The Degree of Canadian Ownership: An Exercise in Futility

A. R. A. Scace

Follow this and additional works at: http://digitalcommons.osgoode.yorku.ca/ohlj

Citation Information
http://digitalcommons.osgoode.yorku.ca/ohlj/vol3/iss2/47

This Article is brought to you for free and open access by the Journals at Osgoode Digital Commons. It has been accepted for inclusion in Osgoode Hall Law Journal by an authorized editor of Osgoode Digital Commons.
THE DEGREE OF CANADIAN OWNERSHIP: AN EXERCISE IN FUTILITY?

A. R. A. SCACE

I

Since the American Revolution in 1774, concern about the extent and degree of Canadian subservience to the United States has been a recurrent and vocal theme in Canadian politics. It has covered the whole social and economic spectrum from cultural annihilation to incorporation as the fifty-first state of the union. Indeed, American economic influence was a motivating factor in the 1867 Confederation between Ontario, Quebec, Nova Scotia and New Brunswick.¹ The two most recent manifestations are to be found in the proposed legislation altering the Canadian and British Insurance Companies Act, the Foreign Insurance Companies Act, the Trust Companies Act and the Loan Companies Act² and the amendments to the Canadian Income Tax Act favouring a degree of Canadian ownership in the equity shares of public and private corporations.³ The latter is the subject of this presentation.

It is indisputable that the investment of long term foreign capital has been a major determinant of Canada's economic growth. Historically, the two main sources have been Western Europe and the United States. However, in the years since 1945, the flow from the United States as a percentage of the total has reached dramatic proportions as illustrated by the following table.⁴

---

³ *Statutes of Canada*, 1963, C-21, s. 28(1); 1964, c. 13, s. 25(1)-(4).
NON-RESIDENT LONG-TERM INVESTMENT IN CANADA
1900-1957 ($000,000)

<table>
<thead>
<tr>
<th>Year</th>
<th>U.S.</th>
<th>U.K.</th>
<th>Total</th>
<th>U.S.%</th>
<th>U.K.%</th>
</tr>
</thead>
<tbody>
<tr>
<td>1900</td>
<td>68</td>
<td>1,050</td>
<td>1,232</td>
<td>14</td>
<td>85</td>
</tr>
<tr>
<td>1914</td>
<td>881</td>
<td>2,778</td>
<td>3,857</td>
<td>23</td>
<td>72</td>
</tr>
<tr>
<td>1918</td>
<td>1,630</td>
<td>2,729</td>
<td>4,367</td>
<td>36</td>
<td>60</td>
</tr>
<tr>
<td>1926</td>
<td>3,196</td>
<td>2,637</td>
<td>6,003</td>
<td>53</td>
<td>44</td>
</tr>
<tr>
<td>1930</td>
<td>4,660</td>
<td>2,766</td>
<td>7,427</td>
<td>61</td>
<td>39</td>
</tr>
<tr>
<td>1939</td>
<td>4,151</td>
<td>2,476</td>
<td>6,627</td>
<td>60</td>
<td>40</td>
</tr>
<tr>
<td>1945</td>
<td>4,990</td>
<td>1,750</td>
<td>6,740</td>
<td>70</td>
<td>30</td>
</tr>
<tr>
<td>1949</td>
<td>5,906</td>
<td>1,717</td>
<td>7,623</td>
<td>74</td>
<td>26</td>
</tr>
<tr>
<td>1953</td>
<td>8,870</td>
<td>2,008</td>
<td>10,878</td>
<td>77</td>
<td>23</td>
</tr>
<tr>
<td>1954</td>
<td>9,692</td>
<td>2,181</td>
<td>11,873</td>
<td>77</td>
<td>23</td>
</tr>
<tr>
<td>1955</td>
<td>10,289</td>
<td>2,347</td>
<td>12,636</td>
<td>77</td>
<td>23</td>
</tr>
<tr>
<td>1956</td>
<td>11,651</td>
<td>2,675</td>
<td>14,326</td>
<td>76</td>
<td>24</td>
</tr>
<tr>
<td>1957</td>
<td>13,035</td>
<td>2,910</td>
<td>16,545</td>
<td>76</td>
<td>24</td>
</tr>
</tbody>
</table>

It is readily seen that in the first twelve post-war years, foreign investment has more than doubled and the United States has been the source of three-quarters of that amount. In addition, much of this has been in the form of direct as opposed to portfolio investment. One authority estimates that of the total direct foreign investment, 83 per cent is of American origin. Furthermore, much of it has been centered in the so called "growth" areas of our economy. As noted by the Minister of Finance in 1963:

The latest figures prepared by the Dominion Bureau of Statistics show that in 1959, 57 per cent of our manufacturing industry, 75 per cent of our petroleum and natural gas industry and 61 per cent of other mining and smelting in this country were controlled by non-residents. Anyone familiar with the financial pages of our newspapers can hardly be unaware of the extent to which these figures have undoubtedly increased since that date...

There seems to be no reason for attacking the validity of these statistics. Rather, they represent a fact of Canadian economic life. Whether they are a necessary evil or, indeed, whether they are an evil will be canvassed below. But first, I plan to discuss the decision to amend the Income Tax Act.

The decision itself came as no surprise to those who had been following the career of Mr. Walter Gordon. In the final report of the Royal Commission on Canada’s Economic Prospects, he adverted to the changes which were to come some six years later:

we believe the main objectives of Canadians in this matter should be: first, to see a larger share of foreign capital invested in the forms of bonds and mortgages, which do not involve control of large sectors of the economy; secondly, to see that the part of foreign investment which is invested in the resource and manufacturing industries is associated in some degree with Canadian capital and Canadian interests, ...

In a footnote it was stated that they had something in the order of 20 to 25 per cent in mind. Again in 1961, Mr. Gordon called for similar legislation.

