Date: 20070430

Docket: A-136-06

Citation: 2007 FCA 169

CORAM: **NADON J.A.**
SHARLOW J.A.
MALONE J.A.

BETWEEN:

SEDONA NETWORKS CORPORATION

Appellant

and

HER MAJESTY THE QUEEN

Respondent

Heard at Toronto, Ontario, on March 12, 2007.

Judgment delivered at Ottawa, Ontario, on April 30, 2007.

REASONS FOR JUDGMENT BY: MALONE J.A.

CONCURRED IN BY: NADON J.A.
SHARLOW J.A.

Date: 20070430

Docket: A-136-06

Citation: 2007 FCA 169

CORAM: **NADON J.A.**
SHARLOW J.A.
MALONE J.A.

BETWEEN:

SEDONA NETWORKS CORPORATION

Appellant

and

HER MAJESTY THE QUEEN

Respondent

REASONS FOR JUDGMENT

MALONE J.A.

I. Introduction

[1] The issue in this appeal is whether Sedona Networks Corporation (Sedona) was, throughout its 1999 taxation year, a Canadian-controlled private corporation (CCPC) as defined in subsection 125(7) of the *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp) (*Act*). In a judgment dated March 2, 2006, a judge of the Tax Court of Canada (2006 TCC 80) dismissed an income tax appeal by Sedona for 1999 on the basis that Sedona was not a CCPC throughout that year. Sedona now appeals to this Court.

[2] A CCPC is generally defined by subsection 125(7) of the *Act* as a Canadian corporation that is not controlled by disqualifying shareholders, such as non-residents and certain public corporations. Under paragraph (b) of the statutory definition, shares owned by disqualifying shareholders are attributed, for the purposes of the definition of CCPC, to a mythical "particular person". If the result of that attribution is that the particular person controls the corporation at any time during the relevant taxation year, the corporation is not a CCPC for that taxation year. The focus of present appeal, therefore, is the number of votes exercised by non-resident persons and public corporations.

[3] The relevant parts of the definition of CCPC reads as follows:

Section 125(7): "*Canadian-controlled private corporation*" means a private corporation that is a Canadian corporation other than …	**Section 125(7):** « *société privée sous contrôle canadien* » Société privée qui est une société canadienne, à l'exception des sociétés suivantes:
(b) a corporation that would, if each share of the capital stock of a corporation that is owned by a non-resident person, by a public corporation (other than a prescribed venture capital corporation), or by a corporation described in paragraph (c) were owned by a particular person, be controlled by the particular person [Emphasis added]	b) si chaque action du capital-actions d'une société appartenant à une personne non-résidente, à une société publique (sauf une société à capital de risque visée par règlement) ou à une société visée à l'alinéa c) appartenait à une personne donnée, la société qui serait contrôlée par cette dernière; [Je souligne]

II. Factual Background

[4] Sedona was incorporated in 1998 under the *Canada Business Corporations Act*, R.S.C. 1985, c. C-44 (*CBCA*), and went into bankruptcy on March 30, 2001. It was in the business of developing, manufacturing and distributing products that enable network service providers to deliver bundled voice data services. During its 1999 taxation year, Sedona incurred $2,929,361 in scientific research and experimental development expenditures. Sedona claimed a refundable tax credit of $927,785 in respect of those expenditures pursuant to sections 127(10.1), 127.1(2) and 127.1(2.01) of the *Act*. Sedona is entitled to that credit only if it was a CCPC throughout 1999.

[5] A number of issues have been raised in determining control of Sedona. "Control" in this context means *de jure* control, which is the control manifested in the ownership of the number of shares required to cast a majority of the votes in the election of the board of directors. However, an exception arises where the corporate constitution or a unanimous shareholder agreement deprives the directors of the authority to manage the business and affairs of the corporation (see *Duha Printers v. Canada*, [1998] 1 S.C.R. 795 [*Duha Printers*] at paragraph 50; *Buckerfield's Ltd. et al. v. M.N.R.*, [1965] 1 Ex.C.R. 299).

III. Analysis

(1) Issued and Outstanding Shares without Options Counted

[6] The first issue relates to 438,597 class B preferred shares of Sedona owned by Bank of Montreal Capital Corporation (BMCC), a wholly owned subsidiary of Bank of Montreal (BMO). BMO is a taxable Canadian corporation and a public corporation for the purposes of the *Act*. (A

second issue arises in relation to options granted by Sedona to employees and others to acquire its treasury shares; that issue is discussed separately in the next section.)

