing. Ownership of exactly fifty per cent of a corporation's voting shares, without more, does not constitute control of that corporation.[70] It would appear then, that if X and Y each owns fifty per cent of the voting shares in corporation A, and give the power to cast a tie-breaking vote to a presumably impartial third party, neither individual can be said to "control" corporation A.

Because there are many and varied implementations of "corporate control" other than by simply owning a majority of the voting shares directly, further authorities must be considered before a definition of the term can be offered. Lord Reid, in *Barclay's Bank, Ltd.* v. *Inland Revenue Commissioners*[71] stated the problem in a nutshell:

> No one doubts that control means voting control—of the majority of votes at a general meeting. If a person holds the majority of the shares and holds them in his own name, there is no difficulty. But there are other possibilities. He may be in real control although he does not hold the majority of the shares in his own name because he also has a legal right to direct another shareholder how he shall vote and can in this way control a majority of the shares. On the other hand, he may be only in apparent control, because, although in fact he is the person who casts the votes, as to some or all of these votes, he may be bound to obtain the consent of someone else. The question is whether . . . control means real control or apparent control, or whether . . . it means both.[72]

Although corporate control may take various forms, the question is which of these methods will fall within the concept of "control" as used in section 39(4)? Canadian courts have had little opportunity to deal with corporate control from this point of view, and we must therefore seek assistance from the English cases.[73] Four leading decisions may throw some light on the matter.

(i) *Himley Estates, Ltd. and Humble Investments, Ltd.* v. *The Commissioners of Inland Revenue*[74] sets forth the principle that

[69] [1940] 4 D.L.R. 699 (B.C. C.A.).

[70] Note that in the *Noble* case, *supra*, footnote 68, in addition to holding exactly fifty percent of the voting shares, the chairman had the right to cast a tie-breaking vote.

[71] [1960] 2 All E.R. 817 (H. of L.). [72] *Ibid.*, at p. 822.

[73] The decisions of the American courts are largely overlooked in this area because of the different rules for interpreting taxation statutes. As a consequence of the more liberal interpretation, more emphasis is placed on real or factual control in the United States of America than on legal control.

[74] (1932), 17 T.C. 367.

while control of a corporation may be legal or factual, it is only the legal control that is to be given effect. In this case, the voting shares of a corporation were held by fifteen persons. There was strong evidence to show that one of the shareholders, Viscount E, was the "directing mind" of the corporation and that he could rely on the co-operation of any or even all of the other fourteen shareholders on any resolution requiring a vote. The issue was whether the company was under the control of not more than five persons and therefore if Viscount E had "control". Whereas there may have been little doubt that he held a very real "factual" power of control, it was held that he did not have "control" within the meaning of the English Finance Act. Rowlatt J. pointed out that:

> There is perhaps abundant material from which it might be inferred that he [Viscount E] could rely upon their willing co-operation *de facto*, but that does not seem to me to be evidence of control in its literal sense either legal or moral. . . .[75]

The Crown appealed the decision to the Court of King's Bench. The appeal was dismissed, Lawrence L.J. concurring and adding:

> For myself, I cannot see how any means other than legal means can give the control of a company . . . .[76]

(ii) *Inland Revenue Commissioners* v. *J. Bibby and Sons, Ltd.*[77] supports the *Himley* case and perhaps goes even further in establishing the principle that having "a controlling interest" in a corporation refers to legal (or apparent) control. The House of Lords was concerned in this case with whether a corporation was controlled by the directors even though some of the controlling shares registered in the directors names were held in trust pending certain marriage settlements.[78] It was argued that the beneficial or "real ownership" of the shares lay with the beneficiaries of the trust and that therefore the directors, as trustees, did not "control" the company. However, the House of Lords held that legal control was in the hands of the trustees. In this regard, Lord Simonds said:

> Those who by their votes can control the company do not the less control it because they themselves may be amenable to some external control.[79]

(iii) *British American Tobacco Co., Ltd.* v. *Inland Revenue Commissioners*[80] may be summarized as follows: company A

[75] *Ibid.*, at pp. 374-375.
[76] *Ibid.*, at p. 379.
[77] [1945] 1 All E.R. 667 (H. L.).
[78] It should be noted that the trustees had considerable authority as to how to vote the shares held in their trust and were not considered to be mere "bare trustees".
[79] *Supra*, footnote 77, at p. 673.
[80] [1943] 1 All E.R. 13 (H. L.).

owned more than fifty per cent of the voting shares in, and therefore controlled, company B; similarly, company B controlled company C. The issue was whether company A indirectly had "a controlling interest"[81] in company C through company B. It was argued that the word "interest" implied a proprietary right so that company A would necessarily have to own the shares in company C directly before it could be said that company A had a controlling interest in company C. The House of Lords rejected this argument holding that company A did have a controlling interest in company C. In effect, the corporate veil of company B was pierced in order to make this finding.

At this point, it might be argued, as has been suggested in the past,[82] that there is a substantial difference between the phrase "a controlling interest" as it appeared in the English Finance Act, and the term "controlled" standing alone in section 39(4) of the Canadian Income Tax Act. Reliance on the words of Viscount Simon L.C. may assist this argument:

> The case turns on the meaning of the words "controlling interest" in the context in which they are used. . . . The word "interest" . . . is a word of wide connotation, and I think the conception of "controlling interest" may well cover the relationship of one company towards another, the requisite majority of whose shares are, as regards their voting power, subject, whether directly or indirectly, to the will and ordering of the first-mentioned company.[83]

Hence, in advancing the proposition that the Canadian courts would not pierce the corporate veil for purposes of section 39(4), one might point to the words of Viscount Simon L.C. and suggest that "interest" implies so wide a connotation that it is even more far reaching than the term "control" standing by itself in this respect. Following this reasoning, one might argue against the application of the *British American Tobacco Co., Ltd.* case[84] to section 39(4) by saying that while company A may have had "*a* controlling *interest*" in company C through company B, section 39(4) seeks to determine "*the* person who *controlled*" company C. Having found that company B was the person who controlled company C, wording would not permit the court to then pierce the corporate veil of company B to find that company A also had control of the same corporation. Thus, whereas the words "*a* con-

[81] This phrase in quotation was taken from the English Finance Act (1937), 1 Edw. 8 & 1 Geo. 6, c. 4, s. 7, which was the statute in question in this case.

[82] Mr. Kenneth H. Brown, Q.C., raises this question in his paper delivered to the Canadian Tax Foundation Conference in 1959, see p. 30 of the Report.

[83] *Supra*, footnote 80, at pp. 14-15.

[84] *Ibid.*

trolling *interest*" would permit the finding of a dual control in the same corporation, the same may not be true of the wording found in the Canadian Income Tax Act. However, although this proposal might well be considered, regard must necessarily be given to the following case.

(iv) *Barclay's Bank, Ltd.* v. *Inland Revenue Commissioners*[85] dealt with the situation where a testator held the controlling shares of a corporation in trust with three other trustees. Although he could not cast the voting shares without the consent of the other trustees, the House of Lords found him to be in "control" of the company, as indicated by the manner in which his name appeared on the company's share register. The *Bibby* case[86] was followed in that the apparent or legal control was given recognition, their Lordships refusing to look behind the share register to determine if the real or factual control lay in someone else's hands. The pertinent issue, taken from the wording of the Act in question, was whether the testator "had the control of the company". Viscount Simonds, during the course of his discussion, referred to the often quoted statement of Rowlatt J. in the *Noble* case[87] and added:

> I see no difference between the natural meaning of the two phrases "having a controlling interest in the company" and "having control of the company". . . .[88]

The same view was taken in the lower court in the *Barclay's Bank* case, and it would therefore appear that there is little left of the argument that there may be a substantial difference between the two terms so as to prevent the courts from piercing the corporate veil to find control under section 39(4) if this decision is to be followed in Canada.

Their Lordships in *Barclay's Bank* attempted to reconcile the *Bibby* case with *British American Tobacco Co. Ltd.* and concluded that there was no conflict between the two decisions. Lord Cohen quoted the words of Lord Evershed from *Inland Revenue Commissioners* v. *Silverts, Ltd.*,[89] expressing his agreement in the matter:

> . . . the questions posed in the *British American Tobacco* case and in the *Bibby* case were different. In neither case was the question the general one: "Who controls the company?" In the *British American Tobacco* case the question was whether (in the ordinary and proper sense of the words) company A held a controlling interest in company C, though the control was exercised, not directly, but indirectly

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[85] *Supra*, footnote 71.
[86] *Supra*, footnote 77.
[87] *Supra*, footnote 67.
[88] *Supra*, footnote 71, at p. 821.
[89] [1951] 1 All E.R. 703, at p. 709 (C.A.).

> through the agency of company B. If the question were raised under some other taxing provision: "Has company B a controlling interest in company C?" an affirmative answer to that question might be given consistently with the affirmative answer to the first question in the *British American Tobacco* case. So, in the *Bibby* case, the question: "Have the directors a controlling interest in the company?" falls to be answered, aye or no, without regard to the possible question (if asked) whether some other person or body has (indirectly) a controlling interest in the same company.[90]

The House of Lords supported the view that control means legal or apparent control, and, generally speaking, would not inquire behind the share register to determine where the real or factual control may lie. However, two reservations must be made with respect to this last statement. Firstly, in accepting the decision of the *British American Tobacco Co. Ltd.* case, it is submitted that effect was given to factual or real control. Although it may be said that this was purely an extension of the concept of legal control, I feel that the House of Lords necessarily had to look behind the share register of company C to the register of company B to find that company A had a controlling interest. Strictly speaking, it is suggested, the apparent or legal control lay with company B only, as indicated by company C's share register. The second reservation is pointed out by Lord Denning in *Barclay's Bank:*[91]

> I am not prepared to subscribe to the view that a man who is a nominee or a bare trustee has control of a company.

This view seems to have received popular support[92] and is therefore a further exception to the common-law rule that corporate control means legal control only. However, a statement made by Viscount Simonds in the same case may forge the key to yet another argument to support the view that Canadian courts may not pierce the corporate veil to find "control" within section 39(4). In approaching the problem of determining the meaning of control as it appeared in the English Finance Act,[93] Viscount Simonds said:

> The answer must depend on the construction of the particular sections under review in the context of the whole Act in which they are found.[94]

Using this statement as a guide and referring to the *British American Tobacco Co. Ltd.* situation, an examination of the Finance Act of 1937, reveals a comparably short and clear-cut section im-

[90] *Supra*, footnote 71, at p. 828. [91] *Ibid.*, at p. 833.

