THE EXECUTORS OF THE ESTATE OF WALTER E. H. MASSEY (DECEASED) ..... APPELLANTS;

1939
*May 25
*Dec. 9

AND

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

ON APPEAL FROM THE EXCHEQUER COURT OF CANADA

Income tax—Assessment of shareholder in respect of excess over par value received on redemption of shares by company—Question whether the "premium" was "paid out of" the company's "undistributed income on hand," within s. 17 (as it then stood) of Income War Tax Act, R.S.C. 1927, c. 97.

Sec. 17 of the *Income War Tax Act*, R.S.C. 1927, c. 97, as it stood at the material date, provided: "Where a corporation, having undistributed income on hand, redeems its shares at a premium paid out of such income, the premium shall be deemed to be a dividend and to be income received by the shareholder."

A company (under due authorization) in 1929 created 5 per cent. cumulative convertible preference shares and increased its common shares, and, with the aid of proceeds of sale of these new shares, called in and redeemed its existing 7 per cent. cumulative preference shares of the par value of $100 each at $110 per share and accrued dividend. The "premium" (of $10 per share) paid on such redemption was charged by the company against its "surplus account." Appellants held shares thus redeemed and were assessed for income tax in respect of the "premium" received, on the ground that it was a "premium paid out of undistributed income on hand" within said s. 17. The assessment was sustained by Maclean J., [1939] Ex. C.R. 41. On appeal:

Held (Davis J. dissenting): The appeal should be dismissed.

Per the Chief Justice and Hudson J.: In view of the manner in which the company's surplus (as shown in its surplus account) was built up and what it represented (as appearing from directors' reports, balance sheets, and other evidence), it must be held that in fact it represented undistributed income actually existing, though in various forms as current assets. The company, having cash on hand (whether derived from sale of shares or a loan), might treat this cash as the embodiment of the surplus. It was clear in point of fact that the directors, with the assent of the shareholders, did intend to pay the premium out of surplus, and, *pro tanto*, to reduce the surplus; and by resorting to the fund of which they made use, they thereby treated that fund as part of the surplus of undistributed income, and, therefore, as "undistributed income on hand." Therefore the conditions of s. 17 were fulfilled. (Also, said premium, so called, was a premium within the contemplation of s. 17.)

*PRESENT:—Duff C.J. and Rinfret, Davis, Kerwin and Hudson JJ.

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Rinfret and Kerwin JJ. agreed with the reasons for judgment of Maclean J. (cited *supra*) in holding that the premium in question was a premium paid out of the company's "undistributed income on hand" within the meaning of s. 17.

Per Davis J. (dissenting): From the facts (discussed) in regard to the source and constitution of the fund out of which the redemption payments were made, it cannot be said that the premium, so called, was "paid out of undistributed income on hand" within s. 17. *Quaere* whether the excess over par value, paid by the company in exercise of its right (given by supplementary letters patent) to redeem at a fixed price without consent of holders of the shares, was strictly "a premium."

APPEAL from the judgment of Maclean J., President of the Exchequer Court of Canada (1), dismissing the present appellant's appeal from the decision of the Minister of National Revenue affirming the assessment of appellants for income tax for the taxation period of 1929 (under s. 17 of the *Income War Tax Act,* R.S.C. 1927, c. 97, as it stood at the material date) in respect of a "premium" of $10 per share paid to them upon the redemption by Massey-Harris Co., Ltd., of preference shares held by appellants in the stock of the company.

The material facts of the case are sufficiently stated in the reasons for judgment in this Court now reported (and are also discussed at length in the judgment appealed from (1)). The appeal to this Court was dismissed with costs, Davis J. dissenting.

C. H. A. Armstrong K.C for the appellant.

F. P. Varcoe K.C. and *A. A. McGrory* for the respondent.

The judgment of the Chief Justice and Hudson J. was delivered by

THE CHIEF JUSTICE.—This appeal raises a question of the construction and application of section 17 of the *Income War Tax Act* (ch. 97, R.S.C. 1927) which is as follows:

> 17. Where a corporation, having undistributed income on hand, redeems its shares at a premium paid out of such income, the premium shall be deemed to be a dividend and to be income received by the shareholder.

The question to be determined is whether certain sums received in 1929 by the appellants from the Massey-Harris

(1) [1939] Ex. C.R. 41; [1939] 4 D.L.R. 225.

Co., Ltd., on the redemption of shares held by them in that Company are assessable to income tax as being within the scope of this definition of income.

