1949
*Feb. 11
*Jun. 24

CARDEN S. BAGG ..... APPELLANT;

AND

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

ON APPEAL FROM THE EXCHEQUER COURT OF CANADA

Revenue—Income tax—Undistributed income of company—Reduction and readjustment of capital stock—Whether undistributed income capitalized—Income War Tax Act, R.S.C. 1927, c. 97, s. 15, 16.

Having an undistributed income on hand, a company, by Supplementary Letters Patent, reduced its capital by cancelling 200 unissued shares of a par value of $100 each and by reducing the par value of 1,800 issued shares from $100 each to $44 each. These 1,800 shares were then converted into 1,800 preferred shares of a par value of $40 each and 1,800 common shares of a par value of $4 each. The Minister of National Revenue, treating the readjustment as effecting a capitalization of income, assessed a tax on appellant, as shareholder of the company, in respect of his share of that income received through the capitalization.

Held, The Chief Justice and Kellock J. dissenting, that the readjustment of the company's capital stock resulted in the undistributed income being capitalized within the meaning of sec. 15 of the Income War Tax Act.

APPEAL from the judgment of the Exchequer Court of Canada (1), O'Connor J., affirming the decision of the Minister of National Revenue confirming an assessment made under the Income War Tax Act.

Hazen Hansard K.C. for the appellant.

John Ahern K.C. and *T. Z. Boles K.C.* for the respondent.

THE CHIEF JUSTICE (dissenting):—The appellant filed an Income Tax Return showing his income for the year ended 31st December, 1938. He received a Notice of Assessment upon that return on the 26th of October, 1942.

He lodged with the Minister of National Revenue a Notice of Appeal dated the 20th of November, 1942, in which objection was taken to the assessed tax for the reasons therein set forth.

The respondent affirmed the assessment on the ground that in 1938 the appellant owned 518 shares of Domestic

*PRESENT: The Chief Justice and Kerwin, Rand, Kellock and Estey JJ.

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Gas Appliances Limited which were reduced or redeemed in that year within the meaning of Subsection 1 of Section 16 of the Act, and therefore the appellant was deemed to have received a dividend according to the provisions of that subsection.

Notice of the decision of the Minister was given to the appellant pursuant to Section 59 of the Act, wherein it was stated that the decision was based on the facts presently before the Minister.

On the 12th of February 1945, a Notice of Dissatisfaction was filed by the appellant through his solicitors, stating that the appellant desired his appeal to be set down for trial.

The effect of the decision of the Minister was that a tax in the sum of $6,887.64 should be levied upon the appellant in respect of his income for the year 1938, said sum including an additional tax of $2,288.06 and $587.78 for interest arising out of the addition made by the Notice of Assessment to the income of the appellant.

In the Notice of Dissatisfaction the reasons in support of the appeal are stated as being:

The appellant was the owner of 518 shares of the par value of $100 each of Domestic Gas Appliances Limited (hereinafter referred to as the "Company") of which 1,800 shares were outstanding and fully paid and non-assessable.

By Supplementary Letters Patent dated 3rd June, 1938, granted to the Company under the Dominion Companies' Act, all these outstanding shares were converted into 1,800 preferred shares of a par value of $40 each and 1,800 common shares of a par value of $4.00 each, and the remaining paid up capital of the Company, which was then lost or unrepresented by available assets, was cancelled. Accordingly the appellant became the owner of 518 preferred shares of the par value of $40 each and 518 common shares of the par value of $4.00 each. Subsequently all of the outstanding preferred shares of the Company were redeemed and the redemption price paid, namely: par plus a premium of 1 per cent, there being no dividends declared prior to the redemption date and then remaining unpaid. As an incident to the redemption of all of the preferred shares, the Company made application for Supplementary Letters Patent reducing the capital stock of the Company by the

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cancellation of all of the 1,800 preferred shares of the par value of $40 each, and these Supplementary Letters Patent decreasing the capital stock were issued on October 8, 1938. In the decision of the Minister, it is said that the 518 shares of the Company owned by the appellant in 1938 were reduced or redeemed within the meaning of Subsection 1 of Section 16 of the Act.

The appellant contended that the subsection in question does not contain any definition of the words "reduce" or "redeem", nor is any to be found in the *Income War Tax Act.*

The operation whereby the appellant became the holder of 518 preferred shares was, according to him, merely a conversion of the 518 shares theretofore held by him. Nothing was bought back or recovered by the Company. That "reduce" or "redeem" is something different from "convert" may be seen by the fact that Subsection 1 of Section 16 was amended by Section 15, Chapter 14 of the Statutes of 1943-44 by the insertion therein of the words "or converts any class of the capital stock or shares thereof into any other class of capital stock, shares or other security therefor".

A perusal of the Supplementary Letters Patent dated June 3, 1938, will, it is contended, show that the preferred shares thereby created, on being reduced or redeemed, were not entitled to participate in the assets of the Company beyond the amount paid up thereon (i.e. $40 per share) plus a fixed premium of 1 per cent of the par value and a defined rate of dividend of 5 per cent per annum.

It is clear that the preferred shares were of a class coming within the provisions of Subsection 2 of Section 16; and it was alleged accordingly that Subsection 1 of Section 16 did not apply to the redemption of the preferred shares which were held by the appellant after issue of the Supplementary Letters Patent, and that the appellant, upon such redemption, could not be deemed to have received a dividend under such subsection.

The conclusions of the Notice of Dissatisfaction were therefore, for those reasons, that the additional tax assessed, namely $2,288.06, and $587.78 for interest, was unlawfully imposed and should be cancelled and the assessment set aside.

After the reply of the Minister to the Notice of Appeal, it was ordered that formal pleadings be filed in this cause. It was upon these pleadings that the appellant was tried before the Exchequer Court of Canada (1).

The allegation of the statement of defence filed by the respondent was that on June 3, 1938, the Company had on hand undistributed income in the amount of $38,091.61 or $21.15 for each of the original common shares, which undistributed income, as a result of the reduction or redemption, was deemed to be received by the shareholders of the Company, including the appellant herein, and became properly taxable pursuant to Subsection 1 of Section 16 of the *Income War Tax Act*. In the alternative, if the shares of the Company were not reduced or redeemed as aforesaid, in any case, as a result of the re-adjustment of the capital stock of the Company, in accordance with the Supplementary Letters Patent, the whole of the said undistributed income was capitalized and is therefore properly taxable in the hands of the shareholders of the Company, pursuant to Section 15 of the *Income War Tax Act*.