[92] Even in the *Bibby* case, *supra*, footnote 77, Lord Russell of Killowen, at pp. 668-669, expressed reservations about a "bare trustee" having control.

[93] See *supra*, footnote 81, as am. by (1940), 3 & 4 Geo. 6, c. 29, s. 55(1) and (3) and s. 58(5).

[94] *Supra*, footnote 71, at p. 820.

posing a tax for the National Defence Contribution. The section in issue in *British American Tobacco Co. Ltd.* reads, in part, as follows:[95]

> 7. Income received from investments or other property shall be included in the profits in the cases and to the extent provided in this paragraph, and not otherwise — . . . (b) in the case of . . . a trade or business carried on by a body corporate, the profits shall include all income received by way of dividend or distribution of profits from any other body corporate in which the first mentioned body corporate has a controlling interest and which is not liable to be assessed to the national defence contribution . . . .

It is evident that the House of Lords, in this case, was dealing with a situation where, in a simply stated and clear section of the Finance Act, the Revenue sought to impose a war contribution on investment profits, but only where the investor corporation controlled the other corporation and in no other circumstances. To have allowed the investor corporation to simply set up another corporation between itself and the controlled company would have permitted a flagrant tax avoidance scheme which skirted the clear intent of the statute. Moreover, it would have enabled the investor corporation to sidestep the only circumstance where this type of tax was to be imposed on investment income. This would, perhaps have been going too far when considering the particular section "in the context of the whole act" that was involved.

But when we turn to the Canadian Income Tax Act and specifically to section 39(4), the spirit of the associated corporations rules seems quite different. Rather than clearly pin-pointing a particular circumstance under which a tax is to be imposed, section 39(4) casts a wide net as if to say, "You will be taxed in any of the multitude of following circumstances, and it matters not how unfair it may be to you". This almost invites the taxpayer to devise means to skirt the Act. If he succeeds, his avoidance will not appear to be so distasteful nor will it constitute so flagrant a defeat of the spirit of the section and the Act as appeared in *British American Tobacco Co. Ltd.* In other words, when comparing the spirit and intent of the sections in the two Acts, it may well be argued that Canadian courts may not be so eager to pierce a corporate veil in order to find "control". On the other hand:

> Although the courts have refused to "pierce the corporate veil" to find indirect ownership of shares, jurisprudence would seem to indicate that they will look through corporations to find indirect control. If so, the only question that remains is whether indirect control may be

[95] *Supra*, footnote 81, Schedule IV. s. 7.

> equated with direct control. The safe assumption for persons seeking to avoid section 39(4) is that a distinction will not be drawn between direct and indirect control. Unless this is the case the purpose of section 39(4) can be defeated quite easily and another round of amendments may be expected.[96]

In the following examples and discussion, the "safe assumption" will be made and control will be treated as if it flows through corporations with the courts taking cognizance of it. Nevertheless, the matter still appears to be undecided in relation to this context.

One further consideration is relevant regarding the extent of the control concept in that section 139(5d)(b), as already discussed, may in all likelihood apply directly to section 39(4). If this is so, of course, the doctrine of control is extended to potential and real control under certain circumstances.[97] Thus, if X left corporation A in trust to his wife for a term of years and the remainder to his son unless, on the happening of a certain contingency, then to his daughter, does this mean that the trustee, the wife, son and daughter would each be deemed to own the shares in and to control corporation A? The unfairness of such a situation where a person receives a contingent or remainderman interest is obvious and requires no further comment.

Distinction should be made between legal corporate control and management control. In the *Bibby* case, Lord Russell of Killowen said that the meaning of:

> . . . controlling interest is not the extent to which individuals are beneficially interested in the profits of a company as a going concern . . . but the extent to which they have vested in them the power of controlling by votes the decisions which will bind the company in the shape of resolutions passed by the shareholders in general meeting.[98]

Two facts appear evident from this statement. Firstly, the control must be exercised by the casting of votes. Secondly, this control is restricted to the business that is carried on in a corporation's general meeting. The management control that is exercised by the directors or officers of a company, once elected, in making day to day decisions does not fall within the meaning of "control" in section 39(4) of the Canadian Act. If X, Y and Z are the directors or officers of both corporations A and B, it cannot be said that corporations A and B are "controlled" by the same persons so as to be associated. Although it is true that the directors have a great deal of authority in the business and day to day decisions of the corporations, this managerial control is legally exercised only within certain limits:

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[96] Leach, *op. cit*, footnote 41, at p. 548.
[97] As enumerated, *supra*.
[98] *Supra*, footnote 77, at p. 669.

> Directors as individuals have no authority unless it is given to them as agents.[99]

Once it is concluded that "control" of a corporation lies with the majority shareholders at a general meeting, let us assume that the power to vote on certain matters is divided between different groups of persons in corporation A. Suppose, that group I shareholders have a majority of the voting shares and may vote on any resolution in a general meeting with the exception of voting for three of company A's five directors. And suppose further that the power to elect this majority of the directors is given to group II, a small, select party of individuals. Which of the two groups is in "control" of the corporation? The Income Tax Act does not assist in solving this problem, but the following statement by Messrs. Adolf A. Berle, Jr. and Gardiner C. Means[100] would lead us to conclude that group II "controls" the corporation in question:

> Since direction over the activities of a corporation is exercised through the board of directors, we may say, for practical purposes that control lies in the hands of the individual or group who have the actual power to select the board of directors (or its majority) . . . .[101]

One might say that the legal control concept can be limited even further to the power to elect a majority of the board of directors, at least in cases where the voting power has been divided as in the above example between groups I and II.

While we know that the legal power to control more than fifty per cent of the votes vests corporate control in the person or group holding such power, one may wonder if the same principle holds true where, for example, a seventy-five per cent majority is required to elect the directors. Viscount Simon L.C. touches on this question in the *British American Tobacco Co., Ltd.* case but does not really refer to the power to elect directors by a larger majority than fifty per cent:

> The owners of the majority of the voting power of a company are the persons who are in effective control of its affairs and fortunes. It is true that for some purposes a 75% majority vote may be required, as, for instance (under some company regulation) for the removal of directors who oppose the wishes of the majority; but the bare majority can always refuse to re-elect and so in the long run get rid of a recalcitrant board. Nor can the articles of association be altered in order to defeat the wishes of the majority, for a bare majority can always prevent the passing of the necessary resolution.[102]

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[99] Fletcher, Cyclopedia on Corporations (1952 ed.), Vol. 5, p. 446.
[100] Modern Corporation and Private Property (1936).
[101] *Ibid.*, p. 69.
[102] *Supra*, footnote 80, at p. 15.

If we accept the principle that corporate control lies with the person or group who has the power to select the board of directors, one may logically argue that where a seventy-five per cent majority is required to meet this end, a mere fifty-one per cent ownership of voting shares is not enough to exert "control". However, although Viscount Simon L.C. deals with the removal of directors and does not directly refer to their election by a seventy-five per cent majority, one may also submit that his statement is strong enough to include election by a seventy-five per cent majority, and that fifty-one per cent is sufficient to "control" the corporation in question. In any event, the control concept is further blurred in meaning by this type of situation.

There are other corporate control devices that do not necessarily involve outright ownership of more than fifty per cent of the voting stock and which may or may not fall within the meaning of the Act, depending on the definition that is to be attached to control. Suppose, for example, that X is the major bondholder in a certain corporation. He holds no voting shares, but being a large creditor of the corporation with the power to enforce repayment of his loan at any time, he may "break" the corporation whenever he chooses. It is clear that he may exert considerable control over the company, presumably even as to the election of directors. X is obviously in the position of having a very real "factual" control over the corporation, but is this controlling device contemplated by section 39(4)? The English common-law cases previously cited would tend to indicate that this method of control does not fall within the Act. However, aside from this direct application of the common law, regard might be given to an interesting interpretation of the meaning of legal control as set forth by Mr. Kenneth H. Brown, Q.C., in his report to the 1959 Canadian Tax Foundation Conference.[103] He states that where powers conferring decisive voting rights are derived from the relevant corporations Act or the company's articles of association and the machinery set up therein, this and only this constitutes "legal control". Mr. Brown points out that in all of the decided cases, legal "control" of a corporation was only recognized where provided for in one of these two documents:

> This, I submit, is the entire key to the meaning of "control" in the legal sense. You must look, and look only, at the relevant Companies Act and the Articles of Association, and see who "controls" through the mechanisms which are found there and there only. . . . It follows that

[103] Pp. 29-31.

> in my opinion, no form of pressure or control which can be brought to bear upon the company or its controlling shareholders from *outside* the corporate structure itself will confer control in the legal sense, no matter how powerful it may be.[104]

He concludes that the major creditor with the power to break the corporation has ". . . no status whatever . . . at general meetings . . . much less 'control' ". Mr. Brown may, in fact, have the "entire key" to the definition of legal control in his proposition. The device of voting by proxy might be followed through to illustrate his point. Mr. Fletcher notes that the right to vote by proxy is not valid unless this power is expressly given by a corporation's articles of association or by statute.[105] The holder of a power to control a corporation by proxy has this power only if it is authorized by the articles of association or by statute; hence, as soon as this happens, this power consitutes "legal control" according to Mr. Brown.

