

BETWEEN :

EMILY L. MERRITT.....APPELLANT;

5

AND

THE MINISTER OF NATIONAL }
REVENUE } RESPONDENT.

1940
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Oct. 24.
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1941
March 19.
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Revenue—Income—Income War Tax Act, R.S.C., 1927, c. 97, s. 19 (1)—1 Edw. VIII, c. 38, s. 22—“Winding up, discontinuance or reorganization of the business of any incorporated company”—“Distribution of the property . . . deemed to be the payment of a dividend to the extent that the company has on hand undistributed income”—Sale of business and assets by one corporation to another—Distribution of property of vendor company to its shareholders held to be within the terms of s. 19 (1) of the Income War Tax Act—S. 22 of 1 Edw. VIII, c. 38, construed not to include undistributed income earned prior to 1935.

S. 19 (1) of the Income War Tax Act, R.S.C., 1927, c. 97, as amended by 1 Edw. VIII, c. 38, s. 11, reads as follows:

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"On the winding up, discontinuance or reorganization of the business of any incorporated company, the distribution in any form of the property of the company shall be deemed to be the payment of a dividend to the extent that the company has on hand undistributed income."

By 1 Edw. VIII, c. 38, s. 22, it was also enacted that:

"Sections . . . eleven (now 19 (1) of the Income War Tax Act) . . . shall be applicable to the income of the year 1935 and fiscal periods ending therein and of all subsequent periods."

Appellant, prior to March, 1937, owned 259 shares of the capital stock of the Security Loan and Savings Company. That company in March, 1937, agreed to sell and transfer to the Premier Trust Company all its assets and undertakings as a going concern, including the good will of its business and any reserves or undistributed profits to which it was entitled in connection with its business. The Premier Trust Company had the right to represent itself as carrying on in succession to the Security Loan and Savings Company such parts of its business as the Premier Trust Company was legally capable of carrying on and also to advertise that the Security Loan and Savings Company was amalgamated with it. The Premier Trust Company agreed to allot and issue to each shareholder of the Security Loan and Savings Company one and one-half fully paid shares of its capital stock for each fully paid share held by such shareholder, or, at the option of such shareholder, to pay \$102 in cash and to allot and issue one-half share of its capital stock for each fully paid share held by such shareholder, provision being made for the adjustment of fractions of shares by payment in cash; to pay in cash at the rate of 5 per cent per annum on each fully paid share held by shareholders of the Security Loan and Savings Company as accrued dividend from December 31, 1936, to the date of issuance of the shares of the Premier Trust Company; to pay the principal and interest on all debentures issued by the Security Loan and Savings Company and outstanding; to assume the payment of all other debts, liabilities and obligations of the Security Loan and Savings Company, and the adoption, performance and fulfilment of all contracts and engagements binding upon that company at the date when the agreement became effective. The Security Loan and Savings Company was taken over as at January 1, 1937, by the Premier Trust Company.

Appellant exercised the option of accepting the sum of \$102 cash and one-half share of the Premier Trust Company for each fully paid share held by her in the capital stock of the Security Loan and Savings Company, and on October 5, 1937, her trustees received the sum of \$26,690.75 from the Premier Trust Company and also a certificate for 130 fully paid shares of the Premier Trust Company registered in the name of the trustees for the appellant.

In May, 1939, the Commissioner of Income Tax assessed appellant for income tax purposes upon income in the sum of \$10,192.60 as the appellant's portion of the undistributed income which the Security Loan and Savings Company had on hand when its property was distributed on the discontinuance of its business. This assessment was affirmed by the Minister of National Revenue from whose decision an appeal was taken to this Court. At the hearing of the appeal it was admitted by counsel for appellant that at the material

time the Security Loan and Savings Company had on hand undistributed income which had accumulated over a period of years and had not been appropriated for any purpose permitted by the Act or according to sound business or accounting practice.

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Held: That there was a discontinuance of business on the part of the Security Loan and Savings Company in a real and commercial sense and it is immaterial whether that was brought about by a sale to or amalgamation with the Premier Trust Company.

