BETWEEN:

ARCTIC GEOPHYSICAL LTD. .....APPELLANT;

AND

THE MINISTER OF NATIONAL REVENUE .....RESPONDENT.

Edmonton 1967 Oct. 31 Dec. 6

Income tax—Associated companies—Whether shareholders of one company "in a position to control second company"—Right of directors to redeem preferred shares—Effect of—Income Tax Act, ss. 39(4)(e); 139(5d)(a) and (b).

A husband and wife held all the issued shares of one company and 1,000 common shares, being all the issued common shares, of appellant company, and were its only directors. Appellant company had in addition issued to other persons 1,000 class B shares which had full voting rights and were redeemable by the directors on any dividend date.

Held, the two companies were not associated within the meaning of s 39(4)(*e*) of the *Income Tax Act.*

(1) The husband and wife were not "in a position to control" appellant company within the meaning of s. 139(5d)(*a*) of the *Income Tax Act.*

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That phrase refers to an existing ability to control by voting power attached to share ownership. Moreover the redemption of shares is not the act of the directors but of the company even though instigated by its directors.

(2) The husband and wife had no right to or to acquire the class B shares or to exercise any control over their voting rights, one of which is a condition essential to the application of s. 139(5d)(*b*).

INCOME TAX APPEAL.

Ronald D. Bell for appellant.

F. J. Cross for respondent.

CATTANACH J.:—This is an appeal from a decision of the *Tax Appeal Board*[1] whereby the appellant was held to be associated with another corporation, namely, Heiland Exploration Canada (1959) Limited and therefore taxable as associated under section 39 of the *Income Tax Act*, R.S.C. 1952, chapter 148 and amendments, for the appellant's 1961, 1962 and 1963 taxation years.

At the outset of the hearing the appellant abandoned its appeal from the Board's decision with respect to the assessment for its 1961 taxation year so that the present appeal relates only to the assessments by the Minister for the appellant's 1962 and 1963 taxation years.

For the purpose of this appeal the parties reached an agreement as to the issue and facts which reads as follows:

> 1. The issue to be decided in each of the several appeals is whether the Appellant was or was not associated with Heiland Exploration Canada (1959) Limited (herein referred to as "Heiland"), in the relevant taxation year within the definition contained in subsection (4) of section 39 of the *Income Tax Act*.
>
> 2 The following facts relative to the issue to be decided are admitted.—
>
> (a) Heiland was incorporated under the Companies Act of the Province of Alberta on 1 June, 1954 and its fiscal period ended on 31 May in each year.
>
> (b) The Appellant was incorporated under the Companies Act of the Province of Alberta on 19 December, 1960 and its fiscal period ended on 31 March in each year
>
> (c) At the date of the Appellant's incorporation and throughout the period from that date until 21 July, 1962 all of the issued and outstanding shares of the capital stock of Heiland were owned by Mr Ira C Mayfield and his wife, Loma B Mayfield, in the following portions:
>
> Ira C Mayfield ..... 19 shares
> Loma B. Mayfield ..... 1 share.

[1] (1965) 39 Tax A B C. 346.

(d) Annexed hereto and marked as Appendix "A" to this agreement is a true copy of the Appellant's Memorandum of Association as it read at all times material to these appeals.

(e) On the day following the date of the Appellant's incorporation, Mr Ira C Mayfield and his wife, Loma B. Mayfield, were named as Directors of the Appellant and they continued to be the only Directors of the Appellant at all times material to these appeals.

(f) On 21 December, 1960, Mr. Ira C. Mayfield and his wife, Loma B. Mayfield, each became the owner of 500 common shares of the capital stock of the Appellant and up to and including the 29th day of December, 1960, Mr. and Mrs. Mayfield were the only shareholders of the Appellant.