Moreover, if Mr. Brown is correct in his analysis of the true meaning of legal control, the following statement of the CCH Canadian Limited in *Associated Corporations* would fall squarely into place:

> It is probable that a private agreement among shareholders specifying the way in which they will vote their shares is not relevant in an issue as to control, unless the corporation was a party to the agreement or otherwise bound to enforce its terms. For example, an agreement among a group of shareholders that they will vote their shares so as to give effect to a predetermined policy need have no bearing on the question of legal control of the corporation, because the corporation's proceedings will be determined in accordance with the votes of its registered shareholders whether or not they comply with the terms of any such agreement.[106]

It is suggested that while this quotation is correct in the views expressed and that it coincides with Mr. Brown's reasoning, there may be some need for modification. In other words, it is agreed that a private arrangement among shareholders is nothing more than a factual control device in itself; but later discussion will tend to show that such a device may give impetus to "legal control" where a "group" of persons is a factor. Also, if section 139(5d)(b) applies directly to section 39(4), the sentence following the above quotation from CCH Canadian Limited is in order:

> On the other hand, the situation is more doubtful where the shareholders have agreed to vote their shares in accordance with the directions of a named person.[107]

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[104] *Ibid.*, p. 31.
[105] *Op. cit.*, footnote 99, p. 206.
[106] *Supra*, footnote 18, p. 15.
[107] *Ibid.*

The voting trust is a device which differs considerably from either the proxy, voting pool or agreement to vote in accordance with the direction of one person:

> It involves the creation of a group of trustees, often a part of the management, with the complete power to vote all stock placed in trust with it. When a majority of the stock is held in trust, as is usually the case, the trustees have almost complete control over the affairs of the corporation yet without the necessary ownership on their part.[108]

It would appear that the person or persons who hold the shares in trust under such a device would be deemed in legal control, not necessarily because of Mr. Brown's proposal nor because section 139(5d)(b) may apply directly to section 39(4), but strictly on the *Bibby*[109] principle that a person holding controlling shares as trustee is regarded as having legal control.

An examination of the concepts of ownership and control has revealed that each is legally determined by separate and distinct methods. Generally speaking, the courts will look through a trust, but not through a corporate veil to find ownership; in contrast, they will not look through a trust but will pierce a corporate veil to find control.[110] It is suggested that perhaps a third category exists in this field closely related to both ownership and control; that is, where control of a corporation is connected to the proprietory rights of the shareholder himself in certain instances. When such is the case, it is submitted that the courts are not likely to pierce a corporate veil in order to find control, for, because of the proprietory factor, to do so would infringe on the concept of a shareholder's limited liability. *In Re Suburban Rapid Transit Company et al.*[111] dealt with just such a situation. The Winnipeg Electric Company owned practically all of the shares in, and therefore "controlled", the Suburban Rapid Transit Company. The latter company defaulted in its obligations to maintain transit lines in a certain area due to financial difficulties. Thereupon, the Municipal and Public Utility Board issued an order directed against the controlling company and ordering it to fulfill, through the company it controlled, the obligations of that controlled company. Robson J.A. ruled the order to be *ultra vires*, and one of his grounds for so doing was as follows:

> The conclusion as to control by the Winnipeg Electric Company was

[108] Berle and Means, *op. cit.*, footnote 100, p. 77.
[109] *Supra*, footnote 77.
[110] Whether or not Canadian courts will follow the English cases in this respect for purposes of s. 39(4) is not definite, for reasons previously outlined.
[111] (1931), 39 Man. R. 402.

> based on the circumstance that all the shares issued by the Suburban Rapid Transit Company, except qualification shares, are held by the Winnipeg Electric Company and that the officers of the Suburban Rapid Transit Company are all officers of the Winnipeg Electric Company. Even if it were to be supposed that this bulk share ownership amounted to "control" . . . there is no ground for supposing that it meant that the company so controlling should put all its own assets behind the obligations of the subsidiary company.[112]

Therefore, while the ownership and control concepts are quite distinct, the two may become intermingled. When this occurs, a court is not likely to pierce the veil in order to find "control". To do so would infringe on the shareholder's proprietory right of limited liability. But when dealing with the taxing of a corporate body, the tax imposition is placed directly on the corporation itself rather than on the shareholder. Whereas the shareholder may still feel the financial effects of such a finding, indirectly, the limited liability concept is still preserved. Hence, there may be some justification for the piercing of a corporate veil to find legal corporate control, even in our Canadian courts, which have shown their reluctance in the past to look through corporations.

Thus far, corporate control has been inquired into chiefly from the standpoint of the individual "person" who exerts this "control", and perhaps several conclusions may be drawn at this point as to the meaning of the concept. However, before doing so, an examination of control as exerted by a "group" may require a modification of some of these conclusions.

6. *Group control*

Paragraphs (b), (d) and (e) of section 39(4) refer to control by a "group" of persons. It would seem that there are three different types of groups:

(i) The related group, defined by section 139(5c)(a) as "a group of persons, each member of which is related to every other member of the group";

(ii) the unrelated group, which, although expressly stated not to be a related group in section 139(5c)(b), is not otherwise defined;[113] and

(iii) the group unrelated in itself but each member of which is related to some other person. This third category is derived from section 39(4)(d). Therefore, while X's father, son and brother are not a "related" group (since X's son and brother are not "re-

[112] *Ibid.*, at pp. 404-405.

[113] "Related" within s. 139(5a), (6), (8) and (9) of the Act, *supra*, footnote 8.

lated"), nevertheless, each member of the group is related to X. So, if X controls corporation A and this group controls corporation B, corporations A and B will be associated if there is a cross-ownership of shares by any one of the four persons.

The main problem when dealing with "groups" in this manner is to determine what machinery the courts will adopt to make a finding of "group" control; that is, to what extent, if any, will the courts look into the facts of each situation. When the Act deals with control by one person, be he an individual acting in his own capacity, a corporate body or a trustee, the cases indicate that as a general rule, local or apparent control, without regard to the facts that lie behind the corporate share register, would be the determining factor in associating corporations.[114] But this principle may not be so easy to apply when the Act brings in the concept of "group" control, for the courts may now have to give considerably more weight to the facts that lie behind the share register itself.

Dealing firstly with unrelated groups of persons, let us assume that X, Y and Z each own one-third of the voting shares in corporation A. Suppose that X and Y also control corporation B, and that Y and Z control corporation C. Is the Minister at liberty to find, for purposes of associating corporations A and B, that X and Y "control" corporation A and then turn around and declare, for purposes of associating corporations A and C, that Y and Z "control" corporation A? Or, ". . . can the Minister choose the particular combination which will result to the greatest benefit to the federal Treasury even though in doing so he would be ignoring the actual facts of the situation?"[115]

Perhaps the unfairness of such situations that may be imposed by the Act becomes more evident where X, Y and Z collectively own just enough shares to control legally corporations A and B. But suppose that corporations A and B have no business similarity to each other whatever, that neither X, Y nor Z are acquainted with one another and that they reside in different parts of the country. The facts would tend to indicate that these individuals were not acting in concert with one another so as to exert any "control" over the two corporations. Nevertheless, the Minister could undoubtedly argue that the corporate share registers would show that "legal control" lies with this unrelated group and that

[114] See *Himley Estates Limited and Humble Investments Limited* v. *C.I.R.*, *supra*, footnote 74, *I.R.C.* v. *J. Bibby & Sons Ltd.*, *supra*, footnote 77 and *Barclay's Bank Ltd.* v. *I.R.C.*, *supra*, footnote 71.

[115] *Op. cit.*, footnote 9, p. 59.

corporations A and B are associated. Are X, Y and Z prevented from rebutting such a presumption?

If the courts were to determine "group" control by giving regard to the true facts of each situation, a more equitable system of corporate association would result. It has already been noted that private agreements or voting pools among a group of shareholders so as to obtain a controlling majority does not, in itself, constitute "control" in the legal sense.[116] Although such an agreement or pool is merely an expression of factual control, it does indicate that a particular group of registered shareholders acted in concert so as to "control" the corporation in question. Nevertheless, legal corporate control always lies with someone, whether it be with one large shareholder or with a vast group of shareholders, and presumably it is the legal control exercised by the group in the form of a majority of the registered votes being owned by that group that is given effect to determine "control".[117] It is submitted, that when dealing with control by a group, factual control (such as the presence of a voting agreement) is the catalyst that determines whether the always existing legal control should be given effect to. For instance, where 5,000 registered shareholders in a large corporation have enough votes to pass a resolution in a general meeting, strictly speaking, legal control is held by that "group" of 5,000 on that particular resolution. Practically speaking, however, a court is not apt to say that "group" control exists for purposes of section 39(4), because the "group" is so numerically large.[118] But if each of these 5,000 shareholders entered into a voting agreement so as to control the corporation legally *and* in fact, the agreement, although merely a factual control, may give effect to the already existing legal control expressed by the majority shareholders of the group. Similarly then, it is suggested that a court should be at liberty to go into the facts to determine whether the existing legal control should be recognized even though a very small group of perhaps three persons is involved. Whereas the fact that three minority shareholders collectively own enough

[116] As set out in the cases referred to in footnote 114.

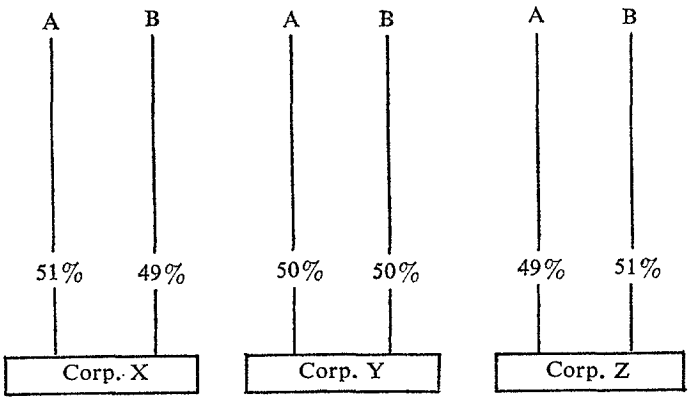
[117] The exceptions cast by s. 139(5d) must be considered with this statement.

[118] Romer L.J. expresses his displeasure in similar legislation in the *Himley Estates* case, *supra*, footnote 74, at pp. 379-380:

> "It appears that there are 750 issued shares in this company held by fifteen people. Any group of eight of those people holds a majority of the shares and the voting power . . . therefore, I am told, I am bound, by the Act, to deem the control of this company to be in each of those groups of eight, of which there are, of course, a very great number — some 6,435, in fact. It is said that applying this quite ridiculous clause. . . ."

voting shares to control a corporation is a strong presumption that "group" control exists within section 39(4), it is nevertheless submitted that the group of three is entitled to rebut this presumption by resorting to facts which show that they did not act in concert with one another. Conversely speaking, the larger the group, the weaker the presumption of "group" control, but this should not mean that the matter is to be conclusively decided simply because the numerical group content is small.

The inequity that may result if the facts lying *behind the share register are not considered when determining "group" control* is a double-edged sword that slashes at the Revenue as well as at the taxpayer. The following example is taken from the CCH Canadian Limited pamphlet on *Associated Corporations*: A and B are unrelated and distribute their voting shares as set out in the chart below.



