1956

*June 5, 6
*Oct. 2

IN THE MATTER OF THE TRUST DEED OF ARTHUR STURGIS HARDY;

THE OFFICIAL GUARDIAN, representing infants and unborn and unascertained persons who may be interested in the corpus of the estate .....APPELLANT;

AND

THE TORONTO GENERAL TRUSTS CORPORATION, Trustee, ARTHUR S. HARDY, JOSEPHINE HARDY, DOROTHY ELVIDGE and IAN F. H. ROGERS .....RESPONDENTS.

ON APPEAL FROM THE COURT OF APPEAL FOR ONTARIO

Companies—Distribution of accumulated profits in form of stock dividend —Immediate redemption of shares so issued—Effect—Whether proceeds income or capital in hands of trustee-shareholder—The Income Tax Act, 1948 (Can.), c. 52, s. 95A, enacted by 1950, c. 40, s. 32—The Companies Act, R.S.C. 1952, c. 53, s. 83(3).

Trusts and trustees—Trust assets including shares in incorporated company—Issue of stock dividend by company as means of distributing accumulated profits—Redemption of shares—Whether proceeds income or capital in hands of trustees—The Income Tax Act, 1948 (Can.), c. 52, s. 95A, enacted by 1950, c. 40, s. 32.

If a company incorporated under the *Dominion Companies Act* elects under s. 95A of the *Income Tax Act*, 1948, as enacted in 1950, to pay tax on its undistributed income, and thereafter creates preference shares, issues them to the shareholders as a stock dividend, and immediately redeems them out of the undistributed profits, the proceeds of the redemption reach the shareholders not as tax-free income but as non-taxable capital. A trustee, therefore, who, holding shares in the company as a trust asset, receives moneys in redemption of preference shares so issued, receives them as capital of the trust rather than as income. From the time that the trustee becomes entitled to receive a certificate for these shares their status, as between the settlor and the remaindermen under the trust, does not differ from that of the shares originally received by the trustee, and a capital asset (the shares) in the hands of a trustee will not be transformed into income merely because the company uses surplus profits to redeem the shares.

Re Fleck, [1952] O.R. 113 (affirmed [1952] O.W.N. 260), overruled.

APPEAL from the judgment of the Court of Appeal for Ontario (1), affirming the judgment of Ferguson J. (2) on a motion for the opinion, advice and direction of the Court. Appeal allowed.

F. T. Watson, Q.C., for the appellant.

G. F. Henderson, Q.C., for the individual respondents.

H. F. Parkinson, Q.C., for the trustee, respondent.

The judgment of Kerwin C.J. and Locke, Cartwright and Nolan JJ. was delivered by

THE CHIEF JUSTICE:—The following question was submitted to a judge of the Supreme Court of Ontario for his advice and opinion:—

> Does the Thirty-one thousand one hundred and sixty-eight dollars ($31,168) representing the proceeds in respect of the share of Arthur Sturgis Hardy and payable to the Trustees of the Trust Deed of the said Arthur Sturgis Hardy on the redemption of 31,168 preferred shares, being part of the redemption of 260,000 preferred shares of G. T. Fulford Co. (Limited) issued by way of stock dividends out of the tax paid undistributed income of the company following an election by the company to exercise rights under Section 95A(1) of the *Income Tax Act*, S.C. 1948, Chapter 52, constitute income or capital in the hands of the Trustees?

(1) [1955] O.W.N. 835, [1955] C.T.C. 220, 55 D.T.C. 1175, [1955] 5 D.L.R. 10.

(2) [1955] O.W.N. 273, [1955] C.T.C. 138, 55 D.T.C. 1062, [1955] 2 D.L.R. 296.

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If he had not considered himself bound (as indeed he was) by the decision of the Court of Appeal in *Re Fleck* (1), Ferguson J., before whom the application came, would have found that the money constituted capital in the hands of the trustees and not income, but in view of that authority he declared otherwise. The Court of Appeal decided that it was bound by its previous decision and dismissed an appeal by the Official Guardian, who now appeals to this Court.

