1935
Mar. 27.
Apr. 30.

BETWEEN:

NORTHERN SECURITIES COMPANY ..... } SUPPLIANT;

AND

HIS MAJESTY THE KING..... RESPONDENT.

Revenue—Income—Income War Tax Act secs. 5 and 9B—Non-resident shareholder in Canadian company—Mining company—Companies Act, s. 98—Dividends paid from reserve funds built up out of profits set aside as allowances for depletion and depreciation of company's assets taxable as income.

Suppliant owned shares of the capital stock of Crow's Nest Pass Coal Company Ltd., a Canadian mining company, which in 1933 distributed $2 per share to its shareholders stating that "this payment is made from Depreciation and Depletion Reserve Funds of the Company." At this time there were no net annual operating profits available for dividends, nor was the company in liquidation. The reserve funds had been built up by amounts set apart from profits as allowances

(1) (1929) Ex. C.R. 101; (1930) S.C.R. 531.

for depreciation, and for depletion of the company's coal reserves, with the approval of the Minister of National Revenue, and in the exercise of his discretion under s. 5 (*a*) of the Income War Tax Act, R.S.C. 1927, c. 97. Pursuant to demand the company paid income tax on the money so distributed. Suppliant by its petition alleged that no tax is imposed by the Act in respect of the distributions so made, and prayed that the money paid as tax be refunded to it.

Held: That the dividends here paid were not distributions of capital but distributions of profits derived from the operations of the company and therefore taxable as income received as dividends.

2. That the true construction of s. 9B, ss. 2 (*a*), Income War Tax Act is that dividends in the hands of a non-resident shareholder shall pay the tax imposed, no matter from whence derived.

PETITION OF RIGHT by suppliant seeking to recover money paid as income tax.

The action was tried before the Honourable Mr. Justice Maclean, President of the Court, at Ottawa.

N. W. Rowell, K.C., and *Peter Wright* for suppliant.

F. P. Varcoe, K.C., for respondent.

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

THE PRESIDENT, now (April 30, 1935), delivered the following judgment:

The suppliant, a company incorporated under the laws of the state of New Jersey, a non-resident of Canada, was, at the time material here, the owner of certain shares of the capital stock of Crow's Nest Pass Coal Company Ltd., a company incorporated under the Companies Act (Canada) for the chief object of mining, and hereafter to be referred to as "the Company."

In the month of September, and in the month of December, 1933, the Company made distributions to its shareholders in the amount of $2 per share. Accompanying each dividend forwarded to shareholders was the following covering letter:—

Enclosed find cheque for $2 per share on the stock of this company recorded in your name at the close of business August 1, 1933.

This payment is made from Depreciation and Depletion Reserve Funds of the Company.

The Company was not in liquidation. The distributions so made from the depreciation and depletion reserve funds of the Company, it is claimed, constituted part of the capital of the Company, or, alternatively, it is claimed,

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the same was paid out of assets or funds of the Company which are exempt from the payment of Income Tax. At the time such distributions were made to shareholders the amount to the credit of profit and loss account had been exhausted, and there were no net annual operating profits available for dividend in the period in question.

The Commissioner of Income Tax, in December, 1933, demanded from the Company the sum of $5,711.40, out of the distributions made or to be made as aforesaid to the suppliant, on the ground that an income tax of five per centum was payable thereon by the suppliant, under the Income War Tax Act, R.S.C. 1927, ch. 97, sec. 9B, ss. 2 (*a*). The Company pursuant to the demand of the Commissioner of Income Tax, deducted the amount of this tax from the amount so payable to the suppliant, and it paid the same to the Receiver General of Canada, under protest; the suppliant has demanded repayment of the said sum, but the same has been withheld. The suppliant in its petition alleges that no tax is imposed on the suppliant by the Income War Tax Act in respect of the distributions made, and prays that the sum so paid, with interest, be refunded.