The CCH pamphlet suggests that: "In this case it may be inferred that both A and B participate in the control of all three companies, particularly if there is a close relationship between the businesses carried on by the companies."[119]

It does appear that before this inference can be made, a court must necessarily look to the facts behind the share registers of each company to find: firstly, that A and B act as a group in controlling the three enterprises—otherwise, the taxpayers may argue that "control" in company X is vested in A, "control" in company Y is vested in AB, and "control" in company Z is vested in B; and secondly, the courts should be permitted to find that "there is a

[119] *Op. cit.*, footnote 18, p. 30.

close relationship between the businesses carried on by the companies". Although it seems quite obvious that A and B act as an unrelated group to control each of these corporations, unless the court is permitted to look to the facts, the Minister may have some difficulty in asserting his claim.

Up to now, we have let the "related group" sit on the sidelines, but let us bring them into the game together with section 139 (5d)(a).[120] Paragraph (a) of section 139(5d) reads:[121]

> (a) 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 whether or not it is part of a larger group by whom the corporation is in fact controlled;

The word "deemed", as it appears in this particular section of the Income Tax Act, has not as yet been adequately defined by Canadian courts. Although this term has been dealt with in various courts, including the Supreme Court of Canada, they have come to two different conclusions as to its meaning because it appears that "deemed" is to be interpreted according to the intent of the section and the statute in which it is used.[122] For purposes of the Income Tax Act and associated corporations, the term "deemed" can be given one of two meanings: (a) that only a *prima facie* situation is created which can be rebutted by evidence; or (b) that it creates an irrebuttable presumption. The Income Tax Appeal Board itself has been contradictory on this point,[123] but the majority of decisions at this level presently take the view that a "deemed" situation permits no elasticity and cannot be rebutted. As yet, we have had no assistance from the Exchequer Court or the Supreme Court of Canada on this matter for the purpose of associating corporations.

In any event, assuming that paragraph (a) of section 139(5d) applies directly to the control concept, a "related group" is "deemed" to "control" a corporation if it is in a position to do so, whether or not it is part of a larger group that in fact controls. Consider the following situation in light of these previous observations:

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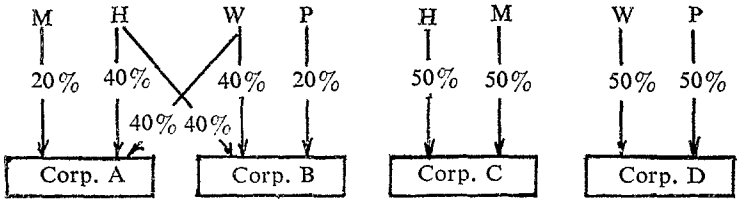
[120] It might be noted that a reading of s. 39(4) will reveal that the "related group" rule is much more all encompassing and inclusive than the rules determining association with unrelated groups.

[121] *Supra*, footnote 8.

[122] Roland Burrows, K.C., Words and Phrases Judicially Defined (1943 ed.), Vol. 2, points out that provincial courts of appeal throughout Canada have differed on the interpretations they have attached to the word "deemed".

[123] Reference might be made to Dr. LaBrie's treatment of this point, *op. cit.*, footnote 21, at p. 180.



Assume that H and W are "related" as husband and wife, each owning forty per cent of the voting stock in each of corporations A and B. Let us assume also that H and W are estranged, and that M is H's mistress and P is W's paramour. M and P are not related to themselves or H and W, and M has twenty per cent of the voting shares in corporation A while P similarly controls twenty per cent of corporation B. Carrying this affair a bit further, we see that H and M have combined to control corporation C, whereas, as might be expected, W and P control corporation D. Actually, M and P need not be so intimate with H and W (respectively), for they could be any unrelated third parties. However, these facts are used merely to bring factual control in sharp contrast with legal control to show that despite the "related group" rule and section 139 (5d)(a), the related group may actually have adverse interests toward one another as individuals. What conclusions are now to be drawn with respect to associating these four corporations? There are perhaps three possibilities:

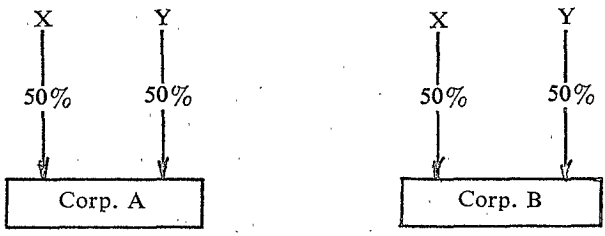
(i) If the word "deemed" in section 139(5d)(a) is to be treated as an irrebuttable presumption, then clearly corporations A and B are associated as being "controlled" by the "related group" of H and W, despite the true facts of the situation. Moreover, it may perhaps be argued that since H and W "control" corporations A and B by virtue of the "deeming" provision, they are not controlled by the unrelated groups of H and M and of W and P, thus preventing an association of corporations A with C and B with D;

(ii) If "deemed" is to be treated as being nothing more than a rebuttable presumption, inferring that the court will look into the true facts of the situation, such evidence would unlikely permit the association of corporations A and B. Rather, these circumstances would tend to associate corporations A and C on the basis that they were "controlled" by the unrelated group of H and M and corporations B and D as being similarly controlled by W and P.

(iii) The Minister may submit that all four corporations are to be associated. He may reason that corporations A and B are associated because H and W are in legal control of both as a

"related group" within sections 39(4) and 139(5d)(a), regardless of their state of affection. Furthermore, by relying on the English cases previously referred to,[124] he may argue that the question is not "who controls?", but rather do H and M "control" corporations A and C, and do W and P "control" corporations B and D. "The answer must be in the affirmative as the corporate share register will testify", the Minister might say, ". . . and the income of all four corporations will be treated as the income of one for taxation purposes." But some doubt may still exist, because if "deemed" is to be treated as an irrebuttable presumption, can the Minister turn around in the face of this presumption and claim that H and M and W and P "control" corporations A and B respectively? To do so would appear inconsistent.

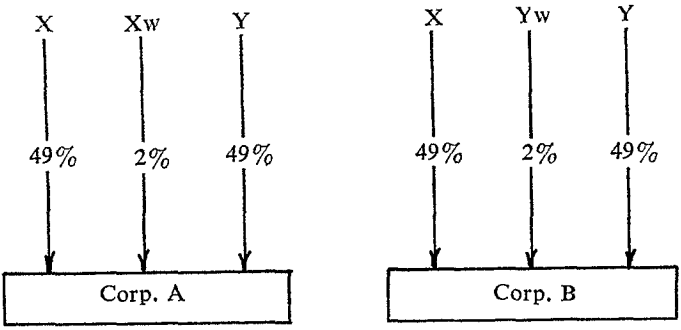
It is not my intended purpose to attempt to solve this problem, but merely to point out that the sections of the Act dealing with associated corporations may lead to confusion, especially when the aspect of "group control" is brought into the picture. This confusion is caused not only by the use of undefined terms such as "deemed", but also, and perhaps more importantly, because the extent to which the courts will be able to look into the facts of each situation is unclear. It is emphasized that the above example is not merely a wild rose plucked from my imagination, but it illustrates the problems that arise when related and unrelated groups are intermingled with voting control closely divided between them. Furthermore, the problem of considering factual control as opposed to legal control is also brought to the fore. An even more obvious and likely situation may be used as an example. Assume that X and Y have equal control of both corporations A and B. The two corporations would be associated under section 39(4)(b).



X and Y desire to disassociate the two corporations, and so, following the reasoning of the present line of Income Tax Appeal

[124] *Supra*, footnote 114.

Board decisions[125] which state that the word "deemed" is an irrebuttable presumption, X and Y give a small percentage of their controlling shares in each corporation to their wives, Xw and Yw respectively.



Although X and Y obviously retain control of corporations A and B "in fact", the Minister may be prevented from making this finding in light of the "deeming" provision of section 139(5d)(a), and the two corporations will remain unassociated as being "controlled" by two different "related groups". But the matter is by no means certain.

Perhaps it has become evident that the factual situations which underlie corporate control can be very important when dealing with "groups". While the strict legal control test[126] may not, in itself, cause too great a burden on the principle of reasonableness in determining associated status where individual persons are involved, the same cannot be said of "group control". This does not mean that the courts will, in fact, look behind the share register to determine the true facts. The most that can be said at present is that the machinery for finding group control is uncertain, for if the legal control test is to be used without regard to the facts, the results may often be inequitous and even a bit ludicrous. The present wording of the Act permits individuals, either separately or as part of a related or unrelated group, to skirt associated status of their corporations with little difficulty and still less imagination. "The number of combinations and permutations of ownership of shares is without limit."[127]

The conclusions to be derived from the group control rules are threefold:

[125] LaBrie, *op. cit.*, footnote 21 and discussion in this paper.
[126] As set out in the English common-law decisions, previously discussed.
[127] *Op. cit.*, footnote 9, p. 30.

(i) There is ambiguity in the meaning of the rules due to lack of proper definition of important terms;

(ii) There is ambiguity as to the extent to which the rules will apply, stemming from the fact that the machinery for determining group control, and the consideration that is to be given to factual and legal control, is not adequately set out; and

(iii) The rules present no major obstacle for groups to arrange their affairs so as to avoid the higher taxation rate.[128]

7. "*Control*". *A definition*

The intention of the foregoing discussion was to bring to light some of the problems that are encountered in determining the meaning of "control" within section 39(4). In considering these observations, it has perhaps become apparent that setting down a definition of this all important term cannot be done in one or two phrases. Consequently, the following propositions are set forth in an attempt to define the control concept as it applies to associated corporations.

(1) Control may be legal or factual, but the term control standing alone in section 39(4) and without more refers only to the legal or apparent control of a corporation with a few common-law exceptions, which control is exercised by the power to cast more than fifty per cent of the voting shares in general meeting, such power being restricted to the election of the majority of a board of directors.

(2) Legal control of a corporation always exists with a person or group, and factual control, while not in itself an element of legal control, may act as the catalyst to determine whether or not the existing legal control shall be given effect to, particularly where group control is in issue.[129]

(3) Legal control is derived from the appropriate corporate statute or the articles of association of the corporation itself; therefore, external control pressure from outside this machinery does not constitute legal control.

(4) The term control within section 39(4) is extended in certain circumstances to real or potential control or both by virtue of section 139(5d)(b), thereby permitting the courts to go behind the corporate share register in such situations.