The respondent claimed therefore that, as of June 3, 1938, the appellant received an amount of $10,055.70, by way of the undistributed income of the Company, and was properly taxable thereon in the year 1938; that the assessment should therefore be affirmed and the appeal from the Minister's decision dismissed.

For the purposes of this case, the appellant admitted that on the 3rd day of June, 1938, the Company had an undistributed income in the amount of $38,091.61 mentioned in the Statement of Defence of the respondent.

The authorized capital of the Company was $200,000 divided into 2,000 shares of a par value of $100 each, of which, as of the 3rd of June 1938, 1800 had been issued as fully paid up.

Included in the capital assets was an item of good will of $180,000. Between 1921 and 1937 there were several write-offs of goodwill, totalling $140,000, and each in turn was charged to surplus.

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This resulted in a reduction of capital from $180,000 to $40,000 and changed a surplus of $38,091.61 into a deficit of $101,908.39.

The Company's return for the year 1938 and the appellant's return for the same year were made accordingly; but it was only, as we were told, in the year 1941 that these write-offs of good will were disallowed by the Department. These disallowances resulted, from a taxation view point, in the Company having undistributed income of $38,091.61. As result of the Supplementary Letters Patent dated the 3rd of June 1938, the authorized capital was decreased from $200,000 to $79,200.

(*a*) By cancelling the 200 unissued shares of a par value of $100 each and

(*b*) by cancelling paid-up capital to the extent of $56 per share upon each of the said 1800 issued shares and thereby reducing the par value of the said 1800 issued shares from $100 per share to $44 per share.

The Supplementary Letters Patent of the 3rd of June 1938 further authorized the Company to convert the 1,800 issued shares of the capital stock of the par value of $44 each into 1,800 preferred shares of a par value of $40 each, and 1,800 common shares of a par value of $4 each. They added that the authorized capital stock of the Company should be $79,200 divided into the above mentioned shares, "subject to the increase of such capital stock under the provisions of the *Companies' Act.*"

Then, the Supplementary Letters Patent of the 3rd of June deal with the rights, permits, privileges, limitations, terms and conditions which the preferred shares shall carry and be subject to.

Subsequent Supplementary Letters Patent were issued on the 8th of October 1938. They recite that the operations authorized by the Supplementary Letters Patent dated the 3rd of June 1938 had been carried out, that the original Letters Patent incorporating the Company (30th December 1918), as amended by Supplementary Letters Patent granted on the 7th of February 1929, were amended and varied by adding thereto the private Companies' clauses and thereby converting the Company from a public Company into a private Company.

Accordingly, these later Supplementary Letters Patent (8th October 1938) decree that the authorized capital stock of the Company shall be $7,200 divided into 1,800 issued common shares of the par value of $4 each "subject to the increase of such capital stock under the provisions of the *Companies' Act.*" In view of that fact, the decrease to that amount of capital stock was effected by the cancellation of the paid-up capital represented by the 1,800 issued preferred shares at a par value of $40 each, which had been redeemed.

The relevant sections of the Act are as follows:—

(15). When, as a result of the reorganization of a corporation or the readjustment of its capital stock, the whole or any part of its undistributed income is capitalized, the amount capitalized shall be deemed to be distributed as a dividend during the year in which the reorganization or readjustment takes place and the shareholders of the said corporation shall be deemed to receive such dividend in proportion to their interest in the capital stock of the corporation or in the class of capital stock affected.

(16). Where a corporation having undistributed income on hand reduces or redeems any class of the capital stock or shares thereof, the amount received by any shareholders by virtue of the reduction shall, to the extent to which such shareholder would be entitled to participate in such undistributed income on a total distribution thereof at the time of such reduction, be deemed to be a dividend and to be income received by such shareholder.

16 (2). The provisions of this section shall not apply to any class of stock which, by the instrument authorizing the issue of such class, is not entitled on being reduced or redeemed to participate in the assets of the corporation beyond the amount paid up thereon plus any fixed premium and a defined rate of dividend nor to a reduction of capital effected before the sixteenth day of April, one thousand nine hundred and twenty-six.

The evidence showed that the undistributed income ($38,091.61) did not appear in either of the annual statements of the Company, that nothing was done with the undistributed income on the reduction and conversion, that the net assets behind the stock of the Company, as disclosed by the audited statement as of December 31, 1937, amounted to $75,000; and that there was no material change in the net assets behind the stock of the Company after the reduction and conversion of the 3rd of June, 1938, and prior to the redemption which took place on the 30th July 1938; that there was no reduction in the number of shares, but there was a reduction in the face value of $100,800; that all the shareholders received on the 3rd

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day of June, 1938, was a certificate for one preferred share of the par value of $40, and a certificate for one common share of the par value of $4 in exchange for a certificate of one common share of the par value of $100; that the new shares were issued as fully paid up.

No amount in money was paid to or received by the shareholders. The Assistant Chief Auditor, Corporation Assessor in the Montreal office of the respondent, explained that as the Company had written off goodwill in the amount of $140,000 between 1922 and 1937, leaving $40,000 out of the original capital of $180,000, the write-offs of goodwill, from a taxation standpoint, reduced the surplus in the books of the Company; but, as the write-offs were disallowed, that resulted in an undistributed income of $38,000 and that, in his opinion, the share capital reduced to $79,200 consisted of $40,000 being the balance left of the original capital plus the undistributed income of $38,091.61.

That opinion of the Assistant Chief Auditor, in my humble view, takes no account of the fact that if the write-offs were disallowed, it follows that the amount of those write-offs ($140,000), in the result, no longer reduced the original capital of $180,000 to the balance of $40,000.