2. That there was a distribution of the property of the Security Loan and Savings Company among its shareholders within the meaning of s. 19 (1) of the Income War Tax Act, and it is immaterial that appellant received the consideration for the sale of her shares directly from the Premier Trust Company.
3. That s. 19 (1) of the Income War Tax Act and s. 22 of 1 Edw. VIII, c. 38, are to be construed as meaning that the "undistributed income" mentioned in s. 19 (1) and taxable as a dividend is limited to that portion of the income of the year 1935 and subsequent periods that was undistributed and not intended to include income earlier earned but undistributed and on hand.

APPEAL under the provisions of the Income War Tax Act from the decision of the Minister of National Revenue.

The appeal was heard before the Honourable Mr. Justice Maclean, President of the Court, at Toronto.

H. G. Stapells, K.C. for appellant.

W. J. Beaton, K.C. and *E. S. MacLachy* for respondent.

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

THE PRESIDENT, now (March 19, 1941) delivered the following judgment:

This is an appeal from a decision of the Minister of National Revenue (hereinafter called "the Minister"), affirming an assessment levied against the appellant in respect of income under the Income War Tax Act, for the year ending December 31, 1937. In this matter the appellant was represented by two Trustees whom she had earlier appointed to collect her income and manage her affairs.

In April, 1938, the appellant, by her Trustees, filed an income tax return in respect of her income, amounting to \$13,972.20, for the taxation period in question, and the tax levied thereon was in due course paid. In May, 1939, the Commissioner of Income Tax assessed the appellant, for the same period, upon additional income in the sum

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of \$10,192.60, the subject-matter of this appeal. The additional assessment was made in respect of what the appellant contends was the payment to her of the purchase price of two hundred and fifty-nine (259) shares of the capital stock of the Security Loan and Savings Company which she sold and transferred to the Premier Trust Company, and which payment the Minister contends was, under the terms of s. 19 (1) of the Income War Tax Act, the payment of a dividend derived from the undistributed income of the Security Loan and Savings Company following the sale by the Securities Loan and Savings Company of all its property and assets to the Premier Trust Company, under the terms of a Provisional Agreement entered into between the Directors of the two said companies, and which Agreement was ratified by the shareholders of both companies. The Agreement involved the purchase by the Premier Trust Company of the issued shares of the Security Loan and Savings Company, of which the appellant was the holder of 259 shares. Sec. 19 (1) of the Income War Tax Act, as amended by s. 11 of Chap. 38 of the Statutes of Canada for the year 1936, provides that:

(1) On the winding up, discontinuance or reorganization of the business of any incorporated company, the distribution in any form of the property of the company shall be deemed to be the payment of a dividend to the extent that the company has on hand undistributed income.

What I have stated to be the contention of the appellant in respect of the additional assessment here in question and one paragraph of the decision of the Minister will reveal rather clearly the point in controversy between the parties and what is the issue for decision here, and that paragraph of the decision of the Minister is as follows:

The Honourable the Minister of National Revenue, having duly considered the facts set forth in the Notice of Appeal and matters thereto relating, hereby affirms the said assessment on the ground that Section 19 provides that on the winding-up, discontinuance, or reorganization of the business of any incorporated company, the distribution in any form of the property of the company shall be deemed to be the payment of a dividend to the extent that the company has on hand undistributed income; that Securities Loan & Savings Company as part of its winding-up proceedings entered into an agreement with Premier Trust Company whereby its assets and business as a going concern were sold to the said Premier Trust Company in consideration of the shareholders of said Security Loan & Savings Company receiving certain shares of Premier Trust Company and/or cash at the election of the shareholders; and that such payment by the Premier Trust Company to the Shareholders of Security Loan & Savings Company was a distribution by Security Loan

& Savings Company to its shareholders; that the Trustees for the taxpayer received the sum of \$10,192.60 as her portion of the undistributed surplus of Security Loan & Savings Company, and by the provisions of Section 19 of the Act this amount was taxable as income of the taxpayer. Therefore, by reason of the said Section 19 and other provisions of the Income War Tax Act in that respect made and provided, the assessment is affirmed as being properly levied.

