Recent Ontario Business Law Changes and Related Tax Considerations

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*(*First published by the Canadian Tax Foundation – 2007 Ontario Tax Conference (Toronto: Canadian Tax Foundation))*

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Ontario's Business Law Modernization Project has been in process for over two years. It was first announced in the 2005 Ontario Budget as an initiative to modernize Ontario's business environment. As stated in the Budget papers:[1]

> *"Modern business laws must reflect current market realities and embody high standards of investor protection and corporate governance. An updated commercial law framework would support a competitive business environment that attracts investment and ensures prosperity for the people of Ontario. … Changes will be proposed to conform Ontario's corporate and securities law and to reconcile inconsistencies and eliminate duplication. Longer term, comprehensive legislation to modernize Ontario's corporate laws to improve governance and accountability will be developed."*

Two phases of the Business Law Modernization Project have been completed to date. Phase I led to the tabling of Bill 41[2] in the Ontario Legislature and the enactment of the *Securities Transfer Act*, 2006[3] which came into force on January 1, 2007. These legislative changes are sometimes referred to below as "Bill 41". Phase II led to the tabling of Bill 152[4] in the Ontario Legislature and involved amendments to a number of corporate statutes including the *Business Corporations Act*[5] and *Personal Property Securities Act.*[6] These legislative changes are sometimes referred to below as "Bill 152". Phase III of the project is currently underway and will involve examination and updating of the statutory framework for the incorporation and governance of not-for-

profit corporations.[7] Throughout the process, the Ministry of Government Services ("MGS") has released Consultation Papers to solicit feedback and input from interested parties. Notably, the Corporate Law Subcommittee of the Ontario Bar Association has responded to each Consultation Paper.[8]

This paper will summarize certain amendments to and/or the enactment of the following statutes and comment on related income tax considerations under the Income Tax Act (Canada)[9] ("ITA"):

- *Securities Transfer Act*
- *Personal Property Security Act*
- *Execution Act*[10]
- *Business Corporations Act*
- *Partnerships Act*[11]

A. Business Corporations Act - Dematerialization

Prior to the coming into force of Bill 41 on January 1, 2007, a corporation governed by the *Business Corporations Act* ("OBCA") was required upon request of the security holder to issue a security certificate or, in the alternative, to provide a non-transferable written acknowledgment of the holder's right to obtain a certificate from the corporation.[12] Because share certificates were one item that could not be signed and delivered electronically, certificates were an impediment to the electronic closing of transactions.[13]

Section 54 of the OBCA as amended by Bill 41 now specifically states that a security issued by a corporation may be represented by a securities certificate or may be an uncertificated security. Unless otherwise provided by the Articles of the corporation, the directors of a corporation may provide by resolution that any or all classes of its shares shall be uncertificated securities. As a result of the foregoing amendment, an OBCA corporation can effectively cease issuing share certificates. This is known as dematerialization. It continues to be required that shares be in registered form[14] and an OBCA corporation continues to be required to prepare and maintain a securities register which records the name and address of persons registered as shareholders and the number and class of shares registered in each such person's name.[15] In the case of a private corporation, paper share certificates would be effectively replaced by the ledger or register maintained in the minute book. In the case of an offering corporation, the replacement may be book based entries maintained electronically by the corporation's registrar and transfer agent.

Since the security certificate is merely evidence of the share, dematerialization does not, in and of itself, have any particular income tax consequences. It is accordingly

noteworthy only so that practitioners may be aware that fewer documents may be required in connection with a share transfer, redemption or other transactional closing.

Previously, a share certificate also indicated the existence of a unanimous shareholder agreement ("USA"). The OBCA previously required that any restrictions on transfer in an USA or a reference thereto must be noted conspicuously on the securities certificate; as such restrictions were otherwise ineffective against a transferee without actual knowledge of same. This provision of the OBCA has been repealed, given that securities may now be uncertificated. The USA provisions of the OBCA have been amended so that where the certificate (if any) did not contain a reference to the USA, a purchaser for value without notice may effectively rescind the purchase transaction or demand fair value payment for the share from the transferor.[16]

Because shares may be either certificated or uncertificated, the methodology of transfer has changed. Previously, the relevant rules were found in Part VI of the OBCA which has now largely been repealed and replaced by relevant provisions of the *Securities Transfer Act* ("STA").[17]

- In the case of a certificated security, endorsement of the security certificate constitutes a transfer of the security upon the delivery of the security certificate on which the endorsement appears, or where the endorsement is on a separate document (such as a minute book form of share transfer), upon delivery of both the security certificate and such other document.[18] The foregoing is similar to the procedure and documentation which would have been used prior to securities transfer legislation.
- In the case of an uncertificated security, delivery occurs when the issuing corporation registers the transferee as the registered owner on the registration of transfer or where the previous registered owner acknowledges that it holds the uncertificated security for the purchaser.[19] The registration of the transfer by the issuing corporation requires "instruction" being a notice to the issuing corporation that directs the transfer of the security to be registered.[20]

Whether a share is a certificated security or an uncertificated security, the issuing corporation treats the registered owner (as determined by the rules relating to

registration of securities in the books of the issuing corporation) as the person entitled to vote; receive notices; receive dividends or other distributions and otherwise exercise all the rights and powers of an owner.[21] This has not changed.[22] Thus, although beneficial ownership for tax purposes of a share may be transferred without effecting same by relevant procedures through the minute book, both the OBCA and the STA clearly state that the corporation shall treat the registered owner as the effective shareholder. In the case of a private corporation, shares may be held in trust and a declaration of trust might be lodged in the minute book, but the registered owner (being in this case the bare trustee) shall be treated as the person entitled to exercise all the rights and powers of an owner. The corporation is not bound to inquire into or otherwise oversee the performance of obligations owed to other persons by the registered owner of securities.[23] The use of bare trust arrangements and transfers of beneficial ownership are unaffected by dematerialization.

B. Securities Transfer Act

Prior to the coming into force of the STA, existing Ontario commercial law relating to the transfer and pledge of shares largely depended on the existence of a share certificate and the rights flowing from delivery and possession. This was workable in the typical private company context but caused uncertainties in the case of publicly traded securities. In the latter case, often an investor's evidence of ownership was simply a trade confirmation slip and a periodic statement of account from the broker. More than one intermediary could be involved. Most trades in publicly traded securities were settled electronically through clearing houses such as The Canadian Depository for Securities Limited (known as "CDS"). The share certificate, if any, might well be in the name of its nominee. Clearing and settlement of trades between brokers who are CDS participants were managed electronically. This was sometimes referred to as a "book based" system. However, existing commercial law largely assumed paper based transactions without levels of intermediaries between the issuer corporation and the investor. The Ontario government considered it desirable that Ontario commercial laws reflect the modern securities market and this was the focus of Phase I of the Business Law Modernization Project. The new legislation provides the framework for electronic securities transactions, including through intermediaries. The Ontario statute is based on the *Uniform Securities Transfer Act*[24] ("USTA") which was developed by a Task Force of the Canadian Securities Administrators and the Uniform Law Conference of Canada. The USTA is based on Article 8 of the American Uniform Commercial Code. An interprovincial STA Working Group was formed to review the USTA on a policy basis and to draft harmonized securities transfer legislation. The Working Group had policy and legal representation from six provinces (British Columbia, Alberta, Manitoba, Ontario, Quebec and New Brunswick). To date, Ontario and Alberta have enacted securities transfer legislation. The STA has complex rules governing the rights of investors, secured parties, the issuing corporation and securities intermediaries in

relation to the transfer of securities and the ability to grant security interests therein. Similar to Article 8 of the American Uniform Commercial Code, it recognizes and defines the bundle of rights of a beneficial owner against the securities intermediary as a “security entitlement” and sets out the manner in which a secured party can perfect its security interest in a security entitlement. Although securities transfer legislation may have been designed with a view to the public markets, the statute applies equally to private companies. In the CRA Roundtable at the 2006 Annual Conference of the Canadian Tax Foundation, the CRA was asked how it might apply the new legislation in administering the ITA. The response was that the CRA was still reviewing the issue but considered that the new Ontario legislation would not affect its interpretation and application of the ITA with respect to the acquisition, holding, transfer or pledging by investors of their interest in financial assets.[25] It should be noted that the STA contains an express provision that the characterization and interpretation of a transaction therein does not affect same for purposes of any other law. Subsection 1(3) states:

> *“The characterization of a person, business or transaction for the purposes of this Act does not determine the characterization of the person, business or transaction for the purposes of any other statute, law, regulation or rule.”*

An interesting concept in this legislation is a “control agreement” which relates to the means by which a secured interest in shares is created and perfected.

To understand the concept of a “control agreement”, it is helpful to have an overview of the STA. The STA distinguishes between the “direct holding system” and the “indirect holding system” for securities.

- In the direct holding system, there is a direct relationship between the issuer corporation and the investor. This reflects the typical relationship between a private corporation and its shareholders.
- In the indirect holding system, there is an indirect relationship between the issuer corporation and the investor. In this case and as referred to above, the securities

may be held through a securities intermediary such as CDS or some other custodian or dealer.

In either system, the security may be represented by a certificate (defined as a "certificated security") or not represented by a certificate (defined as an "uncertificated security"). Bill 41 contained complementary amendments to the *Personal Property Securities Act* ("PPSA") relating to the use of securities as collateral which recognized the different holding systems.

If a shareholder grants a security interest in its shares of a corporation, the secured party will seek to perfect its security interest. Perfection is a term of art in the law of secured transactions and has been said to represent the time when the secured party has the greatest bundle of rights under the PPSA with respect to the collateral.[26] A security interest must be perfected in order to be valid and enforceable against competing security interests.[27] Given the nature of the collateral, perfection may be accomplished in one of the following three ways:

- Control of the collateral[28]
- Possession: if the security is certificated, possession of such certificated security can perfect a security interest in the direct holding system[29]
- Registration: a financing statement can be registered to perfect the security interest[30]

The priority rules[31] in the PPSA provide that "control" is paramount in prioritizing conflicting security interests in shares which are technically referred to as "investment property".[32]

For the above purpose, control does not equate to *de jure* control as used for income tax purposes. The PPSA refers back to the STA to describe control.[33] Control essentially means that the secured party has the ability to deal with the security without requiring any action on the part of the debtor. In the case of a certificated security, one means of accomplishing control is by delivery of the certificated security with an

effective endorsement in blank.[34] In the case of an uncertificated security, one means of accomplishing control is the use of a control agreement.[35] This is an agreement between the issuer corporation, secured party and the person granting the security interest (being a “debtor” for PPSA purposes) under which the issuer agrees that it will comply with instructions from the secured party without requiring any consent of the PPSA debtor. It is not mandatory that the issuer corporation agree to enter into a control agreement, even if the registered owner of securities makes such a request.[36]

A shareholder could grant a security interest in its shares of a corporation. This might be done to secure its own indebtedness or to secure the indebtedness of the corporation. If such shares are uncertificated, the secured party might request a control agreement to perfect its security interest. If the shareholder is otherwise the controlling shareholder of the issuer corporation, then on its face, it is arguable that such a control agreement may provide the secured party with *de facto* control of the issuer corporation. Depending on the identity of the secured party, this may be relevant to CCPC status and associated corporation analysis. In this regard, the saving provision in subsection 256(6), ITA may assist. Subsection 256(6) provides that where a corporation would be regarded as controlled or controlled, directly or indirectly in any manner whatever, by a person (referred to therein as the “controller”), then if the following two conditions are satisfied, the corporation (referred to therein as the “controlled corporation”) is deemed not to have been controlled by the controller at the particular time (although curiously, not deemed to not be controlled directly or indirectly in any manner whatever by the controller). The two conditions are:

(a) There is an enforceable agreement or arrangement under which “on the satisfaction of a condition or the happening of an event which it is reasonable to expect will be satisfied or will happen”, the controlled corporation will cease to be controlled, or controlled directly or indirectly in any manner whatever by the controller and be controlled, or controlled directly or indirectly in any manner whatever by a person or group of persons who deal at arm’s length with the controller.

(b) The purpose for which the controlled corporation was so controlled, or controlled directly or indirectly in any manner whatever was to safeguard interests of the controller in indebtedness owing to it.

