BETWEEN:

LOU'S SERVICE (SAULT) LIMITED .....APPELLANT;

AND

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

Sault Ste. Marie 1967
June 21
Ottawa July 14

Income tax—Controlled company—Preference shares acquiring voting rights if dividends passed—Arrangement by shareholders not to pay dividends—Whether voting rights thereby nullified—Income Tax Act, s. 39.

Three brothers (who with M were the sole shareholders of appellant company) advanced appellant company $30,000 to purchase a service station and received as security preference shares in the company which were non-voting unless dividends were not paid for two consecutive years. By an agreement between the three brothers and M the $30,000 was to be repaid without interest as soon as practicable and before dividends were paid on common shares, M was to be paid a salary and bonus to manage the service station, and profits were to be shared equally by M on the one hand and the brothers on the other. Dividends were not paid on the preference shares for two consecutive years, and in 1961 and 1962 (in which years appellant's common stock was held half by M and half by the three brothers) appellant was assessed as an "associated company" under s. 39 of the *Income Tax Act* as being a company controlled by the three brothers (who also controlled other companies).

Held, a contract between M and the three brothers that the three brothers would not exercise their voting rights on the preference shares was not implied by the terms of the arrangement between them and appellant was therefore controlled by the three brothers.

Buckerfield's Ltd. et al. v. M.N.R. [1965] 1 Ex. C.R. 299; *M.N.R. v. Dworkin Furs (Pembroke) Ltd. et al.* [1967] S.C.R. 223; 67 DTC 5035, applied.

INCOME TAX APPEAL.

P. M. Sedgewick, Q.C. for appellant.

L. R. Olsson for respondent.

CATTANACH J.:—This is an appeal from a decision of the Tax Appeal Board dated November 30, 1964[1] whereby the taxpayer's appeal against its assessments to income tax for its 1961 and 1962 taxation years were dismissed.

The appellant is a joint stock company incorporated pursuant to the laws of the Province of Ontario by Letters Patent dated August 18, 1958.

The issue for determination is whether the appellant was "controlled" by the Hollingsworth brothers during the

[1] (1964) 37 Tax A.B.C. 113.

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relevant taxation years. It is admitted that the three Hollingsworth brothers were a group of persons who, during the material time, controlled other corporations among which was, Soo Mill and Lumber Company Limited, a company dealing in building supplies. Subsection (1) of section 39 of the *Income Tax Act* provides that the tax payable by a corporation under Part I of the *Income Tax Act* is 18 per cent of the first $35,000 taxable income and 47 per cent of the amount by which the income subject to tax exceeds $35,000.

Subsections (2) and (3) of section 39 provide that when two or more corporations are "associated" with each other, the aggregate of the amount of their incomes taxable at 18 per cent is not to exceed $35,000.

Subsection (4) of section 39 provides, in part, that one corporation is associated with another in a taxation year if at any time in the year both of the corporations were controlled by the same person or group of persons.

In assessing the appellant as he did in the two taxation years in question, the Minister did so on the assumption that the appellant was associated with another corporation by virtue of subsection (4) of section 39 because both corporations (that is the appellant and another corporation) were controlled by the same group of persons, namely, the three Hollingsworth brothers.

In *Buckerfield's Limited et al v. The Minister of National Revenue*[2], the President of this Court held that the word "controlled" as used in subsection (4) of section 39 means *de jure* control and not *de facto* control. He said at pages 302-03:

> Many approaches might conceivably be adopted in applying the word "control" in a statute such as the *Income Tax Act* to a corporation. It might, for example, refer to control by "management", where management and the Board of Directors are separate, or it might refer to control by the Board of Directors. The kind of control exercised by management officials or the Board of Directors is, however, clearly not intended by section 39 when it contemplates control of one corporation by another as well as control of a corporation by individuals (see subsection (6) of section 39). The word "control" might conceivably refer to *de facto* control by one or more shareholders whether or not they hold a majority of shares. I am of the view, however, that, in section 39 of the *Income Tax Act,* the word "controlled" contemplates the right of control that rests in ownership of such a number of shares as carries with it the right to a majority of the votes in the election

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

of the Board of Directors. See *British American Tobacco Co. v. I.R.C.* ([1943] 1 A.E.R. 13) where Viscount Simon L.C., at page 15, says:

> The owners of the majority of the voting power in a company are the persons who are in effective control of its affairs and fortunes.

See also *Minister of National Revenue v. Wrights' Canadian Ropes Ltd.* ([1947] A.C. 109) per Lord Green M.R. at page 118, where it was held that the mere fact that one corporation had less than 50 per cent of the shares of another was "conclusive" that the one corporation was not "controlled" by the other within section 6 of the *Income War Tax Act*.