---

5 In this paper, direct investment refers to investment by concerns which are effectively controlled by non-residents.
6 Aitken, Deutsch et al., op. cit., p. 102.
7 Debates, House of Commons, Canada, 1963 volume 2, p. 1000.
8 Royal Commission on Canada’s Economic Prospects, final report, p. 392.
This position cannot be analysed scientifically or proved absolutely. But the fact that a judgment or belief is arrived at in part intuitively does not necessarily make it any the less true. Certainly many of our citizens are unhappy to see Canada as a nation losing a large measure of economic independence more or less by default. Positive action is needed if we are to reverse this trend.9

II

With the advent of the Liberal administration, these views were brought to partial fruition. In contrast to Bill C-123,10 nothing was made mandatory but by section 139A, a new concept was added to Canadian tax jurisprudence.11

(1) For the purposes of this Act a corporation has a degree of Canadian ownership in a taxation year if throughout the sixty-day period immediately preceding that year (or if the corporation did not have a preceding taxation year, throughout the sixty-day period commencing on the first day of the year)

(a) The corporation complied with the following conditions

(i) The corporation was resident in Canada

(ii) either

(A) not less than 25% of the issued shares having full voting rights under all circumstances were owned by one or more individuals resident in Canada, one or more corporations controlled in Canada or a combination thereof, or

(B) the shares of the corporation having full voting rights under all circumstances were listed on a prescribed stock exchange in Canada, and it is established in prescribed manner that no one non-resident shareholder of the corporation owned more than 75% of the shares of the corporation, having full voting rights under all circumstances, alone or in combination with any other person related to him at any time within the period within the meaning of subsection (5a) or (5b) of section 139, and

(iii) where the year commences after December 31, 1964, the number of directors who were resident in Canada was not less than 25% of the total number of directors of the corporation; or

(b) the corporation complied with the conditions specified in subparagraphs (i) and (iii) of paragraph (a) and was a subsidiary wholly owned corporation subsidiary to a corporation that throughout the sixty-day period complied with the conditions specified in paragraph (a)

(2) For the purposes of this section,

(a) a corporation is controlled in Canada at a particular time if at that time the corporation is resident in Canada and more than 50% of its issued shares having full voting rights under all circumstances are owned by one or more individuals resident in Canada one or more corporations controlled in Canada or a combination thereof;

(b) a non-resident person who has a right under a contract in equity or otherwise either immediately or in the future and either abso-
lately or contingently, to, or to acquire, shares in a corporation shall be deemed to own those shares and any other person who actually owns the shares in respect of which the non-resident person has such a right shall be deemed not to own those shares;

(c) where shares are owned by a trustee resident in Canada the shares shall be deemed not to be owned by a person resident in Canada unless it is established that each beneficiary under the trust is an individual resident in Canada; and

(d) where, during any relevant sixty-day period referred to in subsection (1), a director of a corporation who is resident in Canada dies and within 60 days thereafter another person who is resident in Canada is appointed or elected to be a director of the corporation, such other person shall be deemed to have become such a director immediately upon the death of the deceased director.

There were, of course, rewards for any corporation which achieved this degree of Canadian equity participation. It was entitled to claim a capital cost allowance of 50% per annum, computed on a straight-line basis on the purchase price of new machinery and equipment, and the withholding tax on dividends paid to non-residents was reduced to 10% instead of a normal rate of 15%.

Some commentators have supported the amendment on the ground that it was merely a trial balloon designed to test both Canadian and American reactions. If this be so, it is an extraordinary illustration of an irresponsible government acting with complete disregard for its citizens in general and its tax payers in particular. In my opinion, the amendment was puerile in the extreme. For a policy that had been so long in the making, one might have expected the government to choose a less ingenuous draftsman. In any event, the legislation was no sooner promulgated than it was circumvented. To take a purely fictitious example, let us suppose the existence of a Canadian corporation which is the wholly owned subsidiary of an American parent with the following capital structure.

\[
\begin{array}{lcr}
\text{Authorized} & \text{ Issued} \\
1,000 fully voting, redeemable preference shares, par value $5.00 & 200 preference shares & \text{Total}\$5,000.00 \$1,000.00 \$6,000.00 \\
2,000 common shares, par value $1.00 & 1,000 common shares & \text{Total}\$2,000.00 \\
\text{Total} & \text{Total} & \text{Total}\$7,000.00 \$2,000.00 \\
\end{array}
\]

It is to be noted that there are 1,200 issued shares with full voting rights. Since section 139A made no reference to the value of the Canadian held shares, compliance could be achieved by the issue of 400 common treasury shares. If there were no treasury shares, supplementary letters patent increasing the authorized capital would

---

13 Income Tax Regulations, 1100(1)(n).
14 R.S.C. 1952, c. 148, s. 106(1a)(o).
15 Prior to the 1964 amendments, the differential was greater as the normal rate was 20%.
16 There would then be 1,600 issued shares.
solve the problem. The shares would, however, have to be owned either by Canadian residents or a corporation controlled in Canada. This was done in most cases by one of two methods; either

(a) the Canadian subsidiary's solicitors would incorporate a company, the shares of which were all owned by the partners for the sole purpose of holding the qualifying shares, or

(b) the shares would be held by Canadian directors of the Company in trust for Canadian employees. Since the directors could be dismissed at the will of the American parent, effective control of the shares was never lost. In addition, the employee beneficiaries by the terms of the trust were not entitled to the shares in specie but only to a cash division upon termination of their services.

Thus in either case the act had been followed, the company was resident in Canada, 25% of the shares were owned by Canadians and presumably 25% of the directors were Canadians.