(g) On 30 December, 1960, 500 Class "B" shares of the capital stock of the Appellant were allotted to Mr. J. C. Fuller and 500 Class "B" shares were allotted to Mr. V. Van Sant, Jr., neither of whom was related to Mr. Ira C. Mayfield or to his wife, Loma B Mayfield.

(h) Throughout the period commencing on 30 December, 1960 and ending on 20 July, 1962, the only issued and outstanding shares of the capital stock of the Appellant were owned as follows:

Name of Owner	Common Shares	Class "B" Shares
Ira C. Mayfield	500	NIL
Loma B. Mayfield	500	NIL
J. C. Fuller	NIL	500
V. Van Sant, Jr	NIL	500
Total Shares	1,000	1,000

3. If it be decided that the Appellant was associated with Heiland in a taxation year, the appeal from the assessment for that taxation year of the Appellant should be dismissed.

4. If it be decided that the Appellant was not associated with Heiland in a taxation year, the appeal from the assessment for that taxation year of the Appellant should be allowed and the matter should be referred back to the Respondent to reassess the Appellant for that year at the rates of tax prescribed in subsection (1) of section 39 of the *Income Tax Act*.

As recited in paragraph 2(d) there is appended to the agreement as to issue and facts a true copy of the appellant's Memorandum of Association. The portions of the Memorandum pertinent to this appeal are those reciting the rights and conditions attaching to the common shares and Class "B" shares which read as follows:

> The said Class "B" shares shall confer the right to notice of all meetings of the Company and the right to vote with the ordinary (common) shareholders and to have one vote for each Class "B" share held by them.

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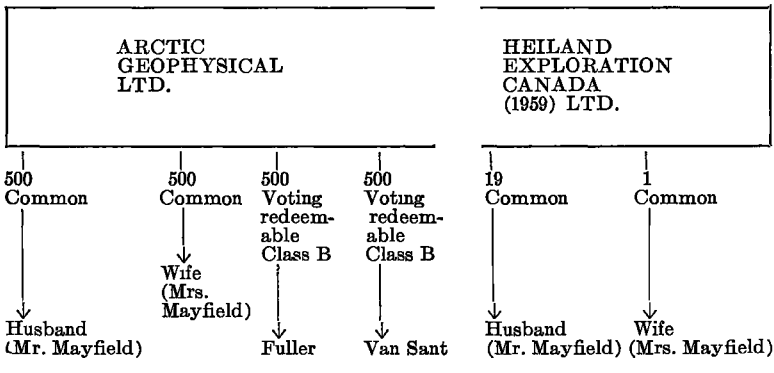
The said Class "B" shares shall be redeemable in whole or in part thereof at the option of the Directors upon any dividend date upon the company giving sixty days notice in writing of such redemption and shall be redeemable at par plus a sum equal to all unpaid preferential dividends in full to the date of redemption. In the event of such redemption being in part the same shall be by lot.

By agreement a true copy of the appellant's Articles of Association as they read at all times material to this appeal were introduced in evidence. During argument reference was made to paragraphs 9 and 49 thereof reading as follows:

> 9. The shares shall be under the control of the Directors who by unanimous resolution and not otherwise may allot or otherwise dispose of the same to such persons and upon such terms and conditions and at such times as the directors think fit.
>
> 49. In the case of an equality of votes, either on a show of hands or on a poll, the Chairman of the meeting at which the show of hands takes place or at which the poll is demanded, as the case may be, shall not be entitled to a further or casting vote.

The shareholdings in the appellant and Heiland are illustrated in graphic form as follows:



The sole issue in the present appeal is, as stated in the agreement as to issue and facts, whether the appellant was or was not associated with Heiland in the appellant's 1962 and 1963 taxation years.

Section 39(1) provides that the tax payable by a corporation under Part I of the *Income Tax Act* is 18 per cent of the first $35,000 taxable income and 47 per cent of the amount by which the income subject to tax exceeds $35,000. However, subsections (2) and (3) of section 39 provide that when two or more corporations are associated with each other the aggregate of the amount of their incomes taxable at 18 per cent is not to exceed $35,000.

