1956
Mar. 27, 28
Aug. 31

HAROLD ERNEST MANNING ..... APPELLANT;

AND

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

Revenue—Income Tax—Trusts—Beneficiary entitled to net revenue from encumbered commercial property for life with power of appointment as to income and corpus—Capital cost allowance retained by trustee to preserve corpus—Whether beneficiary entitled to claim deduction as an exemption—The Income Tax Act, S. of C. 1948, c. 52, as amended, s. 58(4), (5), (6), (6A).

Under a trust agreement involving two parcels of real property, "A" and "B", it was directed that the net income from "A" be divided among the testator's four children share and share alike for their respective lives each with power of appointment as to an undivided one fourth share of the income and corpus; that property "B" be sold and the proceeds used to discharge a mortgage on "A", the surplus if any, to be equally divided among the beneficiaries. Property "A" consisted of a commercial building, "B" a vacant lot. As the revenues from "A" and "B" proved insufficient to pay off a mortgage on "A", a court order was obtained authorizing the trustee to refrain from selling "B", to build thereon a store and apartment building, and to apply the revenues from the two properties to paying off encumbrances. To provide funds for the maintenance of "A" and "B" and pay off the mortgages, the beneficiaries agreed to the trustee setting up a depreciation or capital cost allowance fund into which was paid sums withheld from the revenue derived from "A" and "B". The appellant in computing his income from "A" claimed as a deduction one quarter of the capital cost allowance. The respondent ruled that he was not entitled to the deduction under s. 58 of the 1948 Income Tax Act as under the trust he was entitled to one quarter of the income without reduction of any amount in respect of capital cost allowance. The Income Tax Appeal Board affirmed the disallowance.

Held: That the operation of property "A" was the operation of a business, or at least in the nature of a trade or business, and there was a duty on the trustee to preserve the "corpus" in the interest of the residuary legatees. To assure that, reasonable yearly depreciation was necessary. *Re Estate John Ross Robertson* [1953] 2 S.C.R. 1 at 7. The net revenue was what was left after payment of taxes, interest, licenses and reasonable depreciation, and the four children of the testator were not entitled to claim more than the revenue remaining after deducting the said charges. It followed that the appellant was never entitled to any part of the amount set aside for depreciation. He never did receive it and since it never became his personal income, it was not taxable in his hands.

APPEAL from a decision of the Income Tax Appeal Board.

The appeal was heard before the Honourable Mr. Justice Hyndman, Deputy Judge of the Court, at Toronto.

D. W. Mundell, Q.C. for the appellant.

A. L. DeWolf for the respondent.

HYNDMAN, D.J. now (August 31, 1956) delivered the following judgment:

This is an appeal from the judgment of the learned chairman of the Income Tax Appeal Board.

The claim is made by the respondent under s. 58, subsections (4), (5), (6) and (6A), of the 1948 Income Tax Act, which reads as follows:

58(1) In this Act, trust or estate means the trustee or the executor, administrator, heir or other legal representative having ownership or control of the trust or estate property.

* * *

(4) For the purposes of this Part, there may be deducted in computing the income of a trust or estate for a taxation year such part of the amount that would otherwise be its income for the year as was payable in the year to a beneficiary or other person beneficially interested therein or was included in the income of a beneficiary for the year by virtue of subsection (2) of section 60.

(5) Such part of the amount that would otherwise be the income of a trust or estate for a taxation year as was payable in the taxation year to a beneficiary or other person beneficially interested therein, shall be included in computing the income of the person to whom it so became payable whether or not it was paid to him in that year and shall not be included in computing his income for a subsequent year in which it was paid.

(6) For the purposes of subsections (4) and (5), an amount shall not be considered to have been payable in a taxation year unless it was paid in that year to the person to whom it was payable or he was entitled in that year to enforce payment thereof.

(6A) A beneficiary or other person beneficially interested in a trust or estate who is entitled, either contingently or absolutely, to the property of the trust or estate or some part thereof at some future time, may deduct from the amount that would otherwise be his income from the trust or estate by virtue of subsection (5) such part of the amount that would otherwise be deductible from the income of the trust or estate for the year under regulations made under paragraph (*a*) of subsection (1) of section 11 as the trust or estate may determine; and any amount deductible under this section for a taxation year shall be deducted from the amount that the trust or estate would otherwise be able to deduct under regulations made under the said paragraph (*a*) but shall, for the purpose of section twenty, be deemed to have been allowed to the trust or estate under those regulations in computing its income for the year.

1956

MANNING v. MINISTER OF NATIONAL REVENUE

Hyndman D.J.

I may say at the outset that in my opinion, if depreciation or capital cost allowance as hereinafter mentioned was improperly claimed by the trustee, in view of the said statutory provisions, appellant was properly chargeable for income tax on his personal income in respect of the amount claimed by the respondent.