[7] Excluding the BMCC Shares, the following chart represents the distribution of all Sedona's issued voting shares between, in one column, residents and non-public corporations, and in the other column, non-residents and public corporations:

SHARES	RESIDENTS/NON-PUBLIC	NON-RESIDENTS/PUBLIC
Common and Preferred Shares	9 281 789	9 419 931
Percentage of Control	49.6%	50.4%

[8] Shares in the 'non-residents/public' column are attributed to the "particular person" under paragraph (b) of the definition of CCPC in subsection 125(7). According to Sedona, the BMCC shares should be included in the 'residents/non-public' column. If Sedona is correct, then residents would have controlled Sedona throughout its 1999 taxation year and it would have been a CCPC (assuming all options are ignored in the calculation). According to the Minister, however, these shares are properly to be included in the 'non-residents/public' total because BMCC was controlled by a public corporation (BMO). If the Minister is correct, then the "particular person" would control Sedona (assuming all options are ignored in the calculation), and Sedona would not be a CCPC throughout its 1999 taxation year.

[9] The Minister, relying on *Vineland Quarries and Crushed Stone Limited*, [1966] Ex.C.R. 417, argues that, in determining who controls the votes attached to the BMCC Shares, it is necessary to look though BMCC to its wholly owning parent corporation, BMO. It argues that,

because BMO is a public corporation, the BMCC Shares must be treated for purpose of paragraph 125(7)(b) as though they were owned by the 'particular person' referred to in that paragraph.

[10] However, Sedona argues that on the facts of this case, the applicable principle cannot be found in *Vineland Quarries*, because the voting rights attached to the BMCC Shares rest with a Canadian resident private corporation named Ventures West Management TIP Inc. (Ventures).

[11] Ventures carries on the business of providing venture capital management services. Throughout Sedona's 1999 taxation year, BMCC Shares were the subject of a Management Agreement between BMCC and Ventures. The Management Agreement permitted Ventures to organize and operate three venture capital related programs on behalf of BMO. It gave Ventures the right to exercise, at its sole discretion, the voting rights with respect to the BMCC Shares, as well as the right to acquire those shares in the case where BMCC terminated the agreement without proper cause. A general power of attorney was also executed in order to allow Ventures to carry out these management services on BMCC's behalf.

[12] In my analysis, the correctness of Sedona's argument turns on the principles stated in *Duha Printers at* paragraph 85, where Iacobucci J. provided a comprehensive list of principles for determining *de jure* control:

> (1) Section 111(5) of the Income Tax Act contemplates de jure, not de facto, control.
>
> (2) The general test for de jure control is that enunciated in *Buckerfield's*, supra: whether the majority shareholder enjoys "effective control" over the "affairs and fortunes" of the corporation, as manifested in "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".

> (3) To determine whether such "effective control" exists, one must consider:
>
> *(a)* the corporation's governing statute;
>
> *(b)* the share register of the corporation;
>
> *(c)* any specific or unique limitation on either the majority shareholder's power to control the election of the board of the board's power to manage the business and affairs of the company, as manifested in either:
>
> i. the constating documents of the corporation; or
> ii. any unanimous shareholder agreement [Emphasis added].
>
> (4) Documents other than the share register, the constating documents, and any unanimous shareholder agreement are not generally to be considered for this purpose.

[13] The Judge concluded that the Management Agreement was not to be taken as determinative of *de jure* control because it was not a constating document within the meaning of corporate law, or a unanimous shareholder agreement. At para. 24 he stated:

> The management agreement is an "ordinary" contractual arrangement between BMCC and Ventures which gives the latter wide powers in managing the technology portfolio of BMCC. It is just an external document and, as a general rule, this kind of document is not to be taken into account as determinative of *de jure* control. It does not affect the corporate constitution of BMCC. For instance, it is not a constating document limiting the powers of the BMCC's board of directors to manage its affairs. Nor does it modify the ownership rights of BMCC in the Sedona shares, although such rights may be exercised by Ventures in the course of the provision of its management services.

[14] In my analysis, the Judge was correct to characterize the Management Agreement as he did. It is well established that the owner of voting shares who is obliged by contract to exercise them in a certain way does not thereby divest himself of those rights (see *Duha Printers* at paragraph 81). I see no reason why the same principle should not apply where the owner of voting shares enters into a contract with another person that grants that person a contractual right to vote the shares but not the other incidents of share ownership.

[15] Sedona also argues that the Management Agreement was a unanimous shareholder agreement, which had the effect of restricting the powers of BMCC directors to manage its business and affairs. The Judge did not accept that argument, primarily because BMO was not a party to that agreement. At para. 25 he stated:

> The management agreement cannot be considered to be a USA entered into by BMCC's shareholder either. BMO is not a party to this management agreement. Under subsection 146(3) [of the] CBCA, a person who is the beneficial owner of all the issued shares of a corporation can make a written declaration that restricts in whole or in part the powers of the directors to manage the business and affairs of the corporation, and this declaration is deemed to be a USA. Here, there is no evidence that BMO made such a written declaration. If BMO had the intention of removing or altering directors' powers to manage the business and affairs of BMCC, it would have at the very least intervened in the management agreement and made its intention clear.