The Massey-Harris Co., Ltd., is a manufacturing company created under the provisions of the Dominion *Companies Act*. By a document described as supplementary letters patent of the 17th of February, 1926, the Secretary of State, pursuant to statutory authority, approved a resolution of the Company of the 2nd of February converting 250,000 shares of the capital stock of the Company of the par value of $100 each into 125,000 cumulative preference shares of the par value of $100 and 125,000 common shares of the same value. By this document it was declared:

> The Company shall also have the right without the consent of the holders thereof, from time to time to redeem the whole or any number of the said cumulative preference shares at One hundred and ten (110%) per centum of their par value, together with any accumulated dividends thereon upon giving [the prescribed] notice * * *

The late Walter E. H. Massey at his death was the registered holder of 9,122 of these shares. By a document also described as supplementary letters patent, of March 19th, 1929, the Secretary of State, in exercise of authority vested in him by the *Companies Act*, confirmed a by-law of the company increasing the capital stock of the company from 125,000 7 per cent. cumulative preference shares of $100 each and 500,000 common shares without nominal or par value to 125,000 7 per cent. cumulative preference shares of $100 each (being the already authorized preference shares) and 150,000 5 per cent. cumulative convertible preference shares of $100 each and 1,000,000 common shares without nominal or par value, being an addition of 150,000 5 per cent cumulative convertible preference shares of $100 each and 500,000 common shares without nominal or par value of the company.

Upon the same date the company gave notice to the shareholders of the 7 per cent. cumulative preference shares of its intention to redeem these shares by paying the redemption price of $110 per share together with the accrued dividend. The shares held by the appellants as the executors of the late Walter E. H. Massey were redeemed on the 15th of May, 1929.

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Accompanying the notice to the shareholders was a hypothetical balance sheet certified by the auditors as of the 30th of November, 1928, but modified by making allowances for:

(1) the redemption of the 7 per cent. cumulative preference shares and the issue of 120,899 redeemable 5 per cent. cumulative preferred shares,

(2) the issue of 241,798 additional common shares of no par value at $60 per share,

(3) the writing off of the entire bond discount and expenses shown as an asset on the actual balance sheet of the 30th of November, 1928, and "making reserve against any premium payable on redemption of the 7 per cent. preferred shares,"

(4) the repayment of bank advances out of the proceeds of new capital.

The actual surplus of the 30th of November, 1928, is given in this balance sheet as $6,982,098.02. The surplus left after the deductions mentioned in the third of the allowances enumerated above, amounting to $2,109,960.20, is shown to be $4,872,137.82. This balance sheet was certified by the auditors.

The premium of $10 attributable to 9,122 shares, amounting in the aggregate to $91,220, was duly paid to the appellants and was assessed as taxable income in their hands. I repeat, at the close of the fiscal year ending the 30th of November, 1928, the directors' report to the shareholders showed a surplus of $6,982,098.02. The surplus at the end of the year ending the 30th of November, 1929, was $5,786,337.67. In the year 1929 there was earned a profit of $2,800,813.35, but the deductions on account of bond discount and expenses, premium on 7 per cent. preference shares and dividends paid in the year 1929 had the effect of reducing the surplus to the figure mentioned. The amount paid for premiums on the 7 per cent. preference shares redeemed was $1,100,770. This is all shown in the directors' report to the shareholders for the year ending the 30th of November, 1929, and submitted to the shareholders at the annual meeting on February 21st, 1930.

It seems advisable to notice the manner in which (as it appears from the directors' reports to the shareholders and

the balance sheets) this surplus of nearly seven millions was built up and what it represented. The earliest directors' report and the earliest balance sheet before us are those for the year 1924. The report showed that the surplus at the 30th of November, 1923, that is the end of the fiscal year, was $750,152.73. The surplus at the 30th of November, 1924, ascertained by deducting from the surplus of the previous year a sum required for an adjustment in connection with subsidiary companies' stock and adding the net profit for 1924, is given as $818,709.60, and this sum appears in the balance sheet as a credit to profit and loss account. Net profit for the year is ascertained by deducting from the income for the year's operations interest on borrowings and appropriations for certain reserves. Reserves appear in each of the balance sheets for the years 1924 to 1929 inclusive and are for taxes, foreign exchange, etc., pensions, buildings and equipment, possible losses on collection, fire indemnity, contingent account as called for by charters and by-laws of companies and, as appears from the directors' reports, appropriations were made from time to time during these years for one or more of these accounts. In each year the surplus is ascertained by adding to the surplus of the preceding year the net profit for the year in question and deducting sums paid for dividends, if any, the net profit in each case being arrived at in the manner already mentioned.