If the security interest and control agreement are given to secure the indebtedness of the issuer corporation and it is reasonable to expect that the indebtedness will be repaid, then both of the above conditions are satisfied. If both of the conditions in subsection 256(6), ITA are satisfied, then the controlled corporation is deemed not to have been controlled by the controller at the particular time. Subsection 256(6), ITA does not provide that the controlled corporation is deemed not to have been controlled, directly or indirectly in any manner whatever by the controller at the particular time. Thus, the remedial nature of subsection 256(6) seems questionable if *de facto* control was the concern.[37] Further, if at the particular time, perhaps because of the financial circumstances of the issuer corporation, it is not reasonable to expect that its indebtedness to the secured party will be repaid, then the first of the above conditions is not satisfied. It should be noted that the above conditions must be met at a particular time, rather than only at the time the arrangement (i.e., control agreement) is entered into.[38]

Association as a result of a control agreement may occur in the following situation. If two corporations (referred to as "Corp A" and "Corp B" below) have uncertificated securities; are otherwise not related, not associated and arm's length but have the same lender and the lender has a security interest in the uncertificated securities of each of Corp A and Corp B perfected by means of a control agreement, then Corp A and Corp B may be controlled directly or indirectly by any means whatever, by the same person, i.e., the lender, unless the saving provision in subsection 256(6), ITA applies. As a result, Corp A and Corp B may be associated.[39]

From the secured party's perspective, perfection by control is always preferred. If the security is certificated, then an alternative means by which the secured party can

perfect its security interest by means of control is delivery of the certificate with endorsement in blank. This would likely be accompanied by a share pledge agreement providing that until default, the debtor (person granting the security interest) shall be entitled to remain as shareholder of record and to exercise all voting rights in respect of the share and to receive all dividends and other distributions in respect of the share. Such an arrangement does not seem to raise the same *de facto* control issues as the use of a control agreement in the case of uncertificated securities which is perhaps, one reason to continue to use share certificates.

C. Personal Property Security Act Changes

The personal property security legislation in Ontario is among the oldest in Canada. Equivalent statutes in Western Canada and Atlantic Canada are, to some degree, more uniform as a result of recent amendments. Bill 152 assists in bringing Ontario's personal property security legislation into greater conformity with the other personal property security statutes in the country. Ontario's PPSA came into effect at a time when electronic registration was not possible and paper forms of registration were used for a financing statement and financing change statement. One of the amendments made by Bill 152 is the elimination of paper registration forms.[40] Ontario had the first PPSA registry and a reflection of the age of the system and the technology then available is the method used to describe collateral. Collateral description is limited by a "check the box" system[41] which permits up to five boxes to be checked on the financing statement to classify collateral. It is intended that a narrative description of collateral should become available, apparently when the MGS' computer infrastructure is changed in approximately two years. By way of contrast, all other Canadian jurisdictions currently use a word description to describe collateral.

One notable change to the PPSA as a result of Bill 152 is an amendment to the definition of the term "debtor". As amended, a "debtor" for purposes of the PPSA need not be a person who owes payment or the performance of an obligation to a secured party. Rather, it suffices that a person who owns or has rights to collateral may constitute a "debtor" as defined to provide a security interest in collateral to a secured party. The use of the term "debtor" in the PPSA may, in this regard, seem to be a misnomer. Such person need not owe an amount under a debt obligation nor have issued a debt obligation as contemplated by section 80, ITA.

"debtor means,

(a) a person who,

(i) owes payment or other performance of the obligation secured, and

(ii) owns or has rights in the collateral, including a transferee of or successor to a debtor's interest in collateral,

(b) if the person who owes payment or other performance of the obligation secured and the person who owns or has rights in the collateral are not the same person,

(i) in a provision dealing with the obligation secured, the person who owes payment or other performance of the obligation secured,

(ii) in a provision dealing with collateral, the person who owns or has rights in the collateral, including a transferee of or successor to a debtor's interest in collateral, or

(iii) if the context permits, both the person who owes payment or other performance of the obligation secured and the person who owns or has rights in the collateral, including a transferee of or successor to a debtor's interest in collateral,"

• • •

Thus a person may grant a security interest in collateral without assuming the obligation which is being secured. Prior to the above amendment, there was a difference of opinion among lawyers whether a "debtor" under the PPSA included an owner of collateral without itself assuming any obligations under the secured obligation. Some took the position that the person had to provide a guarantee of a borrower's obligation in order to create a valid security interest in collateral.[42] As a result of the foregoing amendment, it is clear, for example, that where a corporation has borrowed monies, a shareholder may grant a security interest in respect of his/her shares of the corporation without guaranteeing the corporation's debt obligation.

For income tax purposes, the giving of a guarantee ensures that the guarantor of an obligation may have recourse to a capital loss or allowable business investment loss in respect of the borrower's failure to pay. In the classic situation where the shareholder of

a corporation guarantees the borrowing of the corporation, the following legal characterization occurs in the event of the corporation's (borrower's) failure to repay:

- Under typical terms of a guarantee
  - The shareholder (guarantor) guarantees the performance and payment to a named creditor of a debt owed by the corporation to the creditor.
  - The guarantor promises to pay the creditor those amounts as are payable by the guarantor under the guarantee upon written demand by the creditor and such written demand may be deemed conclusive evidence of the default of the corporation.
- If the corporation defaults in payment to the creditor, the creditor makes written demand to the guarantor and the guarantor is obliged to pay, subject to the limit, if any, set out in the guarantee.
- The creditor is typically not bound to exhaust its remedies against the corporation (primary debtor) before being entitled to payment from the guarantor of its liability under the guarantee.
- The guarantor has a right at equity and under the *Mercantile Law Amendment Act* to be indemnified by the corporation as the primary obligor and the right to receive an assignment of every judgment or other security held by the creditor in respect of the guaranteed debt.[43] The guarantee might also specifically provide for assignment of the creditor's rights.

For income tax purposes, because the guarantor has a right to recover from the corporation, the failure or inability to recover may result in the application of subsection 50(1), ITA. Specifically, the guarantor may establish that the debt owing to it (by virtue of the right of indemnification) has become a bad debt. In this manner, a capital loss, or possibly, an allowable business investment loss may arise.

Where the person who owns collateral and has granted the creditor a security interest in the collateral does not owe payment or has not guaranteed the payment of obligations of another, as permitted by the amended definition of "debtor" in the PPSA, the above consequences may not apply. For example, assume that a shareholder may offer

security in support of the corporation's indebtedness but has not expressly guaranteed such debt.

- Upon default of payment by the corporation, the secured party has enforcement remedies available under the security agreement of the shareholder (e.g., a share pledge or general security agreement depending on the collateral) and/or Part V of the PPSA.
- In this case, it is unclear whether the shareholder has acted as guarantor or surety[44] for the corporation. A guarantee has been described as a contractual obligation undertaken by one person (known variously as the "guarantor" or the "surety") in which he promises that a second person (known as the "principal") shall perform a contract or fulfill some other obligation, and that if the principal does not, then the surety will do it for the principal.[45] The shareholder in this example has not promised that the corporation will fulfill its obligation failing which it will do so. Rather, it has simply granted the creditor a security interest in its property with rights of enforcement if there is a default by the corporation.
- If the shareholder is not a surety or guarantor, then it has no right of indemnification against the corporation and subsections 2(1) and (2) of the *Mercantile Law Amendment Act* do not apply.

For income tax purposes, absent a guarantee, such a PPSA debtor may not have an ability to claim a loss, notwithstanding that the creditor may effectively recover the outstanding amount of the borrowing from the shareholder and the corporation may be insolvent, i.e., in circumstances where subsection 50(1), ITA would otherwise apply. Further, in this case, it is also not clear that section 79, ITA applies where the creditor seizes property from the shareholder pursuant to the enforcement remedies permitted under the PPSA. The application of section 79, ITA is dependent on a surrender of property as set out in subsection 79(2):

> *"For the purposes of this section, a property is surrendered at any time by a person to another person where the beneficial ownership of the property is acquired or reacquired at that time from the person by the other person and the acquisition or reacquisition of the property was in consequence of the person's failure to pay all or part of one or more specified amounts of debts owed by the person to the other person immediately before that time."*
>
> [*emphasis added*]

Absent a guarantee, there seems to be no debt owed by the shareholder to the secured party. Thus, although the secured party may legally enforce and claim property of the shareholder (being a PPSA debtor who has granted a security interest in property to the secured party), such property may not be acquired as a consequence of the shareholder's failure to pay a debt owed by the shareholder to the secured party.

Although the amended definition of "debtor" under the PPSA no longer requires the person owning collateral to owe payment or performance of an obligation, as a prerequisite to granting a security interest in such collateral, a guarantee may nonetheless be preferable to ensure that such PPSA debtor has a debt obligation in respect of which a loss may be claimed. Also, a lender may require such a shareholder to guarantee or give an indemnity or other payment obligation so that it may avail itself of additional rights rather than merely the enforcement remedies available under Part V of the PPSA.

D. Execution Act Changes

Certain amendments were made to the *Execution Act* which seem to facilitate the seizure of securities. Prior to these amendments, the seizure of shares required a sheriff to serve a copy of the execution and in the case of shares of a private company, the sheriff was required to offer the shares for sale to the other shareholders of the private company before offering them to the public.

Sections 14, 15 and 16 of the *Execution Act* have been amended to make it clear that:

- The sheriff may seize the interest of an execution debtor in a security by notice to the issuer and such seizure becomes effective when the issuer has a reasonable opportunity to act on such notice.
- Every seizure expressly includes all dividends, distributions and other rights to payment in respect of the security.
- If the seized security has a restriction on transfer pursuant to the terms of the share itself, a restriction imposed by the issuer or pursuant to a unanimous shareholder agreement governed by the laws of Ontario, then the sheriff is bound by the restriction.
- The sheriff or any interested person may apply to the court for assistance and the court may make any order that it considers appropriate regarding the seized share where it considers that a restriction on transfer of the share was made with intent to defeat, hinder, delay or defraud creditors or others.
- The sheriff has been expressly included in the list of persons who may bring the an application for the oppression remedy under the OBCA.

E. Business Corporations Act – Directors' Residency Requirements

Prior to the coming into force of Bill 152, the OBCA contained certain requirements regarding resident Canadian directors. Specifically, subsection 118(3), OBCA previously required that a majority of the directors of every corporation other than a "non-resident corporation" (as defined)[46] shall be resident Canadians[47] provided further that in the case of a corporation with only one or two directors, then the single director or one of the two directors was required to be a resident Canadian. Pursuant to Bill 152, subsection 118(3), OBCA was repealed and replaced with a provision which requires that at least 25% of the directors of a corporation (other than a "non-resident corporation") must be resident Canadians. Thus, there is no longer a requirement that a majority of the members of the board of directors of an OBCA corporation be resident Canadians. In the consultation process leading to the implementation of Bill 152, one of the options under consideration by the MGS[48] had been the repeal of the resident Canadian director requirement and this was also the recommendation of the Corporate Law Subcommittee of the Ontario Bar Association. It would appear that the resident Canadian requirement has some roots in the concept that this might facilitate enforcement and liability provisions against directors although the fallacy in such thinking is the lack of any financial prerequisite for persons serving as directors.

It is interesting to survey and compare the current OBCA director residency requirement versus those of the other Canadian jurisdictions. The results of this comparison are shown in the table below.

Jurisdiction	Directors' Residency Requirement
Federal	25%
Alberta	25%
Manitoba	25%
Newfoundland	25%
Saskatchewan	25%
British Columbia	None
New Brunswick	None
Nova Scotia	None
Northwest Territories	None
Nunavut	None
Prince Edward Island	None
Quebec	None
Yukon	None

Notwithstanding the requirement that at least 25% of the board of directors be resident Canadians, Bill 152 provided some flexibility by amending the quorum requirements for a meeting of directors. Prior to August 1, 2007, the OBCA provided that directors could not transact business at a meeting of directors unless a majority of the directors present were resident Canadians.[49] As a result of the amendments pursuant to Bill 152, the OBCA no longer requires a quorum of resident Canadian directors to validly constitute a meeting of directors.