The sections of the Income War Tax Act which are particularly relevant to the controversy here are the following:

5. "Income" as hereinbefore defined shall for the purposes of this Act be subject to the following exemptions and deductions:—

(*a*) Such reasonable amount as the Minister, in his discretion, may allow for depreciation, and the Minister in determining the income derived from mining and from oil and gas wells and timber limits shall make such an allowance for the exhaustion of the mines, wells and timber limits as he may deem just and fair;

And

9B. In addition to any other tax imposed by this Act an income tax of five per centum is hereby imposed on all persons resident in Canada, ..., in respect of all interest and dividends paid by Canadian debtors, directly or indirectly to such persons, in a currency which is at a premium in terms of Canadian funds.

(2) In addition to any other tax imposed by this Act an income tax of five per centum is hereby imposed on all persons who are non-residents of Canada in respect of

(*a*) All dividends received from Canadian debtors irrespective of the currency in which the payment is made, and

(*b*) All interest received from Canadian debtors if payable solely in Canadian funds except the interest from all bonds of or guaranteed by the Dominion of Canada.

The amount to the credit of the depreciation and depletion reserves, as I understand it, amounted to some $1,900,000, in considerable part consisting of investments and cash, and, I think, it is correct to say, that a portion of such reserves was in a form not available for distribution. These reserve funds had been built up by amounts set apart from profits as allowances for depreciation, and for depletion of the company's coal reserves, with the approval of the Minister, and in the exercise of his discretion under sec. 5 (*a*) of the Act. Precisely how the allowances for depreciation, and the amount or amounts, were arrived at is not clear, but the Commissioner of Income Tax appears to have agreed that ten cents per ton for each ton of coal mined, should be allowed on account of the depletion of the mine or mines owned and operated by the Company. However, these reserves were apparently built up with the approbation of the Minister.

If the Company's depreciation and depletion fund constituted capital, and if the distribution impaired capital, this was permissible only because the Company was a mining company. There is a statutory prohibition against payment of dividends out of capital, if it has the effect of impairing capital, but there is an exception in the case of mining companies. The Companies Act, ch. 27, s. 98, R.S.C. 1927, reads as follows:

> 98. No dividend shall be declared which will impair the capital of the company.
>
> 2. Nothing in this Act shall prevent a company incorporated for the chief object of mining from declaring or paying dividends out of its funds derived from the operations of the company, notwithstanding that the value of the net assets of the company may be thereby reduced to less than the par value of the issued capital stock of the company, or in the case of companies having shares without par value, to less than the amount of capital with which the company shall carry on business as prescribed by this Act, if such payment does not reduce the value of its remaining assets so that they will be insufficient to meet all the liabilities of the company then existing exclusive of its nominal paid up capital.

This provision of the Companies Act permitted the payment of a dividend to shareholders out of funds derived from the operations of the Company, even if it reduced the value of the net assets of the Company to less than the par value of its issued capital stock, and I would emphasize the word *dividend;* it is stated in the Company's financial statement for 1933 that the distributions in question were made to shareholders under the powers

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conferred on the Company by sec. 98 of the Companies Act, out of the depreciation and depletion reserves of the Company. It is not clear to me whether or not, in fact, the distributions here made did impair capital in the sense mentioned in this section.

The facts of the case being stated, and the relevant provisions of the Income War Tax Act and the Companies Act being stated, the point for decision may be put thus: Were the sums distributed to the suppliant derived from income or capital of the Company, or, out of assets or funds of the Company which were exempt from the payment of this income tax.

A number of authorities were referred to by counsel, but it will not be necessary to discuss all of them. The first to be mentioned is that of *Hill* v. *Permanent Trustee Company of New South Wales Ltd.* (1); this was an appeal from the Supreme Court of New South Wales to the Judicial Committee. The trustee company, as trustee of the will of one Hill, held shares in Buttabone Pastoral Co. Ltd., and the latter paid to the trustee company certain sums of money as dividends out of the proceeds of the sale of substantially the whole of its lands, live stock and other assets, it ceasing thereafter to carry on business. The dividends were declared and paid as "a distribution of capital assets in advance of the winding up." The question was, as between a life tenant and a remainderman, whether the dividends were, under the will of Hill, "net income or profits to be derived from such investment or investments," or "capital of my said trust estate." It was held that the dividend should be treated as income and not capital of the trust estate. Their Lordships of the Judicial Committee of the Privy Council, laid down the following proposition, which, I think, is applicable here.