Now, it appears from the hypothetical balance sheet sent to the shareholders with the notice of redemption that any premium payable on redemption of the 7 per cent. preferred shares would be paid out of, or would go in reduction of the surplus of $6,982,098.02 at the 30th of November, 1928; and, in the report of the directors for the year ending the 30th of November, 1929, submitted to the shareholders at the annual meeting on the 21st of February, 1930, the sum paid for such premiums, $1,100,770, is charged to and goes in reduction of such surplus.

We have, as I have said, no directors' reports or balance sheets, prior to 1924 but, from the evidence of Mr. Vardon, there is no doubt, I think, that the surplus at November 30th, 1924, was treated by the company as income and assessable to income tax; and subject to qualification as to a sum of $130,000 transferred to surplus account in 1925,

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the surplus in each year is calculated, as I have said, by adding the net profit for the year to the surplus of the preceding year and deducting sums paid for dividends. The sum of $130,000 was transferred in 1924 direct from the contingent account, $380,000, to surplus, increasing the surplus by that amount and correspondingly diminishing the contingent account. The transfer was explained by the fact that this sum was held in the contingent account of subsidiary companies no longer required because of the surrender of their charters.

I have already observed that in all these years the net profit was as a rule ascertained by deducting from the income from the year's operations, interest on borrowings and appropriations for the reserves mentioned. There are, however, two credits to income, one in the year 1925, and the other in the year 1928, which, perhaps, call for some comment.

The first is a sum of $661,139.20 in 1925, representing "recovery of assets written off in the war years." The other is a profit on the sale of assets in the year 1928 amounting to $835,218.16. Both of these credits, as well as the nature of the receipts they represent, appear explicitly in the directors' reports submitted to the shareholders in the respective years mentioned.

Having regard to the way in which the income account is made up, as already explained, and especially to the appropriations for the reserves mentioned which appear to have been built up by such appropriations from income, it would appear to have been a perfectly natural and reasonable thing to credit both these sums to income account and, this having been done with the assent of the shareholders, it seems to me the net profit in each year, as it appears in the directors' reports, must be considered to fall within the category of income. Subject to a question as to the sum of $130,000 mentioned, the surplus at the 30th of November, 1928, which apparently stood at the same figure on the 15th of May when the Massey shares were redeemed, represented accumulated income. Whether this last-mentioned sum represented accumulated income or not we have no means of knowing.

Turning now to the application of section 17. The question to be determined is whether or not the premium

of $10 a share received by the appellants was paid out of undistributed income on hand. I think it ought to be observed that this is not necessarily the same question as the question to which the learned trial judge seems chiefly to have applied himself, whether it was paid out of undistributed profits available for the payment of dividends. The Dominion *Companies Act*, which governs the Massey-Harris Co., Ltd., provides (s. 98):

> No dividend shall be declared which will impair the capital of the company.

This section does not prevent the distribution of a capital profit provided the effect of doing so will not reduce the value of the assets below the sum total of the liabilities and the share capital. Broadly, it may be said that the company may distribute any of its assets among the shareholders so long as such is not the result of the distribution. The fact, therefore, that the surplus was drawn against for dividends is not at all conclusive; undistributed profits are not necessarily undistributed income within the meaning of section 17; but, I repeat, the proper conclusion from the evidence is that the surplus represented accumulated income with the exception of the sum mentioned of $130,000 which, as I have said, may or may not be within that category. Since the transfer of this sum took place in 1925, the total surplus was drawn upon to the extent of more than 30 per cent. and this sum must, therefore, be proportionately reduced; so reduced it may, I think, be disregarded.

There remains the question whether, within the meaning of section 17, the premiums on the shares redeemed were "paid out of" undistributed income "on hand" which the surplus represented at the time. That the intention of the directors was to charge the premiums against the surplus, that is to say, that they should go in reduction of the surplus, is plain; and it is also plain that the shareholders acquiesced in this manner of dealing with the surplus. The shareholders became aware of it at the meeting of February, 1930, and there is no suggestion that any shareholder ever took exception to it. The undistributed income, no doubt, existed in various forms in the current assets, as Mr. Vardon says, but it was there nevertheless and the fact that it was not in a form in which the

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company could conveniently employ it for the purpose of making payments or convert it into cash does not appear to me to be conclusive upon the point we are considering. I can see no reason why the company, having cash on hand, might not treat this cash as the embodiment of the surplus. If that was done, I do not think it matters whether this cash was derived from the sale of shares or from a loan unless there is something in the law or the constitution of the company preventing such funds being so dealt with.