The foregoing statement was cited with approval and confirmed by the Supreme Court of Canada in *M.N.R. v. Dworkin Furs (Pembroke) Ltd. et al*[3].

The authorized capital of the appellant is divided into one hundred thousand (100,000) preference shares of the par value of one dollar ($1) each and fifteen thousand (15,000) common shares without par value. The maximum consideration for which the common shares could be issued was fixed at $15,000 subject to variations in the manner prescribed in the Letters Patent. The appellant did not avail itself of such provision.

The appellant was incorporated with a private status, with a restriction on the transfer of shares to the effect that no shareholder should transfer any share held by him without first affording the other shareholders the opportunity of purchasing the shares offered for sale.

The preference shares entitle the holders thereof to a five per cent non-cumulative preferential dividend over the holders of the common shares.

The preference shares are subject to redemption, at the amount paid up thereon together with any dividend declared thereon and unpaid, at the discretion of the company; and are also subject to purchase for cancellation at a price not less than the redemption price.

The voting rights of the preference and common shares are set out in paragraph (6) of the conditions attaching to the shares and read as follows:

> (6) The holders of the preference shares shall not, as such, have any voting rights for the election of directors or for any other purpose nor shall they be entitled to attend shareholders' meetings unless and until the Company shall fail, for a period of two (2) consecutive years, to pay the dividend on the preference shares, whereupon and whenever the same shall occur, the holders of the preference shares shall, until dividends aggregating five per cent (5%) per annum have been paid

[3] [1967] S.C.R. 223; 67 DTC 5035.

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on the preference for two (2) consecutive years, be entitled to attend all shareholders' meetings and shall have one (1) vote thereat for each preference share then held by them respectively; holders of preference shares shall, however, be entitled to notice of meetings of shareholders called for the purpose of authorizing the dissolution of the Company or the sale of its undertaking or a substantial part thereof; holders of common shares shall be entitled to one (1) vote for each common share held by them at all shareholders' meetings;

At this point, it is convenient to summarize the events leading to the incorporation of the appellant.

Patrick Joseph Mahon, who had been the successful manager of a service station in Kapuskasing, Ontario for six years, moved to Sault Ste Marie, Ontario, to operate a service station there as a licensee. It was his hope that Imperial Oil Limited would purchase the service station, that he would lease the station from that Company and that he would enter into an agreement to purchase the premises from that Company. However, this arrangement did not materialize. He had purchased a home in Sault Ste. Marie from the Hollingsworth brothers. When his hope of purchasing the service station was not realized he decided to return to Kapuskasing and approached the Hollingsworth brothers to arrange for the disposition of the home he had purchased from them. On being asked, he gave the reason for his decision to do so.

A meeting among the representatives of Imperial Oil Limited, the Hollingsworths, and Mr. Mahon was arranged. The purchase price of the service station was $90,000. Imperial Oil Limited was willing to advance $60,000 secured by a first mortgage on the premises. The Hollingsworths agreed to advance the balance of $30,000. An offer to purchase the premises was made on behalf of a company to be incorporated, which became the appellant herein, and that offer was accepted.

The arrangement between the Hollingsworths and Mahon was that:

(1) Mahon was to operate the service station;

(2) he would receive a monthly salary of $600 plus a bonus of 10 per cent of the net profit before taxes, in any year the profit exceeded $25,000;

(3) the Hollingsworths were to be repaid the $30,000 advanced by them without interest as soon as the affairs of the appellant would permit; and

(4) subject to the foregoing prior charges on the profits, the profits would be shared equally between Mahon on the one hand and the three Hollingsworth brothers on the other.

The Hollingsworths consulted their legal and accountancy advisers, upon whose advice the appellant was incorporated with the capital structure which has been outlined, to implement this arrangement.

Of the 100,000 authorized preference shares of the par value of $1 each, 30,000 were issued, 10,000 to each one of the Hollingsworth brothers in consideration of the $30,000 which they had advanced to the appellant. In the first instance, 6,004 common shares were issued, 2,941 to Mahon and 3,063 to the three Hollingsworth brothers. This was done as a measure of protection to the Hollingsworths so that they would have 51 per cent of the common shares and Mr. Mahon would have 49 per cent. However, on December 30, 1960, a formal agreement was executed whereby 61 common shares were transferred by the Hollingsworths to Mr. Mahon. This was done to overcome the effect of an amendment to section 39 of the *Income Tax Act* made in 1960 and to become operative after December 31, 1960.