III

It was all too easy, and consequently in 1964, section 139A was amended in the following manner. Subsection (1) (a) (ii) became

(ii) either

(A) not less than 25% of the issued and outstanding shares of the corporation having full voting rights under all circumstances were owned by one or more individuals resident in Canada, one or more corporations controlled in Canada or a combination thereof, and equity shares representing in the aggregate not less than 25% of that part of the paid-up capital of the corporation that was represented by all the issued and outstanding equity shares of the corporation were owned by one or more individuals resident in Canada, one or more corporations controlled in Canada, or a combination thereof, or

(B) a class or classes of shares of the corporation having full voting rights under all circumstances were listed on a prescribed stock exchange in Canada, and it is established in prescribed manner that no one non-resident person and no one corporation that did not comply with clause (A) of this subparagraph owned more than 75% of the issued and outstanding shares of the corporation having full voting rights under all circumstances, alone or in combination with any other person related to such non-resident person or such corporation at any time within the period within the meaning of subsection (5a) or (5b) of section 139, and a class or classes of equity shares of the corporation representing in the aggregate not less than 50% of that part of the paid-up capital of the corporation that was represented by all the issued outstanding equity shares of the corporation were listed on a prescribed stock exchange in Canada, and it is established in prescribed manner that no one non-resident person and no one corporation that did not comply with clause (A) of this subparagraph owned equity shares representing in the aggregate more than 75% of that part of the paid-up capital of the corporation that was represented by all the issued and outstanding equity

---

17 R.S.C. 1952, c. 53, s. 48, R.S.O. 1960, c. 71, s. 33.
18 Such persons would not be trustees within the terms of s. 139 A(1).
shares of the corporation, alone or in combination with any other person related to such non-resident person or such corporation at any time within the period, within the meaning of subsection (5a) or (5b) of section 139.

By subsection (2) (e), an equity share was defined to mean

(i) a share, other than a non-participating share, the owner of which has, as owner thereof a right

(A) to a dividend, and

(B) to a part of the surplus of the corporation after repayment of capital and payment of arrears of dividend, upon the redemption of the share, a reduction of the capital of the corporation or the winding up of the corporation, at least as great, in any event, as the right of the owner of any other share, other than a non-participating share, of the corporation, when the magnitude of the right in each case is expressed as a rate based on the paid-up capital value of the share to which the right relates, or

(ii) a share, other than a non-participating share, the owner of which has, as owner thereof, a right

(A) to a dividend, after a dividend at a rate not in excess of 8% per annum of the paid-up capital value of each share has been paid to the owners of shares of a class other than the class to which that share belongs, and

(B) to a part of the surplus of the corporation after repayment of capital and payment of arrears of dividend, upon the redemption of the share, a reduction of the capital of the corporation or the winding up of the corporation, after a payment of a part of the surplus at a rate not in excess of 10% of the paid-up capital value of each share has been made to the owners of shares of a class other than the class to which that share belongs, at least as great, in any event, as the right of the owner of any other share, other than a non-participating share of the corporation, when the magnitude of the right in each case is expressed as a rate based on the paid-up capital value of the share to which the right relates;

Subsection (2) (f) defined a non-participating share as

a share the owner of which is not entitled to receive, as owner thereof, any dividend other than a dividend, whether cumulative or not,

(i) at a fixed annual rate or amount, or

(ii) at an annual rate or amount, not in excess of a fixed annual rate or amount;

and by subsection (2) (g)

“paid-up capital value,” with reference to a share, means

(i) in the case of an unissued share that is deemed by paragraph (b) to be issued and outstanding, the amount determined under clause (B) of subparagraph (viii) of that paragraph, and

(ii) in any other case, an amount equal to the paid-up capital of the corporation that is represented by the shares of the class to which that share belongs divided by the number of shares of that class that are in fact issued and outstanding; and

(B) where

(i) the paid-up capital of a corporation that is represented by all the issued and outstanding equity shares of the corporation is less than

20 R.S.C. 1952, c. 148, s. 139 A(2) (b).
50% of the paid-up capital of the corporation that is represented by all the issued and outstanding shares of the corporation other than non-participating shares, or

(ii) a non-participating share of the corporation, the owner of which has, as owner, a right to a dividend
   (a) at a fixed annual rate in excess of 8%, or
   (b) at an annual rate not in excess of a fixed maximum annual rate, if the fixed maximum annual rate is in excess of 8%, when the right to a dividend is expressed as a rate based on the paid-up capital value of the share to which the right relates, is issued and outstanding, the issued and outstanding equity shares of the corporation shall be deemed not to be equity shares.

The 1964 amendment represents a much higher degree of sophistication. But, again its purpose of "Canadianizing" American subsidiaries could be avoided by the manipulation of the Company's capital structure. Briefly, to qualify under the new section 1.39A (1) (ii) (A), Canadian resident must own (free of any rights of acquisition or control in favour of a non-resident person)

(a) at least 25% (by number) of all fully voting shares outstanding, and

(b) "equity shares" representing at least 25% of the aggregate amount paid up on all outstanding "equity shares" of the corporation.

The term "equity share" as defined above has a meaning quite different from that which normal usage would give to it. *Inter alia*, it is defined *not* to include a "non-participating share". "Non-participating share" is in turn defined by section 139 (A) (2) (f) to mean a share whose owner is *not*, as owner, entitled to receive any dividend other than one which is at, or not in excess of, a fixed annual rate of 8%. The solution is to establish a share having rights that fall within these limits.

Returning to our hypothetical company, its capital could be altered so as to achieve a degree of Canadian ownership as follows:

1. redeem the 200 outstanding preference shares.

2. by supplementary letters patent:
   (a) convert the 1,000 issued and outstanding common shares of the company into two classes of shares as follows:
      (i) 1,000 class A shares, non-voting (unless dividends thereon are in arrears); fully participating on a winding up or other dissolution or distribution of assets (pro rata with other participating shares based upon the relative amounts paid up thereon); carrying a preferential cumulative
dividend of 8% per annum but not enti-
ed to any further dividend in any year;
non-redeemable; par value $1.5021  $1,500.00
(ii) 1,000 common shares, par value $0.1022  100.00

Total Issued capital $1,600.00.

(b) convert the 1,000 authorized but unissued common
shores, par value $1.00 into 10,000 common shares par
value $0.10. These would remain as unissued treasury
shares of the corporation.

(c) cancel the 800 unissued preference shares.

By placing 250 of the new common shares into the hands of the same
persons described with reference to the 1963 provisions, the position
would then be:

1. "... not less than 25% of the issued and outstanding shares
of the corporation having full voting rights under all circum-
stances..." viz., the 1,000 common shares, and

2. "... equity shares representing in the aggregate not less than
25% of that part of the paid-up capital of the corporation that
was represented by all the issued and outstanding equity
shares of the corporation..." viz., $100.00 represented by
the 1,000 issued common shares.