Of course, in the present case the direct and immediate source of the monies put to the credit of the Preference Dividend Account was the money subscribed for share capital and, if that were the whole story, nothing more could be said; but I think it is clear enough in point of fact that the directors, with the assent of the shareholders, did intend, as I have said, to pay the premium out of the surplus and, *pro tanto,* to reduce the surplus; and by resorting to the fund they made use of they thereby treated that fund as part of the surplus of undistributed income and, therefore, as " undistributed income on hand."

If I am right in my view that in fact the surplus represented undistributed income actually existing, though in various forms as current assets, then I think the conclusion is that the conditions of section 17 have been fulfilled.

I should add that, in my view, the premium so-called was a premium within the contemplation of section 17.

For these reasons I think the appeal must be dismissed with costs.

The judgment of Rinfret and Kerwin JJ. was delivered by

KERWIN J.—This is an appeal by the executors of Walter E. H. Massey from a judgment of the Exchequer Court (1) confirming the assessment levied upon the appellants for income tax for the year 1929. The appellants were the owners of a number of preference shares of Massey-Harris Company, Limited, upon the redemption of which they received a premium, and the real point for determination is whether this premium was paid out of the company's " undistributed income on hand " within the meaning of

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section 17 of the *Income War Tax Act*. This section, as it stood at the time of the redemption of the shares in 1929, was in the following terms:—

> Where a corporation, having undistributed income on hand, redeems its shares at a premium paid out of such income, the premium shall be deemed to be a dividend and to be income received by the shareholder.

Before this Court, however, counsel for the appellants took a point that had not been previously raised. He contended that, as section 17 is not a charging section and as there is no evidence that the premium received by the appellants was income accumulating in trust for the benefit of unascertained persons or of persons with contingent interests within the meaning of subsection 2 of section 11 of the Act, the appellants could not be assessed for income tax. Apparently the solicitors for the appellants desired to obtain a decision on the point of substance, and, no doubt, having the assessment made against the appellant executors was considered a convenient method of securing an adjudication. The will of the late Walter E. H. Massey is not before us but it should be assumed that the premium did constitute income accumulating in trust as defined in subsection 2 of section 11 and it must be held that the point is not open to the appellants.

On the other hand, counsel for the appellants abandoned one claim he had advanced before the Exchequer Court, i.e., that as a portion of the surplus account of the company was earned prior to the coming into force of the *Income War Tax Act, 1917,* the premium, if held to be paid out of undistributed income on hand, should be deducted from that portion that had been earned prior to 1917. It is therefore unnecessary to deal with that question.

With reference to the main contention, that section 17 contemplates an actual payment out of accumulated cash income on hand, I agree with the reasons for judgment of the President of the Exchequer Court and have nothing to add.

I would dismiss the appeal with costs.

DAVIS J. (dissenting).—At the time of the redemption of the shares in question and the payment of what has been treated by both parties as "a premium" of 10 per

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cent., the company admittedly had undistributed income but it was not in liquid form—it had gone into and had become part of the physical assets of the company. At the same time the company owed its bankers over six million dollars. Obviously, in any practical business sense the company was not in a position to redeem in cash large blocks of its capital stock at par plus 10 per cent. But the company desired to get rid of heavy dividend burdens on its outstanding preference shares by taking advantage of much lower prevailing interest rates, and worked out a plan whereby it would reduce its annual charge for dividends by $241,798 by calling in outstanding securities and issuing new securities at a lower rate of dividend.

The company, duly incorporated under the (Dominion) *Companies Act*, R.S.C. 1886, ch. 119, had the right, by virtue of supplementary Letters Patent,

> without the consent of the holders thereof, from time to time to redeem the whole or any number of the said [7%] cumulative preference shares at One hundred and ten (110%) per centum of their par value, together with any accumulated dividends thereon.

The company had the further right, by supplementary Letters Patent, to issue 5 per cent. cumulative convertible preference shares of the par value of $100 each as well as additional common shares without nominal or par value.

What actually was done was that the company created and issued a new series of securities (both preference and common shares) and from the proceeds of the sale of these securities realized nearly fifteen million dollars in cash out of which to pay, and did in fact pay, in cash the redemption price of the outstanding preference shares, including what has been called the premium thereon of 10 per cent.

The sole question in this appeal is whether or not the appellants are liable for income tax on the $10 per share received by them as part of the redemption moneys. The Minister of National Revenue contends that they are liable under section 17 of the *Income War Tax Act* as it stood when the said shares were redeemed. That section as it stood at the material date had been enacted by ch. 10 of the Statutes of 1926 in the following words:

> Where a corporation, having undistributed income on hand, redeems its shares at a premium paid out of such income, the premium shall be deemed to be a dividend and to be income received by the shareholder.