The agreement recites, in part, as follows:

> 2 In consideration of the aforesaid transfer of shares the Manager hereby covenants and agrees that the 30,000 5% non-cumulative redeemable preference shares of the par value of $1.00 each in the capital stock of the company now held by the owners shall be redeemed in full before any dividends are ever paid on the common shares without nominal or par value now held by the Owners and the Manager and before any increase in the present salary of SIX HUNDRED DOLLARS ($600 00) per month now being paid to the Manager and before any bonus being paid to the Manager other than the ten per cent bonus now paid to the Manager when the net profit before taxes exceeds $25,000 00

Therefore, as at December 30, 1960, the shareholding in the appellant was as follows:

Shareholder	Preference Shares	Common Shares
Patrick Mahon	Nil	3,002
F. S. Hollingsworth	10,000	1,001
I. W. Hollingsworth	10,000	1,000
E. L. Hollingsworth	10,000	1,001
	30,000	6,004

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No dividends were paid upon the preference shares at any time following the incorporation of the appellant. Accordingly, as at December 1, 1960, being after the lapse of two fiscal years or two calendar years, the preference shares would entitle the holders thereof to voting rights in accordance with the conditions attaching thereto.

In February, 1962, 15,000 preference shares were redeemed, at the prescribed redemption price, being $15,000, and the remaining 15,000 preference shares were redeemed in January, 1963, also at the prescribed redemption price. Accordingly, in the 1961 taxation year, 30,000 preference shares were issued and outstanding and in the 1962 taxation year there were 30,000 preference shares issued and outstanding for part of that year and 15,000 for the balance of the year.

It was explained in evidence that the preference shares were not redeemed earlier because the appellant was required to expend $30,000 to acquire adjoining property to comply with a municipal by-law and to expend a further $5,000 to make improvements. This resulted in a temporary shortage of funds wherewith to effect the redemption of the preference shares.

Counsel for the appellant submitted that, in accordance with paragraph (6) of the conditions attaching to the preference shares, the company did not "fail, for a period of two (2) consecutive years, to pay the dividend on the preference shares", and accordingly the right of the holders of the preference shares to voting rights did not arise. He based his submission on the circumstance that the shareholders had agreed among themselves that there should be no interest on the $30,000 advanced by the Hollingsworths and hence there was an agreement that no dividend should be paid on the preference shares. On this premise, he contended that there was no failure to pay dividends. During the argument, I intimated to counsel that I did not accept his submission in this respect. In my view, the plain meaning of the language of paragraph (6) of the conditions attaching to the preference shares is that if dividends are not declared and paid on the preference shares there has been a failure or default made to pay dividends and the remaining terms of the condition become operative. I need not look into the reason for the failure to pay but merely to the fact that dividends were not paid.

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The crux of the matter lies in the second submission of counsel for the appellant, that is that by agreement among the shareholders, it was tacitly understood that (1) dividends would not be paid on the preference shares; and (2) the holders of the preference shares would not exercise their voting rights when such rights arose.

A shareholder's vote is a right of property which he may exercise as he pleases, but he may, in some cases, bind himself by contract which can be enforced by mandatory injunction to vote or not to vote his shares in a particular way. (See *Puddephatt v. Leith*[4], *Greenwell v. Porter*[5], *Ringuet et al. v. Bergeron*[6], and *M.N.R. v. Dworkin Furs (Pembroke) Limited et al. (supra)*).

The question before me is whether such an enforcible oral contract here existed among the shareholders of the appellant.

It was frankly admitted by the witnesses F. S. Hollingsworth and P. J. Mahon that the question of the payment of dividends on the preference shares was never mentioned in the initial verbal discussions among the three Hollingsworth brothers, Mr. Mahon and the Hollingsworths' advisers nor was the matter of the voting rights vesting in the preference shareholders discussed at any time. Neither matter was mentioned in any subsequent written document. In the agreement dated December 30, 1960 whereby 61 common shares were transferred from the Hollingsworth group to Mr. Mahon so that their respective holdings of common shares became equal specific mention was made of the fact that the 30,000 preference shares outstanding should be redeemed in full before any dividends should be paid upon the common shares and before any increase in salary or bonus to Mr. Mahon would be considered.

There is no mention of an agreement not to declare dividends or not to exercise voting rights on the preference shares in any of the appellant's corporate records so far as I can ascertain from the material before me.

The positive covenants in the oral contract among the shareholders and the written agreement dated December 30, 1960 are that the advance of $30,000 by the Hollingsworths should be repaid forthwith without interest, that

[4] [1916] 1 Ch. D. 200.
[5] [1902] 1 Ch. D. 530.
[6] [1960] S.C.R. 672.

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Mahon should receive a monthly salary of $600 and a bonus of 10 per cent on any profits in any year exceeding $25,000 and that thereafter profits would be shared equally between them, presumably by the payment of dividends on the common shares.

From these affirmative covenants counsel for the appellant argues that certain negative covenants must be implied of necessity, that is there was an agreement among the shareholders not to pay dividends and the preference shareholders undertook not to exercise their votes with respect to those shares, because, as he stated, for the holders of the preference shares to vote would disturb the oral arrangement between the Hollingsworths and Mahon that the profits should be shared equally between them.