[16] Pursuant to subsection 146(1) of the *Canada Business Corporations Act* a unanimous shareholder agreement is defined in the following way:

146(1) An otherwise lawful written agreement among all the shareholders of a corporation, or among all the shareholders and one or more persons who are not shareholders, that restricts, in whole or in part, the powers of the directors to manage, or supervise the management of, the business and affairs of the corporation is valid [Emphasis added].	**146.** (1) Est valide, si elle est par ailleurs licite, la convention écrite conclue par tous les actionnaires d'une société soit entre eux, soit avec des tiers, qui restreint, en tout ou en partie, les pouvoirs des administrateurs de gérer les activités commerciales et les affaires internes de la société ou d'en surveiller la gestion [Je souligne].

[17] Sedona relies on *Duha Printers* at para. 64 for the proposition that a unanimous shareholder agreement may be brought into existence without specific formality and that all that is required is

some written expression of shareholder will. It argues that the Management Agreement meets the description of a unanimous shareholder agreement in relation to BMCC for the following reasons:

- Subsection 1.1(t) provides that a representative be chosen, who is a BMO senior executive, to be the primary point of contact between the Manager and BMO;
- Section 2.5 requires the transfer of BMO assets to be managed by Ventures;
- Ventures is also required to provide services to BMO-TIP (the BMO program of investments) that Ventures, via the Management Agreement, will manage;
- Section 4.2 provides for the secondment of BMO employees to Ventures; and
- Various provisions contained in the Management Agreement provide contractual obligations of Ventures, BMCC and/or BMO.

[18] In essence, Sedona argues that it is through the agency of BMCC, both express and implied, that BMO is made a party to the Management Agreement. As such, the Management Agreement can be construed as a unanimous shareholder agreement between the shareholder of BMCC, BMCC itself and Ventures, which restricts the powers of the directors of BMCC to manage the business and affairs.

[19] In my view, the Judge was correct to find that BMO is not a party to the Management Agreement. The items listed in paragraph 19 are simply provisions that enhanced Ventures' ability to perform its management function.

[20] Even if BMO were a party to the Management Agreement, there is no basis for concluding that the Management Agreement restricted the powers of BMCC's board of directors to manage its business and affairs. Without this restriction, the statutory requirements for a unanimous shareholder agreement are not met.

[21] In summary, Sedona cannot point to any constating document or unanimous shareholder agreement that would have the effect of attributing the BMCC Shares to Ventures, a private corporation. It follows that the BMCC shares fall into the 'non-resident/public' column and must be attributed to the mythical "particular person" under paragraph (b) of the definition of CCPC in subsection 125(7). The result would be that Sedona was not a CCPC during its 1999 taxation year:

SHARES	RESIDENTS/NON-PUBLIC	NON-RESIDENTS/PUBLIC
Common and Preferred Shares	9 281 789	9 419 931
BMCC shares		438 597
Total	9 281 789	9 858 528
Percentage of Control (ignoring options)	48.5%	51.5%

(2) Taking the options into account

[22] In June of 1999, Sedona adopted a share option plan under which certain of its employees and consultants could be granted options to subscribe for common shares of Sedona. During Sedona's 1999 taxation year, options to acquire 733,500 shares were granted to employees or consultants who were resident in Canada, and options to acquire 342,000 shares were granted to employees and consultants who were not resident in Canada.

[23] On July 22, 1999, Manouch Khezri, a non-resident, was hired by Sedona to begin employment on August 2, 1999. On that date, Sedona's board of directors authorized the grant to Mr. Khezri, on October 15, 1999, of options to acquire 458,000 common shares. The date of the granting of that option was deliberately chosen to fall outside of Sedona's 1999 taxation year, which ended on September 30, 1999, in the hope that the status of Sedona as a CCPC in that taxation year would not be jeopardized.