Section 39(4) defines the circumstances under which a corporation is associated with another and reads as follows:

> 39. (4) For the purpose of this section, one corporation is associated with another in a taxation year if, at any time in the year,
>
> (*a*) one of the corporations controlled the other,
>
> (*b*) both of the corporations were controlled by the same person or group of persons,
>
> (*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 of each of the corporations,
>
> (*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, or
>
> (*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 of each of the corporations.

The word "controlled" as used in the above subsection has been held by the President of this Court in *Buckerfield's Limited et al. v. Minister of National Revenue*[2] to mean the right of control that rests in the ownership of such a number of shares as carries with it the right to a majority of the votes, i.e. *de jure* control and not *de facto* control. This interpretation by the President was adopted with approval by the Supreme Court of Canada in *Minister of National Revenue v. Dworkin Furs (Pembroke) Ltd. et al.*[3]

The contention on behalf of the Minister is, as I understood it, that each of the corporations here involved, namely, the appellant and Heiland, was controlled by a "related group" and are accordingly associated within the meaning of section 39(4)(*e*). It was conceded by counsel for the appellant that (*e*) is the applicable paragraph of subsection (4) of section 39 but he did not concede that the appellant was controlled by a related group.

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[2] [1965] 1 Ex C.R. 299.

[3] 67 DTC 5035 at p. 5036.

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It is not disputed that Mr. and Mrs. Mayfield, by virtue of their ownership of all the issued and outstanding shares of Heiland in the respective numbers of 19 and 1, controlled that corporation.

If the test propounded in the *Buckerfield* (*supra*) case was the test here applicable then there would be no question that the appellant was not controlled by Mr. and Mrs. Mayfield because between them they owned only 50 per cent of the issued and outstanding voting shares of the appellant and therefore did not command a majority of the votes.

There is no question between the parties that Mr. and Mrs. Mayfield constituted a "related group" within the meaning of those words as defined in the *Income Tax Act*.

Subsection (4a) of section 39 reads as follows:

> (4a) For the purpose of this section,
>
> (*a*) one person is related to another person if they are "related persons" or persons related to each other within the meaning of subsection (5a) of section 139;
>
> (*b*) "related group" has the meaning given that expression in subsection (5c) of section 139; and
>
> (*c*) subsection (5d) of section 139 is applicable *mutatis mutandis*.

Subsection (5) of section 139 reads as follows:

> (5) For the purposes of this Act,
>
> (*a*) related persons shall be deemed not to deal with each other at arm's length; and
>
> (*b*) it is a question of fact whether persons not related to each other were at a particular time dealing with each other at arm's length.

Relationship is defined in subsection (5a) of section 139 reading in part as follows:

> (5a) For the purpose of subsection (5), (5c) and this subsection, "related persons", or persons related to each other, are
>
> (*a*) individuals connected by blood relationship, marriage or adoption;

Subsection (5c) of section 139 reads in part as follows:

> (5c) In subsection (5a), (5d) and this subsection
>
> (*a*) "related group" means a group of persons each member of which is related to every other member of the group; ...

The contention of the Minister is that Mr. and Mrs. Mayfield are a related group of persons who are deemed to have controlled the appellant by virtue of paragraph (*b*) of subsection (5d) of section 139 or alternatively that the appellant was controlled by a related group of persons

comprised of Mr. and Mrs. Mayfield because at all material times they were in a position to cause all or part of the Class B shares of the appellant to be redeemed and thereby become the majority shareholders. He contends that by virtue of paragraph (*a*) of subsection (5d) of section 139, where a related group is in a position to control a corporation, that group shall be deemed to be a related group that controls the corporation.

