1957

Feb. 18

Oct. 4

BETWEEN:

WILLIAM EWART BANNERMAN .....APPELLANT;

AND

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

Revenue—Income tax—Expenditure for purpose of gaining income from property or business—Reasonably direct relationship required between objective sought, means employed and expenditure made thereon—Winding-up order employed to gain income from shares and rent from real property—The Income Tax Act, 1948, S. of C. 1948, c. 52, ss. 12(1)(a)(b), 81, 82, 105—The Winding-Up Act, R.S.C. 1952, c. 296, s. 10(a).

The appellant deducted from his 1952 taxable income expenditures he claimed to have made for the purpose of gaining income from certain shares of stock and from certain real property. The deductions were disallowed by the Minister whose decision on an appeal to the Income Tax Appeal Board was affirmed. The appellant appealed from the Board's decision.

The shares were in a company formed in 1929 in which the managing director (the president) and the appellant (the vice-president) each held a one-half interest. The real property was owned by the appellant and occupied by the company and the rent to be paid was to be determined on completion of a building then being erected for occupancy by the company. The expenditures were made to end the managing director's control of the company, when following an investigation in 1951 by the income tax authorities the appellant learned that the managing director had diverted to his own use company funds in excess of half a million dollars. Following the inquiry the managing director promised the appellant to make restitution to the company, pay the resultant income tax owing by it, and settle on the amount of rent the company should pay for occupation of appellant's property. The managing director paid the tax but refused to do more and the appellant moved at a shareholder's meeting in April 1952 that the company be voluntarily wound up. The motion was defeated by the president's casting vote. The appellant then applied for an order under s. 10(*a*) of *The Winding-Up Act*, R.S.C. 1952, c. 296. The Court granted the order and appointed a provisional liquidator to manage the company. Pending the managing director's appeal from the order, the liquidator and the two litigants agreed to submit certain contentious matters to arbitration. The arbitrator's finding, signed November 18, 1953, was that as of January 27, 1953, the managing director was indebted to the liquidator for $66,481.37 and that the rent owing the appellant was $15,065.67, based on, but excluding, the annual rent being paid by the liquidator at the time of the award. The managing director refused to abide by the finding and the liquidator brought suit to recover the debt and other sums owing the company and obtained jugdment for $365,114. The expenditures in dispute totalled $13,357.06 of which amount the appellant allocated $10,000 for the purpose of gaining income from the shares and the balance to gaining income in the form of rent from the real property. His contention was that the winding-up proceedings were the only means of forcing restitution to the company and thereby enabling him to gain income from the two sources.

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Held: That the evidence did not support the contention that the rent payments made by the liquidator were the direct result of the winding-up proceedings nor that such proceedings were the only means of collecting rent. Nothing prevented the appellant from having the terms of the lease defined by the usual process of law.

2. That it was the arbitration, not the winding-up, that determined the amount of rent owing and, as the expenditures on the winding-up pre-dated the arbitrator's award, they could have no relation thereto.
3. That in the absence of any definition of the word "purpose" in s. 12(1)(*a*) of *The Income Tax Act*, to conform to its meaning, there should exist at least a reasonably direct relationship between the objective sought, the means employed to obtain it, and the expenditure made thereon and an immediate distinction made between the primary purpose of the expenditure and the indirect and ultimate results therefrom.
4. That it was the moneys expended on the arbitration and not on the winding-up that were directly responsible for the return to the company of all but $66,481.37 of the diverted funds and also fixed at $15,065.67 the rent owing from July 1, 1951 to January 27, 1953 (the date of the liquidator's appointment) and confirmed the rental of $7,314.48 per annum thereafter paid by the latter for reduced space.
5. That to ascertain the appellant's purpose of intent when he applied for the winding-up order, the court must consider his whole course of conduct and other relevant facts on the record and having done so could not credit one so income tax conscious with deliberately seeking a distribution under *The Winding-Up Act* with the heavy incidence of taxation entailed if it could, as it appeared here, be avoided.
6. That to justify the claim that inevitability of distribution under s. 81 of *The Income Tax Act* is a valid substitute for proof of purpose such inevitability must be proven but was not.