Further flexibility was provided by amendment to the prerequisite for a "managing director" or a committee of directors. A substantial portion of the powers of directors can be delegated to a managing director or committee of directors, subject to a statutory list of excepted powers such as the authority to declare dividends or redeem shares.[50] Prior to August 1, 2007, the OBCA required that the managing director be a resident Canadian or in the case of a committee of directors, that a majority of the members of the committee be resident Canadians. These requirements have been deleted.[51]

It is possible that the above amendments may give raise to dual residency issues. Although at least 25% of the board of directors of an OBCA corporation shall be resident Canadians, it appears that the board of directors may effectively operate through its non-resident members. This may either derive from meetings without a quorum of resident Canadian directors; because the managing director is a non-resident; or because the committee of directors consists of non-residents. A corporation incorporated today under the OBCA is deemed to be resident for income tax purposes pursuant to subsection 250(4), ITA but its “central management and control” may be exercised by non-resident directors. Prior to August 1, 2007, the standard operating by-law of an OBCA corporation most likely contained a provision requiring a majority of resident Canadian directors to constitute a quorum; a requirement that any managing director be a resident Canadian; and a requirement that in any committee of directors, the majority of same be resident Canadians. New standard operating by-laws after August 1, 2007 likely have been amended to reflect the repeal of the foregoing statutory requirements. In circumstances where the possibility of dual residence is considered undesirable, it may be prudent to retain the former restrictions.

F. Business Corporations Act - Disclosure of Interest

Section 132, OBCA generally requires a director or officer who is in an actual or potential conflict of interest with the corporation to disclose the nature and extent of such conflicting interest to the corporation. Subsection 132(5), OBCA provides that such an interested director shall not vote in any resolution to approve the contract or transaction in question unless such contract or transaction is, *inter alia*, with an affiliate. The provision only applies to a material contract or transaction.

Bill 152 amended the conflict of interest provision so that such interested director cannot attend any part of the meeting during which the contract or transaction is discussed in addition to not being able to vote on any approving resolution. Because the foregoing could conceivably cause problems with quorum requirements, subsection 132(5.1) was added to the OBCA to provide that the remaining directors shall be deemed to constitute a quorum for purposes of voting on the resolution relating to the conflicted transaction. If all of the directors are interested so that no director may vote on the resolution relating to the particular transaction, new subsection 132(5.2) provides that the contract or transaction may be approved only by the shareholders.

In related group transactions and in particular those involving private corporations, it is not uncommon that the directors and officers of each corporation in the group be substantially intertwined. If the proposed transaction is with an affiliate as defined,[52] then the disclosure of interest rules do not apply. Where the foregoing disclosure of interest provisions apply, it seems that shareholders resolutions rather than directors resolutions may effectively become the norm in approving such transactions. For example, two corporations may not be affiliates yet be related for purposes of the ITA. They may have the same directors and officers. If one corporation proposes to transfer an asset pursuant to subsection 85(1), ITA to the other corporation in consideration of the allotment and issuance of preferred shares, there may be no disinterested directors.

Because the directors of the transferee corporation shall be in a conflict of interest, it is the shareholder or shareholders of the transferee corporation who must approve the transaction.

It should be noted that the conflict of interest provision in section 132, OBCA is drafted in the context of a directors meeting, i.e., a conflicted director cannot attend or vote at a meeting. In private corporations, written resolutions are often used in substitution for a directors meeting. The validity of same is recognized by subsection 129(1), OBCA which provides that a resolution in writing, "signed by all the directors entitled to vote on that resolution at a meeting of directors" is as valid as if it had been passed at a meeting of directors. Because a conflicted director is not entitled to vote on a particular resolution relating to the transaction or contract, the written resolution in lieu of meeting of directors approving such contract or transaction should also be signed only by the remaining directors.

The inability of the conflicted director to vote on a transaction or contract raises a practical question with respect to the first transaction of a corporation. Often, a new corporation may be incorporated for purposes of becoming the transferee corporation in a subsection 85(1) transaction. If shares will first be issued upon the transfer of assets pursuant to subsection 85(1) and if the first director named in the articles is conflicted because he or she is also a director or officer or otherwise has a material interest in the transferor corporation, he or she cannot vote on a resolution to approve the transaction pursuant to subsection 132(1). New subsection 132(5.2), OBCA provides that only the shareholders may approve such transaction but there is no shareholder yet and therefore, no one to approve the transaction. The answer to the foregoing may require the initial issuance of shares (whether the issuance of one common share or a class of nominal value voting shares to the transferor) so that a shareholder may approve the transaction. If that is not done, it appears that subsection 132(7), OBCA may be curative. This provides that such conflicted director is not accountable to the

corporation where profit or gain is realized nor is the contract void or voidable, where the particular conflicted director was present at the meeting or was included in the quorum of a meeting that authorized the transaction, provided that such director disclosed the nature and extent of his or her conflict and the contract was fair and reasonable to the corporation at the time of approval. Thus, in the case of a first director and the first transaction of the corporation with no shareholder available to approve the transaction, provided that the first director duly disclosed his/her conflict and the contract was fair and reasonable, then the effect of subsection 132(7) is that the contract so approved is not void or voidable.

G. Business Corporations Act - Director Liability and Defenses against Liability

Section 134 imposes a standard of care upon directors and officers and expressly requires that every director and officer of a corporation in exercising his or her powers and discharging his or her duties must

(a) act honestly and in good faith and with a view to the best interests of the corporation (sometimes referred to as a statutory fiduciary duty); and

(b) exercise the care, diligence and skill that a reasonably prudent person would have exercised in comparable circumstances (sometimes referred to as a statutory duty of care).

Bill 152 amended the foregoing provision of the OBCA to clarify that the statutory duty of care is owed only to the corporation. This effectively reverses *Peoples Department Store Inc. (trustee of) v. Wise*[53] where the Supreme Court of Canada held that a director of a CBCA corporation owed his statutory duty of care not only to the corporation to other stakeholders such as creditors.

Section 130, OBCA explicitly imposes joint and several liability on directors in certain circumstances including the following:

- purchasing or redeeming shares contrary to the financial solvency test in section 30, 31 or 32, OBCA
- declaring dividends contrary to the financial solvency test in section 38, OBCA
- consenting to the issuance of shares for non-cash consideration where the consideration received is less than the fair equivalent of the money that the corporation would have received if the shares had been issued for money

In the first two circumstances above, directors are liable to restore to the corporation the amount paid or distributed and not recovered by the corporation. In the third

circumstance above, directors are liable to pay the difference to the corporation, i.e., the amount by which the non-cash consideration received is less than the amount of money which the corporation would have received if the shares had been issued for money. The statute provides for a limited defense. In particular, pursuant to subsection 135(4), OBCA directors are not liable if they relied "in good faith" upon financial statements represented by an officer or in a written report of the auditor of the corporation to present fairly the financial position of the corporation in accordance with GAAP or a report of a person whose profession lends creditability to a statement, such as a lawyer, accountant, engineer, appraiser, or other person. This has been referred to as the good faith reliance defence.

Bill 152 broadened the defence provided for in subsection 135(4) into a reasonable due diligence defence, one component of which is the good faith reliance defence. This defence will apply to liability of directors under section 130 (as was the case previously) and the duty to comply with the OBCA and the corporation's constating documents under subsection 134(2). The good faith reliance component has been extended so that directors have a defence if they relied upon interim and other financial reports of the corporation rather than only the annual financial statements (as previously) and further may rely in good faith upon the report or advice of an officer or employee of the corporation where such reliance is reasonable in the circumstances (rather than only the report of a professional, as previously). Curiously, the reasonable due diligence defence will not absolve a director from breach of the statutory fiduciary duty or the statutory duty of care in subsection 134(1). This is a departure from the previous wording of the OBCA whereby the good faith reliance defence was expressly applicable to section 134 generally and therefore a defence against a claim for breach of the statutory duty of care or the statutory fiduciary duty.

The foregoing amendments largely follow amendments which were made to the *Canada Business Corporations Act*[54] ("CBCA") in 2001, except that the reasonable due diligence

defence and good faith reliance defence under the CBCA apply to the CBCA equivalent of subsection 134(1), i.e., breach of the statutory duty of care and the statutory fiduciary duty. The lack of a reasonable due diligence defense or good faith reliance defence for the foregoing may cause directors and officers to better document their decision making process in entering into aggressive tax planning transactions as reliance in good faith upon the written report of a lawyer or accountant (e.g., tax opinion) is no longer available as a defence.

H. Business Corporations Act - Definition of Beneficial Ownership

There has long been a definition of the term “beneficial interest” or “beneficial ownership” in the OBCA.[55] These terms have been defined as including “ownership through a trustee, legal representative, agent or other intermediary”. It is unclear whether “ownership through a trustee” (as referred to in the definition of “beneficial ownership”) may include the right of a beneficiary in a typical discretionary family trust used for estate planning or estate freeze purposes. If so, planners must also be mindful of the corporate law rights deriving from “beneficial ownership” as recognized under the OBCA.

The definition of “beneficial interest” or “beneficial ownership” has been broadened to include an “entitlement holder” which is not a “securities intermediary” within the meaning of the STA. As a result, the definition as expanded will include the ultimate investor but not the intermediary such as the brokerage firm.

Prior Bill 152, there were limited references to beneficial ownership in the OBCA with the result that a beneficial owner, as opposed to a registered owner, had limited statutory rights. Notably, a beneficial owner (in addition to the registered holder) was included as a “complainant” as defined in section 245, OBCA. As a result, a beneficial owner was entitled to commence a derivative action (section 246), bring an application for an oppression remedy (section 248) or apply for a compliance order (section 253). Amendments to the OBCA pursuant to Bill 152 provided additional rights for a beneficial owner including:

- A beneficial owner may submit a proposal and attend the shareholder’s meeting at which the proposal is discussed (subsection 99(1))

- A beneficial owner has the right to examine and make copies of records of the corporation (subsection 145(1))
    - A beneficial owner has a right to request a list of shareholders (subsection 146(1))
- A beneficial owner may apply for an investigation order (subsection 161(1))

Thus, a beneficial owner, including an entitlement holder, has been given a broader set of rights under the OBCA more in line with the rights of registered owners. However, it is the registered owner whom the corporation regards as the person entitled to vote; receive notices; receive dividends or other distributions and otherwise exercise all the rights and powers of an owner.[56]

There is limited jurisprudence dealing with the definition of "beneficial ownership" in the OBCA. Because the definition seems to apply to shareholder remedy provisions of the legislation, the courts have interpreted the term somewhat liberally to ensure that the remedies are given broad scope. Thus in *Czak v. Aumon*,[57] it was held that "beneficial ownership" as defined in the OBCA is not limited to the circumstance where the nominal owner has legal title to the property but the real owner can require the nominal owner to convey the property to him. Rather any person having an equitable claim to shares may qualify as a "beneficial owner" (as defined) whether or not there are shares issued and appropriated to that person but held in the name of another person.

In the context of international tax treaty interpretation, largely deriving from the UK decision in *Indofood International Finance*,[58] there has been recent attention to the expression "beneficial owner" particularly where back-to-back payments or a special-purpose vehicle is involved.[59] In Canada's bilateral treaties, the reference is typically to beneficial ownership of income (e.g., dividends), as opposed to beneficial ownership of the underlying property (e.g. shares). It is the latter to which the OBCA definition relates. Given that the OBCA expressly recognizes the registered owner as the person to whom the issuing corporation may pay dividends as opposed to a beneficial owner

and the remedial nature of the statutory provisions where beneficial ownership is recognized, this definition and its interpretation should be of limited relevance to the beneficial ownership debate resulting from *Indofood*.

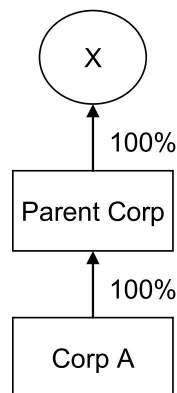
I. Business Corporations Act – Holding Body Corporate

Bill 152 amended the OBCA to permit a "subsidiary body corporate" to own shares of its parent corporation under prescribed conditions.[60] To date, no regulation has been promulgated and there are therefore no prescribed conditions. However, this gives hope for the simplification of corporate reorganizations, particularly those involving upstream transfers.