This provision was carried into the Revised Statutes of Canada 1927, and remained in force until repealed in 1934 (by ch. 55, section 9, of the Statutes of 1934) and present section 17, which does not affect the issue in this appeal, was substituted in the following words:

> Where a corporation redeems its shares at a premium, the premium shall be deemed to be a dividend and to be income received by the shareholder.

The appellants contend they are not liable, in that the said moneys were not "paid out of" undistributed income of the company "on hand" within the meaning of section 17. Counsel for the Minister very frankly and accurately set out in their factum certain facts that were proved at the trial in the Exchequer Court. I set out below a complete paragraph that appears in the respondent's factum:

> On April 30th, 1929, that is fifteen days before the redemption of the 7 per cent preference shares the company was indebted to the Bank in the sum of $6,040,657.99. Between that date and May 16th, the company received cash as follows: in respect of common share subscriptions—$3,737,449.30; in respect of the sale of 5 per cent preference shares—$11,010,900; and in respect of ordinary operations—$398,693.04, making a total of $15,147,042.34. These receipts were utilized as follows: The sum of $971,510.59 was expended for current operations during the period, the sum of $5,000,000 was transferred to a special bank account called the Preference Dividend Account and it was out of this fund that the redemption payments were made, and finally the Bank loan above mentioned was paid off. The company after making these several disbursements, still had a credit balance of $3,124,873.66 on May 15th. This surplus, however, was rapidly depleted as funds were transferred to the preference dividend account to meet redemption cheques as presented. By May 17th, the company was once more indebted to the Bank and the redemption cheques paid on that day and the following days were paid out of loans or advances by the Bank. The Massey stock was paid for by cheques which were accepted for payment on May 15th.

Upon these admitted facts, how can the respondent contend that the $10 per share was "paid out of undistributed income on hand"?

The governing section (17) at the time of the transaction was not, as it is to-day, "Where a corporation redeems its shares at a premium, the premium shall be deemed to be a dividend and to be income received by the shareholder," nor did it declare that premiums "shall be deemed to be paid out of income" as section 21 (6), as enacted by the 1926 statute, had declared with respect to dividends actually declared by a personal corporation. The liability under the section as it stood at the time of

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the transaction involved two matters of fact—(1) undistributed income "on hand," and, (2) a premium "paid out of" such income. The evidence plainly does not establish, in my opinion, the facts necessary to support the contention advanced by the Minister.

Although the income of a beneficiary from an estate is (apart from non-residents) not assessable at its source in the hands of the trustee but assessable against the beneficiary who receives the same, except in those cases where income is accumulating in trust for the benefit of unascertained persons or of persons with contingent interests (section 11), the appellants at no time disputed liability upon the ground that the 10 per cent. payment sought to be taxed was not accumulating in their hands but had been received by the beneficiaries, and it must therefore be taken for the purpose of this appeal that if the 10 per cent. payment in question came under old section 17, the trustees are liable to be assessed.

The question whether or not the $10 per share of the $111.75 per share paid by the company for the redemption of its shares was strictly "a premium" was not raised. It has been assumed throughout that it was and the appeal has been dealt with on that basis, but I should like to reserve the point for consideration should it ever come up in another case. There may well be a difference between the case where a company, having authority to do so, offers its shareholders an opportunity to turn back their shares to the company in payment of a bonus or premium, and the case such as this where the shares were sold to the public with certain defined rights, permitted by statutory authority, which included a right in the company, without the consent of the shareholders, from time to time to redeem the shares at a fixed price (i.e., 110 per cent. of their par value). A company may sell its preference shares, of a par value of $100 each, at $105 or $110 or for any amount in excess of the par value, and if it has authority to repurchase these shares at any time and obligates the holder to resell at any time at a fixed price, I doubt that the exercise of that right of repurchase is redeeming the shares "at a premium." The right here given to the company was not restricted, as it is under section 46 of the English Act of 1929 which provides that a company may, if so authorized by its articles, issue

preference shares which are, or at the option of the company are to be liable, to be redeemed provided that no such shares shall be redeemed except out of profits of the company which would otherwise be available for dividends or out of the proceeds of a fresh issue of shares made for the purposes of the redemption.

I would allow the appeal and set aside the judgment appealed from and the decision of the Minister and the assessment, with costs throughout.

Appeal dismissed with costs.

Solicitors for the appellants: *Armstrong & Sinclair.*

Solicitor for the respondent: *W. S. Fisher.*