APPEAL from a decision of the Income Tax Appeal Board.

The appeal was heard before the Honourable Mr. Justice Kearney at Montreal.

A. J. Campbell, Q.C. for the appellant.

L. Lalande, Q.C. and *J. M. Poulin* for the respondent.

The facts and questions of law raised are stated in the reasons for judgment.

KEARNEY J. now (October 4, 1957) delivered the following judgment:

This is an appeal (heard *in camera*) from a decision of the Income Tax Appeal Board (1), dismissing the appellant's appeal and affirming a re-assessment of his income tax for the year 1952, whereby the sum of $13,357.06, which the appellant had deducted, was added to his taxable income.

(1) [1955] 13 Tax A.B.C. 38; 9 D.T.C. 291.

This amount was expended by the appellant on legal, travelling and telephone expenses, allegedly for the purpose of gaining or producing income from two properties—one a piece of real estate, and the other shares of stock.

The legal point at issue is whether, in the circumstances, the expenditure is a permissible deduction, within the meaning of s. 12(1)(*a*) and not prohibited by s. 12(1)(*b*) of the *Income Tax Act*, S. of C. 1948, c. 52.

The facts are rather involved. In 1929, the appellant, whose main occupation was and still is that of an important executive in a large company, and possessed of a substantial investment income, formed with a business acquaintance since deceased, and hereinafter called "the managing director," "C" company, each acquiring 50% of the issued shares. The new venture was largely carried on by the managing director who, as president, had the casting vote at meetings of the company or its directors.

The appellant was mentally stunned when, in July 1951, he was informed by the Income Tax Branch that an incomplete investigation revealed that the managing director had been diverting company funds for his own use, from 1941 to 1950 inclusive. Later, the amount diverted was found to be over half a million dollars.

The managing director told the appellant that he had made a grave error. He undertook to, first, get the company's tax problem settled, which he did, and then to square accounts with the company and the appellant, but this he failed to do.

At that time the Toronto branch of the company was occupying the yard of the appellant's property in Scarborough Township, while the appellant was erecting a building thereon, which was also to be occupied by the company. Determination of rental and space was left in abeyance pending the building's completion.

At their next meeting in September 1951, although in the meantime the managing director had paid on behalf of the company $318,397.18 income tax arising from his diversions, he changed his attitude, refusing to make further restitution or to cause the company to make an offer to pay rent for the Scarborough property. Further discussions were had but to no avail.

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At the annual meeting of shareholders in April 1952, the appellant, acting on advice of counsel, moved to have a voluntary winding-up of the company. The managing director, by use of his casting vote, defeated the motion. The appellant then applied for a winding-up order under the *Winding-up Act*, R.S.C. 1952, c. 296, s. 10(*e*) which, *inter alia*, provides that a winding-up order may be granted,

> (*e*) when the court is of opinion that for any other reason it is just and equitable that the company should be wound up.

The application was heard by Batshaw J. of the Superior Court of Quebec who, after a hearing lasting 14 days, granted the order on January 27, 1953 (1). A provisional liquidator was appointed, winding-up proceedings suspended, and the liquidator authorized to carry on the company's business, which he has since continued to do. Subsequently the liquidator, the managing director and the appellant agreed to submit certain contentious matters, including the Scarborough property rental, to arbitration and, on June 29 (Ex. C), three chartered accountants were appointed as arbitrators and mediators to make an accounting between (*a*) the liquidators and the managing director and (*b*) the liquidator and the appellant.

Certain other claims by the company against the managing director were specifically excluded by the Deed of Arbitration.