The need for the foregoing amendment derives from the prohibition in subsection 28(1), OBCA that a corporation cannot hold shares in its holding body corporate nor permit any subsidiary body corporate to hold shares of the corporation. Some practitioners have argued that such provision does not cause the issuance of shares to be void.[61] Some have also suggested that the statute implies a five year period during which the offending shares must be disposed.[62] Notwithstanding the foregoing arguments, conservatism typically led to reorganizations being planned to avoid a so-called holding body corporate problem.

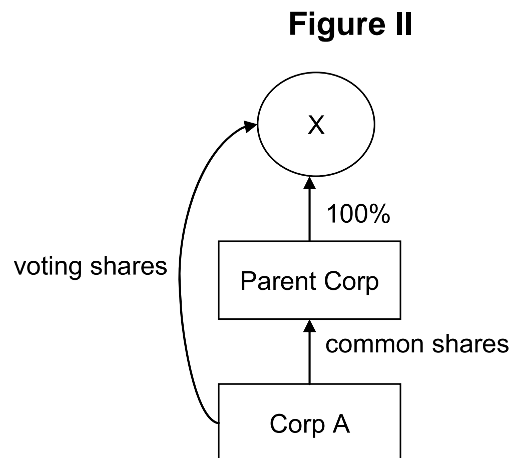
A holding body corporate problem can be encountered in a reorganization involving an upstream transfer of property. In Figure I below, Corp A cannot transfer property pursuant to section 85(1), ITA to its sole shareholder, Parent Corp in consideration of shares because Corp A is a subsidiary body corporate of Parent Corp.

Figure I



To resolve the apparent OBCA prohibition, steps might be taken to cause Corp A to cease to be a subsidiary body corporate of Parent Corp. A sufficient number of nominal voting shares of Corp A could be issued directly to X who otherwise controls Parent Corp as illustrated in Figure II below.

Figure II



As a result, if Parent Corp does not hold voting securities of Corp A carrying more than 50% of the votes for the election of directors, Corp A is not controlled by Parent Corp and not a subsidiary body corporate of Parent Corp.[63]

In the consultation process during Phase II of the Business Law Modernization Project, MGS recognized that other jurisdictions had less stringent prohibitions on the cross-ownership of shares involving a parent and a subsidiary.[64] Specifically, the CBCA permits such cross-ownership of shares in prescribed situations although the only prescribed situation involves a foreign subsidiary of a Canadian corporation which issues publicly traded shares used in a cross border takeover.[65] Also, MGS noted that the *Business Corporations Act* (Alberta)[66] permits a corporation to hold shares in itself or in its parent corporation without restriction as long as such cross ownership is

eliminated within 30 days. The amendment to the OBCA mirrors the federal approach to this issue.

Although Ontario has not prescribed any conditions under which a subsidiary body corporate may own shares of it parent, some insight might be obtained from the response of the Corporate Law Subcommittee of the Ontario Bar Association on this concept. It should be noted that while the Corporate Law Subcommittee favored the relaxing of restrictions on subsidiary ownership of shares in a parent corporation, it did not favor the 30 day window approach of Alberta corporate statute. The Corporate Law Subcommittee stressed the importance of no subsidiary holding beneficially more than 50% of the voting shares of its parent as this would otherwise cause confusion with control concepts. It suggested that the rule permitting a subsidiary to hold shares in its parent should be modeled on the existing solvency rules applicable to a corporate repurchase of shares. The Subcommittee suggested that the same solvency test should apply but on a two level basis, i.e., both in respect of the subsidiary and the parent. Thus, a subsidiary would not be permitted to acquire shares in the parent if the net realizable value of the subsidiary's assets was less than its liabilities and stated capital of all classes or if the net realizable value of the parent's assets was less than its liabilities and stated capital of all classes ranking in priority or equally with such shares. The double solvency test would also require that both subsidiary and parent be able to pay their liabilities as they became due.

Similar to the CBCA, the Ontario amendment provides for prescribed consequences if the prescribed conditions are not met.[67] The federal prescribed consequences are that the offending shares are cancelled; the consideration must be returned; and the entry in the stated capital account for such consideration upon the issuance of the offending shares must be cancelled. The foregoing does not treat the transaction as a nullity or void *ab initio* but rather, seemingly analogous to a share cancellation for consideration. Clearly, there would be tax consequences arising from such prescribed conditions. It

remains to be seen if Ontario will prescribe similar consequences when prescribing conditions to permit a subsidiary body corporate to own share of its parent.

J. Business Corporations Act – Addition to Stated Capital upon Issuance of Shares

Prior to Bill 152, the OBCA provided limited circumstances where, upon the issuance of shares, the corporation could add an amount less than the fair value of consideration received to the stated capital account maintained in respect of the particular class of shares. These circumstances were set out in subsection 24(3), OBCA being where the corporation issued shares in exchange for

- Property of a person who immediately before the exchange does not deal with the corporation at arm's length
- Shares of a corporation that immediately before the exchange or that because of the exchange does not deal with the corporation at arm's length

There are also limited circumstances relating to arrangements and amalgamations.

Subsection 24(3)[68] has been amended so that the addition to stated capital may be suppressed where a corporation issues shares to a person who immediately before the exchange was at arm's length with the corporation provided that such person, the issuing corporation and any other holders of shares of such class consent to same.

The foregoing amendment may be of assistance in a transfer of property to a corporation pursuant to subsection 85(1), ITA. Prior to such amendment, absent a non-arm's length relationship between the transferor and the transferee corporation, there might be a difference between the stated capital of shares and their paid-up capital for income tax purposes because of the inability to suppress the addition to stated capital. Regardless of the addition to stated capital, subsection 85(2.1), ITA would apply so as to effectively suppress the paid-up capital to an amount equal to the aggregate elected amount less non-share consideration. Previously, in circumstances where the

transferor acted at arm's length with the corporation, avoiding the disconnect of paid-up capital and corporate stated capital required the addition of full value consideration to stated capital upon the transfer followed by a reduction of stated capital so that the two amounts would be equal. This will no longer be necessary as the amended OBCA will permit suppression of stated capital in arm's length circumstances.

Prior to the amendment to subsection 24(3), OBCA, in the context of a proposed subsection 85(1), ITA transfer to a newly incorporated corporation, some practitioners (out of an abundance of caution) issued nominal value voting shares to the proposed transferor so as to cause such transferor (being at that point the sole shareholder) and the corporation to be related and therefore deemed non-arm's length prior to the proposed subsection 85(1), ITA transfer of property. Then in the immediately following issuance of shares in consideration for a transfer of property, it was clear that the corporation issued shares in exchange for property of a person who immediately before the exchange did not deal with the corporation at arm's length. As a result, the prior requirements of subsection 24(3), OBCA were clearly satisfied so as to permit the suppression of stated capital upon such share issuance. Other practitioners took the position that the foregoing was not necessary on the basis that the transferor and transferee corporation were factually non-arm's length given that the transferor was likely the incorporator and first director of the transferee corporation. Given the OBCA amendment, it is clear that such an initial issuance of shares is not necessary. The addition to stated capital may be suppressed upon the issuance of shares to an arm's length transferor in consideration for the transfer of property to the corporation.

It should be noted that the amendment to subsection 24(3) requires the consent of any other holders of the same class or series of shares where the transferor and transferee corporation act at arm's length. As a separate class of shares is often used for tax planning purposes, it is difficult to contemplate circumstances where other shareholders' consent might be required.

K. Business Corporations Act – Stock Dividends

Bill 152 amended the OBCA to make it clear that a so-called high-low stock dividend is permitted. Subsection 38(2), OBCA as amended reads:

> *"If shares of a corporation are issued in payment of a dividend, the corporation may add all or part of the value of those shares to the stated capital account of the corporation maintained or to be maintained for the shares of the class or series issued in payment of the dividend."*

Previously, the foregoing provision obscurely required the "declared amount of the dividend stated as an amount of money" to be added to stated capital.

> *"If shares of a corporation are issued in payment of a dividend, the corporation shall add to the stated capital account maintained or to be maintained for the shares of the class or series issued in payment of the dividend the declared amount of the dividend stated as an amount of money."*

Over the years, there has been sporadic debate and commentary on whether the above provision (before the current amendment) permitted a high-low stock dividend.[69] MGS recognized the debate in its consultation document:[70]

> *"There has been some confusion as to the amount that must be added to the stated capital account upon issuance of stock dividends. Section 38(2) does not expressly require that the "declared amount" of the stock dividend required to be added to the stated capital account bear any relation to the shares' fair market value. It is also uncertain whether sections 23(3) and 24(2) (which require that a corporation add the full amount of consideration it receives for shares to the stated capital account for that class or series of shares) apply in the case of a stock dividend since it is not clear whether or not a company is considered to have received consideration for shares issued as stock dividends.*
>
> *As a result of ambiguity in the OBCA, there has been debate on whether or not a corporation is permitted to issue "hi-low" stock dividends (i.e. shares having a high fair market value and low stated capital) often useful for tax planning purposes."*

The debate should now be regarded as settled.

L. Business Corporations Act – Classes of Shares with Identical Attributes

There has long been a debate whether one can create separate classes of shares if such shares have identical attributes but simply different designations or names. Legal texts have taken different positions:

> *"The standard way of achieving share differentiation is to provide in the corporate constitution for the issue of shares of various classes."*[71]

> *"When a corporation has more than one class of share, each class constitutes a distinct subdivision within the total share capital of the corporation. The shares belonging to each class may, but need not, have rights, terms, conditions and restrictions attached to them that distinguish them from the shares belonging to other classes."*[72]

The need or desire for separate classes might be relevant in situations such as the following:

- A private corporation has multiple family members as shareholders. Although their equity interests and voting rights might otherwise be equal, it may be desirable to have the flexibility to pay dividends to certain shareholders but not to others. It seems that this may be achieved if each family member shareholder holds shares of a different class but with identical attributes.
- A private corporation has both Canadian resident shareholders and non-resident shareholders. Although the rights of the resident and non-resident shareholders might otherwise be equal, both in terms of equity and voting rights, it seems that if the resident shareholders hold shares of a different class than the non-resident shareholders, a capital dividend may be declared to the resident shareholders while declaring a taxable dividend to the non-resident shareholders.
- Subsection 86(1), ITA requires that the taxpayer dispose of capital property that was all the shares of any particular class owned by the taxpayer at the particular time in the course of a reorganization of the capital of a corporation. Subsection 86(1) may be relied upon in connection with a "spin-out" reorganization pursuant to paragraph 55(3)(a), ITA. For example, assume that Corp A is an operating business but also owns land. Mr. X is the sole shareholder of Corp A holding

100 common shares. It may be considered desirable to transfer the land to a sister corporation pursuant to a paragraph 55(3)(a) reorganization. Implementation of the reorganization may involve utilizing subsection 86(1), ITA to effectively "carve out" shares to be held by Mr. X whose value represents the fair market value of the land to be transferred to the sister corporation. Thus, Articles of Amendment may be filed to change the 100 common shares into redeemable and retractable Class A preferred shares (with an aggregate redemption/retraction amount equal to the fair market value of the land) and 100 equity shares (whose value represents the balance of the value of the "old" common shares). Because subsection 86(1), ITA requires that a taxpayer dispose of all of his shares of a class, Mr. X must dispose of all of his common shares. Mr. X cannot retain any shares of the same class.[73] As described above, Mr. X disposed of his common shares in exchange for Class A preferred shares and equity shares, therefore to comply with subsection 86(1), the equity shares must constitute shares of a different class than the common shares. However, for valuation and commercial reasons, these shares must be substantially identical to common shares.

- A partial estate freeze in respect of Mr. X's shares of Corp A may be implemented pursuant to subsection 86(1), ITA. Mr. X may wish to continue to benefit from a certain percentage, say, 25%, of the future growth in the value of Corp A with the balance (75%) of the benefit of future growth in value to accrue to the benefit of a child. By Articles of Amendment, the 100 common shares may be changed into redeemable and retractable Class A preferred shares with the typical attributes used in an estate freeze. The concept of a partial estate freeze mandates "common" shares to thereafter be issued to Mr. X and the child in stipulated proportions. However, as described above, subsection 86(1), ITA requires that Mr. X have disposed of all of his common shares. Thus, the Articles of Amendment may create a new class of shares (designated as equity shares) with attributes substantially similar to common shares.