As consequence of the disallowance by the officers of the Department of the respondent, the original capital was reduced only to the extent of the write-offs which were allowed. And, as the write-offs allowed amounted to $100,000, what was left of the original capital was not $40,000 but $80,000 in round figures, or, to accept the figures of the Company, $79,200 which is precisely what the Supplementary Letters Patent of the 3rd of June 1938 authorized, and what the Supplementary Letters Patent of the 8th of October 1938 recognized. The latter Supplementary Letters Patent, taking into consideration the redemption of the preferred shares of the par value of $40 each, which had been issued in the meantime, consequent upon the authorization contained in the former Supplementary Letters Patent, decreed that the capital stock of the Company shall, in the future, be $7,200 divided into 1,800 issued common shares of the par value of $4 each.

It may be said, in passing, that, with respect, the learned trial judge in the Exchequer Court (1), wrongly assumed

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that the disallowance by the Department had been made in each of the years in which the write-offs of goodwill had been made. The evidence shows that it was only in 1941, or three years after the returns made by the Company and by the appellant, that the write-offs were disallowed. However, he recognizes that the sole date and transaction in issue is that of the 3rd of June 1938.

The learned judge therefore asks himself whether the appellant received "an amount by virtue of the reduction" which took place on the 3rd of June 1938, within the meaning of Section 16 (1). He comes to the conclusion that that subsection does not apply; but his view was that as the preferred shares were reduced on 31st July 1938, they then came within the class defined in Subsection 2 of Section 16, and he expressed the opinion that Subsection 2 refers to the shares issued on conversion and not to the original shares. The second question examined by the learned judge was whether the undistributed income was "capitalized" as a result of the reduction and conversion of June 3, 1938, within the meaning of Section 15.

On that point he says that the appellant contended first that if the undistributed income was capitalized, it was capitalized between 1922 and 1937, when the capital asset of goodwill was written-off.

To this the learned judge declares that the Company may add undistributed income to capital by increasing the paid-up capital in each share, thereby increasing the par value of each share. He also says that, in his opinion, "using the undistributed income for the purpose of writing off goodwill did not capitalize it".

The appellant's second contention was that the reduction and conversion did not capitalize the undistributed income. To this the learned judge begins by stating: "it is correct that on the reduction the unissued shares were cancelled and no new additional shares were issued and the paid-up capital in each share was in part cancelled and not increased". But, in his opinion, the reduction did result in the capitalizing of the undistributed income. It is there that I find myself unable to follow the reasoning contained in the judgment appealed from. In my view, the learned judge then confused assets with capital. The judgment is to the effect that if the Petition for the Supplementary

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Letters Patent had disclosed that $140,000 had been lost or was unrepresented by assets and the capital remaining was only $40,000, although the Company had in addition undistributed income of $38,091.61, the capital stock would have been decreased to $40,000 and not $79,200. And he goes on to say: "this would have been accomplished by cancelling the 200 unissued shares and by cancelling paid-up capital of $77.15 per share of the 1,800 issued shares, thereby reducing the par value of each from $100 to approximately $22.85. If the Company then desired to convert the undistributed income into capital, the capital stock would then have been increased from $40,000 to $79,200 by increasing the paid-up capital to the extent of $21.15 per share upon each of the 1,800 shares, thereby increasing the par value from $28.25 to $44.00 per share of the said 1,800 shares."

But, as the learned judge himself says: "that procedure did not take place". And I regret that I can not follow the reasoning which the learned judge deduces from that finding of fact. He asserts that the Company represented that the loss was only $100,800 and not $140,000, and that $79,200 was represented by available assets "whereas only $40,000 was represented by available assets." And he then comes on to say that, as a result, it was clear that the same position was reached as if the capital stock had first been decreased to $40,000 and then increased to $79,200 by first cancelling the paid-up capital in each of the issued 1,800 shares of $77.15 and then increasing the paid-up capital in each share by $21.15.

But, of course, to that reasoning it must first be observed that the Company, when it petitioned for the Supplementary Letters Patent of the 3rd of June 1938, could not represent anything else than it did, since at that time the disallowance of write-offs had not yet taken place. It was made by the Department only in 1941. At the date of the petition and of the issue of the Supplementary Letters Patent of the 3rd of June 1938, the Company represented the facts exactly as they then appeared in its books; and, upon that representation, it was authorized to decrease its capital stock from the sum of $200,000 to the sum of $79,200, by cancelling paid-up capital to the extent of

$56 per share, it being stated that $100,800 had been lost or was unrepresented by available assets. The Company was further authorized to convert the 1,800 issued shares of the capital stock of the par value of $44 each into 1,800 preferred shares of the par value of $40 each, and 1,800 common shares of the par value of $4 each.

The Company did exactly what they had been authorized to do by the Supplementary Letters Patent of the 3rd of June 1938. And the representation it made to obtain that authorization was strictly in accordance with the facts and figures as they then appeared in its books.

Furthermore, on the 31st of July 1938, the Company redeemed the preferred shares. The capital stock of the Company was thereby brought down to the $7,200 divided into 1,800 issued common shares of the par value of $4 each; and this was taken to be henceforth the authorized capital stock of the Company in accordance with the Supplementary Letters Patent of the 8th of October 1938.

The learned trial judge very properly recognized this by saying that under the Letters Patent the paid-up capital upon each share was $44, as a result of the cancellation of the paid-up capital to the extent of $56 upon each share. But it was exactly what the Company had been authorized to do by those Supplementary Letters Patent.

It would appear therefore, first that the learned judge, by his judgment, assumes a state of facts contrary to that which was recognized by the Supplementary Letters Patent, and to what actually took place.

In my view, he could not base the conclusions of his judgment on what he thinks that the Company should have done or might have done, instead of what the Company actually did, and did in accordance with the authorization granted to it by the Supplementary Letters Patent.

In other words, he can not declare that what is stated in these Supplementary Letters Patent, as the true capital resulting from the operations authorized thereby, was not in fact the true capital; and that if the Company had acted otherwise, the result would have been different.

It seems to me that we must truly accept the authorization contained in the Supplementary Letters Patent as they are stated therein. They decree that by the operation

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thus authorized, the capital of the Company would be and was reduced to $79,200; and it is not here nor there to say that only $40,000 was represented by available assets.

