THE MINISTER OF NATIONAL REVENUE ..... APPELLANT;

1955
Mar. 30
June 28

AND

SHELDON'S ENGINEERING LIMITED . RESPONDENT.

ON APPEAL FROM THE EXCHEQUER COURT OF CANADA

Assessment—Taxation—Income Tax—Capital cost allowance claimed by corporation on assets purchased from another—Whether corporations controlled by same persons—Whether dealing at arms length—The Income Tax Act, S. of C. 1948, c. 52, ss. 11(1)(a), 20(2), 127(5).

The respondent was incorporated under the *Companies Act* (Can.) in June, 1949, and by an agreement dated July 4, purchased the assets of Sheldon's Limited, an Ontario corporation. In its income tax return for that year it claimed, under s. 11 (1) (*a*) of *The Income Tax Act,* a deduction in respect to capital cost allowance (depreciation) based on the capital cost to the respondent of certain assets purchased from the old company. The claim was disallowed by the appellant on the ground that by virtue of s. 20 (2) of the Act, the capital cost for the purpose of paragraph (*a*) was deemed to be the capital cost to the old company since the transaction had not been one between "persons dealing at arm's length" within the meaning of that section.

Sheldon's Ltd. was controlled by its president and secretary who held a majority interest which they agreed to sell to three minority shareholders. The latter negotiated a loan with the Bank to finance the purchase and the Bank stipulated that the borrowers should deposit with and assign to it as collateral security eighty per cent of the

*PRESENT: Kerwin C.J. and Taschereau, Estey, Locke and Cartwright JJ.

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issued shares of the old company, that a new company be formed to acquire the shares purchased from the majority interest and the assets of the old company, the new company to issue bonds to be applied toward retiring the loan and that an agreement be obtained with an underwriter to purchase the bonds when issued. The terms were complied with. A new company, the respondent, was incorporated and the shares of the old company deposited with the Bank which had them transferred into the names of its own nominees. The transaction between the two companies was completed on July 4 on which date the directors of the old company passed a by-law authorizing the sale and a winding-up and distribution of its assets. This action was ratified by a general special meeting of its shareholders at which the Bank's nominees were in control. The new company's directors then authorized the purchase of the assets and the bond issue and their action was ratified by its shareholders. The directors then authorized purchase of the controlling interest in the old company and assumption of the bank loan. The result was that the new company became entitled to a conveyance of all the assets of the old company, and by virtue of having acquired all of its issued shares, to the amount realized from the sale of its assets.

Held: At the time the sale of the depreciable property in respect of which the capital cost allowance was claimed, was made, the old company was completely controlled by the Bank. In the circumstances ss. 20(2) and 127(5) of the *Income Tax Act* had no application and the parties were at arms length within the commonly accepted meaning of that expression.

Partington v. *The Attorney General* L.R. 4 H.L. 100 at 122. *Versailles Sweets* v. *Attorney General of Canada* [1924] S.C.R. 466 at 468, applied.

Judgment of the Exchequer Court of Canada [1954] Ex. Cr. 504, affirmed.

APPEAL from a judgment of the Exchequer Court of Canada (1) Potter J., dismissing the appellant's appeal from a decision of The Income Tax Appeal Board (2) allowing the respondent's appeal from its assessment for income tax for the year 1949.

W. R. Jackett, Q.C., E. D. Hickey and *F. J. Dubrule* for the appellant.

D. Guthrie, Q.C. and *H. D. Guthrie* for the respondent.

The judgment of the Court was delivered by:—

LOCKE J.:—This is an appeal from a judgment delivered in the Exchequer Court by the late Mr. Justice Potter (3), by which the appeal of the Minister from a decision of the Income Tax Appeal Board was dismissed. By that decision the present respondent's appeal from its assessment for income tax for the year 1949 was allowed.

(1) [1954] Ex. C.R. 507; 54 D.T.C. 1106.

(2) 7 Tax A.B.C. 353; 53 D.T.C. 11.

(3) [1954] Ex. C.R. 507.