Although effective implementation of the above seems to require different classes of shares to be held by the shareholder(s) in question, there is often no desire to create substantive differences in commercial rights. For example, although the flexibility to pay dividends to different shareholders may be desirable, those shareholders might otherwise be equal. Because of the apparent requirement for separate classes of shares while wishing to retain "common-like" attributes, a practice has developed of creating "common-like" shares with somewhat nominal differences, each with a different

class designation.[74] Examples of such differences that which the writer has seen include:

- Multiple voting (provided that this does not affect the relative voting rights among groups of shareholders)
- Variations relating to the statutory right for a separate class vote as permitted in subsection 170(1), OBCA in respect of the following rights:
    - Paragraph 170(1)(a): increasing or decreasing the maximum number of authorized shares of a class having privileges equal or superior to the particular class
    - Paragraph 170(1)(b): effecting an exchange, reclassification or cancellation of the shares of the particular class
    - Paragraph 170(1)(e): creating a new class of shares equal or superior to the particular class
- Ability to elect stock dividends
- Becoming multiple voting in the event that dividends (perhaps of a certain quantum) are not declared and/or paid within a stimulated period
- Limited preferences (e.g., the first $100) upon liquidation (subject to possible taxable preferred share considerations)

In its consultation process, MGS recognized the concern of whether separate classes of shares could truly be created where they had identical rights and referred to the "artificial differences" to which corporate law practitioners have resorted.[75] In response to the above, subsection 22(7) was added to the OBCA as follows:

> *"The articles may provide that two or more classes of shares or two or more series within a class of shares may have the same rights, privileges, restrictions and conditions."*

The language of subsection 22(7), OBCA seems clear on its face. However, there continues to be discussion on this point.

At the CRA Roundtable session from the 2007 STEP National Conference, the following question was asked regarding the above amendment:[76]

"Ontario has recently passed amendments to many of its corporate and commercial statutes (see Bill 152). Included in this Bill are many amendments to the Ontario Business Corporations Act. One in particular affects the nature of shares.

Amendments are pending to section 22 (the effective date of most of these changes is August 1, 2007). A new subsection 22(7) will provide:

"The articles may provide that two or more classes of shares or two or more series within a class of shares may have the same rights, privileges, restrictions and conditions."

The government consultation document accompanying the bill stated that the rationale for this change was to eliminate the need to create artificial distinctions between different classes of shares to ensure that the different share classes are not disregarded.

The concept of distinguishing classes of shares has been considered several times in Canadian tax courts. The judicial consensus (shared by most practitioners) seems to be that there must be some difference between the terms and conditions of different classes or series of shares to establish their distinctiveness. See for instance, the FCTD decision in Champ 83 DTC 5029; [1983] CTC 1; McClurg and Neuman.

How will CRA now interpret subsection 56(2) and similar provisions? It would appear that these OBCA amendments statutorily overrule the decision in Champ. Will CRA accept that shares can be different just by giving them different names?

CRA Response:

The pending amendment contained in new subsection 22(7) would appear to sanction, to the extent not already regarded as valid, the creation of separate classes of shares that each have the same rights, privileges, restrictions and conditions, including the right to have dividends declared on one particular class of such shares to the exclusion of one or more other class(es) of shares. Such a feature attaching to a number of classes of shares has been considered by our courts on past occasions in connection with the taxation of a disproportionate

amount of dividends declared in favour of the holders of one such class of shares.

Consistent with the Supreme Court of Canada's decision in Neuman v. The Queen (98 DTC 6297 (SCC)), paragraph 9 of Interpretation Bulletin IT-335R2 provides as follows:

Absent a sham, subterfuge or an artificial transaction and provided that proper consideration was given for the shares when issued, subsection 56(2) does not generally apply to dividend income since, until a dividend is declared, the profits belong to the corporation as retained earnings. However, subsection 56(2) may be applicable where dividends are paid to shareholders of a corporation who, having regard to the dividend entitlements of their shares as set out in the articles of incorporation, receive dividends to which they are not entitled and/or where another taxpayer has a pre-existing entitlement to the dividend income paid to shareholders of a corporation.

Whether a taxpayer has a pre-existing entitlement to a dividend can only be determined on a review of all of the relevant circumstances of a particular situation. This determination will not turn solely on whether the shares in question are of one class or more than one class. For example, it is our view that the pending amendment would not alter the decision in Champ (supra) which applied subsection 56(2) in the situation where dividends were only declared on one class of shares even though other classes of shares were entitled to share in those dividends proportionately.

The resolution of other income tax issues that may be affected by the recognition of more than one class of shares that have identical rights, privileges, restrictions and conditions (e.g., calculations of adjusted cost base or paid-up capital) will also depend on the facts and circumstances of the particular situation, including the interpretation that may be given to the pending amendment by a court of competent jurisdiction. In this context, it is generally accepted that "tax law embraces corporate law principles unless such principles are specifically set aside by the taxing statute" (Iacobucci J, in Neuman v. The Queen, supra, at 6304)."

In order to analyze the CRA response above, it is instructive to review the Federal Court-Trial Division decision in *Champ v. The Queen*[77] and the Supreme Court of Canada decision in *McClurg v. MNR.*[78] Both cases involved a reassessment on the basis of subsection 56(2), ITA and consideration of the attributes of shares owned by

various shareholders. The related corporate law issues were discussed at considerable length in *McClurg*.

In *Champ*, there were shares designated as Class "A" voting common shares, Class "A" non-voting common shares, Class "B" voting common shares and Class "B" non-voting common shares. Based upon the limited description in the judgment, it appears that the attributes of the Class "A" and Class "B" voting common shares were identical as were the attributes of the Class "A" and Class "B" non-voting common shares. The dividend rights of the shares are somewhat difficult to discern. The original memorandum of association and the articles of association dated April 10, 1953 contained somewhat generic wording relating to dividends as follows, apparently applicable to all shares (although the above shares were subsequently authorized):

> *"subject to the rights of persons (if any) entitled to shares with special rights as to dividends, all dividends shall be declared and paid according to the amounts paid on the shares; but, if and so long as nothing is paid up on any of the shares in the Company, dividends may be declared and paid according to the amounts of the shares, or, in the case of shares without nominal or par value, the number of shares held."*

The memorandum of association of the company was amended in the 1960's to create the particular Class "A" and Class "B" voting common shares and Class "A" and Class "B" non-voting common shares. The following provision was included in the description of the rights of such shares:

> *"Except with respect to the rights hereinbefore set forth, all classes of shares and the holders thereof shall rank equally as to participation in the capital of the company and may receive such dividends as are declared in respect of their shares, in accordance with the provisions of the articles of association of the company."*

The Federal Court-Trial Division expressly found that the provisions in the original memorandum of association and articles of association applied to the then newly issued

shares. It was by reference to the original terms relating to dividends that the Court found that dividends could not be declared "selectively":[79]

> *"A director of a company, in his discretion, may declare dividends, but cannot do so selectively when the articles of association specifically state:*
>
> > *Dividends may be declared and paid accordingly to the amounts of the shares, or, in the case of shares without nominal or par value, to the number of shares held."*

Having found that the terms and conditions of the shares did not permit the directors of the corporation to declare dividends "selectively" (presumably meaning to differentiate amongst shares although there is no reference to concept of a class of shares), it is unclear why the Court then proceeded in two paragraphs to quote references from two legal texts which have since caused practitioners to focus on distinctive rights as a differentiation between share classes. In particular, *Palmer's Company Law*[80] as follows was cited in *Champ*:

> *"Prima facie the rights carried by the shares rank pari passu, i.e. the shareholders participate in the benefits of membership equally. It is only when a company divides its share capital into different classes with different rights attached to them that the prima facie presumption of equality of shares may be displaced."*

The judgment in *Champ* did not cite the next paragraph from *Palmer's Company Law*, to which there was a footnote comment that there may be different classes of shares although the shares carry the same rights.[81]

> *Speaking generally, a separate class of shares is constituted when the principal rights carried by the shares differ from those carried by other shares; e.g. some shares carry preferential or deferred rights as to dividend or capital, or more votes than other shares. But differentiation between other rights may suffice to create a different class of shares."*

Champ might be viewed as a case involving apparently multiple classes of shares, differently named but all having the same attributes including with respect to dividends.

Because of the above-reproduced excerpt from *Palmer's Company Law*, the lesson learned seemed to be – different classes, different rights.

In contrast, in *McClurg*, the terms and conditions of the three classes of shares as set out in the Articles of Incorporation expressly stated, in the description of each class, that the particular class had the right to receive dividends exclusive of the other classes of shares. In addition, the Class A Common, Class B Common and Class C Preferred could have been distinguished on the basis of other substantive rights:

	Class A Common	Class B Common	Class C Preferred
Voting	✓		
Participating	✓		
Participating only with unanimous directors' consent		✓	
Right to receive dividends exclusive of other classes	✓	✓	
Right to receive dividends exclusive of other classes only with unanimous directors' consent			✓

While one might argue that the requirement of unanimous directors' consent is an example of the "artificial differences" to which the MGS consultation document referred, if that is eliminated, it still seems evident that the Class A Common, Class B Common and Class C Preferred shares in *McClurg* had distinctive rights, which surely should suffice to constitute each as a separate class of shares. The below table eliminates this "artificial difference".

	Class A Common	Class B Common	Class C Preferred
Voting	✓		
Participating	✓	✓	
Right to receive dividends exclusive of other classes	✓	✓	✓

Dickson, C.J. speaking for the majority of the Supreme Court of Canada noted the common law presumption of equality amongst shares and held that in the particular factual circumstances, the presumption of equality with respect to dividends had been expressly rebutted. A "class", it was noted, was not a technical term but rather, served merely as the means by which shares could be treated differently.[82] The majority held that a provision which permits the right to receive dividends exclusive of other classes of shares was a sufficient difference between the shares to rebut the presumption of equality. As stated previously, the classes of shares in *McClurg* did, in any event, have other differences, such as differences between voting and participation rights. Ignoring the "artificial difference" of unanimous directors' consent with respect to the Class C Preferred shares, the identically worded provision in all three share classes was that each class had the right to receive dividends to the exclusion of other classes. Thus, in *McClurg*, the presumption of equality in issue was the presumption of equality with respect to dividend entitlement, not with respect to other share rights.

The presumption of equality derives from the nature of a share. A share is commonly referred to as a "bundle of rights". The share represents the holder's right to participate in voting, division of capital and participation in income. Because a share represents rights, the presumption of equality must apply to each right within the bundle. Although

writers may state that the presumption of equality is rebutted by dividing shares into classes with different rights,[83] it appears that it is the differentiation with respect to a specific right which rebuts the presumption of equality for that particular right as opposed to the fact of a separate class of shares. This is illustrated by the majority reasoning in *McClurg*. In *McClurg*, as described above, the three classes of shares had distinctive rights with respect to voting and participation yet these differences did not factor in the majority's reasoning and the separation into classes by virtue of these rights also did not factor in the reasoning. Rather, the majority focused on one right within the bundle comprising each of the Class A Common, Class B Common and Class C Preferred shares, being the right to receive dividends and found that the presumption of equality had been rebutted with respect to this right. As stated by one writer:[84]

> *"A couple of things seem perfectly clear after all this. One is that the rights in a particular area, dividends for example, are the same for all classes if the corporate constitution does not differentiate among them in that area. It is equally clear that if the corporate constitution explicitly and exhaustively sets out the rights of any particular class, that explicit and exhaustive statement of rights will be applied."*

It is submitted that because it is the presumption of equality that must be rebutted, the revealing distinction between the terms and conditions of the share classes in *McClurg* versus those in *Champ* was that the latter were silent on the ability to declare dividends on any one particular class of shares to the exclusion of any other class of shares. Absent such an express statement, there is a presumption as a matter of corporate law that the right to receive dividends is a right shared equally among all shares of the corporation, regardless of class. The other shares may clearly be shares of a different class with different voting rights (as in *McClurg*), but the relative rights of the two classes must be clear.