The material facts, as I find them, are that the father of the appellant, the late Charles Edward Manning, of the city of Toronto, clergyman, died on the 3rd day of September, 1928, having first made his last will and testament, dated the 20th of February, 1928, the material portions as affecting the issues herein being as follows:

I WILL AND DIRECT that my real estate situate on the north east corner of Bloor Street and Dovercourt Road in the City of Toronto be held in trust and the net income derived therefrom be divided share and share alike among my four children, during their respective lives, without power to dispose of the same in the way of anticipation but with power to appoint or dispose of by will that after his or her decease the share of the income to which such child was entitled shall go and enure to the benefit of such person or persons as are designated by said will, with the further power in like manner to dispose of an undivided one fourth share of the estate or corpus from which said income was derived, in the event of no further disposition then to form part of the residue.

I FURTHER WILL AND DIRECT that the said property shall not be sold nor encumbered beyond that which is in existence at the date of my decease and if the encumbrance thereon during the lifetime of any or either of my said children is reduced or satisfied in whole or in part in any way whatsoever, the said property is not to be further encumbered during the lifetime of any or either of my said children.

I WILL AND DIRECT that my property on the south west corner of Bathurst Street and St. Clair Avenue in the City of Toronto and any other real estate except my Bloor and Dovercourt property be sold as soon after my decease as the market conditions, in the discretion of my executors and trustees would warrant so as to obtain a reasonable price for the same. The property is to be disposed of either by public auction or private sale and upon such terms as to down payment and otherwise as to my executors and trustees may seem meet. I direct that the proceeds of the said sale be applied in reduction or payment of the incumbrance on my said property on the corner of Bloor Street and Dovercourt Road and the balance is to be divided share and share alike among my said four children.

THE rest and residue of my estate I give, devise and bequeath to my beloved wife Florence E. E. Manning for her own use absolutely.

The testator appointed his three children Harold Ernest Manning (the appellant herein), Luella Muriel Manning, and Doris Anita Manning as executors and executrices of his said will. Probate was granted to the above-named son and daughters on the 4th of October, 1928, by the Surrogate Court of the County of York.

The Bloor Street and Dovercourt Road property is hereinafter designated as property A, and the Bathurst Street and St. Clair Avenue property as property B. The present controversy arises in connection with property A only.

Property A, above mentioned, has a substantial building upon it, being three storeys high with a frontage of 94-95 feet on Bloor Street, and a frontage of 160 feet on Dovercourt Road. It was rented to a variety of tenants. The ground floor consisted of shops, and the upper floors were occupied by professional men, and for residential quarters.

At the time of the testator's death, there was a mortgage upon the said property in the amount of about ninety thousand dollars in favour of the National Trust Company Limited, bearing interest at six per cent per annum.

Property B was a vacant, undeveloped lot, except that a small revenue was derived from renting it for signs.

It will be noted that, under the terms of the will, no increase was to be made in the mortgage above-mentioned, the direction being that it should not be sold or encumbered beyond that which was in existence at the date of his decease, and, furthermore, if the encumbrance thereon during the lifetime of any or either of his children was reduced or satisfied in whole or in part, in any way whatsoever, it should not be further encumbered during the lifetime of any of his children.

As to property B, the will provided that the same be sold as soon after his decease as market conditions in the discretion of his executors and trustees would warrant, and that the proceeds of such sale should be applied in reduction or payment of the encumbrance on property A, any balance to be divided, share and share alike, amongst his four children.

At this stage, I might observe that the youngest child was incompetent to manage her affairs, and consequently it was not possible for the beneficiaries in any way to depart from the terms of the trust.

Owing to the depression in the real estate market at the time of the testator's death, and for some time afterwards, the trustees were unable to secure a satisfactory price for property B.

1956

MANNING v. MINISTER OF NATIONAL REVENUE

Hyndman D.J.

In 1931 or 1932, Mr. Manning, the appellant, was approached by the general manager of the National Trust Company with the suggestion that they should at once begin paying off the principal of their mortgage. Mr. Manning was able to prevail on Mr. O'Connor of the trust company to refrain from pressing the demand for reduction of the principal, as he says, because he had in mind the possibility of developing property B and, if and when that came about, they would in all likelihood be able to commence paying on the principal, and so two or three years' extension was granted.

In 1936 an opportunity arose to develop property B, but the demands of the National Trust Company had to be taken into consideration.

Owing to the fact of the incompetence of the youngest sister, it was impossible for the remaining beneficiaries to in any way depart from the terms of the will. Consequently an application was made to the Supreme Court of Ontario and an order made by MacFarland J. on the 20th of March, 1936, the material portions of which are as follows:

> It is ordered that the applicant, executors and trustees may refrain from selling property more particularly described in exhibit 3 to the affidavit of H. E. Manning filed herein, and may cause buildings to be erected thereon in accordance with the plans and specifications referred to in said affidavit and may rent and continue to rent the said buildings.
>
> And it is further ordered that said executors, etc., may borrow on a security of the first mortgage on the said property at such rate of interest as they or he may arrange the sum of $65,000 or such lesser sum as the said executors, etc. may determine and may be arranged.
>
> And it is further ordered that the said executors, etc. may from time to time apply such amounts out of the income to be derived from the said property and buildings in reduction and payment of the encumbrances referred to in the said last will and testament as they may see fit to apply after paying to the committee of the estate of the said Grace Elaine Manning money sufficient for the maintenance, etc.