Hence the Canadian resident share ownership provisions of section
139A (1) (ii) (A) would have been satisfied.23

In addition, it is to be noted that since both the new class A
shares and the new common shares of the company will be "common
shares" as defined in section 139(1) (g) of the Act24 and since there
will be no increase in the amount of paid-up capital of the company
after conversion, there will be no adverse income tax implications
arising from such conversion. Furthermore, the "conditional voting"
characteristics of the Class A shares offers further protection to the
position of the United States parent. By passing one year's dividend
on those shares, they could be made fully voting. This would give the
parent company a preponderant degree of voting control, thus enab-
ling it to carry out any corporate purpose which it thought desirable.

21 The class A shares are "non-participating shares" as defined since their
owner is limited to an annual dividend at a fixed rate—namely 8%—Section
139A(2) (f). These shares are therefore, by definition, not "equity shares"—
Section 139A(2) (e).

22 The common shares are "equity shares" as defined and the amount
paid up on them—namely $100.00—represents the amount paid up on all the
issued and outstanding shares of the company other than "non-participating
shares".

23 This particular structure is not the only alternative. Numerous permu-
tations can be devised within the permissible limits.

24 "Common share" is a share the holder of which is not precluded upon
the reduction or redemption of the capital stock from participating in the
assets of the corporation beyond the amount paid up thereon plus a fixed
premium and a defined rate of dividend.
A major problem with the structure outlined above is the difficulty of servicing the parent company with adequate annual dividends. Because the Class A shares are limited to an 8% annual dividend, the total amount is of necessity limited. Of course, 75% of any dividend declared on the common shares would also go to the parent, but in most cases these would never be significant. However, for the years 1964 and 1965, the problem could probably be met effectively by having the subsidiary declare in 1964 and as of a record date, that is before the date when the capital reorganization is effected, an extra dividend sufficient to meet the parent's requirements in 1964 and 1965. If a "degree of Canadian ownership" was then acquired subsequently, it would relate back to the whole of 1964 and the extra dividend, if paid in 1964, would qualify for the lower withholding rate. An alternative and undoubtedly better method would be to declare a stock dividend on the "non-participating shares". This is possible since section 139A refers only to a dividend and section 139 (1) (k) states that a "dividend" does not include a stock dividend. In this way, the parent's requirements could be effectively serviced but it is to be admitted that the approach is slightly more speculative.

In my opinion, no other methods are available. If the subsidiary loaned money to the parent, it would probably be considered a "deemed dividend" under section 8 and if the loan did not bear a reasonable rate of interest and remained outstanding for more than a year, interest at the rate of 5% would be deemed to have been received under section 19. Nor is the possibility of the subsidiary buying the shares of its parent any more attractive. Under the Ontario Corporations Act it is expressly forbidden for a company to be a shareholder of a company that is its holding company. Under the Dominion Companies Act, it is not explicitly illegal but conservative opinion deems it to be inadvisable. In any event, the proposed amendment to the latter Act will soon resolve the matter so as to make such shareholding a nullity.

In conclusion, the writer submits that the capital structure as outlined complies completely with section 139A (1) (a) (ii) (A). Nevertheless, in all likelihood, its useful life will be quite circumscribed. The history of the legislation and of the government's continuing policy in this regard renders it probable that new provisions will be promulgated in 1965. Undoubtedly, they will be more stringent. All gaps can be closed by a one sentence formulation such as: "all classes of shares both in number and value". Considerable speculation has arisen as to why this had not been adopted. As noted previously, a possible but unlikely reason is that the government has been testing the response of both the American authorities and the American corporations with Canadian subsidiaries. More plausible is the suggestion

---

25 This is so by virtue of the opening words of Section 139A.
26 R.S.O. 1960, c. 71, s. 94(1).
27 Fraser and Stewart, Company Law of Canada, p. 97.
28 The Senate of Canada, Bill S-22, s. 13.
of sheer ineptitude. Nonetheless, it cannot be expected that this will continue.

IV

With regard to section 139A (1) (a) (ii) (B) and the alternative of listing on a prescribed stock exchange, the results have not been much more encouraging. Theoretically, the section can be circumvented. The requirements are:

1. a class of shares having full voting rights must be listed and no one non-resident person or corporation must own more than 75% of such shares, and

2. a class of "equity" shares representing in the aggregate not less than 50% of that part of the paid-up capital represented by all the issued and outstanding "equity" shares must be listed and no one non-resident person or corporation may own more than 75% of that part of such paid-up capital.

The solution is to establish three classes of shares as follows:

\[\begin{array}{ll}
\text{Class A: voting common shares} & 1,000 \\
\text{Class B: non-voting common equity shares} & 1,000 \\
\text{Class C: non-participating shares} & 1,000,000 \\
\end{array}\]

The Class C shares would all be held by the American parent and would not be listed. The Class B shares would be listed and 250 would be held by Canadian residents. The Class A shares would be listed and 250 would be held by Canadian residents. Thus, both requirements would have been met yet the parent company would retain control by owning \(\frac{3}{4}\) of the voting shares and would also own the preponderant portion of the paid-up capital.

Practically, the solution is of no utility since such shares would not be listed by any stock exchange. In general, the exchanges' test for listing is based on the breadth of distribution and such a capitalization would not be recognized.

At the time of writing, only three corporations have issued new securities.\(^2\) In total, these represent an additional 3,550,000 shares with an issue value of $71,625,000. The largest was the offering of 2,500,000 common shares at $24.00 per share by Union Carbide Canada Limited.\(^3\) According to the most recent report, a number of companies are considering new issues but to date, movement has been extremely slow. There are a number of possible reasons for this malaise all of which result from the insufficiency of the incentive.

The withholding tax differential is now only 5%.\(^3\) Therefore, on every dollar of operating profit, there is an actual differential of

---

\(^2\) They are Kelsey Wheel Company Limited, Union Carbide Canada Limited and Weldwood Canada Limited.

\(^3\) In point of fact, this was the largest share offering in Canadian history.