Mr. Arthur Sturgis Hardy, referred to in the question, is one of the beneficiaries entitled to share in the estate of the late Senator Fulford, who died October 15, 1905. The trust deed is dated August 7, 1928, and was made between Mr. Hardy, as settlor, and The Toronto General Trusts Corporation, as trustees. That trust deed, after reciting the fact that the settlor, in the event he should survive his mother, who was a daughter of Senator Fulford, would be entitled to one-quarter of a distributive share or interest in one-half of the capital of the residuary estate, and the desire of the settlor to assign to the trustees 85 per cent. of his share if and when he should become entitled thereto, declared that:—

> Securities or assets, if any, of the estate of the Honourable George Taylor Fulford which may be assigned and transferred in specie to the Trustees herein by the Executors and Trustees of the Estate of the said Testator to form or partly form the said eighty-five per cent of the distributive shares of the Settlor in said estate shall be retained by the Trustees as investments of the Trust Estate,

this being followed by provisions for changing the investments from time to time. One of the obligations imposed upon the trustees was:—

> During the lifetime of the Settlor, but subject as hereinafter provided, to pay to the Settlor or to expend for his benefit the net annual income derived from the Trust Estate,

with power to encroach upon the capital in a manner which does not affect the present consideration. Among the powers conferred upon the trustees was to take up as part of the trust estate any allotment of new stock in any com-

(1) [1952] O.W.N. 260, [1952] C.T.C. 196, [1952] D.T.C. 1050, [1952] 2 D.L.R. 657, affirmed [1952] O.W.N. 260, [1952] C.T.C. 205, [1952] D.T.C. 1077, [1952] 2 D.L.R. at 664.

pany whose stock formed part of such estate, to purchase the proportion of shares allotted by reason of the shares held, all of such new shares to be held as part of the trust estate.

A further paragraph of the trust deed read:—

> Provided further, and notwithstanding anything hereinbefore contained, the Settlor hereby declares that shares of Capital Stock in the G. T. Fulford Company, Limited, and Dr. Williams Medicine Company, Limited, Fulford Hanson Company or of any subsidiary Company of the G. T. Fulford Company Limited or in any business way connected therewith or of any one or more of said Companies which may be assigned and transferred to the Trustees in the due course of the administration of the estate of the said Honourable George Taylor Fulford deceased, as representing or forming part of the eighty-five per cent. of the Settlor's distributive shares therein may be retained by the Trustees herein as investments of the Trust Estate for such length of time or times as they the Trustees in their discretion may deem advisable, without the Trustees incurring liability by so retaining same; the intention of the Settlor is that no shares in the Capital stock of any of said Companies or business hereinbefore referred to in this paragraph shall form part of the fifteen per cent. of his distributive shares in the said estate which he intends to retain for his own use and purpose and which is not included in the Trust Estate hereby assigned, transferred and set over.

The G. T. Fulford Co. (Limited) was incorporated following the death of Senator Fulford in the year 1905 under the provisions of the *Dominion Companies Act,* to take over and carry on the business theretofore engaged in by him. The authorized capital was originally 10,000 shares of the par value of $100 each, and of these shares the trustees in due course received 1,193, which were held under the terms of the deed of trust. From the time of its incorporation the company actively engaged in business, earning substantial profits, and on December 31, 1949, had accumulated a surplus from earnings amounting to $314,063.41.

By appropriate steps the company elected under subs. (1) of s. 95A of the *Income Tax Act,* 1948 (Can.), c. 52, enacted by 1950, c. 40, s. 32, to be assessed and to pay a tax on such accumulated earnings and this being done, there remained in the hands of the company a tax-paid undistributed surplus of $266,953.90. Thereafter a by-law was adopted enabling the company to issue fully paid shares for the amount of any dividend, and on January 6, 1953, supple-

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mentary letters patent were granted to the company increasing the authorized capital by the creation of 500,000 3 per cent. non-cumulative redeemable preference shares of the par value of $1 each.