[128] Reference might be made to the CCH pamphlet, *op. cit*, footnote 18, which outlines many and varied "grouping" schemes that skirt the strict wording of s. 39(4).

[129] This proposal again relies on my suggestion that the courts should look into the facts and give them consideration if any degree of logic is desired when seeking to determine "group" control.

(5) Control by individual persons may be multiple, not only through the application of the common law, but also by virtue of section 139(5d)(b). However, this prohibition may or may not be subject to modification in consideration of the effect of the "deeming" provisions and also where control by a "group" is in issue.

(6) Control of a corporation may be closely tied in with proprietory rights of ownership affecting the concept of a shareholder's limited liability, in which case a court would be loath to pierce a corporate veil to find such control; however, it is thought that this proprietory aspect of control is not affected by taxation statutes.

IV. *Circumstances That May Arise in Relation to Associated Corporations. Some Practical Examples.*

As a further analysis of the Act relating to associated corporations, let us examine some of the corporate machinery that has been used in the past or that may foreseeably be used at some future time, and attempt to determine what effect section 39 may have on such control devices.

In dealing with this phase and the examples that follow, two factors should be kept in mind. Firstly, it is presumed that the *Partington*[130] rule of strict statutory interpretation is to be applied if any of the illustrated circumstances were to be disputed in a court of law. Secondly, since the major factor to be dealt with is the determination of "control" as applicable to section 39(4), the propositions defining the term as laid out previously herein should be kept in mind.

The particular circumstances under discussion will be dealt with under five sub-headings and grouped appropriately.

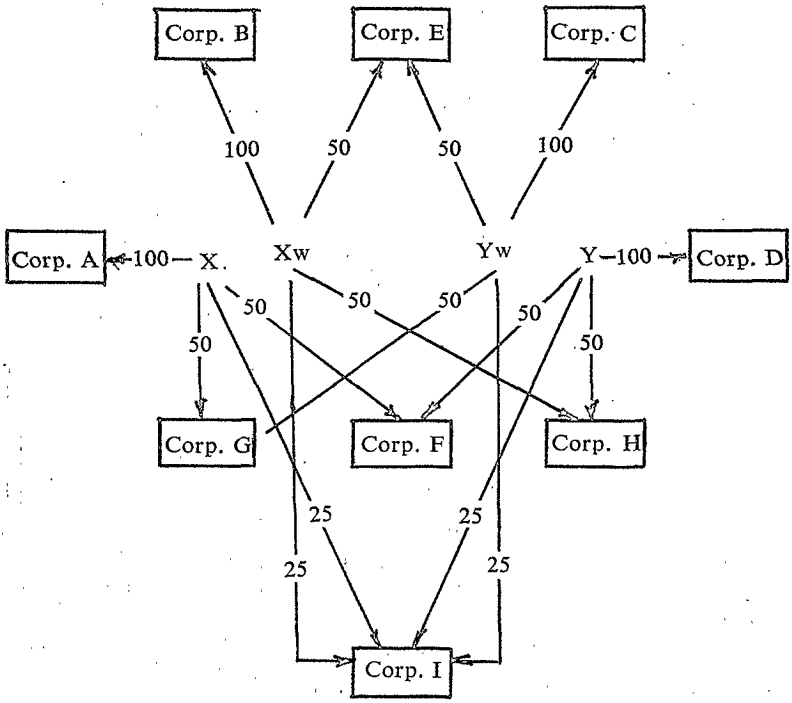
1. *Corporate partnerships*

Perhaps the major shortcoming of the Income Tax Act, with reference to associated corporations, is the fact that no account has been made for partnerships consisting of corporations. For example, let us assume that X and Y, two unrelated individuals, wish to incorporate a business which may well yield corporate profits in the excess of $35,000.00 annually. Rather than incorporating one company, each of them incorporate and control a separate company. X owns and controls corporation A, and Y similarly owns and controls corporation B. Corporations A and B thereupon enter into a partnership to carry on the business. Both corporations

[130] *Supra*, footnote 5.

remain quite unassociated despite the fact that they are carrying on the same business enterprise under the direction of X and Y. If X and Y each have trustworthy, compatible wives who are "unrelated" to anyone else in the group outside of their husbands, nine such corporations could be formed and cemented into a partnership to carry on a certain enterprise.

To illustrate how this scheme might be set up, assume that X and (Xw) are married to each other, as are Y and (Yw). They incorporate nine companies and control them as shown in the chart below:



Each of the four individuals completely controls each of corporations A, B, C and D. The wives combine to control corporation E and the husbands similarly control F. Corporations G and H are each controlled by one of the husbands acting in concert with the other's wife. Each individual is then given an equal one-quarter controlling interest in corporation I and the nine corporations enter into a partnership. "In the case of three unrelated partners with three unrelated wives, at least twenty-one companies may

be formed that could form a partnership for the carrying on of the same enterprise without any two of them being controlled by the same group and without, therefore, any one of them being associated with any of the others." [131]

On the one hand, it would be only reasonable to permit three unrelated men who have formed three economically unassociated corporations to enter into a corporate partnership for business purposes without being deprived of the lower tax rate. But, as Mr. Godfrey points out,[132] "being permitted, with the aid of their wives, to form twenty-one unassociated companies to carry on what is essentially one enterprise or business is a bit thick and should be stopped". Mr. Godfrey's suggested solution in this regard is interesting and one to which some reference might be made:

> What I am suggesting is that in the case of the same unrelated groups controlling more than one company there must be an additional requirement before the companies can be considered associated, namely, that they either have substantial business dealings with each other or that they are engaged in the same line of business. If neither one of these additional requirements is present I can see nothing objectionable in their having as many companies as they want, taking advantage of the lower tax rate. . . .
>
> I think the answer is simple and reasonable. Basically, for one enterprise or joint venture, I am inclined to think that there should be only a total of $25,000 [133] of profits enjoying the low tax rate, no matter how many companies are engaged in the enterprise and regardless of who the shareholders of the company might be.[134]

Mr. Godfrey elaborates further on his solution, but he essentially lays out its basic concept in the words just quoted. It is submitted that not only is his suggestion worthy of merit in relation to corporate partnerships, but, as further discussion will show, this concept of economic association might well replace our present control test.

Mr. Harold Buchwald [135] raises an interesting question with reference to corporate partnerships. He presupposes that two corporations, each of which are closely held by a family group, have entered into a corporate partnership; he then sets out the following reasoning: [136]

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[131] *Op. cit., supra*, footnote 9, p. 56. [132] *Ibid.*

[133] Subsequent to Mr. Godfrey's remarks, the Act was amended so as to set the dividing line at $35,000.00 rather than $25,000.00.

[134] *Op. cit.*, footnote 9, p. 57. In *R.* v. *Strauss*, [1960] Ex. C.R. 315, the partnership entity was recognized to the extent that the sale of an interest in the partnership by a taxpayer at a profit was treated as a capital gain, being the sale of a business entity and not of partnership property.

[135] (1961), 4 Can. Bar J. 266. [136] *Ibid.*, at pp. 275-277.

> Do the corporate partners end up with two unassociated tax bases, or do they end up with something much worse from a taxation point of view than two associated corporations, namely two personal corporations with no tax bases whatsoever? This is the question posed by some who have shied away from the utilization of corporate partnerships. Their argument runs something like this:
> —each corporate partner is wholly owned or controlled by an individual and the members of his family;
> —it derives at least one quarter of its income from an interest in property, to wit: its share in the partnership; and
> —if it had no other business but its interest in the partnership, it does not carry on an active financial commercial or industrial business;
> —ergo, it falls foursquare within the definition of a personal corporation set out in section 68(1) of the Income Tax Act. . . .
> It is urged that . . . the corporate partner has . . . acquired a share in a partnership, an interest in another entity. According to Lindley . . . "A partnership interest is simply the right to acquire property." . . . Reinforcement is taken from the wording of section 6(c) which speaks of the "taxpayers" income *from* a partnership, thereby recognizing it as a separate entity of sorts — an investment-type of entity. Add to this the fact that the partnership is required to keep separate accounts from those of its members, making it a separate accounting entity.

Although cases may arise where it is most doubtful if such corporations were in a position of "something much worse from a taxation point of view" if they were treated as personal corporations (depending on the amount of their taxable income), Mr. Buchwald does seem to prefer the view that each corporate partner carries on business as a person within the partnership, both in fact and in law. The income of the partnership is the income of such corporation within it from the *business* carried on by each corporation. The partnership is not likely to be accredited with such a high degree of personality, being excluded from the definition of "person" in the Act, and not being required to file a separate tax return. "It would appear that the merits are with those who do not feel the corporate partnership results in personalizing the partners."[137]

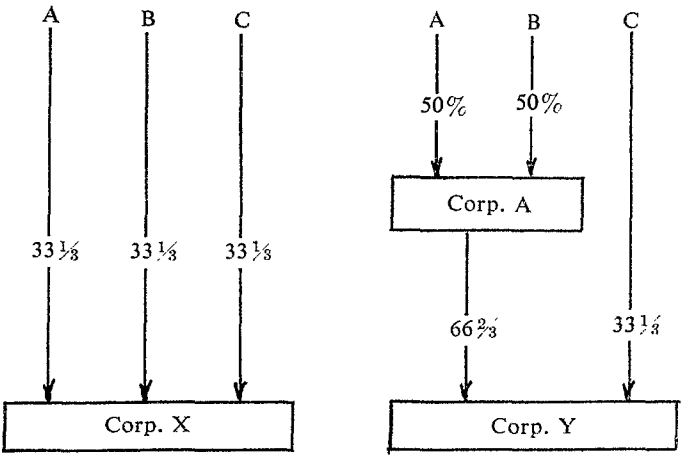
This latter view seems to be held by the Revenue, for although it is known that corporate partnership schemes have been employed to avoid association, there does not appear to be a single case where the Revenue has taken the taxpayers to task on the basis of their being personal corporations.