In this light, it may be seen that new subsection 22(7), OBCA is helpful but not a panacea to tax issues arising from share rights. It is submitted that where the particular

tax planning requires a separate class of shares, subsection 22(7), OBCA permits the planning and implementation to proceed using two or more classes with identical rights. However, the fact that two classes of shares exist is not determinative in and of itself with respect to the relative priorities or preferences between the two classes, such as dividend rights. The above is borne out by the following analysis applying subsection 22(7), OBCA to the typical planning situations outlined at the beginning of this section.

Two of the planning situations outlined at the beginning of this section related to the desire to pay dividends to certain shareholders but not others, while maintaining the same commercial rights *inter se*. In this case, it is submitted that subsection 22(7), OBCA does not, in and of itself, resolve the potential subsection 56(2), ITA issue. It is clear that unless otherwise provided in the Articles of Incorporation or by statute, the right of shareholders to receive dividends is presumed to be equal. Thus, although subsection 22(7), OBCA expressly states that two classes of shares may have identical rights, it is submitted that it is the relative rights between the classes which must nonetheless be expressly addressed as otherwise the presumption of equality will not have been rebutted. For example, if it is considered desirable to have Class A common shares and Class B common shares with otherwise identical attributes so that one may declare dividends on the Class A common shares but not on the Class B common shares, it is submitted that as in *McClurg*, the terms and conditions of each of the Class A common shares and Class B common shares must state that the particular class has the right to receive dividends exclusive of the other class. If so, then the presumption of equality has been rebutted. The other class of shares should not be considered to have any pre-existing entitlement and on the basis of *McClurg*, subsection 56(2), ITA should not apply. If there is no such express statement in the terms and conditions of such shares, while they may constitute two classes of shares pursuant to subsection 22(7), OBCA, the common law presumption of equality may require dividends to be declared and paid equally on both classes.

The third and fourth planning situations outlined at the beginning of this section related to a subsection 86(1) reorganization where existing common shares are exchanged for a certain number of preferred shares and equity shares (whether in connection with a "spin-out" reorganization or a partial estate freeze). In these situations, it is submitted that the equity shares may have identical attributes as the common shares on the basis of subsection 22(7), OBCA. This is not a case where the common law presumption of equality relating to share rights is in issue. Rather, it is the technical requirements of subsection 86(1), ITA which must be met and that requires the taxpayer to dispose of all of his shares of a particular class. Upon the exchange of the common shares (whether by contract or by Articles of Amendment), the taxpayer's common shares are disposed of and the taxpayer receives therefor, preferred shares and equity shares. The effect of subsection 22(7), OBCA is that the common shares and equity shares are shares of two different classes, notwithstanding that they have identical attributes. On this basis, it should suffice to create the equity shares with identical attributes as the "old" common shares, but with a different designation. Because the equity shares are a different class, as the taxpayer will have disposed of all of his/her common shares, he/she will necessarily have disposed of all of his/her shares of that class. As an aside however, if both common shares and equity shares are issued and outstanding at the same time and a dividend is declared, because the common law presumption of equality will not have been rebutted, then the result in *Champ* should obtain as new subsection 22(7), OBCA does not assist.

It is trite to state that paid-up capital is computed on a class basis. Similarly, under the OBCA, a stated capital account is maintained in respect of each class of shares.[85] Therefore, as subsection 22(7), OBCA provides that two classes of shares may have identical attributes, this should result in a separate stated capital account for each class of shares. As paid-up capital is similarly computed on a class basis, the paid-up capital

of two classes of shares with identical attributes should also be computed for each class.[86]

M. Partnerships Act – Full Shield Limited Liability Partnership

Bill 152 amended the *Partnerships Act* (“PA”) to permit a “full shield” limited liability partnership (“LLP”).[87] Prior to such amendment, the liability protection of a partner in an LLP was “partial shield”.

- Such a partner was not liable in respect of a negligent act or omission committed by another partner or employee of the partnership in the course of the partnership business.
- There was no liability protection for the partner’s own negligence or that of persons under his/her direct supervision or control.
- There was no liability protection for the general debts or obligations of the partnership.

Subsection 10(2), PA was amended to provide that:

- A partner in an LLP is not liable for the general debts or obligations of the partnership.
- A partner in an LLP will continue to be liable for the negligent acts or omissions of a person under his/her direct supervision, but not for those of a person under the partner’s “control”.
- A partner will be liable for the negligent or wrongful act or omission of another partner or an employee who is not under the partner’s direct supervision if such act or omission was criminal or constituted fraud; or if the partner knew or ought to have known of the act or omission and did not take the steps that a reasonable person would have taken to prevent it.[88]
- The “full shield” amendment does not protect the partner’s interest in the partnership property from claims against the partnership respecting a partnership obligation.[89]

Because of the full shield amendment, a partner of a limited liability partnership now constitutes a “limited partner” for purposes of the “negative ACB” rules in subsection 40(3.1), ITA and the at-risk rules in subsection 96(2.2), ITA. Notwithstanding that a

partner of an Ontario LLP is not a limited partner under the *Limited Partnerships Act,*[90] the definitional parameters for a "limited partner" in paragraph 40(3.1)(a) and paragraph 96(2.4)(a), ITA are broader. Specifically, paragraph 40(3.1)(a), ITA refers to the circumstance where:

> *"by operation of any law governing the partnership arrangement, the liability of the member of the partnership is limited (except by operation of a provision of a statute of Canada or province that limits the member's liability only for debts, obligations and liabilities of the partnership, or any member of the partnership, arising from the negligent acts or omissions or misconduct that another representative of the partnership commits in the course of the partnership business while the partnership is a limited liability partnership)"*

The wording of paragraph 96(2.4)(a), ITA is identical. It is clear that a partial shield LLP is expressly carved out of the above definition (see the words in parentheses) but there is currently no exclusion in respect of a full shield LLP. The above issue was raised with the Department of Finance in 2003 which stated:[91]

> *"From a tax policy perspective … we see no basis for distinguishing between the income tax treatment accorded to a partner of a full shield professional LLP and that accorded a limited partner of another partnership."*

This gives little hope of any legislative amendment.

Because a partner in a full shield LLP constitutes a "limited partner" for purposes of the negative ACB rule in subsection 40(3.1), ITA, where the adjusted cost base of the partner's partnership interest is negative at fiscal year end, there is deemed to be a gain from the disposition of the interest equal to the amount determined under subsection 40(3.11), ITA. This is generally equal to the negative balance. The deemed gain is added back to the ACB of the partnership interest pursuant to subparagraph 53(1)(e)(vi), ITA which has the effect of bringing the ACB back to zero. The problem (which has been highlighted by other writers)[92] is that a partner's share of the income of the partnership is added to the ACB of his/her partnership interest after the end of the

partnership's fiscal period pursuant to subparagraph 53(1)(e)(i), ITA.[93] However, pursuant to subparagraph 53(2)(c)(v), ITA, distributions and draws during the fiscal period are subtracted in the computation of the partner's ACB. The mismatch in the addition to ACB creates a timing issue and a possible negative ACB problem for partners of a full shield LLP. The foregoing may not be a problem for every partner, but requires monitoring of ACB. For many equity partners of a full shield LLP, the ACB of his/her partnership interest may increase year over year simply because income exceeds the distributable cash. There may be an issue for newer partners who have not made any substantial capital contribution and whose partnership interest ACB has not simply increased over time because of undistributed income. Similarly, there may be an issue for partners who have withdrawn substantial capital as might be permitted in some partnerships for those individuals nearing retirement. The Department of Finance has indicated that it will recommend a change to subsection 40(3.1), ITA to provide that the ACB of a full shield professional LLP be adjusted at the end of the fiscal period of the LLP to reflect income or loss allocations at that time.[94] Assuming that such an amendment is made, this may resolve the negative ACB issue. It should be noted that no draft amendment has been released to date.

When the above timing issue with respect to calculation of the ACB of a partnership interest was confirmed by the CRA in 1995,[95] it was suggested that the advances rather than draws might be made to partners during the partnership fiscal year and after year end, (i.e., after the partner's share of income of the year just ended was added to the ACB of his/her partnership interest), a draw could be made which would be set-off against the advances of the preceding year.[96] The foregoing steps would likely be repeated year after year. While the foregoing merits consideration (in the absence of the legislative amendment indicated by the Department of Finance), it is submitted that the characterization of such advances is not clear. The amount cannot be received as, on account or in lieu of payment of, or in satisfaction of, a distribution of the partner's

share of the partnership profits or partnership capital because such an amount is deducted in the computation of the ACB of the partnership interest pursuant to subparagraph 53(2)(c)(v), ITA. However, there is some question whether there can be a debt as between partnership and partner, i.e., whether a partnership can make a loan to a partner. Presumably, an advance is a loan without terms of repayment. In *FCMI Financial Corp. v. Minister Finance (Ontario)*,[97] a case dealing with Ontario capital tax, the Ontario Court of Appeal did not distinguish between an advance or a loan:

> *"An advance or loan connotes a commercial transaction where value is transferred in exchange for a debt. The parties to the transaction intend to create and do create a debtor/creditor relationship."*

With respect to debt as between the partnership and a partner, *Lindley and Banks on Partnership*,[98] the leading British text on partnership law, makes the following statement:

> *" … a feature which is peculiar to the English law of partnership and which, in turn, distinguishes it from the laws of Scotland and other EU countries, i.e., a refusal to recognize the firm as an entity separate and distinct from the partners who compose it. Notwithstanding a number of inroads in recent years, this feature remains as central to the law of partnership as it was in Lord Lindley's day. Thus, as no one can owe money to himself, it was held (and would still be held today) that no debt could exist between any member of a firm and the firm itself and, whilst the courts of equity would, in winding up the affairs of a firm, treat it as the debtor or creditor of its members (as the case might be), this was only for book-keeping purposes, so as to enable accounts to be settled between the partners."*
>
> *[emphasis added]*

A Canadian text, *A Practical Guide to Canadian Partnership Law*,[99] makes a similar statement:

> *" … a partnership is not an artificial person distinct from the members composing it, although a partner is essentially treated as such by universal trade practice and by law in some jurisdictions. … a partner can be the debtor or the creditor of the co-partners but cannot be a debtor or creditor of a partnership of which he is a member."*

While a partnership is regarded as a separate person resident in Canada for purposes of computation of income,[100] it is the common law tradition (as espoused above) that a partnership is an aggregation of persons rather than an entity which seems to call into question the ability to lend to a partner. However, the PA does refer to advances from a partner to the partnership, as distinguished from capital contributed by a partner to the partnership.

Section 24, PA provides rules governing the interests of partners in partnership property and their rights and duties in relation to the partnership, subject to any agreement among the partners. Rule 3 refers to advances and capital:

> 3. *"A partner making, for the purpose of the partnership, any actual payment or advance beyond the amount of capital that he or she has agreed to subscribe is entitled to interest at the rate of 5 per cent per annum from the date of the payment or advance."*

Section 44, PA deals with the settling of accounts between the partners after a dissolution of the partnership and contemplates in rule 2(b) therein, a payment for advances as opposed to capital.

> 2. *"The assets of the firm, including the sums, if any, contributed by the partners to make up losses or deficiencies of capital, are to be applied in the following manner and order,*
>
> (a) *in paying the debts and liabilities of the firm to persons who are not partners therein;*
>
> (b) *in paying to each partner rateably what is due from the firm to him or her for advances as distinguished from capital;*
>
> (c) *in paying to each partner rateably what is due from the firm to him or her in respect of capital."*

There is no reference in the statute to the converse, i.e., advances from the partnership to a partner. If there can be payments from the partner to the partnership which are not in the nature of capital contributions, it may be argued that just as there may be payments received by the partner which are not on account of capital, perhaps

payments may be received by the partner from the partnership which are not on account of partnership profits. These would be outside subparagraph 53(2)(c)(v), ITA. While the above seems to support the concept of an advance at least from a partner to the partnership (notwithstanding the common law tradition gleaned from the texts referred to above), query whether a year over year system of “advances” followed by a clearing draw might nonetheless be considered to be amounts received in lieu of payment of a share of profits. This raises doubts about the use of advances to address the potential negative ACB issue pending legislative amendment to subsection 40(3.1), ITA.