The facts disclosed by the evidence, in so far as it appears to me to be necessary to consider them, are as follows: Sheldon's Limited, a company incorporated under the Companies Act of Ontario (hereinafter referred to as the old company), had for many years prior to 1949 carried on a manufacturing business at Galt, Ont. As of June 1st in that year 4,009 of the common shares had been issued and, of these J. P. Stuart and S. E. Nicholson owned a total of 2,177: 1,168 were held by W. D. Sheldon, Sr. and the remainder by W. D. Sheldon, Jr. and a number of other persons whose identity is immaterial. W. D. Sheldon, Jr. was employed by the company in the capacity of Chief Engineer and G. M. Egoff, W. C. Caldwell and H. W. Mogg were also in the company's employ. Some time prior to the month of June 1949, these four persons had learned that Stuart and Nicholson who, as stated, together held more than fifty per cent of the issued shares and directed the company's policy and occupied the positions of President and Secretary, respectively, wished to sell their shares. In order to prevent the control of the company being acquired by outside interests, Sheldon, Jr., acting on behalf of himself and Egoff, Caldwell and Mogg, entered into negotiations for the purchase of these shares, and an arrangement was concluded whereby Stuart and Nicholson agreed to accept $165 a share in cash for them. The following arrangements were then made by Sheldon, Jr. for the purchase of these shares and the continuing of the business: he arranged to borrow a sum of $359,205, the total purchase price of the shares, from the Royal Bank of Canada, the bank stipulating as a condition of making the loan that eighty per cent of the issued shares of the old company would be lodged with it as collateral security, that a new company should be formed for the purpose of acquiring the shares purchased from Stuart and Nicholson and the assets and good will of the old company, the new company to issue bonds of the face value of $300,000 to be applied towards retiring the loan to Sheldon, Jr. and that an agreement be obtained with an underwriter satisfactory to the bank to purchase the bonds when issued. Sheldon, Jr. was able to

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arrange with all of the minority shareholders of the company to exchange their shares for shares in the new company on an agreed basis, and on June 9, 1949 made an agreement with an underwriter agreeable to the bank for he purchase of the bonds when issued.

The present respondent was incorporated under the provisions of the Dominion Companies Act by letters patent dated June 15, 1949, its capital consisting of 16,000 preferred shares of the par value of $25 each and 80,000 common shares without nominal or par value. On June 17, 1949, Sheldon, Sr., Beatrice B. Sheldon, his wife, and Sheldon, Jr. hypothecated to the Royal Bank their total shareholdings in the old company aggregating 1,259, as security for the loan referred to, and on June 21, 1949, Sheldon, Jr. hypothecated to the bank 2,173 of the shares which he had agreed to purchase from Stuart and Nicholson. It was, apparently, on the latter date that the purchase of these shares was completed and the moneys paid. It is to be noted that, while the collateral security for the loan taken by the bank was on what appears to be the bank's customary form of hypothecation whereby the security was assigned to the bank as general and continuing collateral security for the fulfilment of the present and future obligations of the borrower, the bank, in addition to obtaining the certificates, presented them for transfer to the old company, directing that new certificates be issued in the name of its nominees, A. S. McKay and S. M. Baird. The minutes of a meeting of the directors of the old company held on June 21 show that on that date Stuart resigned as president and director of the company and Sheldon, Jr. was appointed to both offices in his place, and Nicholson resigned as director and secretary, being replaced by Egoff.

The new company having been incorporated and the arrangement with the underwriter made, the proposed transaction between the two companies was completed on July 4, 1949. On that date the companies entered into an agreement in writing for the sale of all the assets of the old company to the new company for an agreed consideration of $1,267,904.44. The agreement specified the sale price of the various kinds of assets sold. So far as it is necessary to consider them, the amounts were: $206,160.18 for the buildings; $348,108.71 for machinery, tools, equipment and

office furniture; $1,326.35 for motor vehicles and equipment and $20,054.42 for patents, patterns, drawings and cuts. To the extent of $517,825.06, the purchase price was to be satisfied by the assumption by the new company of the liability of the old company in respect of a dividend which had been declared by the directors of the old company. At 3 o'clock in the afternoon of that date, the directors of the old company met, declared a dividend in the amount above stated, payable to shareholders of record as of the day following, passed a by-law authorizing the sale, authorized the execution of the sale agreement above mentioned and elected directors in place of two members of the Board whose resignations were then presented. The directors further passed a by-law authorizing the winding-up of the company and the distribution of its assets among the shareholders. This meeting was followed by a special general meeting of the shareholders at which McKay and Baird, who then were in control of the company, were represented by a proxy given to them by Sheldon, Jr. and Egoff, which ratified the by-laws theretofore passed by the directors.