On January 21, 1953, a resolution was adopted by the directors which, after reciting the amount of the tax-paid undistributed income on hand, read:—

> IT IS RESOLVED that a stock dividend be and the same is hereby declared to be payable out of the said tax paid undistributed income to shareholders of the company as of this date in the amount of one preference share for each common share held by a shareholder.

On the same date, a further resolution was passed, which, after reciting the issue of the 10,000 preference shares, resolved that they be redeemed, and this was done, the trustees receiving from the company the sum of $1,193.

On April 10, 1953, a resolution declaring a further stock dividend of 25 of the preference shares for each common share "payable out of the said tax paid undistributed income" was adopted. A resolution authorizing their redemption was passed later on the same day. These were then redeemed, the trustees receiving a further sum of $29,975.

While in the view that I take of the matter it does not assist in the determination of the question, it may be noted that at the meeting which authorized the stock dividend and the redemption of the preferred shares, the chairman stated that it had not been the intention of the company to make the preference shares part of its capital structure and that they had been created with the sole view of immediately redeeming them when they were issued in order to take advantage of the provisions of the *Income Tax Act* whereby the company might by paying a tax of $47,109.51, distribute the tax-paid surplus tax-free in the hands of the shareholders. The motive or purpose is, however, irrelevant if it is made out that the accumulated profits have been capitalized: *Commissioner of Income Tax, Bengal v. Mercantile Bank of India, Limited et al.* (1).

I consider that none of the provisions of the *Income Tax Act* affects the question as to whether these moneys were income to which the settlor was entitled or capital which the trustees were required to hold for the benefit of those entitled in remainder.

(1) [1936] A.C. 478 at 495.

While the resolutions of January 21 and April 10, 1953, referring to a stock dividend "to be payable out of the said tax paid undistributed income" might have been more clearly expressed, both resolutions were undoubtedly passed under the authority of s. 83(3) of the *Companies Act,* now R.S.C. 1952, c. 53, the intention obviously being to convert the tax-paid undistributed income to the extent of $260,000 into capital and to issue the preference shares fully paid to the shareholders. There was no intention that the dividend should be paid in money to the shareholders as the wording of the resolutions might suggest. It was the said sum of $260,000 which by virtue and in consequence of the resolutions became part of the paid-up capital of the company that was employed for the redemption of the shares.

The respective rights of the settlor and those entitled in remainder are to be tested as of the time when the issue and allotment of the shares was authorized and their distribution directed.

It is the action taken by the company that is decisive of the matter. In *In re Bouch; Sproule v. Bouch* (1), Fry L.J. said in part:—

> When a testator or settlor directs or permits the subject of his disposition to remain as shares or stock in a company which has the power either of distributing its profits as dividend, or of converting them into capital, and the company validly exercises this power, such exercise of its power is binding on all persons interested under him, the testator or settlor, in the shares, and consequently what is paid by the company as dividend goes to the tenant for life, and what is paid by the company to the shareholder as capital, or appropriated as an increase of the capital stock in the concern, enures to the benefit of all who are interested in the capital.

This statement of the law was approved in the judgment delivered by Lord Herschell in the House of Lords on the appeal (*Bouch and Bouch v. Sproule* (2)), and in *Commissioners of Inland Revenue v. Blott; The Same v. Greenwood* (3), per Viscount Haldane at p. 186. While the latter case was one concerned with income tax, Viscount Haldane discussed the general principle applicable in the case of companies incorporated under *The Companies (Consolidation) Act,* 1908, and while part of his remarks are inapplicable to companies incorporated by letters patent

(1) (1885), 29 Ch.D. 635 at 653. (2) (1887), 12 App. Cas. 385 at 397.
(3) [1921] 2 A.C. 171.