A partner in a full shield LLP is a limited partner for purposes of the at-risk rules in subsections 96(2.1) – (2.7), ITA. In general terms, such rules limit the amount of losses which may be deducted by a limited partner to the “at-risk amount”. The “at-risk amount” is calculated in subsection 96(2.2), ITA and is largely measured by the ACB of the partner’s partnership interest. Any loss of the partnership which is not deductible by the limited partner in the year as a result of the foregoing restriction is deemed to be a “limited partnership loss” which may be deducted in subsequent years from income of that partnership pursuant to paragraph 111(1)(e), ITA. The above may be of academic interest only.

Because of the full shield amendment, a partner of an LLP is no longer jointly and severally liable for the debts of the partnership. The LLP likely has an operating line of credit or term loans taken to fund certain expenditures of the business, but absent a guarantee having been given by the partner, he/she is not jointly and severally liable in respect of same. As a result, the principal amount of all such indebtedness of an LLP constitutes a “limited-recourse amount” pursuant to subsection 143.2(8), ITA:

> *“For the purpose of this section, the unpaid principal of an indebtedness is deemed to be a limited-recourse amount of a taxpayer where the taxpayer is a partnership and recourse against any member of the partnership in respect of the*

indebtedness is limited, either immediately or in the future and either absolutely or contingently."

The above definition is relevant for the tax shelter investment rules. In general terms, in the case of a partnership, the consequence of the tax shelter investment rules pursuant to subsection 143.2(6), ITA is that the amount of an expenditure is reduced by the limited-recourse amounts that can reasonably be considered to relate to the expenditure. However, a prerequisite to the application of these rules is that there must be a "tax shelter investment" as defined in subsection 143.2(1), ITA.

The definition of "tax shelter investment" is rather convoluted as it applies to a partnership and in turn, ties into the definition of a "tax shelter" in subsection 237.1(1), ITA. Both definitions are broadly worded. If a taxpayer's interest in a particular partnership constitutes a "tax shelter", then it is a "tax shelter investment" to that taxpayer. This derives from paragraph (a) of the definition of "tax shelter investment". However, the consequence of the foregoing is that any other person's interest in that partnership is also a 'tax shelter investment" because of subparagraph (b)(ii) of the definition of "tax shelter investment". Relevant portions of the definition are reproduced below.

"tax shelter investment means
(c) *a property that is a tax shelter for the purpose of subsection 237.1(1), or*
(d) *a taxpayer's interest in a partnership where …*
(ii) another interest in the partnership is a tax shelter investment"

Given the manner in which the above definition and prerequisites are presented, the question is whether a partner's interest in a full shield LLP is a "tax shelter". This surely seems unlikely since presumably there are no losses or other amounts represented to be deductible in respect of the partnership interest, but rather representations regarding income. On this basis, the above analysis is academic but a curious thought process because of the full shield amendment.

N. Concluding Comments

This paper has summarized a number of corporate law statutory amendments from Ontario's Business Law Modernization Project. Some amendments, such as subsection 22(7), OBCA which statutorily permits two classes of shares with identical attributes and subsection 38(2), OBCA relating to stock dividends, have direct relevance to tax planning and were clearly aimed at addressing longstanding issues. Other amendments, notably the full shield LLP amendment to the PA, are clearly of direct relevance to partners of professional service firms because such partners have become "limited partners" for certain purposes of the ITA.

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[1] 2005 Ontario Budget Papers, Paper B, page 16.

[2] Tabled in the Legislature as Bill 41, *Securities Transfer Act* on December 1, 2005.

[3] S.O. 2006, c.8.

[4] Tabled in the Legislature as Bill 152, *Ministry of Government Services Consumer Protection and Service Modernization Act*, 2006 on October 19, 2006.

[5] R.S.O 1990, c.B.16, as amended.

[6] R.S.O 1990, c.P.10, as amended.

[7] Presently governed by the *Corporations Act*, R.S.O. 1990, c.C.38.

[8] Available on the website of the Ontario Bar Association, Business Law Section www.oba.org/en/bus/bus_en/submissions.aspx

[9] R.S.C. 1985, c.1 (5th Supp.), as amended.

[10] R.S.O. 1990, c.E.24, as amended.

[11] R.S.O. 1990, c.P.5, as amended.

[12] Subsection 54, OBCA previously read:
"(1) Every security holder is entitled upon request to a security certificate in respect of the securities held by the security holder that complies with this Act or to a non-transferable written acknowledgement of the security holder's right to obtain a security certificate from a corporation in respect of the securities of the corporation held by the security holder, but the corporation is not bound to issue

> more than one security certificate in respect of a security or securities held jointly by several persons, and delivery of a security certificate to one of several joint security holders is sufficient delivery to all."

[13] The Ministry of Government Services News Release (December 1, 2005) released upon introduction of Bill 41 stated:

> "The *Securities Transfer Act*, if passed, would bring Ontario up to date with current business realities by giving the same kind of legal certainty to securities transferred electronically as those that are transferred by physically moving paper certificates."

[14] See section 22, OBCA. There is no longer a definition for the term "registered form" in the OBCA. The definition previously found in the OBCA has largely been replicated in subsection 1(1), *Securities Transfer Act* but with respect to a certificated security only. Presumably in the case of an uncertificated security, this should simply be interpreted as meaning that the corporation has a record of the registered owner of such share which requirement may be satisfied by the securities ledger which an OBCA corporation is required to maintain.

[15] See section 141, OBCA.

[16] Subsections 108(8) – (11), OBCA provide:

- Where a person who was not a party to the USA acquires a share, he/she is deemed to be a party whether or not he/she had actual knowledge of the USA at the time of acquisition.
- If such transferee is a purchaser for value without notice of the USA and the certificate, if any, does not contain a reference to the USA, then the transferee may send a notice of objection to the transferor and the corporation within 60 days of actual receipt of a copy of the USA.
- The notice of objection entitles the transferee to rescind the purchase agreement or demand that the transferor pay to the transferee the fair value of the shares, determined as of the close of business on the day on which the transferee delivers the notice of objection to the corporation. In this case, the transferee can also recover the amount by which the consideration paid exceeds the fair value so determined.

[17] Previously, sections 72, 73 and 74, OBCA dealt with the endorsement of a registered security. These provisions have now been repealed. Section 53, OBCA now states:

> "Except as otherwise provided in this Act, the transfer or transmission of a security is governed by the *Securities Transfer Act, 2006*".

[18] See section 73, STA.

[19] See subsection 68(2), STA.

[20] See definition of the term "instruction" in subsection 1(1), STA.

[21] See subsection 64(1), STA.

[22] Subsection 67(1), OBCA was not amended by Bill 41 and is substantially similar to subsection 64(1), STA.

[23] See subsection 67(4), OBCA.

[24] Available on the website of the Uniform Law Conference of Canada www.ulcc.ca

[25] A summary of the CRA Roundtable proceedings is often published by the CRA in the Income Tax Technical News ("ITTN"). To date, an ITTN issue has not been released with the 2006 Roundtable. The Roundtable was summarized in Tax Topics, Report #1814, December 14, 2006 (CCH Canadian Limited).

[26] Richard H. MacLaren, *Secured Transactions in Canada*, 2nd ed. (Toronto:Carswell, 1989), paragraph 3.01.

[27] See section 20, PPSA.

[28] See section 22.1, PPSA.

[29] See subsection 22(2), PPSA.

[30] See section 23, PPSA.

[31] See section 30.1, PPSA.

[32] See subsection 1(1), PPSA. A security, whether certificated or uncertificated is an investment property.

[33] See subsection 1(2), PPSA which refers to control of a certificated security, uncertificated security or security entitlement in the manner set out in sections 23-26, STA.

[34] See section 23, STA. Control of a certificated security may also be accomplished by registration by the issuer. It seems unlikely that the shareholder (PPSA debtor granting the security interest) would request the issuer corporation to register the secured party as the registered holder since the registered holder is thereafter treated by the corporation as the person entitled to exercise all the rights of an owner pursuant to subsection 64(1), STA. If the secured party is the registered holder of the certificated security, such secured party may have *de jure* control, subject to the saving provision in subsection 256(6), ITA discussed herein.

[35] See paragraph 24(1)(b), STA. Note that "control agreement" is not a defined term in the STA so that the description herein is a conceptual one. In the case of an uncertificated security, as an alternative to a control agreement, the secured party is considered to have control and thereby to have perfected its security interest if the uncertificated security is delivered [paragraph 24(1)(a), STA]. One means of delivery of an uncertificated security requires the issuer to register the secured party as the registered owner of such security [subparagraph 68(2)(b)(ii), STA] which raises the same concern regarding *de jure* control as mentioned, supra note 34. In the alternative, an uncertificated security is delivered (and therefore the secured party has control and has perfected its security interest) if another person who previously became the registered owner acknowledges that it holds the uncertificated security for the secured party [subparagraph 68(2)(b)(ii), STA]. It is unclear whether this means that the shareholder being the PPSA debtor granting the security interest and the registered owner of the security can simply acknowledge that thenceforth it holds the uncertificated security for the secured party.

[36] See subsection 27(3), STA. Conversely however, the issuer corporation cannot enter into a control agreement unless the registered owner consents.

[37] CRA document no. ACC9732, September 20, 1990 discusses the distinction between "controlled" and "controlled, directly or indirectly in any manner whatever" in the context of subsection 256(6), ITA but does not expressly refer to the closing words of subsection 256(6) which include only the word "controlled" and not "controlled, directly or indirectly in any manner whatever".

[38] See CRA document no. AC58268, October 17, 1989; and CRA document no. 5-8268, October 17, 1989.

[39] There is a further saving provision in subsection 256(3), ITA which is similarly worded to subsection 256(6), ITA but which, if applicable, deems the two corporations (i.e, the two corporations which are controlled, directly or indirectly in any manner whatever by the same person) to not be associated with each other in the year. However, if the saving provision in subsection 256(6), ITA does not apply, the similarly worded condition in subsection 256(3) should also not be satisfied.

[40] See new definitions of "financing statement" and "financing change statement" which now refer to "required format" as opposed to the prior language of "required form or format".

[41] The five boxes are consumer goods; inventory; equipment; accounts; other.

[42] Prior to the amendments resulting from Bill 152, the term "debtor" did not expressly contemplate a person who had rights in collateral but did not owe payment. The prior definition read:

> "debtor" means a person who owes payment or other performance of the obligation secured, whether or not the person owns or has rights in the collateral, …"

[43] This arises pursuant to subsections 2(1) and (2) of the *Mercantile Law Amendment Act* R.S.O. 1990, c.M.10*:*

> (1) "Every person who, being surety for the debt or duty of another or being liable with another for any debt or duty, pays the debt or performs the duty is entitled to have assigned to the person or to a trustee for the person every judgment, specialty or other security that is held by the creditor in respect of the debt or duty, whether the judgment, specialty or other security is or is not deemed at law to have been satisfied by the payment of the debt or the performance of the duty."
>
> (2) "Such person is entitled to stand in the place of the creditor, and to use all the remedies and, on proper indemnity, to use the name of the creditor in any action or other proceeding in order to obtain from the principal debtor, or any co-surety, co-contractor or co-debtor, indemnification for the advances made and loss sustained by such person, and the payment or performance made by the person is not a defence to such action or other proceeding by the person."

[44] Surety is not considered to be a form of undertaking distinguishable from a guarantee: Kevin P. McGuiness, *The Law of Guarantee*, 2nd ed. (Toronto: Carswell, 1996), paragraph 3.6.

[45] McGuiness, ibid, paragraph 3.17. This characterization is to some extent driven by the *Statute of Frauds* R.S.O. 1990, c. S.19, as amended which refers in section 4 thereof to a writing requirement for

certain contracts including a "special promise to answer for the debt, default or miscarriage of any other person".