There is no evidence to establish that statement in the judgment appealed from and, moreover, that statement is directly contrary to what is stated in the Supplementary Letters Patent and what was authorized. It should be sufficient to add that, even if at that time the write-offs had already been disallowed, the disallowance only amounted to decreasing the write-offs by $40,000, which would mean that instead of having properly written off $140,000 of the goodwill asset, the Company should have written off $100,000; and the asset of goodwill back of the capital was therefore $79,200 instead of only $40,000. The result must then be as stated in the representations of the Company to the Secretary of State, and in the Supplementary Letters Patent consequently issued, that the capital remained at the figure of $79,200.

But the Department in 1941, when disallowing the write-offs, elected to treat the amount whereby they were disallowed not as a reduction in the capital, but as an amount representing undistributed income. Not to say anything of the arbitrary method whereby a sum of $40,000 re-added to the goodwill asset was transformed into an amount of undistributed income, even then accepting that method (as the Company did), whether you call it increased goodwill asset or undistributed income, still it can not be said that that amount did not represent available assets whereby the capital reduced to $79,200 was guaranteed.

I confess my inability to follow the reasoning of the Department that a disallowance of the writing off of some part of the goodwill asset could result in the creation of that amount of undistributed income.

The capital, as authorized by the Supplementary Letters Patent, as a result of the disallowance of the writing off, was merely brought down to $79,200, and not to $40,000.

However, the appellant also contended that if we are to admit that the $38,091.61 was undistributed income before the reduction, it remained undistributed income

after the reduction and reconversion, and that it was not converted into capital by the reduction.

There again, if we are to accept that contention, it would not follow at all that such undistributed income was capitalized on the reduction, nor that the operation was thereby brought under Section 15 of the Act. There was no reorganization of the corporation. Even if we say that the operation amounted to a "readjustment of the capital stock", the undistributed income having remained so after the reduction and conversion, as is assumed in this argument, cannot be treated as having been converted into capital by the reduction or as having been "capitalized". Therefore, Section 15 does not apply.

As to Section 16 (1) the judgment appealed from is to the effect that it does not apply to the facts of the present case, and I agree with that conclusion.

It is not perhaps decisive that in 1943 by Statute 7, Geo. VI, Ch. 14, Section 16 (1) was amended in order to insert the words: "or converts any class of the capital stock or shares thereof into any other class of capital stock, shares or other security thereof, the amount or the value of any consideration or right" etc.

It is apparent that the amendment was to cover exactly the situation that we have in the present case. It may be said that if the amendment was made, it was because the Section as it read previously did not cover the case sought to be met by the amendment. If that were so, *cadit quaestio*. If however it is argued that the amendment was made only to make the matter clearer or indisputable, my answer to that would be that as Section 16 (1) read previously, it did not cover the precise case that we have here. As for Section 16 (2), its purpose is only to exclude from the application of Section 16 (1) certain cases which are not the case now before us.

For these reasons, I would allow the appeal, set aside the judgment appealed from, declare that the assessment made against the appellant was illegally imposed, and declare that in the return of the appellant nothing should be added in respect of the conversion of shares of the capital stock of Domestic Gas Appliances Limited, the whole with costs against the respondent both in this Court and in the lower Court.

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Kerwin J.

KERWIN J.:—Mr. Carden S. Bagg appeals against a decision of the Exchequer Court (1) affirming the assessment against him under the *Income War Tax Act* in respect of his income for the year 1938. The first dispute involves what the respondent contends was the capitalization of the undistributed income of Domestic Gas Appliances Limited (of which the appellant was a shareholder) as a result of the readjustment of its capital stock in 1938 and is based upon section 15 of the Act as it stood at the relevant time:

> 15. When, as a result of the reorganization of a corporation or the readjustment of its capital stock, the whole or any part of its undistributed income is capitalized, the amount capitalized shall be deemed to be distributed as a dividend during the year in which the reorganization or readjustment takes place and the shareholders of the said corporation shall be deemed to receive such dividend in proportion to their interest in the capital stock of the corporation or in the class of capital stock affected.

The Company, incorporated by letters patent under the *Dominion Companies Act*, had an authorized capital of $200,000 divided into 2,000 shares of $100 each, of which 1,800 had been issued and of which the appellant was the owner of 518. On June 3, 1938, supplementary letters patent were issued doing two things:—

1. The authorized capital was decreased from $200,000 to $79,200, such decrease being effected
   (*a*) by cancelling the 200 unissued shares of a par value of $100 each and
   (*b*) by cancelling a paid-up capital to the extent of $56 per share upon each of the said 1,800 issued shares and thereby reducing the par value of the said 1,800 issued shares from $100 per share to $44 per share.
2. The said 1,800 issued shares of the par value of $44 each were converted into 1,800 preferred shares of a par value of $40 each and 1,800 common shares of a par value of $4 each.

In accordance with the supplementary letters patent, the 518 shares owned by the appellant were converted in 1938 into 518 preferred shares of a par value of $40 each and 518 common shares of a par value of $4 each. Still later in the same year the preferred shares, and in 1941 the common shares, were redeemed. In the latter year, the Minister ascertained that while $140,000 for goodwill

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had been originally included in the company's capital assets, that sum had been entirely written off by the Company in various amounts between 1922 and 1937. He, thereupon, disallowed the various items making up the total. The result of this was that in 1938, immediately before the supplementary letters patent, the Company had a surplus of $38,091.61, which, as between the parties to these proceedings, was formally admitted to be undistributed income.

The appellant does not deny that within the meaning of section 15 there was a readjustment of the Company's capital stock by the supplementary letters patent on June 3, 1938, but contends that the $38,091.61 undistributed income was not capitalized as a result of the readjustment. The Company's balance sheet as at December 31, 1938, which was filed as Exhibit 2, shows $9,100.31 of assets, made up of cash in bank, accounts receivable, and deferred charges. On the liability side is $1,097.43 for accounts payable, and provision for income taxes, and then, under the head "Capital Stock" appears the following:—

Preferred 5 per cent Non-cumulative Shares—	
Authorized and Issued—	
1,800 Shares of $40 each	72,000
Less	
Redeemed during year	72,000
Common—	
Authorized and Issued—	
1,800 Shares of $4 each	7,200

We are not concerned with the redemption of the $72,000 preferred shares which occurred in the year 1938 some time after June 3rd, except to note that that redemption must have been carried out by paying the necessary sum in cash. A comparison of Exhibit 2 with Exhibit 1, which is the Company's balance sheet as of December 31, 1937, makes it apparent that if one had been prepared as of June 2, 1938, it would have shown $72,000 more on the assets side and on the liabilities side would have appeared preferred shares of the same amount without a deduction for the redemption. Making allowance for an operation of five months in place of twelve, the total assets would thus have been approximately $81,100.31.