Having obtained this order, the question arose as to how they should meet the demands of the National Trust Company in respect of reducing the principal of their mortgage. It was concluded that there would be available non-taxable revenues from property A, representing depreciation allowance, as also non-taxable revenue from parcel B development. Mr. Manning, in his evidence, testified that he had always claimed, and was allowed, depreciation on parcel A up to the year 1951, when it was disallowed by the Income

Tax Department, and the amount of $404.81 being one fourth of such depreciation was assessable to his individual income, from which this appeal arises.

In view of the condition of affairs, that is the now two mortgages, it was found that they would likely need at least six thousand dollars a year with which to reduce the principal of the mortgages.

Although there is nothing by way of agreement in writing up to 1951 between the three children, *sui juris*, and the National Trust Company, acting for the youngest sister, the evidence is that, after many meetings and conferences among them, it was decided and agreed that the amount allowed for depreciation on both buildings, and if necessary a portion of the net revenue, be applied on the said mortgages, and, as a matter of fact, over all those years following 1936, and up to and including 1951, no part of the depreciation on the buildings was paid to them.

It is contended that these amounts for depreciation were not only not paid to the beneficiaries but, furthermore, that if necessary by agreement they disclaimed the same, the reason being that it was absolutely necessary, for the preservation of the properties as against the mortgages, that such payments to them should not be made or demanded. If this contention is sound, there would be no liability on the part of the appellant to be charged with income tax on his share of such depreciation.

I cannot see that an agreement to give up part of a right to certain revenues—in this case, depreciation from an estate—(assuming in this case they were in law entitled to receive it, which I do not think they ever were), operates as a repudiation of the legacy, especially when it is not in any way prejudicial to other interested persons.

See Halsbury's Laws of England, second edition, volume 34, section 160.

It is clear that none of the said beneficiaries had any reversionary interest in property A. Assuming that they were entitled to the sums claimed as depreciation I am of opinion that they legally could disclaim any right thereto. It is true that there was no written agreement between them, but I am satisfied such disclaimer was in fact verbally

1956

MANNING v. MINISTER OF NATIONAL REVENUE

Hyndman D.J.

agreed to and acted upon by them. The fact that they never since 1936 received or demanded payment strengthens the testimony of appellant that such agreement was in fact made.

But apart from what I have said above it seems to me that the crucial point in the case is as to the right of the trustees in administering the estate, to charge depreciation in respect of said property A.

According to the evidence of the appellant, as trustee of the estate he always claimed, and was allowed, depreciation by the Income Tax authorities, and it was only in 1951 that such depreciation was disallowed.

The learned chairman of the Tax Appeal Board held (1) that the operation of property A was not carrying on a business entitling the trustees to make a charge for depreciation.

In view of the fact, as said above, that property A is a large, and in my view a purely commercial building, with rented shops, offices, and living apartments, I am of opinion that the operation of such a property should be regarded as a business, or at least, in the nature of trade or business.

Furthermore it seems to me that there was a duty or obligation on the part of the trustees to maintain or preserve the "corpus" in the interest of the residuary beneficiaries, whoever they may be following the exercise or non-exercise of a power of appointment provided for in the will. In this case such deductions for depreciation were used to reduce the large mortgage on the property. If no such reduction took place the property, when it comes into possession of the residuary beneficiaries, it might possibly be of little value, or possibly lost through foreclosure. In my view it was a proper accounting system used by the trustees in ascertaining what the net revenue of the property was.

The only interest of the four legatees in property A was the receipt by them of the *net revenue* for life. The residuary beneficiaries are the real owners of the property, subject to the life interest of the four children in the net revenue.

(1) (1954) 54 D.T.C. 366.

It seems to me therefore that it is most important that the property should be kept intact for the residuary beneficiaries, and to insure that, reasonable yearly depreciation would be necessary. Otherwise, as stated above, it is possible that, when they come into possession, there may be little value left for them.

As said by Kellock, J. *in re Estate John Ross Robertson* (1):

> . . . The theory of such write-offs is maintenance of capital. If there are no profits until after proper write-offs for depreciation have been made, the fact that ultimate realization produces a surplus over book values, a result dependent on market conditions at the time of sale, does not establish that, after all, there were additional profits.

I am therefore of opinion that *net revenue* in this instance is that which is left after payment of taxes, interest, licenses, if any, insurance and other lawful expenses, and reasonable depreciation. In other words the four children of the deceased testator were not entitled to claim more than the revenue remaining after first deducting the said charges.

If I am correct in this, then it follows that the appellant was never entitled to receive any part of the amount set aside for depreciation. He never did receive it, and in my opinion never was entitled to such. It therefore never became part of his personal income, and consequently not taxable in his hands.

Therefore I would allow the appeal with costs, set aside the said assessment and direct that a further assessment be made, excluding therefrom the said sum of $404.81.

Should any question arise as to the actual amount improperly assessed to appellant then the matter may be spoken to.

Judgment accordingly.

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(1) [1953] 2 S.C.R. 1, 7.