1960
Apr. 8
1961
June 19

BETWEEN:

GOLDEN ARROW SPRAYERS LIMITED ..... APPELLANT;

AND

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

Revenue—Income tax—Patent rights, sale of—Non-arm's length transaction—Capital cost allowance—Income Tax Act, S. of C. 1948, c. 52, ss. 127(1)(af), 127(5)(a)—Income Tax Act, R.S.C. 1952, c. 148, s. 20(4)(a)—Patent Act, R.S.C. 1952, c. 203, s. 49.

The appellant company was incorporated in 1952 to take over the assets and business of Golden Sprayers Ltd., a company which for a number of years had manufactured and sold farm chemical sprayers under patents owned by P, its president and controlling shareholder. After arrangements were made to obtain an underwriting of 250,000 shares of the new company at one dollar per share less 25 per cent commission, the subscribers to the Memorandum of Association chose P, P's son and three others, two of whom had been shareholders in the old company, as directors. The directors appointed P president and approved the allotment to him of 200,000 shares for the use of his patents, P taking no part in the voting. They also approved the purchase of the assets of the old company for 100,000 shares of the new company's stock. A return allotment filed with the Registrar of Companies showed the amount per share treated as paid up in cash for the shares allotted to P as $150,000. The appellant claimed a capital cost allowance for its 1953 taxation year of $8,816 in respect to the acquisition of the right to use the patents. The Minister disallowed the claim and re-assessed for an additional $3,921. The appellant's appeal to the Tax Appeal Board was allowed in part. On a further appeal to this Court

Held: That the right to the use of P's patents was "property" as defined by s. 127(1)(*af*) of the *Income Tax Act*, S. of C. 1948, c. 52, "a right of any kind whatsoever", and such a right, directly related to patents, is essentially depreciable property being coextensive to the 17 year duration of the patents themselves. (cf. *Patent Act*, R.S.C. 1952, c. 203, s. 49).

2. That under s. 127(5) of the *Income Tax Act*, 1948, P indisputably was "one of several persons by whom it (the appellant corporation) is directly or indirectly controlled" and therefore cannot be deemed to have dealt at arm's length with it in matters pertaining to this appeal. *Miron Freres Ltd. v. M.N.R.* [1955] Ex. C.R. 679; *M.N.R. v. Kirby Maurice Co. Ltd.* [1958] Ex. C.R. 77 at 84-5.

3. That under s. 20(4)(*a*) of the *Income Tax Act*, R.S.C. 1952, c. 148, the capital cost should be fixed at the cost to P the original owner, namely $700.

APPEAL from a decision of the Tax Appeal Board[1].

The appeal was heard before the Honourable Mr. Justice Dumoulin at Calgary.

W. Adamson for appellant.

C. E. Smith, Q.C. and *T. E. Jackson* for respondent.

DUMOULIN J. now (June 19, 1961) delivered the following judgment:

This is an appeal from a decision of the Income Tax Appeal Board dated July 2, 1959[1], in respect of the income tax assessment for taxation year 1953, of Golden Arrow Sprayers Ltd., a company having its Head Office at Calgary, Province of Alberta. The appeal was allowed to the extent only of $1,000.

The material facts giving rise to this litigation offer no complexities.

Golden Arrow Sprayers Limited, incorporated in Alberta, on November 20, 1952 (cf. ex. "C"), replaced to all intents an older firm operating under the style of Golden Arrow Services Ltd., which, for many years, had manufactured farm-chemical sprayers according to patent rights, the property of one John E. Palmer, its President and Manager.

With a view to expanding their field of business, the directors of Golden Arrow Services Limited, decided that a proper method of raising additional capital would be the incorporation of another company, Golden Arrow Sprayers Limited, that would purchase and take over the entire assets of the former organization. Arrangements were at once concluded to "obtain an underwriting on 250,000 shares of the new Company at $1 per share, less 25 per cent. commission".

In furtherance of the afore-mentioned decision, original subscribers to the Memorandum of Association met on November 21, 1952, and chose as first directors, John E. Palmer, his son, Harry E. Palmer, Harold Milburn, Secretary of the out-going Golden Arrow Services Ltd., Harvey Brown and Karl F. Zeise, a foreman in the employ of the above company. Exhibit "2" relates the minutes of this initial meeting.

[1] (1959) 22 Tax A.B.C. 260; 13 D.T.C. 371.

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A further meeting of the newly elected Board of Golden Arrow Sprayers took place, the same day, at 3.00 p.m., designating John E. Palmer as President of the Company (ex. "3"). At 3.30 p.m., again on November 21, 1952, a third meeting of directors occurred approving ". . . the issue and allotment of 200,000 shares of the capital stock of the Company in consideration of the use of the Palmer Patents. Such shares to be issued and allotted when such Company received a certificate to commence business from the Registrar of Companies (cf. Statement of Facts, para. 4 and exhibit 5, s. 2)". These shares were to be placed in escrow with the Montreal Trust Company pending the issue of a certificate to commence business.