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It is true that at that time, as a result of the various write offs, the Company showed on its books a substantial deficit and that the disallowance by the Minister had not then occurred, but the Company, itself, by the supplementary letters patent reduced its capital by approximately the amount of the deficit and, as I have already stated, for the purposes of this case the appellant admits that the Company had on hand $38,091.61 undistributed income. Under section 15, the two questions to be determined are whether that income was capitalized and, if so, was it as a result of the readjustment of the Company's capital stock. The answers to both depend upon what the Company did and the evidence of William Edward Johnson makes that matter clear. The charter of the Company was surrendered in 1941 but he had been an accountant with the Company and was called as a witness by the appellant to state that no payment was made by the Company to the shareholders as a result of the readjustment,—apparently having in mind the provisions of section 16 of the Act. But the first two questions and the answers thereto on his cross-examination are as follows:—

Q. Can you tell us what happened to the undistributed income of $38,091.61 which existed at the date when the change in the capital set-up of the Company took place?

A. Could I have that question again? (Question read by reporter). Well, the effect of the letters patent which were issued was to reduce or write off the capital of the Company by $100,800, thereby reducing the capital to $79,000, or $77,000. I just do not recall the amount. Now, you asked me what happened to the $38,000. Well it is assumed then that $38,000 still remained in the Company and formed part of the $79,000.

Q. That is right? the $38,000 formed part of the $79,000? A. That is right.

If the problem be treated as one of fact, the testimony of this witness is conclusive and, in so far as they are matters of law, upon the fact deposed to by him, that the Company changed the undistributed income into capital, the answer in law is that that change or capitalization was as a result of the readjustment of June 3, 1938.

The conclusion renders it unnecessary to consider the provisions of section 16. The appeal should be dismissed with costs.

RAND, J.:—The question in this appeal is whether the company in reducing its share capital brought about a capitalization of undistributed income within the meaning

of section 15 of the Income Tax Act and the answer has been left by the parties to be drawn from the barest skeleton of fact.

The original capital of the company was $200,000 divided into 2,000 shares of $100 each. Of these, 1,800 were issued as paid up and the original capital assets as set forth on the balance sheet included an item of $140,000 for goodwill. From time to time between 1921 and 1937 this amount was written off, but the details do not appear. On June 3, 1938 following an application under section 61 of the *Companies' Act* supplementary letters patent effected a reduction of capital, first of the 200 unissued shares and then of the paid-up par value of the 1,800 shares from $100 to $44. This new capital of $79,200 was in turn converted into 1,800 shares of preferred stock of a par value of $40 and 1,800 shares of common stock of a par value of $4, all paid up. The letters empowered the company to redeem the preferred shares at a premium of 1 per cent and converted it from a public to a private company. On June 18, 1938 a resolution providing for the redemption of the preferred shares was passed, and following the redemption application was made and letters patent issued for a further and corresponding reduction of capital.

Some time after the readjustment in 1938, the income authorities reviewing the accounts of the company found that on June 3, 1938 when the first supplementary letters issued there was $38,091.61 of undistributed income in the assets of the company; and treating the readjustment and conversion as effecting a capitalization of this income. which I take to mean profit, assessed a tax on the petitioner, a shareholder in the company, in respect of his share of that income received through the capitalization.

An increase of capital assets may be effected in several ways, but where the shares are of one class only with the same rights, I see no reason why the company by such action as was taken here, cannot appropriate profits to lost capital. Whether it does so is a question of intention, and it must appear that the appropriation was to be irrevocable.

The limited accounts before us indicate that there was no profit reserve and that all the assets were treated as a blended mass. The accumulated income was part of those assets and it represents the difference between the $140,000

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of goodwill apparently written off and the debit balance in assets and liabilities of $101,908.39 shown as of June 30, 1938. Whether from these facts an actual intention to make a provisional or temporary appropriation to capital can be inferred is doubtful: certainly it was not specific and nothing binding on the company took place: and the power to revoke would remain until an act has made the appropriation definitive; *Stanley* v. *Read* (1). The admission of the appellant confirms that view. All we have up to this point is, therefore, the disappearance of the goodwill item and the absence of a profit reserve.

But the petition for reduction contained certain representations. It was represented as the ground for reduction that capital "had been lost or was no longer represented by available assets". The loss was stated to be $100,800 The original resolution to reduce was passed on May 6, 1938 and the debit balance on June 30, 1938 as mentioned was $101,108.39. No doubt the actual amount represented as loss was dictated by its being the amount that would permit the nearest approximation to the value of the actual assets by a reduced capital with a par value in whole dollars.

But the implication of the petition is that the remaining capital is intact, and that the new share capital of $79,200 is represented by that value of existing capital assets: that what was stated to be lost was all that was lost. Such a representation necessarily involves the final commitment of the undistributed profits, or, as the matters appeared to the shareholders at the time, of all the then existing assets of the company, to capital; and the company cannot now be heard to say the contrary.

That this was the result intended seems to be confirmed by what followed. Between June 18 and September 20, 1938 the preferred shares with premium, amounting in all to $72,720, were redeemed. By new supplementary letters patent the share capital on October 8, 1938 was further reduced to $7,200, consisting of the 1,800 shares of common stock. This amount again was the approximate value of the then total assets and the implied representation is again that they are capital assets.

(1) (1924) 2 Ch. 1.

The question my be raised whether the effect of the petition was not merely to destroy a power to change an existing state of things, namely, a *de facto* capitalization indicated by the form of the balance sheet which must be taken as confirmed in time. But section 15 strikes at a final and conclusive appropriation which the readjustment brings about. Until the moment of the new letters that clearly did not take place; at that moment it did; and to treat the effect as suggested would, in my opinion, be to make too subtle a distinction as to the nature of the so-called power to revoke, which, in other situations involving special and conflicting interests in relation to profits, might prove embarrassing: to treat, in other words, the loss of the continuing right to deal with the profits as such, where there has been no specific application to capital, as effecting a piecemeal appropriation at the times of the various balance sheets over a period of many years.