\(^3\) Supra, footnotes 14 and 15.
21\% or 2\%\ldots\textsuperscript{32} From this must be subtracted the current 7-8\% discount between the exchange rates of the Canadian and American dollar and the result is then approximately 2\% on every dollar of operating profit. If one assumes that the legal and stock exchange costs of a public issue are approximately $100,000, a company must have an operating profit in excess of $5,000,000 in the first year for the withholding tax differential to act as an incentive. This of course does not take into account the United States foreign tax credit which further exacerbates the situation. Thereby, a United States corporation can credit against its United States tax the foreign taxes paid directly by it as well as the foreign corporate taxes appropriate to dividends received from its foreign subsidiaries. Such credit is limited in amount to the United States tax (48\%)\textsuperscript{33} otherwise payable on the foreign source income. Any excess is not creditable.\textsuperscript{34} However, such limitation is not applied to each item of foreign income but to the aggregate in a given foreign country, or, if an election is made, with respect to the aggregate of all foreign income.\textsuperscript{35} Thus a corporation with world-wide interests might have to pay 56.8\%\textsuperscript{36} on its Canadian source-income but only 38\% on its Swiss income. The excess credit on the Canadian income can then be used to reduce the United States tax otherwise payable on the Swiss source income.

The net effect of the above is that a broadly based American corporation with a considerable amount of low tax foreign income will have little regard for the 5\% withholding tax differential. To some extent, this is less true with the advent of the post 1965 rate of 48\%\textsuperscript{37} but the success or failure of Canadian policy should not be dependent on fortuitous changes abroad. Pursuant thereto consideration might be given to a graduated incentive scheme such as:

<table>
<thead>
<tr>
<th>Canadian participation</th>
<th>10% rate</th>
<th>5% rate</th>
<th>0 rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>25%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>30%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>35%</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Or, a more effective “carrot” would be the complete elimination of all withholding tax. This of course would still leave an excess credit for the American parent but with rising taxes in hitherto low tax

\textsuperscript{32} Operating Profit $1.00
Corporate Taxes $0.50

Net Profit $0.50
15\% withholding tax $0.75
10\% withholding tax $0.50
net difference 2.5\%

\textsuperscript{33} After 1965, the tax payable on taxable income over $25,000 is 48\%. In 1964 and 1963, it was 50\% and 52\% respectively.

\textsuperscript{34} Canadian Tax Journal, vol. XI, No.1, p. 52.

\textsuperscript{35} United States Revenue Code, Sections 901-4 or C.C.H., Federal Tax Guide (1) 1965, p. 656.

\textsuperscript{36} This calculation is based on a corporate rate of 52\% plus a 10\% withholding rate on the assumption that the corporation has complied with section 139A.

\textsuperscript{37} Nor does the reasoning apply to a company whose sole subsidiary is based in Canada.
countries, the incentive might very well become important. In any event, by Article VI.2 of the Canadian-United Kingdom Tax Agreement, no withholding tax is payable on dividends from a wholly owned Canadian subsidiary to a British parent. Since a treaty takes precedence over domestic legislation, section 139A has no application to the United Kingdom. However, the important point is that a precedent exists for the abolition of the withholding tax and it is to be hoped that such an alteration will be made.

With regard to the capital cost allowance provisions, a detailed study of their application to a particular company would be beyond the scope of this paper. Suffice it to say that the class covered is not unduly broad and is premised on the fact that the company in question will be undertaking a program of expansion within the short term. If, however, the proceeds from the underwriting are used for a dividend payout to the parent, then the subsidiary must have either a strong current position or the ability to borrow extensively in the bond market. In summary, it would seem that the current incentives can only be attractive to the largest and most profitable American subsidiaries. Yet these are the very companies which are best able to generate internal capital and thus equalize the tax differential. One must therefore draw the conclusion that section 139A(1)(a)(ii)(B) is bound to be of rather limited utility unless the withholding tax is decreased even further and a more liberal capital cost allowance provided.

In addition, the actual wording of the section should be noted with care, viz.,

"That no one non-resident person and no one corporation that did not comply with clause (A) of this subparagraph owned more than 75% of the issued and outstanding shares of the corporation . . ."

The shareholders need not be Canadian; in point of fact, they may be American. By means of regulation 3100 to the Income Tax Act, machinery has been devised for establishing such facts, but it still remains impossible for the Minister of National Revenue to determine the matter categorically. Indeed, the sworn declaration need only establish that the listed securities were held by a large number of persons and that no one non-resident shareholder alone or in combination held more than 75% of the shares. The net result is that the Act may only force the American parent into the acceptance of a minority position rather than as intended, the acceptance of a Canadian minority. Furthermore, regulation 3100 may constitute an unwarranted invasion of the corporate structure and finances of the parent company. The normal rule is that so long as a taxpayer

---

38 A feature of the present legislation is that Canada now receives the tax rather than the United States Treasury.
39 Notice of termination of the Agreement was given by Canada in June, 1964, effective January 1, 1965. The text of the revised Agreement is not yet available.
40 This is based on the assumption that the parent would not desire an increase in the minority position by a further share offering.
complies with the law, disclosure is not required. Now, disclosure is a necessary prerequisite to compliance. Again no definite answer can be given; it is a question of public policy. Assuredly though, if the shoe were on the other foot, cries of further American interference would be rampant. Perhaps, of all the criticisms which have been levied to date, this is the most serious as it indicates the utter futility of the policy no matter how formulated. More charitably, it may indicate that the listing requirement is all that is feasibly enforceable.

V

Having considered the defects as to form and content, the writer would now like to discuss the wisdom of the amendment. Numerous arguments have been proffered in its favour. They are as follows:

1. As the position of American capital becomes even more dominant, the Canadian economy will become more and more integrated with that of the United States. Continuing integration could lead to complete economic domination and the loss of political independence.

2. In some circumstances, the best interests of Canada might not be exactly the same as the best interests of the shareholders of a foreign parent company with subsidiaries in Canada, for example there might be less diligence in searching for new export markets if the demand could be satisfied by the American parent.

3. Inter-company pricing policy might favour the parent rather than the subsidiary, viz., low prices on supplies to the parent and high prices for finished goods the other way with resultant inflation in Canada.

4. Canadian subsidiaries may be prohibited from buying their supplies in the cheapest markets and forced to buy from the parent corporation. The same has been said about possible competition in common export markets.