[24] Options to acquire shares are relevant to determination of the status of Sedona as a CCPC because of paragraph 251(5)(b), the relevant portion of which reads as follows:

Section 251(5): For the purposes of subsection 251(2) and the definition "Canadian-controlled private corporation" in subsection 125(7),	(5) Pour l'application du paragraphe (2) et de la définition de "société privée sous contrôle canadien" au paragraphe 125(7):
…	…
(*b*) where at any time a person has a right under a contract, in equity or otherwise, either immediately or in the future and either absolutely or contingently,	*b*) la personne qui, à un moment donné, en vertu d'un contrat, en equity ou autrement, a un droit, immédiat ou futur, conditionnel ou non:
(i) to, or to acquire, shares of the capital stock of a corporation or to control the voting rights of such shares, the person shall, except where the right is not exercisable at that time because the exercise thereof is contingent on the death, bankruptcy or permanent disability of an individual, be deemed to have the same position in relation to the control of the corporation as if the person owned the shares at	(i) à des actions du capital-actions d'une société ou de les acquérir ou d'en contrôler les droits de vote, est réputée occuper la même position relativement au contrôle de la société que si elle était propriétaire des actions à ce moment, sauf si le droit ne peut être exercé à ce moment du fait que son exercice est conditionnel au décès, à la faillite ou à l'invalidité

that time [Emphasis added].	permanente d'un particulier, [Je souligne]

[25] In essence, subparagraph 251(5)(b)(i) deems a person who has a contractual right to acquire shares at some future date to have the same position in relation to the control of the corporation as if the person already owned the shares. An option to acquire a share is a right that fits within the scope of paragraph 251(5)(b). It is not clear whether whatever right Mr. Khezri was granted on July 22, 1999 fell within paragraph 251(5)(b) at any time during Sedona's 1999 taxation year. Because of that uncertainty, it is convenient to conduct the analysis first without taking the Khezri options into account.

[26] The Judge made two key findings in relation to the options issue. First, he held that the option rights contemplated by paragraph 251(5)(b) could never be attributed to the particular person under paragraph (*b*) of the definition of CCPC in subsection 125(7). His reasoning was that paragraph 251(5)(*b*) does not deem anyone to own shares; it only creates a legal fiction of control of a corporation (see Reasons at para. 13). Secondly, the Judge chose not to decide whether Mr. Khezri's rights should be included in determining whether Sedona was a CCPC in its 1999 taxation year because he found that consideration to be irrelevant in light of his other conclusions.

[27] In my analysis, the legal fiction created by the paragraph 251(5)(*b*) is directed at the concept of ownership, not control. Once it is determined that a person has an option to acquire treasury shares that falls within the scope of paragraph 251(5)(b), it is necessary to assume that the

option is exercised and the related shares are actually acquired by the holder of the option. Then, it is necessary to determine how many votes are attached to the shares actually issued and the shares that would be issued if the options were exercised. Finally, answering the question asked by paragraph (b) of the definition of CCPC in subsection 125(7), it is necessary to determine how many votes should be attributed to the mythical "particular person". As this was not the approach adopted by the Judge, I am compelled to conclude that the Judge made a legal error in his interpretation of subparagraph 251(5)(b)(i). In my view, the correct interpretation of these provisions requires them to be applied as follows. If it is assumed that all of the non-Khezri options were exercised in 1999, the control calculation would be as follows:

SHARES	RESIDENTS/NON-PUBLIC	NON-RESIDENTS/PUBLIC
Common and Preferred Shares (including BMCC Shares)	9 281 789	9 858 528
Options	733 500	342 000
Total	10 015 289	10 200 528
Percentage of Control	49.55%	50.45%

[28] If all of the votes attached to the shares in the 'non-resident/public' column are attributed to the "particular person" referred to in paragraph (b) of the definition of CCPC in subsection 125(7), the particular person would control Sedona in its 1999 taxation year. It follows that Sedona did not qualify as a CCPC in that year. This conclusion makes it unnecessary to determine whether or not the right granted to Mr. Khezri fall within paragraph 251(5)(b) during Sedona's 1999 taxation year.

IV. Conclusion

[29] As the Judge correctly determined that Sedona was not a CCPC during its 1999 taxation year, there is no basis for reversing his decision. I would dismiss this appeal with costs.

"B. Malone"
J.A.

"I agree
M. Nadon J.A."
"I agree
K. Sharlow J.A."

FEDERAL COURT OF APPEAL

NAMES OF COUNSEL AND SOLICITORS OF RECORD

DOCKET:	A-136-06
STYLE OF CAUSE:	SEDONA NETWORKS CORPORATION v. HER MAJESTY THE QUEEN
PLACE OF HEARING:	TORONTO
DATE OF HEARING:	MARCH 12, 2007
REASONS FOR JUDGMENT BY:	MALONE J.A.
CONCURRED IN BY:	NADON J.A SHARLOW J.A.
DATED:	APRIL 30, 2007

APPEARANCES:

Roger Taylor Al-Nawaz Nanji	FOR THE APPELLANT
Daniel Bourgeois Carole Benoit	FOR THE RESPONDENT

SOLICITORS OF RECORD:

Couzin Taylor LLP Barristers & Solicitors Ottawa, Ontario	FOR THE APPELLANT
John H. Sims, Q.C. Deputy Attorney General of Canada Ottawa, Ontario	FOR THE RESPONDENT