In these circumstances the evidence is conclusive that the reduction of June 3rd involved the irrevocable appropriation of the undistributed profits to capital and was, therefore, a capitalization within the meaning of section 15.

I would, therefore, dismiss the appeal with costs.

KELLOCK, J. (dissenting):—The appellant, prior to the 3rd of June, 1938, was the owner of 518 shares of a par value of $100 each, of the capital stock of a Dominion company whose authorized capital was 2,000 shares, of which 1,800 had been issued. On the last mentioned date, by supplementary letters patent, the authorized capital was decreased from $200,000 to $79,200, such decrease being effected, (*a*) by cancelling the 200 unissued shares; (*b*) by cancelling paid up capital to the extent of $56 per share on each of the outstanding 1,800 issued shares, thus reducing the par value of each share to $44 per share; and (*c*), by converting the 1,800 issued shares of the par value of $44 into 1,800 preferred shares of the par value of $40 and 1,800 common shares of the par value of $4. These letters were issued upon it having been made to appear to the Secretary of State that paid up capital to the extent of

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the reduction in the paid up issued shares was "lost or unrepresented by available assets" pursuant to 24-25 Geo. V, cap. 33, sec. 49 (1) (*b*).

Subsequently, in 1941, the respondent, in determining the net income of the appellant for income tax purposes, for the year 1938, added a sum of $10,955.70, being $21.15 in respect of each of the original 518 shares of stock held by the appellant. The company, over a period of years, commencing in 1922, had written off capital to the extent of $140,000 represented by good-will, and $38,091.61 of the above amount had been written off against undistributed profits. The income tax assessors took the stand that the obsorption of these profits against good-will would not be recognized by the Crown. The result of this ruling was that the company, so far as the tax on income of the appellant as a shareholder was concerned, had on hand at the date of the letters patent this sum of $38,091.61 of undistributed profits.

The claim of the respondent, on this set of facts, was that this last mentioned sum had been "capitalized", within the meaning of section 15 of the *Income War Tax Act,* as the result of the readjustment brought about by the supplementary letters patent and this contention was sustained by the Exchequer Court (1). The court held however, that section 16, upon which the Crown had at first relied, had no application. For the purposes of the proceedings, the appellant accepted the ruling of the assessors.

Sections 15 and 16 above mentioned are as follows:

15. When, as a result of the reorganization of a corporation or the readjustment of its capital stock, the whole or any part of its undistributed income is capitalized, the amount capitalized shall be deemed to be distributed as a dividend during the year in which the reorganization or readjustment takes place and the shareholders of the said corporation shall be deemed to receive such dividend in proportion to their interest in the capital stock of the corporation or in the class of capital stock affected.

16. When a corporation having undistributed income on hand reduces or redeems any class of the capital stock or shares thereof, the amount received by any shareholder by virtue of the reduction shall, to the extent to which such shareholder would be entitled to participate in such undistributed income on a total distribution thereof at the time of such reduction, be deemed to be dividend and to be income received by such shareholder.

16 (2). The provisions of this section shall not apply to any class of stock which, by the instrument authorizing the issue of such class, is

(1) [1948] Ex. C.R. 244.

not entitled on being reduced or redeemed to participate in the assets of the corporation beyond the amount paid up thereon plus any fixed premium and a defined rate of dividend nor to a reduction of capital effected before the sixteenth day of April, one thousand nine hundred and twenty-six.

With respect to section 15, the appellant does not contend that there had not been a "readjustment" of the capital stock of the company by reason of the supplementary letters patent, but he denies that any part of the undistributed income, if capitalized, had been capitalized *as a result* of the readjustment.

There is, perhaps, some difficulty in arriving at the exact facts, but in my view the case was fought out below upon the basis that, to the extent of the $38,091.61 here in question, the write-offs of good-will totalling $140,000 had been made against earned income. That the figure of $38,091.61 of undistributed income was produced by the action of the income tax authorities in disallowing these write-offs of good-will is established by the evidence of the only witness called on behalf of the respondent. He testified as follows:

Q. And that is what, you say, produced an undistributed income of $38,000? A. No; I say that by disallowing these write-offs, then we arrive at $38,000.

Q. And you say that is undistributed income? A. That is right.

That it was common ground that the write-offs above referred to were made, pro tanto, out of earned income appears firstly, in the argument of counsel for the respondent at trial and, secondly, in the reasons for judgment of the learned trial judge (1). In his argument counsel for the Crown said:

Notwithstanding the apparent disappearance of the $140,000 in capital by the writing off of an equal amount, there must have been some other items in the company's set-up to compensate for part of this loss, the difference between $40,000 and the new capital of $79,200. There must have been something there. What is it? Mr. Gregory told us that it was this undistributed income of $38,000; and he was not contradicted on that point by Mr. Johnson of the company. I think it is common ground that the new capital of $79,200 was made up by the balance remaining of the original capital, $40,000 and this undistributed income of $38,000. Therefore this $38,000 became capitalized. Instead of appearing *in the books of the company* as an earned surplus or undistributed income, *it was transferred to the capital account. It was capitalized.*

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I shall deal later with that part of the above contention which refers to the composition of the "new capital".

That nothing was done so far as the company was concerned, on or after the 3rd of June, 1938, in the way of capitalization of the sum in question is expressly dealt with in the evidence of the company's auditor, who, in speaking with respect to the period commencing on that date, gave the following evidence:

Q. And you are familiar with the statements and the books of the Company, are you not? A. Yes.

Q. From those statements and those books can you tell the Court whether or not there was anything done on the books or in the statements which in any way represented a capitalization of any part of that undistributed income at that time? A. There was nothing done that I know of.

As to the understanding of the learned trial judge (1) that he was called upon to deal with the case on the above basis, I quote the following extracts from his reasons:

The appellant contends first that if the undistributed income was capitalized, it was capitalized between 1922 and 1937. That is, that it was capitalized *when the earned surplus was used for the purpose of writing off the capital asset of good-will.*

Again:

In my opinion *using the undistributed income for the purpose of writing off good-will* did not capitalize it.