Following these meetings of the old company, the directors of the new company, then consisting of Sheldon, Jr., Egoff, Mogg, Caldwell and D. R. Dattels (who represented the underwriter on the Board pursuant to the agreement for the sale of the bonds to which I have referred) met. At this meeting a by-law authorizing the purchase of the assets of the old company and the execution of the agreement was adopted and applications for 24,001 common shares were accepted and the shares allotted: of these, Sheldon, Jr., Egoff, Caldwell and Mogg were allotted 18,000 shares. A further by-law passed authorized the issue of the bonds in pursuance of the arrangements made in advance of the incorporation of the company. Following this, a special general meeting of the shareholders was held at 6 o'clock, ratifying the above mentioned by-laws. At 6.30 o'clock, a further meeting of the directors was held which authorized the purchase by the company of the 2,177 shares of the old company which had been purchased from Stuart and Nicholson and the assumption by the company of the liability of Sheldon, Jr. to the Royal Bank and, in addition, the purchase of 1,832 shares of the old company, the consideration being fully paid shares in the new company,

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these shares being duly allotted. Upon the carrying out of these arrangements, the new company became the owner of all of the issued shares in the old company and entitled, as such, to the dividend which had been declared on the previous day.

It will be seen from the foregoing recital that the persons who negotiated the transaction whereby the assets of the old company were purchased and conveyed to the new company were Sheldon, Jr. and his three associates. Its completion was made possible by the loan secured from the Royal Bank of Canada with the assistance of Sheldon's parents, and the arrangements which Sheldon, Jr. was able to make, prior to the incorporation of the new company, with the underwriter and the minority shareholders. The result of the transactions carried out on July 4th was that the new company became entitled to a conveyance of all the assets of the old company under the terms of the agreement of purchase and, at the same time, by virtue of having acquired all of its issued shares, became entitled to the amount realized from its assets.

S. 11(1)(*a*) of the *Income Tax Act* ((Can.) c. 52, 1948 as amended by 1949 (Can. 2nd Sess.) c. 25, s. 4) provides that a taxpayer may deduct in computing his income such part of the capital cost to the taxpayer of property, if any, as is allowed by regulation.

S. 20 of the Act, as amended by s. 7 of the amending Act of 1949, provides, *inter alia,* that where depreciable property did at any time after the commencement of 1949 belong to one person who has by one or more transactions between persons not dealing at arm's length become vested in the taxpayer, the capital cost of the property to the taxpayer shall be deemed to be the amount that was the capital cost of the property to the original owner.

In the tax return filed by the respondent, the capital cost of the assets upon which depreciation could be claimed was stated at the amounts agreed to be paid for them as above stated. As contrasted with these figures, their undepreciated capital cost upon the books of the old company were: as to the buildings $107,228.05; as to the machinery, tools, equipment and office furniture $91,547.27 and as to the patents, patterns, drawings and cuts $6,695.30. By the assessment made the depreciation claimed was

reduced by $6,672.14 and it is the increased amount of the tax by reason of this partial disallowance of the claim which is involved in these proceedings.

It is not contended by the Minister that the capital value assigned by the respondent to the assets in question was less than their true value. The values assigned were indeed substantially less than the value of these assets, in the opinion of an appraiser who had valued them some time theretofore at the instance of the old company. The good faith of the respondent in the matter is not impugned, the only questions between the parties being as to the true construction of the relevant provisions of the statute.

The question to be determined is whether, at the time the assets of the old company became vested in the new company, the contracting parties were persons "not dealing at arms length", within the meaning of that expression in s. 20(2). As to the time at which the assets in question vested in the respondent, I agree with the learned trial judge that it was at the time of the execution of the agreement by the respondent on July 4, 1949.

The *Income Tax Act* does not define the expression "dealing at arms length", though s. 127(5)(*b*) provides that, for the purposes of the Act, corporations controlled directly or indirectly by the same person:—

> Shall, without extending the meaning of the expression "to deal with each other at arms length", be deemed not to deal with each other at arms length.

The expression is one which is usually employed in cases in which transactions between trustees and *cestuis que trust,* guardians and wards, principals and agents or solicitors and clients are called into question. The reasons why transactions between persons standing in these relations to each other may be impeached are pointed out in the judgments of the Lord Chancellor and of Lord Blackburn in *McPherson* v. *Watts* (1). These considerations have no application in considering the meaning to be assigned to the expression in s. 20(2).