I do not think that such an implication necessarily follows. The clear agreement between the parties as is disclosed by the evidence was that the Hollingsworths would be repaid $30,000 as expeditiously as possible, without interest, and Mahon was to be paid the salary and bonuses indicated above. After this had been done profits would then be divided equally.

The redemption provisions attaching to the preference shares provided the means by which the Hollingsworths would be repaid their advance of $30,000. It follows from the oral agreement among the shareholders that, since no interest was to be paid on the advance, no dividends would be paid upon the preference shares was provided for in paragraph (1) of the conditions attaching to such shares. The declaration of dividends is a matter of discretion, when funds are properly available for that purpose, vested in the board of directors. Here the shareholders and the directors were the same persons.

However, when dividends are not declared and paid for two consecutive years, as was the circumstance here, then by virtue of paragraph (6) of the preference shares conditions the holders of those shares became entitled to vote. The facts that the Hollingsworths were to be repaid $30,000, that Mahon was to receive a salary and bonus after which profits would be shared equally, does not detract or in any way impugn the right to vote on the preference shares which arose in the Hollingsworths. The fact that they did not do so or that they did not have any occasion to do so is immaterial. What is material, is that the right

to vote the preference shares existed in the Hollingsworths and that right would vest control of the appellant in their hands being the ownership of such a number of shares as carries with it the right to a majority of the votes in the election of the board of directors.

The onus is on the appellant to show that a contract existed between the Hollingsworths and Mahon by which the Hollingsworths specifically undertook not to exercise the voting rights vested in them by virtue of ownership of the preference shares. In my view, such an undertaking cannot be implied, either from the terms of the oral agreement between the Hollingsworths and Mahon, nor from paragraph 2 of the written agreement among them and the appellant dated December 30, 1960 which has been quoted above. I do not think that the terms of the oral agreement precluded the Hollingsworth brothers from exercising any voting rights on the preference shares except in breach of such agreement. The terms of that agreement were not set forth with sufficient clarity to so imply or that the contracting parties must have intended such a term to be part of the agreement among them.

On the contrary, such a term was not specifically discussed and agreed upon by the parties. In my view, the arrangement among them is reflected in the Letters Patent incorporating the appellant and the distribution of the share capital. This was done on professional advice. In the first instance, the Hollingsworths were given the majority of the common shares. This was changed to overcome an amendment to the *Income Tax Act* at a time when the Hollingsworths were satisfied of the business integrity of Mahon who had been previously comparatively unknown to them. But the measure of protection obviously designed for the benefit of the holders of the preference shares, in that the holders thereof would have voting rights when dividends thereon were not declared and paid for two consecutive years, was not changed nor, as I have intimated before, can I imply that the exercise of those rights were necessarily precluded by the terms of an oral agreement among the parties.

It follows that the Minister was right in assessing the appellant as he did and its appeal herein must be dismissed with costs.

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During the course of the argument, counsel for the Minister submitted that if there had been an oral agreement of the nature alleged by the appellant which by implied terms precluded the Hollingsworth brothers from exercising voting rights on the preference shares held by them, Mahon would not have been entitled to enforce such agreements because it was not to be performed within one year within the meaning of section 4 of the Statute of Frauds, 1960 R.S.O. chapter 381 and no memorandum in writing existed sufficient to satisfy the Statute.

Counsel for the Minister moved for leave to amend the reply by pleading the Statute of Frauds if such pleading were necessary in order to argue that Mahon would have been unable to obtain an injunction restraining the Hollingsworth brothers from the exercise of voting rights on the preference shares in breach of the oral agreement.

I expressed the view that the Minister's motion should be denied (1) because paragraph 10 of the reply might have been adequate to permit the Minister to argue that point, (2) the appellant would be prejudiced by an amendment at such a late stage bearing in mind that the matter had come to trial on the pleadings as drafted and (3) if the motion were allowed, I would do so only on terms as to costs.

However, I reserved the disposition of the application and afforded counsel an opportunity to exchange and file written argument on the Minister's motion to amend the pleadings and the applicability of the Statute of Frauds in the circumstance of this appeal since I had expressed doubts that the Minister was in a position to raise the Statute of Frauds as he was not a party to the oral contract and that the Statute was not being relied upon as a defence to an action on the contract but merely by way of answer to the appellant submission that an injunction would issue in a proceeding by Mahon against the Hollingsworths to restrain them from exercising voting rights on the preference shares.

I have now had the opportunity of reading the written submission of counsel and upon more mature reflection, assisted by those submissions, I adhere to my original view and dismiss the Minister's motion for leave to amend his reply.