By award signed November 18, 1953 (Ex. A), a majority of the arbitrators found that, as of January 27, 1953, (a) the managing director was indebted to the liquidator for $66,481.37 and (b) the liquidator, for occupancy of the Scarborough property, was indebted to the appellant for $15,065.67, based on an annual rental of $7,314.48 being paid by the liquidator at the time of the award.

Notwithstanding the agreement by the parties to abide by the findings, the managing director refused to pay the $66,481.37, and the liquidator, on behalf of the company, brought suit to enforce payment thereof together with other sums excluded from the arbitration, including penalties for income tax infractions, damages, interest and costs, amounting in all to $2,271,180.63. Judgment was subsequently obtained for $365,114.27 together with interest and costs

(1) [1953] R.C.S. 107.

(Ex. 4). The heirs of the managing director and the liquidator appealed from the judgment, and their appeals are still pending.

I enquired during the hearing if counsel could agree on what portion of the $13,357.06 expended on procuring the winding-up order was allegedly for the purpose of gaining rental and dividend income respectively. Such agreement was not reached but, by consent, the appellant and his counsel subsequently filed affidavits setting out that, of the $3,357.06 for telephone and travelling expenses, $500 was attributable to rental and, of the $10,000 expended on legal expenses, $2,000 was chargeable to the question of rental, leaving a balance of $10,857 attributable to gaining of share income.

As I have reached the same conclusion in respect of expenditure on rental and dividend income, further comment on the merits of apportionment can be dispensed with.

Regarding the alleged $2,500 expenditure *re* rental income, the appellant's notice of appeal states that, upon legal advice, he instituted proceedings under the *Winding-up Act,* there being no other way to force restitution of the amounts diverted and subsequently to obtain payment of rent; and that the expenditure made in the winding-up proceedings did in fact directly result in producing income to the appellant from his property and that he "has received $15,065.67 for occupation rental for his said real property for the period May 1st, 1951 to December 31st, 1952, and is in receipt of subsequent regular rental income therefrom . . .," on which tax has been paid to December 31, 1954.

I do not think that the appellant is justified in his contention that there was no other way to obtain payment of rent except through winding-up proceedings and such proceedings, I consider, were for purposes other than to obtain rental. If the only issue between the appellant and the company were the disagreement concerning rent, this would not, in my opinion, constitute a valid reason to justify the granting of a winding-up order. I believe that recognition of this fact explains why the appellant, in his letter of April 27, 1953 (Ex. B), which accompanied his income tax return and described the purpose of the expenditure claimed as a deduction, failed to mention rental recovery. Nothing

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prevented the appellant, during the period extending from July 1950 to January 1953, from suing the company in either the province of Ontario or Quebec to have the terms of the lease determined. In such proceedings the terms of the lease would have been the only issue, but during the extended hearing for a winding-up order the question of rental never arose.

It might conceivably have been a ground for seeking a winding-up order if the company's failure to pay the rent had been due to the fraud or bad faith of its managing director. There is nothing in the evidence to indicate that such was the case. Neither the space to be occupied nor the price per foot to be paid had been determined prior to the granting of the winding-up order, and five months after it had been granted, the terms being still unsettled, it was thought necessary to have recourse to arbitration proceedings.

I am also of the opinion that the evidence does not bear out the appellant's contention that the $15,065.67 and subsequent rental payments made to him by the liquidator were the direct result of his expenditure on winding-up proceedings.

It was the arbitration award of November 8, 1953, which dealt with "the accountability of the Liquidator to W. Ewart Bannerman for rent of premises owned by the latter and occupied by . . ." "C" company (Ex. A. p. 2(*c*)), that determined the liquidator's indebtedness of $15,065.67 for rent from July 1, 1951 to January 27, 1953. It also confirmed the rental of $7,314.48 the liquidator was then paying for reduced space in the Scarborough property (Ex. A, appendix "B", p. 2—see transcript p. 15), thus dispensing with further accounting.