5. The Canadian investor is not being given an opportunity to invest in growth shares and thus is not allowed to share in the country's prosperity. To the apologists who say that anyone interested can invest in the shares of the parent, it is answered that this raises problems of exchange rate fluctuation, increased taxation and the loss of the 20% dividend tax credit available on dividends from Canadian companies.

---

47 If the policy is partially designed to affect Canadian exchange reserves, a tax on retained surplus might be more effective.
All of the above arguments may be true. Certainly they contain some element of truth. But, in the absence of any factual basis, they carry no more weight than a straw in the wind.\textsuperscript{48} Thus the Royal Commission on Canada's Economic Prospects expressed merely a personal opinion when it said:

\begin{quote}
It seems to us that on the whole those Canadian subsidiaries of foreign companies which have adopted the policies we are suggesting have made a greater contribution to the Canadian economy in many ways than others that have not such policies. Those that have done so appear to be more interested and aggressive in developing their Canadian operations and to be more aware of Canadian problems and viewpoints. There is no way in which we can prove the general proposition scientifically, but it is a definite impression we have gained as a result of our travels, hearings and discussions.\textsuperscript{49}
\end{quote}

While the writer does not dispute the right of a person or a group to hold and express an opinion, it is felt that when an attempt to classify companies as good or bad corporate citizens according to the degree of their Canadian ownership becomes manifest in a legislative enactment, it should be based on a sound legal or economic foundation. It is not readily apparent that this is the case with section 139A. The same is true of certain provisions of Bill C-123,\textsuperscript{50} for example section 36B of the Trust Companies Act which compels the directors of a company to refuse the entry of a transfer of any share of the capital stock to a non-resident if the total number of shares held by non-residents exceeds twenty-five per cent of the total issued and outstanding shares. An obvious and significant difference exists between the two statutes. One is attempting to establish a Canadian position, the other protecting an established situation. But what is the basic policy? Is it motivated simply by a desire to discriminate? Is it directed at all corporations or only those which are affluent and powerful? No indication has been given. Little discussion has been attendant on both pieces of legislation so that the public labours in shadow. Nevertheless, an attempt will be made in a later section of the paper to answer some of the problems.

The amendment to the Income Tax Act as it is presently formulated encourages Canadians to take a minority position in American concerns. When times are good or when honest corporations are involved, a minority position is not dangerous. But such conditions are not omnipresent and hence it is important to consider the available protection. From a legal point of view, the leading case on shareholders' meetings is \textit{Foss v. Harbottle}\textsuperscript{51} which is authority for the proposition that in all matters of internal management, the majority is supreme subject to certain exceptions as summarized in \textit{Gray v. Yellowknife Gold Mines Ltd. (No. 1)}\textsuperscript{52} Thus a majority cannot validate an \textit{ultra vires} act. It must act with \textit{bona fides} and due considera-

\textsuperscript{48} It is to be hoped that the Royal Commission on Taxation will produce some further information.
\textsuperscript{49} \textit{Royal Commission on Canada's Economic Prospects}, final report, p. 395.
\textsuperscript{50} \textit{Op cit.}, p. 1.
\textsuperscript{51} (1843) 2 Hare 461.
\textsuperscript{52} [1947] O.R. 928 (C.A.) at 963.
tion for the opinion of dissentients and it must abide by all special majority requirements.\textsuperscript{53} It is evident that the protection is circumscribed and it is unlikely that an action would lie where the parent, in a general meeting, caused the subsidiary to forego some anticipated profit or expansion.\textsuperscript{54} For this answer, one must turn to the jurisprudence of parent-subsidiary relations which is wholly undeveloped in Canada. In general, any conclusions can only be based on tentative analogies drawn from the American and English experience.

In the United States, a fiduciary relationship is imposed upon a majority shareholder and minority shareholders are permitted to sue the majority for violation of the obligation on a majority's part to exercise its power of control fairly. The Supreme Court of the United States in the case of \textit{Southern Pacific Co. v. Bogert},\textsuperscript{55} upheld a suit by the minority shareholders of the Houston Texas Railway Company against the Southern Pacific for violation of its fiduciary duty as ultimate majority shareholder even though it acted through yet another subsidiary. Mr. Justice Brandeis stated that minority shareholders are entitled to individual redress against wrongful injury of their interest by a majority shareholder.\textsuperscript{56} One author suggests that the Court will offer relief from majority approval of corporate action although the tests of when such relief will be granted are not uniform throughout the individual states.\textsuperscript{57} However, it would seem that in most jurisdictions, the test is one of "fairness" to the minority shareholder. The American Bar Association Model Corporations Act makes provisions for this fiduciary duty.\textsuperscript{58}

In England, the recent case of \textit{Scottish Cooperative Wholesale Society Ltd. v. Myer}\textsuperscript{59} is interesting as it throws a more direct light on the relationship between a parent and its subsidiary. There, a company (the subsidiary) was formed with a majority of the shares held by the parent and a minority held by shareholders who managed the business. When the minority had outlived their usefulness, the parent caused their nominee directors to play a passive role and do nothing to promote the interests of the subsidiary and in fact the parent withheld from the subsidiary its supply of necessary raw materials by quoting uneconomical prices. Meanwhile, it set up its own division to carry on the same business and supplied it with raw materials at the normal prices.\textsuperscript{60}

An application was brought by the minority shareholders under section 210 of the United Kingdom Companies Act\textsuperscript{61} to wind up the

\begin{enumerate}
\item This view is buttressed by the recent case of \textit{Fallis and Deacon v. United Fuel Investments Ltd.}, [1964] S.C.R. 205.
\item 250 U.S. 483.
\item \textit{Ibid}, p. 78.
\item \textit{Op cit.}, vol. 1, p. 13.
\item [1959] A.C. 324.
\item [1959] A.C. 324.
\item In any event, the case would not be covered by the exception to \textit{Foss v. Harbottle.}
\item 11 & 12 Geo. VI, c. 33.
\end{enumerate}
subsidiary and for an order requiring the parent to purchase the minority position at a price reflecting the value of the shares prior to their devaluation as a result of the parent's conduct. It must be remembered that this case dealt with a statutory right which is not applicable in Canada and there is no provision in our law which affords a minority shareholder the relief sought in this case. However, in dealing with the parent-subsidiary relationship, the House of Lords adopted the view of the Lord President of the First Division of the Court of Session when he said:

...the truth is that, whenever a subsidiary is formed as in this case with an independent minority of shareholders, the parent company must, if it is engaged in the same class of business, accept, as a result of having formed such a subsidiary, an obligation so to conduct what are in a sense its own affairs as to deal fairly with its subsidiary.62

Lord Keith adopted this statement and expanded it by saying:

Conducting what are in a sense its own affairs may amount to misconducting the affairs of the subsidiary.63

Lord Denning in his judgment64 also reaffirmed the view of the Lord President, that their Lordships were concerned with the manner in which the affairs of the subsidiary were being conducted, that is, with the conduct of those in control of its affairs and stated that if the nominee directors or the shareholders behind them conduct the affairs of the company in a manner oppressive to the other shareholders, the Court will bring an end to the oppression under section 210. In conclusion it would seem that unless the American authorities are relied upon or an analogy is drawn to the English statute, the Canadian minority shareholders do not have a cause of action against the American parent for failure to pursue a corporate opportunity. With respect to an action against the subsidiary itself, this seems unlikely since any damages which were recovered would be paid by the subsidiary in effect to itself as a minority shareholders' derivative action is only one which the company itself would have. Nevertheless, the English and American experience may still act as a deterrent to the unbridled use of its corporate power by the American parent.

With regard to the legal liability of the directors of the subsidiary viv à vis the company, the leading Canadian case is Cook v. Deeks65 which was an appeal taken from the Supreme Court of Ontario to the Judicial Committee of the Privy Council. In that case, the company was incorporated to undertake the construction of railway lines for the C.P.R.. The company successfully bid on and constructed certain lines and eventually, two directors of the company obtained a further contract in their own names to the exclusion of the company. An action was instituted by the minority shareholder to recover the profit made by the directors. It was held that if the

63 Supra, footnote 59 at 362.
64 Ibid, p. 364.
contract in question was entered into under such circumstances that the directors could not retain the benefits of it for themselves, then it belonged in equity to the company and ought to have been dealt with as an asset of the company. In the same way, if the directors had acquired for themselves property or rights which they must be regarded as holding on behalf of the company, a resolution that the rights of the company should be disregarded in the matter would amount to forfeiting the interest of the minority shareholders in favour of the majority, and that, by votes of those interested in acquiring the property for themselves. The Judicial Committee held that such use of voting power has never been sanctioned by the Courts and held that the directors were liable to the company for the profits. Obiter, their Lordships stated that if the view were taken that in the circumstances the directors had exercised discretion or decided on a matter of policy, different results would have ensued. However on the facts, they could not accept such a conclusion.

Although the case dealt with the relationship between the directors and the company, a possible extension might be made by replacing the directors with the parent company for whom they act. In such a case, if the parent company instructed its nominees not to act or to act in a positive manner so as to exclude the subsidiary, both the directors and the parent might be required to account for the profits. This assumption does not have the force of law in Canada, but if the Court were willing to impose liability, such an end could be attained by the extension of Cook v. Deeks. In any event, the directors of the subsidiary are in a precarious position since notwithstanding the parent-subsidiary relationship, there is an undisputed fiduciary relationship imposed on the directors to act in the best interests of the subsidiary.

In the Scottish Cooperative case referred to above, Lord Keith, in dealing with the role played by the directors of the subsidiary who were nominees of the parent, stated⁶⁶ that he could not but think that where directors, having power to save the company, lie back and do nothing, that they are not conducting the affairs of the company, but in reality, they are conducting the affairs of the company in breach of their duty as directors. His Lordship drew an analogy between the parent-subsidiary relationship and the relationship between partners, stating that if one partner operates a business competitive with the partnership without the knowledge and consent of the others, he is acting contrary to good faith. Similarly, Lord Denning, stated that the nominee directors probably thought their just duty was to the parent, but in this they were wrong and that by subordinating the interest of the subsidiary, they conducted the company's affairs in a manner oppressive to the other shareholders. Nor did the fact that the directors were only guilty of non-feasance carry any weight. In his opinion, oppression could exist merely because

⁶⁶ Id. at 363.
the directors did nothing in the subsidiary's interest when they were under a duty to act positively.

In conclusion, the above represents a rather extreme case of parent-subsidiary conflict. Also *Cook v. Deeks* has real reference only to personal profit by the directors. Nevertheless, it is a definite possibility that they would be rendered liable. As Lord Denning stated:

So long as there is harmony between the parent and subsidiary and their interests are not in conflict the nominee directors could do their duty to both companies without embarrassment. But so soon as the interests of the two Companies were in conflict the nominee directors were placed in an impossible position.67

Nevertheless, these conclusions are to a large degree speculative. The fact remains that a right without a remedy is inconsequential. On the supposition that the alleged disadvantages which stem from foreign ownership are valid, they are not adumbrated by merely amending the Income Tax Act. For greater certainty, an alteration of the federal Companies Act68 is also required in order to protect those who have become minority shareholders.69

VI

As noted in Part V, the Royal Commission on Canada's Economic Prospects averted to a number of unfavourable aspects which they thought flowed from foreign ownership of Canadian industry. Unfortunately, their hypotheses were purely conjectural in nature and completely devoid of any statistical foundation. For this reason, two recent publications—*The Exports of American-Owned Enterprises in Canada* by Mr. A. E. Safarian70 and *Policies and Practices of United States Subsidiaries in Canada*71 by the Canadian-American Committee are of extreme importance. With regard to the latter, their purpose was to remedy the lack of current statistics which had proven a bar to any sound quantitative analysis of the problem. To effect this end, 47 firms were interviewed. Apparently, these included all the relatively large companies operating in the Canadian manufacturing and resource industries. Nineteen of the 47 had some degree of Canadian equity participation ranging from a very small percentage to over 50 per cent. Unfortunately, the results were not tabulated so that the findings are quite imprecise. Also, the results are to some degree biased as only those questions to which favourable replies could be given would be answered. Nevertheless, as a counterbalance to the existing generalizations, they are informative and valuable.