Further, in referring to the supplementary letters patent, the learned trial judge said:

But in fact the good-will had been written off in the sum of $140,000. And the capital stock was to be decreased to $79,200 on the basis that this sum had not been lost, but on the contrary was represented by assets. Now that arose from the fact that *the company regarded the sum of $38,091.61 as capital* and "used" it as capital and *represented it to be capital in the Petition* to the Secretary of State. And that position is quite in accordance with the first contention of the appellant that *it was capitalized when it was used for the purpose of writing off good-will.*

These facts as thus stated by the learned trial judge (1) are expressly adopted by the respondent in its factum, which states:

The facts are set out in detail in the reasons for judgment.

It thus appears that so far as the company was concerned it had, over the years, in fact written off capital of $140,000, of which $38,091.61 had been written off against income, thus producing a deficit in capital account of $101,908.39. The refusal on the part of the income tax authorities to

(1) [1948] Ex. C.R. 244.

recognize this use of the $38,091.61 was with relation to the *appellant's income* for the year 1938. It is not shown that the company itself acquiesced, or indeed, that this ruling was one with which it was in any way concerned, and it is, in my opinion, important to bear in mind that the situation which is to be taken as fact as between the parties to these proceedings, was not at all the actual facts upon which either the company or the Secretary of State acted, the one in applying for, and the other in issuing the supplementary letters patent.

This being the position, what is it upon which the respondent relies as establishing that this sum of $38,091.61, which it insists was undistributed income immediately before the issue of the letters patent, became capital immediately thereafter? It is undoubted that the letters patent reduced the amount paid up on the outstanding shares but how did the letters produce a metamorphosis in the character of the $38,091.61? According to the evidence quoted above, the company did nothing.

Such a change must, in the first place, depend upon some act of the company with the intention of appropriating income to capital. The only act of the company in appropriating this sum to capital took place in the years before June 3, 1938, and this is the very thing the respondent refuses to recognize. How then can the respondent take the position that an act of the company before June 3, 1938, which, in order to clothe the sum in question with the character of income it will not recognize, can be used on or after that date to constitute an appropriation to capital? It is not shown that if the company had applied for the supplementary letters patent on the basis of the state of facts the Crown now insists upon, the company, on its part, or the Secretary of State, would have demanded that the write-offs of the $140,000 of good-will should, to the extent of the undistributed income on hand, be made good out of income. Such an appropriation will not invariably be insisted on; *Poole* v. *National Bank of China* (1); Re *Rowland and Marwood's Steamship Co.* (2). If the Crown had come into court on the theory that, while the company had in fact written off the amount in question out of profits, it could at any time reverse this action, but

(1) [1907] A.C. 229. (2) 51 Sol. J. 131.

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had lost that right by an express or implied representation on the grant of the supplementary letters that it would not do so, it would have been open to the appellant to show, if he could, that the original appropriation had been irrevocable or became so before June 3, 1938. This, however, was not the issue and, in my opinion, such an issue is not to be disposed of on the evidence adduced.

I think therefore, the Crown's contention with respect to section 15, as applied to the facts which it insists upon, cannot prevail. The issue of the letters patent reduced the amount paid up on the issued capital stock but, in my opinion, it did nothing more.

In fact the only argument addressed to this court on behalf of the Crown in support of its contention under section 15 is thus expressed in its factum:

> 19. The original authorized capital of the company was $200,000 divided into 2,000 shares of the par value of $100 each, of which, as of the 3rd day of June, 1938, 1,800 shares had been issued as fully paid up.
>
> 20. Included in the capital assets was an item of good-will in the amount of $140,000. Between the years 1921 and 1937 there were several write-offs of the good-will of the company totalling $140,000. This resulted in a reduction of capital from $180,000 to $40,000. However, by the above mentioned Supplementary Letters Patent the *capital stock* of the Company was reduced to only $79,200.
>
> 21. It is submitted therefore that the *difference* between the above mentioned amounts of $40,000 and $79,200 must be represented *by the undistributed income* admitted by the company to be in its hands as of 3rd June, 1938, with the result that such undistributed income was capitalized within the meaning of section 15 of the *Income War Tax Act.*

If it is taken to be the fact, as the Crown insists, that immediately before the letters patent the assets of the company included $38,091.61 of undistributed income, the reduction in the par value of the capital stock had nothing to do with capitalizing those profits. They were *assets* but it is, in my opinion, a complete non-sequitur to say that merely by the writing down of the par value of the shares, that which was a revenue asset became a *capital asset.*

The argument, in my opinion, begs the question in dispute.

With respect to section 16, it may be questioned whether the language "reduces . . . any class of the capital stock or shares thereof" contemplates a reduction in the par value of the shares outstanding. Assuming, however, that the subsection would extend so far, I do not think it can

be said that the appellant received anything "by virtue of the reduction" in question in this case. As already pointed out, it is not shown as a matter of evidence that these undivided profits did not in fact remain as a fund to which resort might be made by the company for dividends. If that be so, the fund might become the subject of a dividend or dividends in the future, but that had not taken place at any time material to these proceedings.

I would allow the appeal with costs here and below.

ESTEY, J.:—This appeal is from a judgment in the Exchequer Court (1) affirming a decision of the Minister of National Revenue requiring the appellant to pay income tax on the sum of $10,955.70, being the sum of $21.15 on each of 518 shares of capital stock which the appellant held in Domestic Gas Appliances Limited.

The Domestic Gas Appliances Limited, hereafter called "the company" was formed in 1919 with an authorized capital of 2,000 shares at a par value of $100, of which 1,800 shares had been issued and were outstanding on June 3, 1938. When formed the company included in its assets an item of $140,000 as good-will which during the period from 1921 to 1937 had been written off and as of June 3, 1938, the company had tangible assets to the value of $79,200. In its balance sheet of December 31, 1937, the assets are listed under three headings, cash in bank, accounts receivable and an amount owing from a trust company.