The issue here had its origin in a Provisional Agreement entered into, in March, 1937, between the Directors of the Security Loan and Trust Company (hereafter called "the Security Company"), a Loan Company incorporated under the laws of the Province of Ontario, and the Directors of the Premier Trust Company (hereafter called "the Premier Company"), a Trust Company incorporated by an Act of the Parliament of Canada, and the principal terms of the Agreement were the following. The Security Company agreed to sell and transfer to the Premier Company, and the Premier Company agreed to purchase from the Security Company, the whole of the assets and undertaking of the Security Company as a going concern, including the goodwill of its business, and the same was so described in the Agreement as to include any reserves or undistributed profits to which the Security Company was entitled in connection with its business. The Premier Company was to have the right to hold out and represent itself as carrying on in succession to the Security Company such parts of the latter's business as the former was legally capable of carrying on, and to use the words, "with which is amalgamated the Security Loan and Savings Company" or "any other words indicating that such business is carried on in continuation of or in succession to the said Vendor." The Provisional Agreement was to become effective only upon the ratification of the shareholders of the respective parties to the Agreement, and in due course the same was so ratified in accordance with all legal requirements. The consideration for the assets and property so agreed to be sold was that the Premier Company should allot and issue to each shareholder of the Security Company one and one-half fully paid shares (of the par value of \$100 each) of its capital stock for each fully paid share held by such shareholder, or, at the option of such shareholder, to pay \$102 in cash and to allot and issue one-half share of its capital stock, for each fully paid share held by such shareholder; and provision was made for the adjustment of

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fractions of shares of the Premier Company by payment in cash, and the shareholders of the Security Company were also to be paid a sum in cash equivalent to accrued dividend, at the rate of five per cent per annum, on each fully paid share held by them, for the period from December 31, 1936, to the date of the issuance of the shares of the Premier Company to which they would be entitled under the terms of the Agreement. Further, the Premier Company agreed to pay the principal and interest of all debentures issued by the Security Company and outstanding, and to assume the payment of all other debts, liabilities and obligations of the Security Company, and the adoption, performance and fulfilment of all contracts and engagements binding upon that company at the date when the agreement became effective.

In due course the appellant, by her Trustees, exercised the option of accepting as the consideration for her shares \$102 in cash and one-half share of the Premier Company for each fully paid share held by her in the capital stock of the Security Company. On October 5, 1937, the Premier Company remitted to the Trustees, on behalf of the appellant, a cheque for \$26,690.75, being, it was so stated in a covering letter, the cash consideration for the appellant's 259 shares in the capital stock of the Security Company, at \$102 per share, and an amount for an accrued dividend as provided for by the Agreement, less a deduction resulting from the cash adjustment of a fraction of one fully paid share receivable by the appellant, under the terms of the option exercised. Concurrently the Trustees received a certificate for 130 fully paid shares of the Premier Company registered in the name of the Trustees for the appellant.

As already stated, in May, 1939, the appellant was assessed for additional income in the period in question, in the sum of \$10,192.60, and that additional income is claimed to have been the appellant's proportion of the undistributed income which the Security Company had on hand, when its property was distributed on the discontinuance of its business. As stated by officers of National Revenue, this additional assessment was made on the grounds, "that the sale of the business of the Security Loan and Savings Company to the Premier Trust Company has been considered as falling within section 19 of

the Act"; that "your share of the undistributed income is fixed at \$10,192.69," and "is included in the amount of cash or fully paid shares of the Premier Trust Company which was paid to you under the terms of the agreement . . ."; and that "upon the winding-up of the Security Loan and Savings Company (taken over as at January 1, 1937, by the Premier Trust Company), there was made a distribution to shareholders of the undistributed income of the Company, which consisted of \$212,431.41 or \$39.35 each of the 5,398 shares in the hands of the shareholders." It was contended on behalf of the appellant that no part of the distributed property of the Security Company was received by the appellant within the meaning of s. 19 of the Act, and that anything she received for her shares was from the Premier Company, and further, that any distribution made of the property of the Security Company took place after the appellant ceased to be a shareholder therein. The principal question which I have therefore to consider is whether what was done here was a "winding-up, discontinuance or reorganization" of the business of the Security Company, and if so, whether there was a distribution "in any form" of its property among its shareholders, and particularly any undistributed income then on hand, within the meaning of s. 19 (1) of the Act. The appellant raises the further contention, namely, that by s. 22 of Chapter 38 of the Statutes of Canada for the year 1936, an Act amending the Income War Tax Act, it was only any undistributed income earned in the years 1935, 1936 and 1937, that was liable for the tax under s. 19 (1) of the Income War Tax Act, and that during such years the Security Company had no surplus undistributed income, and that therefore there was no undistributed income liable for the tax on the distribution of any property of the Security Company. The questions raised by the appeal would appear to turn almost entirely upon the construction to be placed on s. 19 of the Income War Tax Act, and s. 22 of Chapter 38 of the Statutes of Canada for 1936.