The words do not appear in the *Income War Tax Act,* though the same subject matter is dealt with in s. 6(1)(*n*) of that Act. In addition to appearing in ss. 20 and 127, the term is employed in ss. 12(3), 17(1), (2) and (3), 36(4)

(1) (1877) 3 App. Cas. 254.

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and 125(3) of the *Income Tax Act*. S. 127(5) does not purport to define the meaning of the expression generally: it merely states certain circumstances in which persons are deemed not to deal with each other at arms length. I think the language of s. 127(5), though in some respects obscure, is intended to indicate that, in dealings between corporations, the meaning to be assigned to the expression elsewhere in the statute is not confined to that expressed in that section.

Where corporations are controlled directly or indirectly by the same person, whether that person be an individual or a corporation, they are not by virtue of that section deemed to be dealing with each other at arms length. Apart altogether from the provisions of that section, it could not, in my opinion, be fairly contended that, where depreciable assets were sold by a taxpayer to an entity wholly controlled by him or by a corporation controlled by the taxpayer to another corporation controlled by him, the taxpayer as the controlling shareholder dictating the terms of the bargain, the parties were dealing with each other at arms length and that s. 20(2) was inapplicable. The present is not such a case, in my opinion, and the question is whether the expression is properly applicable in the circumstances disclosed by the evidence. W. D. Sheldon, Jr. alone, did not, nor did he, together with his three associates Egoff, Caldwell and Mogg, control the old company at the time on July 4, 1949, when the resolutions and by-laws authorizing the sale to the new company were adopted by the directors and subsequently confirmed by the shareholders. I cannot accept the contention advanced on behalf of the Minister that, by reason of s. 73 of the *Companies Act* (R.S.O. 1937, c. 251), Sheldon was entitled to vote upon the shares standing on the share register of the company in the names of McKay and Baird. That section, in my opinion, has no application to a case in which, in addition to the instrument of hypothecation, an actual transfer of the shares to the creditor has been made. It would require an express provision in the *Companies Act* to authorize any person other than a shareholder or a proxy to vote at meetings of the company.

At the time these steps were taken by the old company, it was completely controlled by the bank. The bank depended to a great extent for the repayment of its loan to Sheldon upon the successful disposition of the bonds to be issued by the new company and, as it was pointed out in the evidence, the prospects of making a successful sale of the bonds might well have been prejudiced had the value of the depreciable assets acquired by the new company been shown at their original cost to the old company instead of at their fair value. At the time the meetings of the new company were held at which the purchase was authorized by the directors and shareholders of the new company, Sheldon, Jr. did not hold the controlling interest in the new company, though it would appear that, following the meeting of the directors held at 4.30 o'clock on the afternoon of July 4, when some of the applications for shares in the new company were accepted and the shares allotted, the combined holdings of Sheldon, Jr., Egoff, Caldwell and Mogg constituted a majority of the shares, and that it was later on the same day that the shareholders' meeting confirmed the by-law authorizing the purchase.

In this situation ss. 20(2) and 127(5)(*b*) had no application, in my opinion. While the arrangements which were carried into effect at the meetings of the two companies on July 4 were made in advance and, no doubt, included settling the consideration to be paid for the depreciable assets, it was the bank and not Sheldon, Jr., either alone, or together with his associates, that was in command of the old company after June 21.

S. 20(2) of the *Income Tax Act* may have been intended to cover a more extended field than s. 6(1)(*n*) of the *Income War Tax Act* but, if so, the nature of the extension has not been made clear. In *Partington* v. *The Attorney General* (1). Lord Cairns said in part:—

> . . . as I understand the principle of all fiscal legislation, it is this: If the person sought to be taxed comes within the letter of the law he must be taxed, however great the hardship may appear to the judicial mind to be. On the other hand, if the Crown, seeking to recover the tax, cannot bring the subject within the letter of the law, the subject is free, however apparently within the spirit of the law the case might otherwise appear to be.

(1) (1869) L.R. 4 H.L. 100 at 122.

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This rule so stated for the construction of a taxing statute was adopted by Duff J., as he then was, in *Versailles Sweets* v. *Attorney General of Canada* (1).

The transaction in question does not fall within the letter of the law, in my opinion, and the respondent is entitled to the relief given in the judgment at the trial. I consider that the parties were at arms length, within the commonly accepted meaning of that expression.

The appeal should be dismissed with costs.

Appeal dismissed with costs.

Solicitor for the appellant: *T. J. Dubrule.*

Solicitors for the respondent: *Cassels, Brock & Kelley.*