> A limited company not in liquidation can make no payment by way of return of capital to its shareholders except as a step in an authorized reduction of capital. Any other payment made by it by means of which it parts with money to its shareholders can only be made by way of dividing profits. Whether the payment is called "dividend" or "bonus," or any other name, it still must remain a payment on a division of profits.

This means that any distribution of money, except on a reduction of capital, by which assets are released to the

(1) (1930) A.C. 720.

shareholders, can only be a distribution of profits, by whatever method it is made. Their Lordships also stated:

So long as such a company is a going concern and is not restricted as to the profits out of which it may pay dividends, it may distribute as dividends to its shareholders the excess of its revenue receipts over expenses properly chargeable to revenue account . . . On the other hand, if the company instead of distributing the same balance as dividends, resolved upon liquidation, the shareholder would be repaid his share of capital and in addition the share of surplus assets in the liquidation attributable to his shares . . . but no part thereof would belong to a tenant for life as income; it would all be corpus of the trust estate.

Their Lordships referred to the case of *Bouch* v. *Sproule* (1) also cited before me; and much consideration was given to this case by the Supreme Court of New South Wales in the Hill case. Discussing this case their Lordships said:

It is not in their Lordships' view, an authority for the proposition that the company's statement of intention determines as between tenant for life and remainderman whether a sum paid away by the company to a shareholder who is a trustee is income or corpus of his trust estate. In *Bouch* v. *Sproule* no moneys, in fact, left the company's possession at all. It is not an authority which touches a case in which a company parts with moneys to its shareholders. The essence of the case was that the company, not by its statements, but by its acts, showed that what the shareholders got from the company was not a share of profits divided by the company, but an interest in moneys which had been converted from divisible profits into moneys capitalized and rendered for ever incapable of being divided as profits.

In that case it was proposed to distribute accumulated profits as a bonus dividend, and to allot new shares (partly paid up) to each shareholder, and to apply the bonus dividend in part payment of the new shares, and this was done; in this way the profits were permanently added to the company's capital, and it was held that no sum was paid as a dividend. But that is not the case which I have to decide.

Then discussing a decision of the High Court of Australia, in the case of *Knowles* v. *Ballarat Trustees, Executors and Agency Co.* (2), a case which the Supreme Court of New South Wales followed in reaching their decision in the *Hill* case, their Lordships make the following pertinent observations:

A careful consideration of the judgments delivered by the majority of the High Court judges satisfies their Lordships that the decision is based upon the view that a company, when dividing among its shareholders a sum of accumulated profit, is entitled to dictate and determine whether the moneys so received by the shareholder shall, in his hands

(1) (1887) 12 A.C. 385.
(2) (1916-17) 22 C.L.R. 212.

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be deemed corpus or income. Their Lordships know of no earlier authority justifying this view. It is a matter with which the company has not the remotest concern. If payment to the shareholders is made out of profits it is income of the shares, and no statement of the company or its directors can change it from income into corpus. Their Lordships agree with and are content to refer to, the dissenting judgment of Isaacs, J. as a correct exposition of the law.

In the *Knowles* case the facts were that the directors of a limited company, which was not in liquidation, by resolution resolved upon the payment to the shareholders of (1) a dividend of 6d. per share; (2) a bonus of 6d. per share; and (3) "distribution of assets 10s. per share," which was paid out of accumulated profits. The question for determination was whether the 10s. per share was paid out of capital or income. The High Court (Isaacs J. dissenting) held that the moneys were capital of the trust estate, because though they were payments of cash made out of accumulated profits the company intended the moneys to be a distribution of capital as distinguished from dividends. Their Lordships, it will be seen, accepted the dissenting judgment of Isaacs J. as the correct exposition of the law.