[46] The term "non-resident corporation" is defined in subsection 1(1) of the OBCA as:

> "a corporation incorporated in Canada before the 27th day of April, 1965 and that is not deemed to be a resident of Canada for purposes of the *Income Tax Act* (Canada) by subsection 250(4) of that Act."

[47] It is interesting to note that the term "resident Canadian" is defined in subsection 1(1), OBCA by reference to being "ordinarily resident" (an undefined term) rather than by reference to residence for income tax purposes.

[48] Ministry of Government Services Business Law Modernization Project Consultation Document, "Directors' Residency Requirements".

[49] See subsection 126(6), OBCA. This rule did not apply to directors of a "non-resident corporation". Subsection 126(7), OBCA (since repealed) provided that business could be transacted notwithstanding that a majority of resident directors are not present provided that a resident Canadian director who was unable to be present approves the business transacted in writing or by telephone or other communications facilities and provided further that a majority of resident Canadian directors would have been present had that particular director been present.

[50] Subsection 127(3), OBCA provides that the following cannot be delegated to a managing director or committee of directors:

(a) submit to the shareholders any question or matter requiring the approval of the shareholders;
(b) fill a vacancy among the directors or in the office of auditor or appoint or remove any of the chief executive officers, however designated, the chief financial officer, however designated, the chair or the president of the corporation;
(c) subject to section 184, issue securities except in the manner and on the terms authorized by the directors;
(d) declare dividends;
(e) purchase, redeem or otherwise acquire shares issued by the corporation;
(f) pay a commission referred to in section 37;
(g) approve a management information circular referred to in Part VIII;
(h) approve a take-over bid circular, directors' circular or issuer bid circular referred to in Part XX of the Securities Act;
(i) approve any financial statements referred to in clause 154 (1) (b) of the Act and Part XVIII of the Securities Act;
(i.1) approve an amalgamation under section 177 or an amendment to the articles under subsection 168 (2) or (4); or
(j) adopt, amend or repeal by-laws.

[51] See subsection 127(1), OBCA.

[52] See definition of "affiliate" in subsections 1(1) and 1(4), OBCA. This is largely a test of common control.

[53] [2004] 3 S.C.R. 461.

[54] R.S.C. 1985, c.C-44, as amended.

[55] See subsection 1(1), OBCA.

[56] Supra note 22.

[57] [1990], 69 D.L.R. (4th) 567 (Ont. S.C.), paragraph 9.

[58] [2006] EWCA Civ158.

[59] See Jack Bernstein and Louise Summerhill, *"Beneficial Ownership"* (2006) vol. 14, no. 8 Canadian Tax Highlights, 3-5; Sandra Slaats and Albert Baker, *"Beneficial Ownership: Special-Purpose Vehicles"* (2006) vol. 14, no. 5 Canadian Tax Highlights, 1-2; Patrick Marley. *"Recent International Cases"*, 2006 Tax Conference, Canadian Tax Foundation; Michael N. Kandev, *"Beneficial Ownership: Indofood Run Wild",* Tax Topics, Report #1812, November 30, 2006 (CCH Canadian Limited).

[60] See subsections 24(9) - (11), OBCA.

[61] This is presumably based upon subsection 17(3), OBCA which effective states that a corporate act is not invalid notwithstanding that it is contrary to the statute.

> "Despite subsection (2) and subsection 3(2), no act of a corporation including a transfer of property to or by the corporation is invalid by reason only that the act is contrary to its articles, by-laws, a unanimous shareholder agreement or this Act."

[62] Subsection 28(2), OBCA states:

> "A corporation shall cause a subsidiary body corporate of the corporation that holds shares of the corporation to sell or otherwise dispose of those shares within five years from the date the body corporate became a subsidiary of the corporation."

[63] R.S.O 1990, c.B16, subsection 1(2) states:

> "For the purposes of this Act, a body corporate shall be deemed to be a subsidiary of another body corporate if, but only if,
>
> (a) it is controlled by,
>
> (i) that other, or
>
> (ii) that other and one or more bodies corporate each of which is controlled by that other, or
>
> (iii) two or more bodies corporate each of which is controlled by that other, or
>
> (b) it is a subsidiary of a body corporate that is that other's subsidiary."

R.S.O 1990, c.B.16, subsection 1(3) states:

> "For the purposes of this Act, a body corporate shall be deemed to be another's holding body corporate if, but only if, that other is its subsidiary."

R.S.O 1990, c.B16, subsection 1(5) states:

> "For the purposes of this Act, a body corporate shall be deemed to be controlled by another person or by two or more bodies corporate if, but only if,

(a) voting securities of the first-mentioned body corporate carrying more than 50 per cent of the votes for the election of directors are held, other than by way of security only, by or for the benefit of such other person or by or for the benefit of such other bodies corporate; and
(b) the votes carried by such securities are sufficient, if exercised, to elect a majority of the board of directors of the first-mentioned body corporate."

[64] Ministry of Government Services Business Law Modernization Project Consultation Document dated May 29, 2006, p.15.

[65] See subsection 31(4), CBCA and Canada Business Corporations Regulations, 2001 SOR/2001-512, sections 36-38.

[66] R.S.A. 2000 c. B-9, subsection 32(2.1).

[67] Subsection 29(11), OBCA addresses the position referred to in note 61 above, by providing for the prescribed consequences, "despite subsection 17(3)".

[68] See paragraph 24(3)(a)(iii), OBCA. It may also be noted that the ability to suppress the addition to stated capital in subparagraph 24(3)(a)(ii), OBCA relating to the transfer of shares of a non-arm's length corporation now applies not only to the transfer of shares of such corporation but "another interest in" such a corporation. The meaning of such term is not clear.

[69] The most extensive discussion appears to be written by Brian Nichols, "Corporate Law Matters Of Interest To Tax Practitioners," 1993 *Ontario Tax Conference*, (Toronto: Canadian Tax Foundation, 1993), 2B:1-31. More recently, different points of view were taken by Jack Bernstein, "*Provincial Corporate Shopping*" (2001) vol. 9, no. 9 Canadian Tax Highlights, 67 and Colin Smith, "*OBCA High-Low Shares*" (2002) vol. 10, no. 12 Canadian Tax Highlights, 92-93.

[70] Supra note 64, p.11.

[71] Bruce L. Welling, *"Corporate Law in Canada"*, (Markham: Butterworths, 1991), p. 612.

[72] Kevin P. McGuiness, *"The Law and Practice of Canadian Business Corporations"*, (Markham: Butterworths, 1999), p.287, paragraph 5.25.

[73] This may also be an issue where a taxpayer transfers common shares "back" to the issuer corporation pursuant to subsection 85(1), ITA and receives common shares in consideration therefore. See CRA document no. 2004-0092561E5, November 10, 2004 as commented upon in John Fabbro, "2005 Legislative Update Including Administrative Announcements," 2005 *Ontario Tax Conference*, (Toronto: Canadian Tax Foundation, 2005), 1A:1-22 at 1A:17.

[74] Earl E. Palmer and Bruce L. Welling, "*Canadian Company Law*", (Toronto: Butterworths, 1986), p.8-22 gives the following example of the gradation in differentiation in share rights.

"The articles of a corporation state:
(i) There will be two classes, A and B,
(ii) A gets pink certificates, B gets lilac;
(iii) A can be exchanged for B at the shareholder's option, but B can't be exchanged

for A;

(iv) A are officially designated as “class A common shares”, while B’s official designation is “class B preferred shares”;

(v) A shares have “unrestricted rights” and B shares are entitled to vote at all shareholders’ meetings and will be paid $10 per share in “preference” to any return of capital on the A shares should the corporation be dissolved;

(vi) B shares have no dividend rights.

Suppose the corporation now has 200 shares outstanding, half represented by pink certificates, half by lilac. The directors pass a resolution “that a dividend of $1,000 ($10 per share) be paid today on each class A share”. The *Champ* case suggests that if the articles stopped after (i) above, the result would be a $5 dividend on all shares. Assume that to be correct, and assume that if the articles contained clauses (i) through (vi) the dividends would be paid only to class A shareholders. What if the articles contained more than (i) but fewer than (vi) clauses; at which stage does the result change?”

[75] Supra note 64, p. 6.

[76] Available at the website of STEP Canada http://www.step.ca/resources/conferenceRoundtable.asp

[77] 83 DTC 5029 (FCTD).

[78] 91 DTC 5001 (SCC).

[79] *Champ*, supra note 77 at paragraph 9.

[80] Vol. 1, 23rd ed., C.M. Schmitthoff ed. at p. 387, paragraph 33-06.

[81] Ibid. The footnote in question did qualify with the word “exceptionally”.

[82] *McClurg*, supra note 78 at paragraph 30-31:

> “….a pre-condition to the derogation for the presumption of equality, both with respect to entitlement to dividends and other shareholder entitlements, is the division of shares into different “classes”. …The division of shares into separate classes, then, is the means by which shares (as opposed to shareholders) are distinguished, and in turn allows for the derogation from the presumption of equality.
>
> ● ● ●
>
> The concept of share “classes” is not technical in nature, but rather is simply the excepted means by which differential treatment of shares is recognized in the Articles of Incorporation of a company.”

[83] McGuiness, supra note 72, p. 287, paragraph 5.23.

[84] Palmer and Welling, supra note 74, p.8-31.

[85] Subsection 24(1), OBCA states:

> “A corporation shall maintain a separate stated capital account for each class and series of shares it issues.”

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[86] David G. Roberts, "Some Issues in the Determination of Paid-up Capital", (1992) vol.40, no.2 *Canadian Tax Journal* 338 at footnote 19.

[87] "Full shield" limited liability partnerships are also permitted in British Columbia, Saskatchewan and New Brunswick. Limited liability partnerships established under the British Columbia Partnerships Act have some distinct differences from those established in the other provinces. For a discussion of same, see Bill Maclagan and Kevin P. Zimka, "New Business Vehicles: British Columbia Limited Liability Partnerships and Alberta Unlimited Liability Corporations," 2005 *British Columbia Tax Conference*, (Vancouver: Canadian Tax Foundation, 2005), 6:1-29.

[88] See subsection 10(3)(c), PA.

[89] See subsection 10(3.1), PA.

[90] R.S.O. 1990, c.L.16, as amended.

[91] Department of Finance Comfort Letter dated July 11, 2003.

[92] Maclagan and Zimka, supra note 87 at 6:15; David G. Thompson, "Professional Corporations," 2005 *British Columbia Tax Conference*, (Vancouver: Canadian Tax Foundation, 2005), 16:1-76 at 16:36; Robin MacKnight, "*Ontario Commercial Law Update: Cents and Nonsense"* (2007) vol.7, no.3 Tax for the Owner- Manager.

[93] This has been the position of the CRA since 1995 and is technically correct based on the wording of subparagraph 53(1)(e)(i), ITA. See Income Tax Technical News No. 5, July 28, 1995.

[94] Supra note 91. The letter indicated that such amendment, if enacted would apply to allocations of income or loss made by a full shield LLP on or after December 31, 2001.

[95] Supra note 93.

[96] Leonard R. Vandenberg, CMA, "Year-End Tax-Planning Considerations for the Owner-Manager," *Report of Proceedings of Forty-Eighth Tax Conference*, 1996 Tax Conference (Toronto: Canadian Tax Foundation, 1997), 55:1-46 at 55:38. The relevant discussion related to a management partnership established as a limited partnership under provincial law.

[97] 2007 CarswellOnt 2560 (Ont. CA), paragraph 33. The case involved Ontario capital tax issues and in particular, the computation of a corporation's taxable paid-up capital. Under the Corporations Tax Act (Ontario), paragraph 61(1)(d) as it read for the 1988 and 1989 taxation years in issue required all sums or credits advanced or loaned to the corporation by any government to be included in the computation of the corporation's paid-up capital. The question was whether an income tax liability or unpaid income tax should be treated as an advance or loan by the government.

[98] R.C. Anson Banks, "*Lindley and Banks on Partnership*" 18th ed. (London: Sweet & Maxwell, 2002), p.5.

[99] Alison R. Manzer, *"A Practical Guide to Canadian Partnership Law",* (Aurora: Canada Law Book, 2006), paragraph 1.240.

[100] Pursuant to subsection 96(1), ITA.