The expenditure claimed as a deduction covered a period preceding December 12, 1952 (Ex. A-5), but the appellant and his attorney participated in the arbitration proceedings which began only in 1953, and therefore the preceding expenditure could have no relation to the arbitration proceedings or any expenditures made thereon.

Next to be considered is the more important question, namely, the expenditure ($10,857) said to have been made by the appellant for the purpose of gaining income from his shares in "C" company.

In a case such as the present one, where the purpose of the expenditure is allegedly not confined to one property or to one objective but to a succession of results, each objective or result becomes increasingly remote. In the absence of any definition of the word "purpose," as found in s. 12(1)(*a*), I think, to conform to its meaning, there should exist at least a reasonably direct relationship between the objective sought, the means employed to obtain it, and the expenditure made thereon.

The appellant, both in his pleadings and testimony, claimed that, as a result of his own action and the subsequent proceedings taken and to be taken by the liquidator, 50 per cent of the monies recovered by the company would ultimately be received by him as a taxable dividend under s. 81(1) of *The Income Tax Act*.

I think that an immediate distinction must be drawn between the primary purpose of the expenditure and indirect and ultimate results therefrom. In my opinion there is evidence in this case of a primary purpose. The managing director, having promised to make restitution, went back on his word and defiantly declared that he had done nothing wrong and that everything that the company had made was due to him and he "was entitled to all" he "had taken," (p. 3 of transcript). In Ex. B, the appellant refers to the removal of the managing director. At p. 16 of his testimony he spoke of "first of all putting the company into liquidation and having a liquidator appointed that" he "could deal with." Batshaw J., in his judgment removing the managing director and appointing the interim liquidator, said: ". . . the Court is of the opinion that the elementary rules of ordinary business morality would preclude the application of that by-law" (which gave the president a casting vote) "in favour of a president who sought to use same to perpetuate his corrupt administration . . ."

On the evidence, I think the appellant's immediate and most urgent purpose in making the expenditure on winding-up proceedings was to oust a defiant managing director from the control of the company's affairs, thus preventing him from continuing his corrupt practices and using his official position to protect his personal interest to the

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detriment of the shareholders in general, and the appellant in particular. The expenditure claimed as a deduction, I consider, must be attributed essentially to that purpose.

Furthermore, the arbitrators who were also mediators, apart from deciding the rental issue, determined the amount which the managing director had diverted to be $547,934.67. After taking into account payments made by the managing director, to or for the account of the company, the adjustments and transactions between the parties, which took place during the course of the arbitration proceedings, all but $66,481.37 of the diverted funds had been recovered for the company (Ex. A, Appendix "A", p. 1).

It was the monies expended on the above-mentioned proceedings, and not the appellant's expenditure in 1952, which were immediately responsible for recoveries made for the account of the company and which do not constitute income to the appellant.

As regards his receipt of the assets in the manner alleged, the appellant submits, firstly, that it was his intention to bring this about and, secondly, that this in any event would inevitably follow in consequence of his recourse to a winding-up order. This latter claim is important because, if established, it might be sufficient in itself to constitute purpose, and counsel placed the greatest reliance on it.

To ascertain the appellant's intent at the time he retained counsel and on their advice applied for the winding-up order, I consider the court should not rely only on his statement but should weigh it in the light of his conduct, and other relevant facts and circumstances disclosed in the record should also be considered. Cameron J., in *Gairdner Securities Ltd. v. Minister of National Revenue* (1), speaking of proof of intention notwithstanding the taxpayer's evidence, said:

> I am of the opinion that its true nature is to be determined from the taxpayer's whole course of conduct, viewed in the light of all the circumstances.

The appellant made the following statement to counsel at the hearing (p. 24 of transcript):

> Q. In so far as it rests with you, Mr. Bannerman, is it your intention that the business and assets of this company be sold and that the

(1) [1952] Ex. C.R. 448 at 457.

assets (proceeds) be distributed among the shareholders according to law?