2. *The corporate veil*

We have seen that while the corporate veil will not be pierced so as to find "ownership" of shares, the situation may be quite

[137] *Ibid.*, at pp. 276-277.

different when seeking "control". However, for reasons previously outlined, some doubt may exist as to whether Canadian courts will follow the English decisions and look through corporations to determine control. If this is not to be the policy with reference to section 39(4), then, of course, vast inroads into corporate splitting will present themselves to the taxpayer. But if our courts do choose to pierce the veil, the next question is, "How far will they go?" Consider the following example taken from CCH Canadian Limited:[138]



For practical reasons, the above control machinery is very similar to having A, B and C outrightly controlling one third of each of corporations X and Y, except that in such circumstances, the corporations would be associated. In this example, however, the Minister may find association more difficult. In the first place, the corporate veil must be pierced. But even after this is done, will the courts go a step further to find that A, B and C collectively control the two corporations? This may be true as far as corporation Y is concerned, but the taxpayer may argue that corporation X is controlled by a different group consisting of merely two persons, that is, A and B, A and C or B and C. At present, the result is undetermined.

3. *Corporate splitting and mathematics*

It was pointed out earlier in this article that the previous seventy per cent ownership test was unsatisfactory mathematically,

[138] *Op. cit.*, footnote 18, p. 31.

for it permitted a majority shareholder to divest himself of thirty-one per cent of his corporate ownership and still make a considerable financial saving for himself at the expense of the Revenue.[139] This basic principle might still find use under the present amendments so as to create several disassociated corporations.

Assume that X wishes to incorporate four unassociated companies, namely, corporations A, B, C and D. X takes unto himself twenty-five per cent of the voting shares in each of the corporations and divides the remaining seventy-five per cent control as follows:

In corporation A: twenty-five per cent to corporation C, twenty-five per cent to corporation D, and twenty-five per cent to employees, p and q.

In corporation B: twenty-five per cent to corporation A, twenty-five per cent to corporation C, and twenty-five per cent to employees r and s.

In corporation C: twenty-five per cent to corporation B, twenty-five per cent to corporation D, and twenty-five per cent to employees t and u.

In corporation D: twenty-five per cent to corporation B, twenty-five per cent to corporation A and twenty-five per cent to employees v and w.

None of the four corporations is controlled by the same person or group of persons. Assuming that each corporation has a taxable income of $35,000.00, or $140,000.00 in total, the Revenue would receive $30,400.00 in taxes. But if corporations A, B, C and D were associated, $59,850.00 would be paid for tax purposes. Of the saving of $29,450.00, $27,400.00 belongs to the employees and $2,050.00 is retained by X and the corporations themselves. In other words, if the corporations were associated, they and X would retain a net income of $80,150.00 after taxes, but under X's method of splitting up control, they and X would net $82,200.00, despite the fact that twenty-five per cent of the control and ownership has been given to various employees. In addition, the employees themselves receive $27,400.00. Moreover, since the present association test is not based on ownership but on control, X might use preferential shares so as to allow corporations A, B, C and D to retain an even greater amount in tax savings than the $2,050.00 figure. Undoubtedly, the Minister will object to such an arrangement, arguing firstly that the corporate veil should be pierced so as to find that X is actually in control of seventy-five per cent of each of the corporations. Previous discussion has indicated that

[139] See *supra*.

such a finding is still a moot point in Canada. Nonetheless, the Minister may object to corporation D owning shares in corporation A and vice versa. Although it is true that the statute prevents a subsidiary corporation from owning shares in one of its parent corporations,[140] this rule applies only where two corporations are, in fact, parent and subsidiary to each other. Before one may say that this situation exists, one or more corporations (the parents) must "control" the other (subsidiary). Hence, X might suggest that since none of the above corporations "control" any of the others, there is no parent-subsidiary relationship so as to prevent such an arrangement.

4. *Casual observations and preferred shares*

With reference to the preceding example, X has still another alternative that is perhaps less complicated and more certain. The use of preferential shares can be an invaluable weapon to the tax avoider, enabling him to employ various methods of skirting the strict letter of the law of section 39(4). Assuming that X still wishes to incorporate four unassociated companies, let us say that he issues a class of shares having full or even magnified voting powers in each of the corporations, although they are almost valueless from a financial aspect. By distributing these shares among his employees so that a different group of employees control fifty per cent of the voting power in each of the four corporations, with X retaining the remaining fifty per cent, it cannot be said that X controls any of the corporations.[141] In addition, X also creates a second class of preferred shares with no voting power. This class, however, represents the real wealth of the corporation, signifying almost complete "ownership", but separate from legal "control". The employee who values his job more than the valueless voting shares he owns would likely see eye to eye with X as to the manner in which his votes will be cast. There is no doubt that X holds a very powerful factual control, but it is doubtful if this control device is caught by the Act. This method has, in fact, been used, and the preference share device is quite effective when close friends, employees or "unrelated" relatives assist the avoider.

Section 139(5d), assuming that it applies directly to section

[140] For example, reference might be made to The Corporations Act of Ontario, R.S.O., 1960, c. 71, ss. 90 and 94.

[141] Note that X must not have the power to cast a tie-breaking vote as occurred in the *Noble* case, *supra*, footnote 68, otherwise he will be deemed to have legal control.

39(4), deals with the potential right to control under a contract, and presumably this includes stock options to purchase. For instance, if X has an option to buy the controlling stock of corporation A, X is "deemed" to be in control. We have seen that some degree of ambiguity exists with the effect of the "deeming" provisions on the concept of "control". Mr. H. H. Stikeman, in suggesting a disassociation device, seems to be of the opinion that not only are the "deeming" provisions irrebuttable, but they do not permit the Minister to rely on common law so as to effect a dual alternative. This may possibly be inferred from the following statement:[142]

> Another alternative which is gaining popularity is to make use of stock options. If each company in a number of companies which would otherwise be associated gives an option over its voting stock to a person who is a stranger to all the shareholders in the other companies, disassociation will result because an option is equated to ownership for this purpose. Thus low value voting shares that control might be so optioned as to prevent association.

While the actual ownership, and hence control, may still be with the holder of the voting shares, Mr. Stikeman suggests that the Minister can no longer rely on this by virtue of the "deeming" provision. He therefore uses the "deeming" provision as a device to disassociate, combining it with the use of preferred shares to make it even more effective. Even if Mr. Stikeman is correct, a question may still arise where X holds controlling shares in trust for Y until Y attains the age of twenty-five, then to Y absolutely. Is X deemed to own and control the voting rights, or is Y? Perhaps both of them do under paragraph (b) and there may still be a field where duality of control applies.

One of the most obvious and simple devices of creating unassociated corporations is to rely on the two weaknesses dealing with control by related persons. Firstly, there must be a cross-ownership of shares, as between husband and wife for instance, before two corporations separately controlled by each of them can be related. For instance, if X controls corporation A and gives his wife absolute control of corporation B, the companies remain unassociated as long as neither individual owns shares in the other's corporation. Secondly, when it is realized that close relatives, such as uncles and nephews, are really not "related" within section 39(4), control may be distributed in many and varied ways. If these devices are sprinkled with various preferred shares, the

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[142] *Op. cit.*, footnote 43, p. 3.

avoider can easily sidestep association and still funnel a vast majority of the corporate profits to himself.

The leading Canadian authority on corporation law, Mr. V. E. Mitchell, makes the following statement on the use of preferential shares:

> Sometimes it has been sought to incorporate into the constitution of the company a provision whereby the minority interest should have the right to appoint a majority of the directors.[143]

Mr. Mitchell touches on an aspect of splitting the control itself rather than by dividing it among various groups by using preferred shares. Previously in this analysis it had been suggested that where controlling powers have been split in this manner, corporate "control" lies with those shareholders who have the power to elect a majority of the board of directors. But in the absence of statutory clarification, of course, the matter is not as yet settled.

5. *Control methods in the United States of America. Some "Elegant" devices*

We have looked into some of the corporate control mechanisms that may either skirt association completely or, if nothing more, cause confusion. But, ". . . it must be admitted that the devices [of controlling a corporation] are not so effective nor, as one might say, so elegant, as those which exist in the U.S.A."[144] We have seen that preferential shares will enable a person to "own" two or more corporations while at the same time he divests himself of all legal control, but still retaining a powerful real control. This is also dealt with by Messrs. Adolph A. Berle and Gardiner C. Means, who point out that "Ownership of wealth without appreciable control and control of wealth without appreciable ownership appear to be the logical outcome of corporate development".[145] For example, by setting up an intricate corporate mechanism, the Van Sveringen brothers were at one time able to control several railroad systems by an investment of less than twenty million dollars, whereas the railroad systems' combined assets exceeded two billion dollars; less than one per cent ownership was required to maintain control.

Messrs. Berle and Means maintain that there are five major types of control:[146]

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[143] A Treatise on the Law Relating to Canadian Commercial Corporations (1916), p. 72.

[144] Hornsey, Some Aspects of the Law Relating to Company Control (1950), 13 Mod. L. Rev. 471, at p. 478.

[145] *Op. cit.*, footnote 100, p. 69.

[146] *Ibid.*

(i) Control through almost complete ownership;
(ii) Majority control;
(iii) Control through a legal device without majority ownership;
(iv) Minority control;
(v) Management control.

The first three are categorized by them as being "legal control", the latter two as "factual control". However, on closer examination of some of the control devices that fall within these categories, one may find that such clear-cut categorizations are not so easy to make for purposes of section 39(4).

(i) *Control through almost complete ownership.* It is obvious that where X controls a corporation by owning absolutely ninety per cent of its voting shares, he has legal control within section 39(4). This is perhaps the clearest example of "legal control".

(ii) *Majority control.* As the heading denotes, this involves the ownership of a majority of the corporation's voting stock. For example, assume that each of five persons owns an equal twenty per cent of the shares in a corporation. If, on an issue to be voted on, three of these shareholders vote one way and two another, then the three people are said to have majority control on that particular issue. The other two have lost this control, although they still have an ownership interest of forty per cent of the corporation. This is the first step in separating ownership from control. For purposes of section 39(4), it would appear that a group of three could exert "control" in this example, and it would be especially clear where the three persons act in concert so as to control two corporations. But the problem may become more complicated when a very small group exerts control by binding the majority to their wishes. Suppose that corporation A is controlled by 100 shareholders, each of whom owns a one per cent voting share. Let us further assume that fifty-one of these shareholders also own one per cent each of the voting shares in corporation B. Can it be said that the same "group" has "control" over corporations A and B, so as to associate them? Previous discussion indicated that this may be doubtful where there is nothing to show that each of the fifty-one men acted in concert. Nonetheless, suppose evidence was adduced to show that each of these fifty-one shareholders entered into a contract to control both corporations A and B by voting their shares in the same manner on any issue, to be determined by a majority decision of the fifty-one. Proceeding further, if the group of fifty-one casts its votes as a majority of

twenty-six decides, can it further be said that the "group" of twenty-six has "control" within section 39(4)? It is possible that if twenty six members decided to control two or more corporations in this manner, relying on their agreement with the other twenty-five, then they could exert a very real control. However, it is suggested that this is where the line should be drawn between legal and factual control—in effect, between majority and minority ownership. The most that can then be said is that the control by the group of twenty-six is not "legal control", being dependent on the registered votes of all fifty-one shareholders. However, a voting contract or an agreement among the group of fifty-one, although in itself merely a factual control lying outside the articles or statutes, may give effect to the legal control that does exist within the fifty-one owners.