Their Lordships of the Judicial Committee in the *Hill* case, adopted the reasoning of Eve, J. in another case cited before me, *In re Bates* (1). There, the directors of a limited company, owning and operating steam trawlers, sold some of them for sums exceeding the values at which they stood in the company's balance sheet; the proceeds were carried to a suspense account and were subsequently distributed as cash bonuses to shareholders, accompanied by a covering letter stating that such bonuses were capital payments, and not liable to income tax. While the issue in this case arose as between a tenant for life and remainderman, yet it lays down a principle which, I think, is applicable here. It was held that the payments not having been capitalized by the issuance of bonus shares increasing the total capital, the payments were income receivable by the tenant for life, and that the fund was one which the company could treat as available for dividend and could distribute as profits. Eve J. said:

> In this state of affairs it was a fund which the company could treat as available for dividend and could distribute as profits, or having regard to its power to increase capital could apply for that purpose by, for example, increasing the capital, declaring a bonus and at the same time

(1) (1928) Ch. Div. 682.

allotting to each shareholder shares in the capital of the company paid up to an amount equivalent to his proportion of the bonus so declared. Unless and until the fund was in fact capitalized it retained its characteristics of a distributable property . . . no change in the character of the fund was brought about by the company's expressed intention to distribute it as capital. It remained an uncapitalized surplus available for distribution, either as dividend or bonus on the shares, or as a special division of an ascertained profit . . . and in the hands of those who received it, it retained the same characteristics.

It might be convenient here to observe that the effect of the notification of the Company here, that the dividend paid came from the depreciation and depletion funds was no doubt done with the intent that it might assist in protecting the recipients from liability to taxation, but as Eve, J. stated in the *Bates* case, the mere impressing of these distributions with the appellation of "Depreciation and Depletion Reserve Funds of the Company," cannot determine their true character. Nor can the fact that the distributions made here were described in the covering letter as a "payment," and not a "dividend," determine that they were not payments of dividends.

Finally, I shall refer to another cited authority, *Lee* v. *Neuchatel Asphalte Co.* (1), because of a discussion there as to reserve funds of a limited company, and of the proposition that a company is debtor to capital. That case decided that, under the English Companies Act,—and the same would be true, I think, of the Canadian Companies Act—there was nothing to prevent a company formed to work a wasting property, for example a mine, from distributing as dividend, the excess of the proceeds of working above the expenses of working, nor did the Companies Act impose on the company any obligation to set apart a sinking fund to meet depreciation in the value of a wasting property. If the expenses of working exceed the receipts, the accounts must not be made out so as to show an apparent profit, and so enable the company to pay a dividend out of capital, but the division of the profits without providing a sinking fund is not such a payment of dividends out of capital as is forbidden by law. I may quote Lord Lindley:

In an accountant's point of view, it is quite right, in order to see how you stand, to put down company debtor to capital. But the company do not owe the capital. What it means is simply this: that if you want to find out how you stand, whether you have lost your money

(1) (1889) 41 Ch. Div. 1.

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or not, you must bring your capital into account somehow or other. But supposing at the winding-up of the concern the capital is all gone, and the creditors are paid, and there is nothing to divide, who is the debtor? No one is debtor to any one. If there is any surplus to divide, then, and not before, is the company debtor to the shareholders for their aliquot portions of that surplus. But the notion that a company is debtor to capital, although it is a convenient notion, and does not deceive mercantile men, is apt to lead one astray. The company is not debtor to capital; the capital is not a debt of the company.

* * * * * *

As regards the mode of keeping accounts, there is no law prescribing how they shall be kept. There is nothing in the Acts to shew what is to go to capital account or what is to go to revenue account. We know perfectly well that business men very often differ in opinion about such things. It does not matter to the creditor out of what fund he gets paid, whether he gets paid out of capital or out of profit net or gross. All he cares about is that there is money to pay him with, and it is a mere matter of book-keeping and internal arrangement out of what particular fund he shall be paid. Therefore you cannot say that the question of what ought to go into capital or revenue account is a matter that concerns the creditor. The Act does not say what expenses are to be charged to capital and what to revenue. Such matters are left to the shareholders. They may or may not have a sinking fund or a deterioration fund, and the articles of association may or may not contain regulations on those matters. If they do, the regulations must be observed; if they do not, the shareholders can do as they like, so long as they do not misapply their capital and cheat their creditors. In this case the articles say there need be no such fund, consequently the capital need not be replaced; nor, having regard to these articles, need any loss of capital by removal of bituminous earth appear in the profit and loss account.

All this is, I think, very pertinent here. It was not suggested that the Company was required to set up a depreciation or depletion fund, or to maintain the same intact for the ultimate repayment of capital. In fact, that could not be said because the dividends paid came from such a fund, and by virtue of the powers conferred on the Company by sec. 98, ss. 2, of the Companies Act, the Company was empowered to pay such dividends out of any funds which it possessed, even if it impaired capital.