At this same meeting, the sale by Golden Arrow Services to Golden Arrow Sprayers of all its assets was approved as against an allotment by Purchaser to Vendor of 100,000 shares fully paid up and non-assessable of the Purchaser's capital stock (cf. exhibits "D", "4" and "A", the latter dated January 2, 1953).

A subsequent Return of Allotment filed with the Registrar of Companies showed ". . . the amount . . . treated as paid up in cash for the 200,000 shares was $0.75 per share, or $150,000". The incipient company, having obtained the requisite certificate, on or about February 26, 1953, the aforesaid 200,000 shares were then issued and allotted to J. E. Palmer.

For its 1953 taxation year the Appellant ". . . claimed a capital cost allowance in respect to the acquisition of the right to use the said patents in the sum of $8,816. This capital cost allowance was disallowed by the Minister and the Appellant reassessed for an additional sum of $3,921.43".

This much for the facts; now as to the conflict of law, thus occasioned, it is succinctly formulated by Appellant in the following lines, under the sub-title "Statement of Reasons for Objections", page 3.

> The question now arises as to the amount at which the capital cost to the Company of the licence to use the Palmer Patents should be fixed.
>
> This then raises the question of whether the Company and Palmer were on the 21st day of November, 1952, dealing at arm's length.

It seems hardly necessary to note that in the Appellant's opinion, J. E. Palmer, albeit President and Manager of the purchasing company, was, nevertheless, dealing at arm's length when he assigned the utilization of his three Patents to Golden Sprayers at a "price" of two hundred thousand shares. Exhibit "4", true to say, mentions that: "Mr. Palmer wished it to be pointed out to the meeting that he did not vote in respect to the said motion", which ratified the transaction in exhibit "5", the agreement between John E. Palmer, Patentee, and Golden Arrow Sprayers Ltd., Licensee allotting shares for the right to use the Patents.

The respondent's basic argument appears in subsections (*a*) (*b*) (*c*) and (*d*) of paragraph 9 of its "Reply to Notice of Appeal", it reads:

> 9. (*a*) . . . the Appellant in calculating this income claimed as a deduction for capital cost allowance the sum of $8,816 in respect of the licence which it had obtained by an agreement dated the 21st day of November, A.D. 1952 with John E. Palmer to use certain patents,
>
> (*b*) . . . the Appellant at the time it acquired the licence from John E. Palmer was not dealing at arms length with John E. Palmer, and,
>
> (*c*) that John E. Palmer was the original owner of the patents,
>
> (*d*) that the capital cost of the patents to John E. Palmer was nothing, . . .

A brief oral evidence was adduced on Appellant's behalf, consisting of Messrs. John E. Palmer's and Harold Milburn's testimonies.

Palmer substantiated the averments of the Statement of Facts, and declared that he "had not given nor promised to give any of his shares to the other directors of Golden Arrow Sprayers Ltd." He also agreed holding presently in his own right 253,000 shares of this latter company, thereby becoming its controlling shareholder.

Mr. Harold Milburn, it will be remembered, was the Secretary of the older organization before assuming a directorship in the younger one.

On November 21, 1952, he attended the 3:30 p.m. meeting "when 200,000 shares of the new concern were granted to J. E. Palmer, an allotment that encountered no difficulty whatever". According to this witness "the life of Golden Arrow Sprayers Ltd., was dependent upon the use of Palmer's patents, and therefore, it seemed reasonable to extend adequate pecuniary appreciation to the patentee".

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Thus summarized, the case raises, in my mind, a threefold question:

1. Was the right to use Palmer's patents, acquired by the Appellant on November 21, 1952, a "depreciable property", as foreseen in s. 20(2) of the 1948 *The Income Tax Act* (S. of C. 1948, c. 52)?
2. Was John E. Palmer dealing at arm's length with Appellant company when he concluded the deals aforecited?
3. Should the first query receive an affirmative answer, and the second, a negative one, in that event, what would be the capital cost to the taxpayer, i.e. Golden Sprayers, of the depreciable property thus obtained?

Section 127(1)(*af*) opposite the expression "property" sets forth that it "means property of any kind whatsoever whether real or personal or corporeal or incorporeal and, without restricting the generality of the foregoing includes a right of any kind whatsoever, a share or a chose in action".

It may be held beyond doubt that a title to the use of Mr. Palmer's patents assuredly fits into the unrestricted category of "a right of any kind whatsoever". Moreover, such right, directly related to patents, is essentially depreciable property, being coexistensive to the 17 year duration of the patents themselves (cf. *Patent Act*, R.S.C. 1952, c. 203, s. 49).

The second point unquestionably is the pivotal one. Section 127, s-s. (5)(*a*), text of 1948, though not purporting to define restrictively "arm's length" enacts that:

> 127(5) For the purpose of this Act,
>
> (*a*) a corporation and a person or one of several persons by whom it is directly or indirectly controlled,
>
> * * *
>
> shall without extending the meaning of the expression "to deal with each other at arm's length", be deemed not to deal with each other at arm's length.