I entertain no difficulty over the construction to be given the words "winding-up, discontinuance or reorganization," as used in s. 19 (1) of the Act. In construing those words we must look at the substance and form of what was done here. In the case *In re South African Supply and Cold*

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Storage Company (1), Buckley J. had to consider whether or not there had been a winding-up "for the purpose of reconstruction or amalgamation," and he said "that neither the word reconstruction nor the word amalgamation has any definite legal meaning. Each is a commercial and not a legal term, and, even as a commercial term has no exact definite meaning." I think that would be equally true of the words of s. 19 (1) which I have just mentioned. There was no "winding-up" of the Security Company by a liquidator, but there was in fact, I think, a winding-up of the business of that company and I think the word "winding-up" may be given that meaning here, although I need not definitely so decide because, in any event, there was a "discontinuance" of the business of the Security Company, and whether that was brought about by a sale to or amalgamation with the Premier Company is, in my opinion, immaterial. I therefore think there is no room for any dispute of substance but that the Security Company discontinued its business in a real and commercial sense, and that for a consideration it disposed of all its property and assets, however far that may carry one in deciding the issues in this case. There is, therefore, no necessity for attempting any precise definition of the words "winding-up, discontinuance or reorganization." What was done with the business of the Security Company fell somewhere within the meaning and spirit of those words. Neither do I entertain any doubt that there was a distribution of the property of the Security Company among its shareholders, in the sense contemplated by s. 19 (1) of the Act, under the terms of the Agreement after its ratification by the shareholders of the Security Company. It is immaterial, in my opinion, that the consideration received by the appellant for her shares happened to reach her directly from the Premier Company and not through the medium of the Security Company.

I propose now to discuss the merits of the appeal just as if the only point involved therein were that of the construction of s. 19 (1) of the Act. At first it seemed to me that the additional assessment made on account of undistributed income was not ascertained upon a proper basis, particularly in that no allowance appeared to have been made in the assessment of that income for such por-

tion of it as represented a distribution of capital receipts, namely, the receipt of \$102 per share for each fully paid up share which the appellant held in the capital stock of the Security Company, which on its face would appear as a return of capital and should not therefore be taken into account in determining the amount of the dividend to be assessed. Sec. 19 (1) of the Act in effect says that on the "winding-up, discontinuance or reorganization" of the business of an incorporated company, and on the distribution in any form of the property or assets of the company among its shareholders, the same shall be deemed to be a dividend taxable, in so far as the same comprises any undistributed income on hand. Mr. Stapells admitted that there was on hand at the material time undistributed income of the Security Company in the amount of some \$212,000, and by that admission I feel bound. That means that the Security Company had on hand a reserve of over \$212,000, representing undistributed income which had accumulated over a period of years, and which had not been appropriated for any purpose permitted by the Act, or according to sound business or accounting practice. On the hearing of the appeal it was not explained to me how the amount of this undistributed income was ascertained. It is obvious that the book reserve of the Security Company for undistributed income, as appearing on its Balance Sheet for the year ending on December 31, 1936, was not accepted by the taxing authorities, which would be quite proper. That reserve there appears as a liability "To the Shareholders," in the sum of \$335,000. The undistributed income on hand here must have been ascertained by computing the total of the net profits or income of the Security Company over certain prior taxable periods, and deducting therefrom any dividends hitherto paid out of such income, and all other deductions properly allowable in a computation of the net profits or gains of the corporation. Upon this basis the total amount of undistributed profits would be ascertained, and the apportionment of such sum among the shareholders, on any distribution thereof, would be ascertained according to their several interests, and it would appear that this was the procedure followed here by the taxing authorities. In principle, that must have been the basis on which the undistributed income of the Security Company was ascertained and the apportionment made