(iii) *Control through a legal device without majority ownership.* Messrs. Berle and Means cite three examples to illustrate this form of control. In all cases there is a clear separation of ownership from legal control.

The first of these illustrations hinges on the use of preferential shares. This device has already been discussed in this article, and the obvious example is that of the individual who holds perhaps only one fourth of the value of the stock in a corporation. However, since his shares have magnified voting powers, he may actually have more than fifty per cent of the corporation's voting control, hence "legal control" within the Act.

The second method is that of "pyramiding", a system whereby X will hold a slight majority of the voting shares in corporation A. This corporation in turn holds the majority of the voting shares in corporation B. Corporations A and B may combine to control corporation C and so on down the line. When this process is multiplied a number of times, and even accelerated by using preferred shares, X can control a vast network of corporations with very little investment of ownership capital. This was the device used by the Van Sveringen brothers, referred to earlier. However, the question to be determined is whether X has "control" of the companies at the bottom of the pyramid, or more specifically, whether the corporations within such a network are associated within section 39(4). It would appear that an important factor to be considered is the extent to which the *British American Tobacco Co., Ltd.* case[147] principle of piercing corporate veils is to be

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[147] *Supra*, footnote 80.

applied.[148] To say that X did, in fact, have control would seem rather unfair for two reasons. Firstly, the primary purpose of pyramiding is not for tax avoidance, but rather to allow one person or group (who are often very well qualified) to direct the operations of a whole chain of business enterprises without the necessity of having to own a majority of the shares. In fact, this would be almost impossible for any one person or small group where the ownership interest of a giant corporation might run into several billion dollars. Secondly, X, the magnate at the top of the pyramid who owns perhaps one per cent of the network's total shares, will not be overly concerned about the loss of a few thousand tax dollars from the companies at the bottom of the pyramid. This, of course, is due to the fact that the vast majority of ownership in these companies is held by groups of individual shareholders, and they, not X, will be most affected by a sudden jump of the tax rate. It is somewhat unfair to subject them to this higher rate simply because X has a controlling interest many times obscured by corporate veils.

The third example used by Messrs. Berle and Means in this category is that of the voting trust. A group of trustees is formed, usually under the direction of the corporation management, and they are given the power to vote shares placed in their trust. These trustees have legal ownership of the shares and the "beneficiaries" hold trust certificates entitling them to all the material gains the shares produce. Only the voting rights have been stripped, and the capital for the stock is provided by the beneficiaries. It would seem that under such an arrangement, the trustees would be deemed to have voting "control", both at common law and by virtue of section 139(5d)(b).

(iv) *Minority control.* Where stock ownership in a large corporation is widely dispersed among a great number of shareholders so that no one person or small group is in a position to vote more than fifty per cent of the shares, "minority control" becomes an important factor in exerting control over a corporation. This is the situation whereby a person (or group) has a sufficient number of shares to form a nucleus so as to draw the votes of other shares to the minority nucleus. However, at no time does the minority shareholder own more than fifty per cent of the voting shares. Usually a legal device, such as the proxy system, is used to col-

[148] Note also that association might well result by strictly applying s. 39(4)(a) where there is a straight-line pyramid (*i.e.*, corporation A controls corporation B, which controls corporation C) Also, association might otherwise result by applying s. 39(4)(b) in conjunction with s. 39(5).

lectivize the controlling shares with the minority. Messrs. Berle and Means use the example of the proxy battle between John D. Rockefeller Jr. and Colonel Stewart of the Standard Oil Co. of Indiana to illustrate the power of "minority control". Management is extremely powerful where the proxy system is employed, as it was here, because it is able to choose the personnel that form the proxy committee—in effect, they choose their own voters. Since it is very expensive and complicated for a minority shareholder to set up his own proxy machinery, the strong influence of management can be appreciated even more. Rockefeller, who owned 14.9 per cent of the stock in Standard Oil, making him a large minority shareholder, had a disagreement with Colonel Stewart, representing the management faction. Rockefeller set up his own proxy machinery to combat that of Colonel Stewart, and it is thought that because Rockefeller himself had a large number of shares, even though in the minority, this acted as a nucleus around which many shareholders contributed their proxy votes. Rockefeller won the battle, and while there were many factors contributing to his victory, there is no doubt that his "minority control" was important.

It is not likely that "minority control" in itself is contemplated within the Act, for it is purely a factual control device that relies on other devices before corporate control is finally achieved. However, it must be remembered that outside of the minority controller's power of persuasion and influence, he must usually rely on a legal device to attain final control. In the Standard Oil illustration, it is most doubtful if a "group control" power was exerted which would have been within our Income Tax Act with respect to the large group of shareholders who sided with Rockefeller. But when we turn to the proxy device, it would seem that it would have been caught by sections 39(4) and 139(5d)(b). Fletcher's *Cyclopedia on Corporations* points out that "the right to vote by proxy . . . is as effective as voting in person".[149] Moreover, there is no power to vote by proxy, unless it is expressly provided for by the corporation's articles of association or the relevant companies act.[150] Once this device is used, it would certainly appear to fall within section 139(5d)(b), and also within Mr. Brown's test for legal control.[151] However, since the "minority control" situation is usually restricted to very large corporations, the consideration of a preferential tax rate on the first $35,000.00 would be of much

[149] *Op. cit.*, footnote 99, p. 207.
[150] *Ibid.*
[151] *Op. cit.*, footnote 103.

less concern to anyone involved than I have shown, even in this brief discussion.

(v) *Management control.* As was seen in the above example, management can and often does effect a very powerful factual corporate control. This control is not exercised through stock ownership directly, but rather through the management's ability to influence the voting shareholders to elect a favourable board of directors. Control of the proxy machinery or the setting up of complimentary voting trusts are prime examples of the management's influential powers. But this category of control lies at the other end of the scale, being purely factual and not covered by our Act. Even though X, Y and Z may be the officers of two corporations and maintain a strong factual control over their shareholders in the manners suggested, and even though they may be acting in concert to achieve these ends, the two corporations will not be associated on this ground alone.

Messrs. Berle and Means suggest other minor control methods, some of which have already been discussed. The financial control of a strong creditor of a corporation has been dealt with in light of the Act. Management control, combined with minority control, have been dealt with separately, but collectively, these devices can be most powerful although not contemplated by the Act. If in the Standard Oil example, Colonel Stewart and Rockefeller combined their powers (which in fact they may have done until their disagreement), a strong factual control could be imposed on the corporation. However, when these powers are split, the parties have to resort to legal devices of control, which would probably come within section 39(4).

There also exists the situation where X buys shares from a company in financial difficulties. However, before putting up the required capital for the shares, that is needed by the corporation to carry on its business, it is agreed by the major shareholders that a new board of directors will be elected as X directs. Certainly X has very strong corporate control powers, even though he may own much less than fifty per cent of the voting shares. X's control is factual and does not fall within the common-law definition of legal control. This question becomes more doubtful when section 139(5d)(b) is applied. Does X have "a right . . . under contract . . . or otherwise . . . to control the voting rights . . ."? Perhaps he does, even though he has no legal control power. If so, does this mean that the majority shareholders, who have "legal control", no longer have "control" within the Act, this "control" being

passed on to X by virtue of the operation of section 139(5d)(b)? Would such an agreement between X and the majority shareholders tend to disassociate another corporation controlled by the same shareholders, and at the same time associate this corporation with any that X may legally control? Or would the courts be apt to say that *all* corporations controlled by X, the majority shareholders and the corporation under discussion, be associated, thus employing a double standard? The answers are not clear at the present time, and the wording of the Act offers little assistance.

V. *Suggested Alternatives and Solutions.*

It is hoped that this analysis has brought to light some of the problems that exist with reference to the amendments in question herein. Sections 39 and 139 suffer from somewhat careless draftmanship and a lack of well-defined terms. Moreover, there has been a use of general terms to cover a wide range of situations that will tend to associate corporations which may have no business or economic association whatsoever, and many of which may have been incorporated for business convenience rather than tax avoidance purposes. The irony of the whole situation is that the tax avoiders, the very people whose activities the government tried to curtail, can still avoid the higher rates quite handily. In other circumstances, the results are completely ambiguous and confusing. Most writers on this subject are agreed that no small degree of difficulty does exist. Some have shown how other countries have attacked similar problems, and others have offered solutions of their own.

Mr. Irwin explained to the Canadian Tax Foundation conference[152] that some countries, notably New Zealand and the United States of America, rely on ministerial or court discretion to uphold reasonableness in taxation draftsmanship. In New Zealand, for example, the Commissioner under the taxation Act[153] is empowered to use his discretion to determine whether two or more corporations with substantially the same shareholders are associated if such corporations were established for the primary purpose of tax avoidance rather than for business convenience. It was not until recently[154] that an appeal from the Commissioner's decision could be taken to a board of review, but even at that stage, the discretionary power is final at the administrative board level.

In the United States of America, the Commissioner may allocate gross income, credits or allowances to two or more corpora-

[152] *Op. cit.*, footnote 9, pp. 48-50.
[153] *Ibid.*
[154] *Ibid.*

tions which are owned or controlled directly or indirectly, by the same interests.[155] The commissioner's discretionary powers are wide in this respect. Moreover, the courts give considerable assistance in this regard in that they will look behind corporate machinery and determine the real purpose of its being set up in a particular manner and ignore tax avoidance schemes.[156]

Mr. Irwin is quick to point out, however, that ministerial discretion is not favoured in Canada.[157] Furthermore, the Canadian courts' policy of strict statutory interpretation is quite different from that of the United States, with the result that our taxation statutes are drafted so as to set down narrow and specific rules. If these rules are inadequately framed, then we must look elsewhere than to ministerial or court discretion for a solution.