For the reasons to be found in the several foregoing decided authorities, I think, the suppliant must fail. Even if the dividends paid out were derived from capital, the same could be lawfully paid therefrom by virtue of sec. 98 of the Companies Act, which permits mining companies to pay

dividends out of its funds derived from the operations of the company, notwithstanding that the value of the net assets of the company may be thereby reduced to less than the par value of the issued capital stock of the company . . .

But while this provision of the Companies Act permitted the Company to pay a "dividend," even if it impaired capital, that does not make the payment of the "dividend" a distribution of capital, which might have been done by reducing the capital of the Company, if the Company had acquired the power to do so; it permits that which was done here, the payment of "dividends" to shareholders, from funds derived from the mining operations of the company, which, I think, must be held to constitute income in the hands of the shareholders, because it is a dividend upon shares of the capital stock of the Company. The exception, as to the payment of dividends, in favour of mining companies where capital is impaired, does not give a new characteristic to the dividend paid; it is like any other dividend and is not a return of capital. It seems to me that the reserve funds in question here, built up from profits earned from the operations of the Company, could be treated by the Company, and were treated by the Company, as a fund available for dividend, and they could and did distribute the same, or a portion thereof, as profits derived from the operations of the Company. Accordingly, I am of the opinion that the dividends here paid were not distributions of capital but distributions of profits derived from the operations of the Company and therefore taxable as income received as dividends, under the particular provisions of the statute here in question.

But I do not think it is necessary to rely upon decided authority to determine the point at issue here. It is sufficient, I think, to look at sec. 9B alone. What did the legislature intend by enacting sec. 9B? Plainly, I think, it was to impose a tax upon two classes of dividends, and also upon interest payments,—excepting those made in respect of bonds of the Dominion of Canada—paid by Canadian debtors, regardless of the source from which they came. It is a tax quite distinct from the income taxes contemplated by sec. 9 of the Act, and the other provisions of the Act have no application to sec. 9B. It is a tax upon certain dividend and interest payments payable by the recipient thereof. A reference to the first clause of 9B will show that the tax is payable only on dividends received by residents of Canada when the same is payable in a currency which is at a premium in terms of Canadian funds.

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The purpose of this clause is quite obvious. Then dividends paid to non-residents of Canada are taxable, with the object, I assume, of placing all shareholders in Canadian companies on a parity, in respect of dividends paid by such companies. Then under ss. 5 of sec. 9B, the tax is imposed on many of the persons, companies, associations, etc., that are exempt from income tax under sec. 4 of the Act. But for the sake of convenience it seems to me sec. 9B might have been enacted as an independent statute, because it only purports to tax specific receipts of moneys, when paid as dividends or interest, by Canadian debtors, and in respect of which no deductions are allowable. I do not think one is required to go behind the payments and enquire into anything antecedent. Therefore it would seem to me to be unnecessary to look beyond the four corners of sec. 9B to determine the question at issue here. The tax here in question is something "in addition to any other tax imposed by this Act," and the receipt of moneys that are taxed seem plainly defined, and to it there are apparently no exceptions, except that ss. 2 (*b*) exempts from the tax, interest paid upon bonds of the Dominion of Canada, and by 9B (5), the tax falls upon many which are ordinarily relieved of income tax under sec. 4 of the Income Tax Act. I think therefore that it was the intention of the legislature by sec. 9B 2 (*a*), to tax any dividend payable to a non-resident shareholder, by a Canadian debtor, and no other enquiry is necessary except whether the dividend was paid or payable. The true construction of sec. 9B 2 (*a*) is, I think, that dividends in the hands of a non-resident shareholder shall pay the tax no matter from whence derived, and out of such dividends the tax is to be captured.

Accordingly, it is my opinion that the dividends paid the suppliant were taxable, and were not payments out of capital or out of funds free of the tax in question. Even if the dividends were derived from capital it was nevertheless a "dividend" here. The point at issue is of considerable importance and I can quite appreciate how contrary views might be held concerning it. In the circumstances there will be no order as to the costs of the trial.

Judgment accordingly.