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among its shareholders, and it would appear to me that there could hardly have been any other way of doing this with any degree of accuracy. Ordinarily, where a company possessing a balance of undistributed profits has wound up, or discontinued its business, and that balance is divided among the shareholders, each shareholder receives his portion as his share of the company's surplus assets, and it does not become a part of his total income, but here, by s. 19 (1), any distribution of such undistributed income is deemed to be a dividend and therefore taxable. In any event, it is here conceded that at the material time there was undistributed income on hand in the amount of \$212,000 and over, and the method of computing the same was not in any way attacked, so that is conclusive of the existence of undistributed income on hand at the material time here, and of the amount thereof, by whatever manner the amount was computed. Now, that much being settled the proportion of the undistributed income assessable against the appellant on the distribution of the property of the Security Company was ascertainable in the manner I have pointed out, and she is deemed to have received it as a dividend, and she is accordingly liable for the assessment of the tax thereon. The purpose of s. 19 (1) is, on the discontinuance of the business of a corporation and on a distribution in any form of its property among its shareholders, to tax as a dividend that portion of such property as is represented by undistributed income then on hand, just as if such income had been distributed in the form of dividends to shareholders in each taxation period as earned. That is a matter apart from what may be the capital position of the corporation. Therefore, upon a consideration only of s. 19 (1) of the Act, my conclusion would be that the appellant was liable for the tax in question.

As earlier intimated, Mr. Stapells submitted an alternative ground in support of this appeal, and that must be carefully considered. His submission was that any liability for the tax under sec. 19 (1) of the Act was limited by s. 22 of Chap. 38 of the Statutes of Canada for 1936, an Act amending the Income War Tax Act, to any undistributed income of the year 1935 and subsequent periods, and he alleged that there was no undistributed income of the Security Company of the year 1935 and material subsequent periods, which I understood to be conceded, and

that therefore there was no undistributed income on hand for distribution at the time material here, and that upon this ground alone the appeal must succeed.

Section 22 of Chap. 38 of the amending statute of 1936 provides that s. 11 of the same Act (enacted as s. 19 (1) of the Income War Tax Act) was to be applicable to the income of the year 1935 and all subsequent periods. The section reads:

(22) Sections eleven of this Act shall be applicable to the income of the year 1935 and fiscal periods ending therein and of all subsequent periods.

The construction to be attributed to this section is not without its difficulties. Some assistance may be derived from the history of this section. In 1924, by Chap. 46 of the Statutes of that year, there was enacted for the first time as section 5 thereof what is now s. 19 (1) of the Income War Tax Act, and in precisely the same words, and by s. 8 (2) thereof it was enacted that:

Sections five hereof shall be deemed to be applicable to the income for the taxation period 1921 and subsequent periods.

The word "income" in that section must, I think, have been intended to relate to the "undistributed income" mentioned in s. 5 of the same Act, and it would seem also to mean that it was only the "undistributed income" of the year 1921 and subsequent years that was subject to the tax and not any income earned prior to the year 1921 and undistributed.

The above mentioned section 5 of the 1936 Act, which in the meantime had become s. 19 of the Income War Tax Act as found in Chap. 97 of the Revised Statutes of Canada, 1927, was repealed by s. 4 of the Statutes of Canada for the year 1930 and re-enacted as s. 19 (1) of the Income War Tax Act, and in the same language, except that there were added at the end thereof the words, "earned in the taxation period 1930 and subsequent periods," so that the concluding words of the section read: "to the extent that the company has on hand undistributed income earned in the taxation period 1930 and subsequent periods." There was added as a new subsection 19 (2), but that is not, I think, of any importance here. Apparently s. 8 (2) of the Act of 1924 was omitted from the Income War Tax Act as it appeared in the Revised Statutes, 1927, but the Act of 1930 enacted as s. 7 thereof the following:

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This Act shall be deemed to have come into force at the commencement of the 1929 taxation period and to be applicable thereto and to fiscal periods ending therein and to subsequent periods, . . .

This section would be applicable to s. 4 of the Act of 1930, enacted as s. 19 (1) of the Income War Tax Act, and while those two sections would appear to be in conflict as to the period when the tax became exigible, yet, it would seem clear that they are to be read as referring to "undistributed income" earned in either the 1929 or the 1930 taxation period, and subsequent periods, and not to income earlier earned, and on hand and undistributed.