Mr. Stikeman suggests that:[158]

> The real solution may not lie in more detailed rules to enforce "association" coupled with a variance in the tax rates for the smaller corporations with a large gap between the tax rates on taxable income under $25,000 and over that amount and with it the temptation to indulge in schemes. Possibly graduated income brackets, starting from some lower figure than $25,000 taxable income and running up to say $100,000 might deter many taxpayers from seeking somewhat artificial solutions by making the expected tax savings insufficient to warrant their efforts.

This is perhaps not the whole answer to the problem, for although the tax rate would be gradually increased up to $100,000.00, a wide gap would still exist between a very low corporate income figure and the suggested $100,000.00 mark. Mr Stikeman's solution is not a substantial alternative to deter a corporation that earns $100,000.00 from forming many small corporations by a corporate partnership system for example, so as to still take advantage of a considerably lower tax rate.

Mr Carlyle submits that:[159]

> Section 39(4) could achieve its purpose by the following language or words of like effect: "For the purposes of this section, corporations are associated with each other in a taxation year if the main purpose for the creation of one or more of the corporations was the reduction of taxes that would otherwise be imposed by the rates of tax under sub-section (1) of this section".

Mr. Carlyle seems to be headed in the right direction with his proposal, but perhaps he leaves the matter too wide open. Moreover, the Income Tax Act does contain a fairly similar provision

[155] *Ibid.*
[156] *Supra*, footnote 4.
[157] *Op. cit.*, footnote 9, p. 50.
[158] *Op. cit.*, footnote 43, pp. 3-4.
[159] *Op. cit.*, footnote 6, at p. 375.

that presumably could be applied to section 39(4). Section 138(1) reads:[160]

> Where the Treasury Board has decided that one of the main purposes for a transaction or transactions effected before or after the coming into force of this Act was improper avoidance or reduction of taxes that might otherwise have become payable under this Act, . . . the Treasury Board may give such directions as it considers appropriate to counteract the avoidance or reduction.

In examining Mr. Carlyle's suggested wording (assuming that he is not considering ministerial discretion) and that of section 138(1), I believe that very little effect would be given to either in a court of law. It is doubtful whether the courts would assume unto themselves this role of fact finders only with little or no reference to the law, especially in light of the *Partington*[161] and *Curran*[162] rule of strict interpretation of taxation statutes. The above provisions would completely undermine the common-law rule in this respect if this rule were applied. In other words, these provisions attempt to give almost complete discretionary powers of taxation to the courts to be determined on the merits of each separate case. On this ground alone, I do not think that the judiciary would give much notice to this line of draftsmanship.

If we should momentarily assume that some effect were to be given to these provisions, what would be the result? Perhaps even more confusion than exists today. Dr. LaBrie, in examining section 138(1), felt that there would be considerable difficulty[163] in determining the meaning of some of the terms within this section. For example, what meaning is to be given to the phrase, "improper avoidance", or to the term "main purpose"? Furthermore, if under such a provision the courts were to hold that a certain class of corporations was not to be associated in certain circumstances, and if the government did, in fact, wish to associate these particular corporations, the immediate result would be the passing of amendments. After several such instances, we would then be in a position of having a wide, generally worded section supplemented by a list of specific rules with uncertain results, much as we have today. And while Mr. Carlyle's suggestion[164] and the provisions of section 138(1) seem concerned with tax avoidance, certainly we should have a better test to associate corporations than merely to determine whether or not they are separated for tax avoidance purposes.

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[160] *Supra*, footnote 8. [161] *Supra*, footnote 5. [162] *Ibid.*
[163] *Op. cit.*, footnote 21, at pp. 114-124, for a full discussion on s. 138.
[164] *Op. cit.*, footnote 6, p. 375.

It is suggested that a more purposeful test of associating corporations would be one of economic or business association regardless of whether separate corporations are controlled by the same shareholders, relatives or totally different groups.[165] The example of the shoelace and restaurant companies being controlled by the same person[166] would result in disassociation since each is completely separate from the other economically and for business purposes.[167] Of course, it may be a good policy to subject a person in control of two corporations to a higher tax rate since he derives greater profit for himself. But since the individual shareholder is already taxed at a higher progressive rate directly as a result of his earnings through his corporations, to apply the same principle directly to his corporations also, amounts to a rather unfair double progressive taxation. If one objects to the economic association test on the ground that the shareholder in control of two or more corporations should be taxed at a higher rate, it is submitted that the progressive taxation rate principle is already enforced once against the individual personally, and that there is therefore no need to apply it again.

It may occur to the reader that determining economic or business association would necessitate the consideration of the facts in each case to some degree. Canadian courts have on occasion felt that evidence required the piercing of a corporate veil and did so to find that "several" corporations were actually carrying on the same business enterprise.[168] It is therefore proposed that the association of corporations would be more effective and reasonable if a set of clear rules were drafted laying out the essential circumstances under which corporations were to be associated and based on a test of economic association. These rules should be broad enough so as to allow considerable leeway to the courts to look into the facts of each case to some degree and determine the status of such corporations by this dual application; that is, one of law as set out in the framework wording of the statute, the other of fact, permitting the court to work within that framework.

[165] This is really an extension of Mr. Godfrey's plan, which he applied only to the corporate partnership problem, *op. cit.*, footnote 9, p. 56.

[166] See *supra.*

[167] The concept of "*enterprise entity*" is growing in the United States where the separate legal identities of corporations will be ignored for certain purposes where it is found that substantially the same shareholders are carrying on one business enterprise under several corporate heads.

[168] In *Palmolive Mfg. Co. (Ont.) Ltd.* v. *R. etc.*, [1933] S.C.R. 131, it was held that, although two companies were separate legal entities, the corporate veil was to be pierced in this case as they carried on the same business enterprise, one company acting merely as the agent or a department of the other.

Thus, the matter would not be left as wide open as Mr. Carlyle suggested, nor as narrow as the present Act sets out. Many of the inequities that are suffered by both taxpayer and Revenue would then disappear.

In illustrating what is meant by broadly worded rules (and aside from economic association), let us consider once again section 139(5d)(a) which states that "where a related group is in a position to control . . . it shall be *deemed* to be a related group that controls . . .". If the word "deemed" creates an irrebuttable presumption, it has been noted in two examples that unfair results might occur; for instance, the estranged man and wife would be deemed to control, and two unrelated individuals could possibly disassociate corporations by giving one share to their wives.[169] But if, as this proposal implies, the word "deemed" was changed to "presumed", thus permitting the courts to look beyond the presumption at evidentiary facts, the results in each of the above two examples would probably be reversed—and more equitable to all parties concerned.

Other shortcomings could be improved upon, as has been suggested earlier, which, though minor by comparison, would help to clear away some of the anomalies that exist. An accounting might be made for corporate partnerships, and the saving provisions of section 39(6) and (6a) could be appropriately extended. In addition, important terms might be defined and some "tailoring" would improve the "related persons" rules.

Although it is not my intention to attempt to re-draft section 39(4), I believe that the association rules, as they presently stand, are quite ambiguous, unreasonable and insufficient, both as to draftsmanship and underlying principle. These rules should be completely discarded and new ones drafted. As I have suggested, an underlying principle of economic association encased in a set of clear guiding rules permitting evidentiary consideration would be more favourable.

VI. *Conclusion.*

There has been considerable criticism of the sections dealing with associated corporations, ranging from their extreme unfairness (particularly to family groups) to the gaping loopholes.[170] Much

[169] See *supra.*

[170] Reference might be made to Mr. Carlyle's article, *supra*, footnote 6, the 1960 Canadian Tax Foundation Conference Report, and Mr. Stikeman's Tax Service Letter, *supra*, footnote 43, or Mr. Leach's article, *supra*, footnote 41.

of this dissatisfaction is largely due to the Act's complete disregard for economic association of corporations. On the one hand, there are instances where corporations will be associated simply because a certain percentage of shares is distributed among similar groups or trustees, although they have no economic or business association whatsoever. On the other hand, many situations will arise, as they have arisen in the past, whereby several corporations that are carrying on exactly the same business enterprise will not be associated because their promoters have been astute enough to disperse shareholdings in a manner not contemplated by section 39(4). Instead of considering facts and the "enterprise entity", the present sections attempt to set out a rigid set of rules in general, undefined terms creating a "blur on the tax boundaries". Mr. Carlyle hits the nail squarely on the head when he says that ". . . too often shrapnel rather than solid shot is used, and the result has often been to injure or immobilize the innocent and not always the intended victim".[171] The associated corporations rules leave us with three major shortcomings:

(i) Corporations with no economic association will be "associated", even though such an association could be most unfair and at times ridiculous;

(ii) The tax avoider can still sidestep the higher rate by forming several corporations which may even be carrying on the same business enterprise;

(iii) In some cases, utter confusion will arise due to ambiguous terms.

A further criticism, which may even be attached to the above list as a fourth major weakness, is set out by Mr. Stikeman:[172]

> The preoccupation of the draftsman with small loopholes is out of all proportion to the overall picture. In its increasing endeavours to make the Income Tax Act precise and scientific in its application so as to be fair to all taxpayers, the only risk-taking that is encouraged is fiscal, while the economic and commercial venturing are being more and more discouraged. The very objective of fairness defeats itself. The sophisticated and daring are presented with means of tax minimization perfectly within the law which exists in the name of fairness to all, but which can give to those who exploit them a substantial advantage over their fellow taxpayers. It is becoming more profitable to spend time and effort to save tax dollars than it is to earn them in the first place.

Perhaps no better words can be used to summarize this analysis than to quote Mr. Marcel Belanger when, discussing associated

[171] *Op. cit.*, footnote 6, p. 370. [172] *Op. cit.*, footnote 43, p. 4.

corporations at the 1960 Canadian Tax Foundation Conference, he said:[173]

> A prayer written many centuries ago, which has always impressed me strongly, is the Litany. In these supplications, heaven is implored to deliver humanity from different scourges, such as pestilence, famine, war, etc. If that prayer were to be written anew to bring it up to our times, I feel sure that the Church would add this essential petition: "From the inequities, complexities and uncertainties of the Income Tax Act, Good Lord, deliver us if at all possible! Amen."

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[173] *Op. cit.*, footnote 9, pp. 50-54.