As of June 3, 1938, Supplementary Letters Patent were issued confirming the cancellation of the 200 unissued shares and a reduction of the 1,800 to $44 per share ($79,200) on the basis that the $56 per share "has been lost or is unrepresented by available assets." These Supplementary Letters Patent also confirmed the conversion of these 1,800 shares into 1,800 preferred shares at a par value of $40 and 1,800 common shares at a par value of $4 each. The company by this operation reduced its outstanding share capital to the amount of $79,200 being the equivalent of the actual value of its assets.

It was also provided in these Supplementary Letters Patent that the company might on resolution of the direc-

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tors redeem all or any of the preferred shares outstanding on payment of $40 plus a premium of one per cent and an amount equal to dividends declared prior to the redemption date and then remaining unpaid. In fact in 1938 these preferred shares were redeemed and the common shares taken up in the course of its liquidation in 1941.

The appellant prior to June 3, 1938, had 518 shares at a par value of $100 each and after the issue of the Supplementary Letters Patent had 518 preferred shares at a par value of $40 each and 518 common shares at a par value of $4 each.

In 1941 the auditors of the Department of National Revenue examined the books of the company, disallowed certain items as written off and determined that as of June 3, 1938, the company had $38,091.61 undistributed income. The Department of National Revenue takes the position that this sum of $38,091.61 was capitalized by virtue of the steps taken and confirmed by the Supplementary Letters Patent and that within the meaning of sec. 15 of the *Income War Tax Act* the appellant must be deemed to have received his share thereof through the allotment to him of the new shares of stock. The judgment (1) here appealed from confirms that view.

The foregoing steps confirmed by the Supplementary Letters Patent effected a change in the capital structure of the company that constituted a readjustment of its capital stock within the meaning of sec. 15.

15. When, as a result of the reorganization of a corporation or the readjustment of its capital stock, the whole or any part of its undistributed income is capitalized, the amount capitalized shall be deemed to be distributed as a dividend during the year in which the reorganization or readjustment takes place and the shareholders of the said corporation shall be deemed to receive such dividend in proportion to their interest in the capital stock of the corporation or in the class of capital stock affected.

If the amount of $38,091.61 undistributed income by virtue of the same steps was capitalized then within the meaning of the foregoing sec. 15 this amount "shall be deemed to be distributed as a dividend" and the appellant as a shareholder of the said company "shall be deemed" to have received his proportion of such dividend.

(1) [1948] Ex. C.R. 244.

The respondent submits that the sole effect of the steps confirmed by the Supplementary Letters Patent was to reduce the par value of the outstanding shares in the company from $100 to $44 per original unit in recognition of the fact that $56 par value thus cancelled had "been lost" or was "unrepresented by available assets." Under this submission the $38,091.61 must be regarded either as having been capitalized in the course of the write-offs or that it remained as undistributed income after the issue of the Supplementary Letters Patent.

The chief assistant auditor of the Department of National Revenue explained that the company in writing off the $140,000 good-will had turned the surplus of undistributed income into a deficit of $101,908.39 and that the undistributed income disappeared in the write-off of good-will. The auditor of the company stated, when his attention was directed to the item of $38,091.61, that it was "not reflected" on the company's balance sheet of December 31, 1937. He also stated, "In my opinion, as a result of the Supplementary Letters Patent no amount was capitalized as of that time" and that he entertained this opinion because "if any amount was capitalized it had been capitalized prior to the date of the Supplementary Letters Patent." This is the evidence relative to previous capitalization. It is not supported by any formal action on the part of the company other than what may be assumed to have taken place at directors' and shareholders' meetings where the accounts are passed. It rather suggests that in the books of the company some change had been made that effected in that sense a capitalization. Any change so effected does not prevent the company taking such action with respect to the assets so dealt with as it may deem desirable. In this case the appellant was a substantial shareholder and has formally admitted, for the purposes of this case "that on the 3rd day of June, 1938, Domestic Gas Appliances Limited had an undistributed income in the amount of $38,091.61." Under all these circumstances, it cannot be held that the item had been capitalized in a manner binding upon the company prior to the 3rd of June, 1938.

The petition to the Secretary of State praying the issue of these Letters Patent was not placed in evidence. The

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letters disclose, however, an intent and purpose on the part of the company to adjust its outstanding and fully paid share capital to the value of the "available assets." These assets as disclosed by its balance sheet on December 31, 1937, consisted of cash in bank, accounts receivable and an amount owing from a trust company. As the auditor stated, the amount of $38,091.61 was "not reflected" on the balance sheet. It is, however, not suggested that the amount was not there as an asset. He further intimated that no change material to the issues here under consideration was effected between December 31, 1937, and June 3, 1938.

It is the value of the "available assets" that constitutes the sum of $79,200. The company possesses no other assets and while this sum is not specifically referred to as capital or income in the Supplementary Letters Patent, it is clear that it alone is the total asset behind the stock. The undistributed income in the sum of $38,091.61 is part of this fund which in the readjustment as confirmed by the Supplementary Letters Patent has become the total capital asset of the company. This conclusion seems unavoidable unless you import back into the capital account some fictitious item or items which would then restore the condition removed by the steps confirmed by the Letters Patent.

In this adjustment the shareholders have received no money, but what in substance has taken place is the elimination of all fictitious items in the capital structure, first by replacing them with the undistributed income, and when that was exhausted by a readjustment of the capital stock to an amount equal to the actual value of its total assets.

Further, these Supplementary Letters Patent read as a whole, and particularly that portion stating that the reduction of $100,800 in the capital stock was made upon the basis that it "has been lost or is unrepresented by available assets," indicate that the company was readjusting its capital structure in a manner that in a commercial sense left no part of its available assets as a potential fund of income for the payment of dividends but rather as a capital fund upon which dividends as earned might be paid.

This view is confirmed by the accountant of the company. He stated that the capital of the company was reduced to $79,000 or $77,000, he could not remember which, and that he assumed the $38,000 still remained in the company and formed part of the $79,000. If, therefore, the $79,000 was capital and the $38,000 was part of it, the accountant believed the company had capitalized the $38,000.

The appeal should be dismissed with costs.

Appeal dismissed with costs.

Solicitors for the appellant: *Montgomery, McMichael, Common, Howard, Forsyth & Ker.*

Solicitor for the respondent: *T. Z. Boles.*