In 1933, s. 19 of the Income War Tax Act was amended by Chap. 41 of the Statutes for the year 1932-33, by adding a new subsection thereto which had reference to private investment holding companies but that is not, I think, of interest in the present case. In 1934, by s. 10 of Chap. 55 of the Statutes of that year, s. 19 (1) of the Income War Tax Act was repealed and re-enacted but omitting the words "earned in the taxation period 1930 and subsequent periods," which words I pointed out just above had been added to s. 19 (1) by the Act of 1930, but so far as I can see s. 7 of the Act of 1930, which made s. 19 (1) of the Act applicable to the 1929 and subsequent periods, was not repealed, which again adds to the confusion.

Then we come back to Chap. 38, s. 11 of the Act of 1936, which re-enacted s. 19 (1) of the Income War Tax Act, as it is now in force, and which, as earlier mentioned, enacted s. 22 thereof which provides that s. 19 (1) shall be applicable "to the income of the year 1935 . . . and of all subsequent periods," and it is those sections that are in debate in this case and which must be construed.

It will appear from this historical review of s. 19 (1) that, in some periods at least, the undistributed income of a company subject to the tax, when wound up or on a discontinuance of its business, was not the total undistributed income of the company, but only that undistributed income that was earned in a specified year or taxation period and subsequent periods, as, for example "undistributed income earned in the taxation period 1930 and subsequent periods," as provided by s. 4 of the Act of 1930, which was enacted as s. 19 (1) of the Income War Tax Act. It is true that those words were subsequently

omitted from s. 19 (1) of the Act in subsequent amending Acts, but there was in force, for a portion of the time thereafter at least, a section corresponding to s. 22 of the Act of 1936. Therefore we have had it stated for a time, as a plain matter of public policy in a public statute, in unequivocal language, that where undistributed income of a company was made taxable as a dividend under s. 19 (1) of the Act the same was applicable only to that income earned and undistributed in a specified year and of all subsequent periods, and not to the total undistributed income on hand. And there would doubtless be a great deal to say in favour of the principle of such a provision, and it may be assumed that the same was enacted only after mature consideration on the part of those responsible for the administration of the Income War Tax Act.

Now, here we have s. 19 (1) of the Act saying that in certain events the undistributed income of a company on hand, is taxable as a dividend, and we have the qualifying s. 22 saying that s. 19 "shall be applicable to the income of the year 1935 . . . and of all subsequent periods." That section speaks of "the income of the year 1935," and it states that s. 19 "shall be applicable to the income of the year 1935 . . . and of all subsequent periods," and this I think must refer to the "undistributed" income of the year 1935 and succeeding years; otherwise there would have been no purpose in using such words in the Act, or in fact enacting section 22 at all, because s. 19 (1) by itself was complete and fairly easy of construction, if it were intended that the tax was applicable to all undistributed income on hand, regardless of when it was earned and accumulated. Moreover, it is, I think, fair to say that those two sections would appear to reflect the restoration of a principle that was quite plainly expressed in an earlier enactment of what is now s. 19 (1) of the Act, and it is not improbable that this would have continued had not some draftsman decided to make several sections of the Income War Tax Act subject to a common qualification, and thus we find such a section as that numbered 22 in the Act of 1936. I am of the opinion that s. 19 (1) and s. 22 of the Act of 1936 are to be read and construed as meaning that the "undistributed income" mentioned in s. 19 (1) and taxable as a dividend is limited to that portion of the income of the year 1935

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and subsequent periods that was undistributed, and was not intended to include income earlier earned but undistributed and on hand; at least one can say it is not clear, nor is it hardly possible to say with any confidence, that the contrary was intended, or that those sections were intended to be so construed against the taxpayer, and in those circumstances I do not think the taxpayer can be held liable for the tax under s. 19 (1) of the Act beyond that which I have stated. In any event that is the conclusion which I have reached after an anxious consideration of those two sections of the Act.

I therefore allow the appeal, but if on the settlement of the minutes of judgment there appears to be any doubt or diversity of opinion as to whether there were any undistributed income of the Security Company on hand at the time material here, and subject to the tax under this judgment, the assessment in question will be remitted back to the Minister for review and revision. In any event the appellant will have her costs of this appeal.

Judgment accordingly.