67 Id. at 366.
68 R.S.C. 1952, c. 53.
69 This has not been done by the proposed bill to amend the Companies Act now before the Senate.
70 Presented at the annual meeting of the American Economic Association, Boston, December 28, 1963.
(a) Some of those interviewed thought that a minority interest strengthened the Canadian management's hand whenever there was an apparent conflict between the parent and the subsidiary. However, it seems that a larger number felt that so long as the parent had actual voting control, policies in which the parent had a predominant interest would never be compromised in favour of the subsidiary, no matter how large the minority holding.\(^7\)

(b) Of those who took the former view, apparently all thought that a minority Canadian equity participation was correlated directly with a greater responsiveness to the Canadian national interest.\(^7\)

(c) Another point of view expressed by officers of companies with a Canadian equity position was that some degree of ownership was a Canadian moral right.\(^7\)

On the other side, a number of unsupported opinions were proferred, but of more than casual interest was that of an official whose Canadian subsidiary had a very substantial minority participation. His position was that the subsidiary is at a very serious disadvantage in vying with branches in the United States and with wholly owned subsidiaries in other countries for the parent's attention. As stated in the report:

Why should the parent company devote time, talent, and other resources to the Canadian operation for only a part of the profits when it can get 100% of it elsewhere?\(^7\)

The argument could continue \textit{ad infinitum}. The results of the study are informative but on balance disappointing. Yet, they do represent a first attempt at evaluating in a meaningful form the underlying factual and economic bases of the problem.

Safarian's article represents a more concrete, albeit narrower, analysis of the same general problem. His purpose was to determine whether American-owned firms as opposed to those with some degree of Canadian ownership were less likely to export and in particular to export to the United States. Approximately 227 Canadian firms owned by non-resident Americans in the manufacturing, mining and petroleum industries were questioned with a response rate based on total assets equal to 40 per cent. Although subject to the usual qualifications regarding private surveys, the results indicated that American ownership had little or no effect on export policy and export volume.\(^7\) Understandably, the larger firms are apparently more export orientated.\(^7\) Seemingly, the paper has laid to rest the myth that ownership and exports are in some way related, but nonetheless, it would be interesting to see a government sponsored study which dealt with the subject on the basis of a degree of Cana-
dian ownership. Rumour has it that such results may emanate from the Carter commission but until they exist, the legislators are operating in a vacuum.

VII

The subject matter of this paper has been the analysis of a current and contentious Canadian problem. However, the desire for a greater Canadian equity participation has its roots in a much larger problem namely the search by Canadians for a national identity. As such, it contains an emotional content which cannot be rationally evaluated and which invariably colours any effort at reasoned criticism. So too, it can become a political football and thereby, there is a tendency that those elements which are amenable to logical scrutiny will be disregarded in the harangue of the hustings. It is the lawyer's role to prevent this. Pursuant thereto, the writer submits that certain conclusions may be drawn which will form a basis of departure for future research.

1. To date, the two enactments of section 139A have cultivated an aura of uncertainty, the first by its sophomoric draftsmanship, the second by its complexity. Businessmen are entitled to a clear exposition of government policy rather than what presently appears to be a hesitant white paper. Until this defect is cured, the success of the policy will of necessity be limited.

2. It is a truism that there are only two ways to move a man — by pulling or pushing. In the absence of compulsion, a more attractive incentive is required than the present 5 per cent. withholding tax differential. Given the American tax legislation, the effect is nugatory. As a recommended alternative, the writer suggests at least the abolition of all withholding tax for those corporations which comply.

3. At present, no effective remedy is available to the Canadian shareholder who follows the Government's admonition to accept a minority position. Nor does a remedy seem to be foreseeable in the immediate future. Such a deficiency is both inconsistent and lamentable.

4. As yet, no extensive research has been undertaken which would determine whether the evils which the Gordon Commission referred to exist or whether they are merely delusions engendered by Canada's schizophrenic national personality. If they do, it is certain that by itself section 139A is not a panacea. Perhaps more charitably, one should note the words of the Canadian-American Committee:

It might be legitimately doubted that the... action will necessarily help to attain the goal in all cases; also, it may be found that sometimes the goal could as well be reached by other means. Nevertheless,...

Such analysis that has been done indicates that the latter is the correct view.
minority ownership by Canadians is one of several means towards an end.\textsuperscript{79}

Parent-subsidiary conflicts will not be exorcised by the present legislation. It is only to be hoped that it may give rise to a greater appreciation of Canadian sentiments.

5. One is still left to wonder whether the best available method has been adopted. Indeed, are there others?\textsuperscript{80} Conformity to the legislation does not give birth to a "good" corporate citizen and \textit{vice versa}. Many companies with substantial Canadian ownership are not Canadian oriented. In addition, Safarian's paper indicates that the larger the company, the less may be the evil.\textsuperscript{81} Yet, no indication has been given as to whether the policy is directed at the giants or the pygmies. On the basis of the pending trust and insurance legislation,\textsuperscript{82} one might legitimately suppose the former. As a matter of pure academic interest, it would be interesting to know; as a matter of sound policy, it is essential.

In summary, ignorance forbids the conclusion that the policy objective of section 139A must forever remain as an exercise in futility. However, at the date of writing, it would be incorrect to say that the legislation has reached Olympian heights of effectiveness. For those who approve of the legislation in principle if not in substance, the words of Mr. Dalton Robertson are consoling:

Certainly there are no quick or easy solutions—as the present government has discovered to its pain and chagrin. But the fact remains that Canada, for the first time in the post war years, has a government that is attempting to make basic changes in the difficult and sensitive area of this country's commercial life.\textsuperscript{83}

The next move will be eagerly awaited!

\textsuperscript{79} Lindeman, \textit{Op cit.}, p. 23.
\textsuperscript{80} A restriction on American investment in Canada imposed by the United States authorities might cause less reaction.
\textsuperscript{83} Canadian Tax Foundation, 1963 Conference, \textit{The Importance of Being Canadian}, p. 19.