A. That is correct.

The arbitrators' report indicates that the appellant was intensely income tax conscious and I cannot credit anyone, particularly the appellant, with deliberately seeking a distribution of the company's assets under the *Winding-up Act* with the heavy incidence of taxation entailed, if it could be avoided. The appellant is in one of the higher brackets of the income tax scale and, if, when all assets were realized upon, the proceeds were distributed, some idea of the appellant's income tax assessment can be judged by the balance sheet of the company for the year 1955 (Ex. 5), which, subject to auditors' remarks, shows fixed assets at cost amounting to over one million and the company's surplus to almost three-quarters of a million dollars.

The appellant has likewise failed to prove that inevitably a distribution under s. 81(1) of the *Income Tax Act* will take place.

81.(1) Where funds or property of a corporation have, at a time when the corporation had undistributed income on hand, been distributed . . . on the winding-up . . . of its business, a dividend shall be deemed to have been received at that time by each shareholder equal to the lesser of

(*a*) the amount or value of the funds or property so distributed or appropriated to him, or

(*b*) his portion of the undistributed income then on hand.

I consider it is likely, for one thing, that the company, under s. 105 of the *Income Tax Act*, will elect to create tax-paid undistributed income. Since such income is defined in s. 82 and is not included in s. 81(*b*), to a large extent at least, it could reach the shareholders as non-taxable capital instead of taxable dividends. (See *Waters v. Toronto General Trusts Corporation* (1) and *In re Hardy* (2).) It would be possible for the liquidator under s. 35 of the *Winding-up Act* to make such election.

It is also probable, I think, that the company will continue as a going concern since, according to the evidence of the liquidator, its business has been carried on at "a very substantial profit" (p. 33 of transcript) and the court, under s. 18 of the *Winding-up Act*, has power to make permanent the suspension order which has been in force since January 1953. True, the liquidator testified that he

(1) [1956] S.C.R. 889. (2) [1956] S.C.R. 906.

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could see no other solution but to offer eventually the company for sale, predicated on the belief that the appellant and the heirs of the managing director were not likely to carry on together in the future. He admitted that, if the personnel of the shareholders should change, there was a possibility of ending the liquidation and that the company could continue "on its prosperous way" (p. 40 of transcript).

The evidence indicates that the said heirs and the appellant have a common interest in avoiding payment of unnecessarily high income taxes, and that it would be to their respective interests to sell the shares of the company rather than to wind it up and distribute its assets.

On behalf of the appellant, it was urged that it was not necessary to show that income resulted from the expenditure made, and it would suffice if the expenditure were made for the purpose of gaining income, although that purpose was not realized. Counsel for the respondent did not take issue with this principle but submitted, correctly I think, that, to justify the claim that inevitability of distribution under s. 81 is a valid substitute for proof of purpose, such inevitability must be proven, and that such proof was not made.

Counsel for the appellant stated that, as far as he was aware, this was the first case upon which a deduction based on the admittedly narrow grounds of the applicability of s. 81 had been made. In my view, the appellant is not entitled to succeed in respect to the deduction, because I consider his ultimate receipt of monies "deemed to be a dividend" is too unlikely or, at best, too uncertain and remote to establish a reasonably direct relationship between the object or purpose sought, the means employed, and the expenditure made thereon.

A further reason why the appellant failed to justify the deduction is to be found in s. 12(1)(*b*). Counsel for the appellant admitted that, if a distribution of assets occurred as alleged, it would inevitably follow, because of the appellant's present stock ownership, that some portion of the monies received by him would constitute capital in his hands. If recourse were had to s. 105, the amount thus received would be very much increased. It is for the appellant to establish the extent, if any, of the expenditure made

for the purpose of gaining or producing income, as contrasted with a return of capital but he failed to do so.

For the above-mentioned reasons, the appeal is dismissed with costs and the re-assessment made for the year 1952 is affirmed.

Judgment accordingly.