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under the *Dominion Companies Act*, the statement at p. 182 as to the effect of the company's action applies equally, in my opinion, to such companies:—

> Such a company is a corporate entity separate from its shareholders, but the latter can control its action by passing resolutions in general meeting. If these resolutions are directed to what falls within the capacity of the company as the Act of Parliament defines it, they are treated as concerned with internal management, and if they have been passed in accordance with the statute and the articles of association no Court has jurisdiction to interfere in a question which is for the proper majority of the shareholders alone. The company, acting with the assent so given of the shareholders, can decide conclusively what is to be done with accumulated profits. It need not pay these over to the shareholders. It can convert them into capital as against the whole world, including, as I think the principle plainly implies, the Crown claiming for taxing or for any other purposes. The only question open is, theerfore, whether the company has really done so.

In the present matter it is abundantly clear that it was the desire of the shareholders to distribute the accumulated profits among the shareholders without paying the high rate of income tax that would be payable by them if the dividend was declared in cash. In so far as the shareholders themselves were concerned, this result was accomplished by the creation, allotment and subsequent redemption of the preference shares. That in doing so they affected the rights of the settlor and those entitled in remainder in the present matter was not a matter with which *qua* shareholders or directors they were concerned.

In *Commissioners of Inland Revenue v. Fisher's Executors* (1), Lord Sumner, referring to statements which appear in some of the reported cases that it is the intention of the company that is said to be dominant, said that desires and intentions are things of which a company is incapable, these being the mental operations of its shareholders and officers, and that:—

> The only intention that the company has, is such as is expressed in or necessarily follows from its proceedings. It is hardly a paradox to say that the form of a company's resolutions and instruments is their substance.

It was the net annual income derived from the trust estate which the trustees were required to pay to the settlor. The fully paid-up preference shares allotted to the trustees were part of the authorized capital of G. T. Fulford Co. (Limited) and were accretions to the capital of the estate. From the time when the trustees became entitled to receive a certificate from the company for these preference

(1) [1926] A.C. 395 at 411.

shares, their status as between the settlor and those entitled in remainder did not differ from that of the common shares received by the trustees from the Fulford estate. There is nothing in the language of the trust deed to indicate an intention that the word "income" should be given an extended meaning and include distributions of this nature.

In a judgment delivered contemporaneously herewith in *Re Waters; Waters v. The Toronto General Trusts Corporation et al.* (1), Kellock J., with whose reasons I agreed, left open a point that did not arise in that case. It is now necessary to deal with it and it must be laid down that a capital asset (shares) in the hands of trustees will not be transformed into income merely because a company uses surplus profits to redeem shares. In fact those undistributed profits do not reach the shareholders as tax-free income, but as non-taxable capital. It must be taken that *Re Fleck* (2), was wrongly decided.

The appeal is allowed and the question submitted to the Court answered by stating that the moneys referred to constitute capital in the hands of the trustees. All parties may have their costs in all courts out of those moneys, the costs of the trustees to be as between solicitor and client.

RAND J.:—For the reasons given by me in *Re Waters; Waters v. The Toronto General Trusts Corporation et al.* (1), judgment in which is being delivered contemporaneously with this, I would allow the appeal and answer the question submitted by stating that the moneys referred to constitute capital in the hands of the trustees. The costs of all parties in all courts shall be paid out of these moneys, those of the trustees as between solicitor and client.

Appeal allowed.

The Official Guardian for Ontario: P. D. Wilson, Toronto.

Solicitors for the respondents The Toronto General Trusts Corporation: Parkinson, Gardiner, Roberts, Anderson & Conlin, Toronto.

Solicitors for the other respondents: Gowling, MacTavish, Osborne & Henderson, Ottawa.

(1) *Ante*, p. 889.

(2) [1952] O.R. 113, [1952] C.T.C. 196, [1952] D.T.C. 1050, [1952] 2 D.L.R. 657, affirmed [1952] O.W.N. 260, [1952] C.T.C. 205, [1952] D.T.C. 1077, [1952] 2 D.L.R. at 664.