Section 139(5d) reads in part as follows:

> (5d) For the purpose of subsection (5a)
>
> (*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;
>
> (*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, except where the contract provided that the right is not exercisable until the death of an individual designated therein, be deemed to have had the same position in relation to the control of the corporation as if he owned the shares;

In my view paragraph (*b*) of subsection (5d) of section 139 has no application in the facts of the present appeal. Under that paragraph a person in order to be deemed to be in the same position in relation to control of a corporation as if he owned the shares, that person must have a right under a contract, in equity or otherwise (1) to the shares, (2) to acquire the shares, or (3) to control the voting rights of the shares. The only conceivable right which Mr. and Mrs. Mayfield may have had under the redeemable feature attaching to the Class B shares in the appellant would be to bring about, by corporate action, the cancellation or elimination of those shares which is a right entirely different from a right to those shares or to acquire those shares. The voting rights attaching to the Class B shares were vested in the holders thereof, namely, Mr. Fuller and Mr. Van Sant, Jr. who were strangers, in the tax sense, to Mr. and Mrs. Mayfield. There is no suggestion in the agreed statement of facts, nor was any evidence adduced to suggest, that Mr. and Mrs. Mayfield had any right by contract, in equity or otherwise to exercise any control over the voting rights of the Class B shares. The clear implication is that the voting rights of those shares were the sole prerogative of the holders thereof. Therefore none

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of the conditions precedent to a person being deemed to be in the same position in relation to control of a corporation as if he owned the shares as contemplated by paragraph (*b*) of subsection (5d) of section 139 is present here.

With respect to paragraph (*a*) of subsection (5d) of section 139, counsel for the Minister points out that immediately following the incorporation of the appellant, Mr. and Mrs. Mayfield were the only shareholders, each of whom held 500 common shares and, being the only shareholders, they became the only directors. As directors and by virtue of the authority vested in them by paragraph 9 of the Articles of Association, they caused to be issued 500 Class B shares to Mr. Fuller and 500 Class B to Mr. Van Sant, Jr. Because of the equality of votes so resulting, Mr. and Mrs. Mayfield could perpetuate themselves in the positions of directors. As directors they could issue additional shares to themselves or redeem Class B shares and so ensure control in themselves by reason of holding the preponderance of voting power. From these circumstances counsel for the Minister submits that while Mr. and Mrs. Mayfield are a related group, with equal voting power to the other shareholders, and so are not in control of the appellant, nevertheless by virtue of the authority vested in them by the Memorandum of Agreement and Articles of Association as directors, from which position they could not be ousted, they could change the balance of voting power should they so desire and accordingly they are "in a position to control" the appellant within the meaning of those words where they appear in section 139(5d)(*a*). Therefore, he contends, Mr. and Mrs. Mayfield are deemed to be a related group that controls the appellant.

After giving careful consideration to the argument of counsel for the Minister I cannot accede to the correctness of the proposition upon which his contention is based. In my view the words "in a position to control" must refer to a presently existing ability to control by voting power attached to ownership of shares, rather than being in a position to acquire or obtain such control predicated upon some future act such as the redemption of Class B shares.

Furthermore, the act of redeeming Class B shares is the act of the corporation even though that action could be instigated by Mr. and Mrs. Mayfield in their capacity as directors.

To me the language of section 139(5d)(*a*) contemplates the circumstance where a group of persons each of which is related to the other by blood relationship, marriage, adoption or otherwise as outlined in section 139(5a) is in a position to control a corporation by reason of their collective holding of a majority of the voting power in shares, even though they might be part of a larger group of persons who are also so related and who, in fact, exercise control of the corporation. Such a related group, which is part of a larger related group, being in a position to control a corporation by ownership of a majority of the voting shares, is deemed to be a related group that controls the corporation even though the members thereof do not, in fact, do so to the exclusion of others to whom they are also related.

It follows therefore that the appellant and Heiland were not associated and that the appeal with respect to the appellant's 1962 and 1963 taxation years is allowed. The matter is referred back to the Minister for reassessment accordingly. The appellant is entitled to its costs to be taxed in the usual way.