Reverting to the admitted facts we see that Appellant's executive body had J. E. Palmer for chairman of the Board and Manager, his son, Harry, and two of the old company's employees, Harold Milburn and Karl Zeise, as co-directors, one being the secretary, the other a foreman

of Golden Arrow Services. Palmer, senior, to all material intents, owned the merging company and could dictate to the nascent one any terms or conditions he wished to impose both as patentee and through his ascendency over his son and associates or, should I say, his employees. Out of five directors, this man could control four, himself included. At all events, J. E. Palmer undisputably was "one of several persons by whom it (the appellant corporation) is directly or indirectly controlled", and therefore cannot be deemed to have dealt at arm's length with Golden Arrow Sprayers Ltd., in matters pertaining this appeal.

Two precedents, among many, bear out this interpretation. In Re: *Miron & Frères Limited and the Minister of National Revenue*[1] the factual incidents were substantially these:

> The appellant (in 1948) acquired a farm from one of its shareholders at a price far exceeding the original cost to the vendor. The appellant claimed a capital cost allowance based on the price paid. All the issued shares of the appellant, minus three, were owned by the vendor and his five brothers, with more than one half of the shares being owned by the vendor and any three of his brothers . . .
>
> HELD: The appeal should be dismissed. Under s-s. (5) of s. 127 of the *Income Tax Act, 1948,* c. 52, the appellant and the vendor were deemed not to have dealt with each other at arm's length.
>
> *Per* Kerwin C.J. and Fauteux J.: *Since the appellant was controlled by the vendor and three of his brothers, the vendor was one of several persons by whom the appellant was directly or indirectly controlled* (italics are mine).
>
> *Per* Taschereau, Kellock and Abbott JJ.: The appellant failed to show error in respect of the Minister's conclusion that the transaction was not one between persons dealing at arm's length.

Mr. Justice Cameron, in *Minister of National Revenue v. Kirby Maurice Co. Ltd.*[2], wrote:

> That s-s. (5) of s. 139 does not purport to define all transactions which are not at arm's length is made clear in the case of *M.N.R. v. Sheldon's Engineering Ltd.* (1955 S.C.R. 637) where Locke J., in delivering the judgment for the Court, said at p. 643: "The words (i.e., to deal with each other at arm's length) do not appear in the *Income War Tax Act,* though the same subject-matter is dealt with in s. 6(1)(*n*) of that Act. In addition to appearing in ss. 20 and 127, the term is employed in ss. 12(3), 17(1), (2) and (3), 36(4) and 125(3) of the *Income Tax Act.* Section 127(5) does not purport to define the meaning of the expression generally; it merely states certain circumstances in which persons are deemed not to deal with each other at arm's length. I think the language of s. 127(5), though in some

[1] [1955] S.C.R. 679.

[2] [1958] Ex. C.R. 77 at 84, 85.

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respects obscure, is intended to indicate that, in dealings between corporations, the meaning to be assigned to the expression, elsewhere in the statute is not confined to that expressed in that section."

On the merits of the case Cameron J. continues thus:

> The evidence of Maurice satisfies me completely that the transaction by which the franchise came into the hands of the respondent was not one at arm's length. The Act does not define the expression, and it would perhaps be unwise for me to attempt to do so. It is sufficient to state that in my opinion, in a vendor and purchaser matter, an arm's length transaction does not take place when the purchaser is merely carrying out the orders of the vendor, and exercising no independent judgment as to the fairness of the terms of the contract, or seeking to get the best possible terms for himself . . . In effect, Maurice was both vendor and purchaser, and while he was not actually a shareholder at the time the agreement of October 1, 1952 was signed he had in fact full control of the entire operation.

A comparable situation exists here: the all-important patent rights owned by Palmer, the impressive bulk of his stock-holdings, plus his parental connection with one and business ties with two other directors, his presidency of the appellant company, were of such a nature that "he had in fact full control of the entire operation" now under review, and, I repeat, was therefore, not dealing at arm's length, with the appellant.

There now remains for determination the assessment of a capital cost to Golden Sprayers Ltd., of the "depreciable property" acquired, in other words the "right to use", these oft-mentioned patents.

Section 20(4) and (*a*) of this subsection provide the relevant rule:

> 20(4) Where a depreciable property did, at any time after the commencement of 1949, belong to a person (hereinafter referred to as the original owner) and has, by one or more transactions between persons not dealing at arm's length, become vested in a taxpayer, the following rules are, notwithstanding section 17, applicable for the purposes of this section and regulations made under paragraph (*a*) of subsection (1) of section 11:
>
> (*a*) the capital cost of the property to the taxpayer (i.e. Golden Arrow Sprayers Ltd.) shall be deemed to be the amount that was the capital cost of the property to the original owner (i.e. John E. Palmer).

John E. Palmer asserted having spent "about $700 to secure his patents for 'Spraying Nozzle, Field Marker' and an application for a third patent now abandoned". This expense, I believe, represents the capital cost of the property to its original owner and should be allowed to the appellant.

For the reasons above, the appeal is dismissed, save that appellant will be granted a capital cost allowance of $700 in respect of its income tax return for taxation year 1953. The Minister of National Revenue is entitled to the costs of this appeal after taxation.

Judgment accordingly.