BETWEEN:

NATIONAL TRUST COMPANY LIMITED, executor of the will of SIR LYMAN MELVIN JONES, Deceased ..... } APPELLANT;

AND

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

1934
Nov. 19.
1935
May 7.

Revenue—Income War Tax Act—Premium paid on redemption of capital stock of corporation taxable as income.

Held: That the premium paid by a corporation upon the redemption of its capital stock, in excess of the par value of the stock, is income and taxable under the Income War Tax Act, R.S.C. 1927, c. 97.

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 Angers, at Ottawa.

C. B. Henderson for appellant.

W. S. Fisher for respondent.

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

ANGERS J., now (May 7, 1935) delivered the following judgment:

This is an appeal by the National Trust Company Limited, in its quality of executor of the will and trustee of the estate of Sir Lyman Melvin Jones, late of the city of Toronto, in the province of Ontario, deceased, from the decision of the Minister of National Revenue affirming an assessment made for the year 1929 against the estate of the said late Sir Lyman Melvin Jones, under the Income War Tax Act (R.S.C., 1927, ch. 97).

The facts, which are either admitted or established by documentary evidence, are briefly as follows:

Sir Lyman Melvin Jones died on or about April 15, 1917. Probate of his last will and testament was granted by the Surrogate Court of the County of York on June 22, 1917; a copy of the will and probate was filed as exhibit 1.

By his said last will and testament Sir Lyman Melvin Jones appointed as executors and trustees his wife, Louise

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Melvin Jones, his daughter, Eallien Necora Crawford Brown, and the National Trust Company Limited. The latter is the only surviving executor and trustee.

For sometime prior to 1929 the estate of Sir Lyman Melvin Jones was the owner of 2,900 preferred shares of the capital stock of Massey-Harris Company Limited.

Massey-Harry Company Limited was incorporated by letters patent of the Dominion of Canada, granted, it was said by counsel for the appellant at hearing, in 1891. The date is not material. Its capital consisted then of 250,000 common shares of $100 each.

By supplementary letters patent issued in February, 1926, according to a statement by counsel for the appellant which was admitted, the capital of the company was changed to 125,000 7% cumulative preference shares of $100 each and 125,000 common shares of the same par value. By consent of the parties, the letters patent of February, 1926, were not filed.

By further supplementary letters patent granted on March 10, 1927, the capital was again changed; the preferred stock was not altered, but the common shares were split in 4 and made shares with no par value. We are not concerned with the common shares in the present case.

An extract of the supplementary letters patent of the 10th of March, 1927, was by consent filed as exhibit 2. The clauses of these letters patent dealing with the preferred shares which are of any interest herein are the following:

(*a*) The holders of the said cumulative preference shares shall be entitled out of the available profits of the company to cumulative dividends on the capital for the time being paid up thereon at the rate of seven (7%) per centum per annum for each fiscal year of the company (payable at such times as the Board of Directors shall determine) in preference and priority to any payment of any dividend on the common shares for such fiscal years.

(*b*) .....

(*c*) .....

(*d*) The company shall have the right at any time for the purposes of redemption and cancellation with the consent of the holders thereof, to purchase any of the said cumulative preference shares then outstanding at any price not exceeding one hundred and ten (110%) per centum of their par value.

(*e*) The company shall also have the right without the consent of the holders thereof, from time to time to redeem the whole or any number of the said cumulative preference shares at one hundred and ten (110%) per centum of their par value, together with any accumulated dividends thereon upon giving notice of its intention to redeem to be sent through

the mails by prepaid registered post addressed to the holders of such cumulative preference shares at their last respective addresses appearing upon the books of the company at least thirty (30) days prior to the date specified for redemption and stating that such shares will be redeemed at the head office of the company. The holders of such cumulative preference shares shall be bound to surrender their shares in pursuance of such notice and to surrender corresponding certificates of shares and thereupon the company shall cause to be paid to the shareholders the amount payable to them respectively in case of such redemption and from and after the date of redemption mentioned in said notice no dividend shall be payable on such cumulative preference shares, and the holder or holders thereof shall cease to be shareholders in respect of such cumulative preference shares unless payment of the redemption money shall not be made on presentation of the respective certificates at the head office of the company on or before the date specified for redemption. . . . .

On March 19, 1929, new supplementary letters patent were granted to the company deleting and expunging from the letters patent incorporating the company and all letters patent supplementary thereto the provisions relating to the capital stock contained therein and substituting therefor the following:

The capital stock of the said company shall consist of 125,000 7% cumulative preference shares of $100 each (being the already authorized preference shares) and 150,000 5% cumulative convertible preference shares of $100 each, and 1,000,000 common shares without nominal or par value (including the already authorized 500,000 common shares without nominal or par value) subject to the increase of such capital stock under the provisions of the said Act.

The supplementary letters patent of the 19th of March, 1929, a certified copy whereof was filed as exhibit A, contain clauses substantially similar to clauses (*a*), (*d*) and (*e*) of the supplementary letters patent of the 10th of March, 1927 (exhibit 2) hereinabove reproduced; they are clauses (*a*), (*c*) and (*d*).

In virtue of clause (*e*) of the supplementary letters patent of the 19th of March, 1929, the holders of 7% cumulative preference shares were given the right, at any time up to ten days before the date specified in any notice as the day of redemption of such shares, to convert the whole or any number of their shares into a like number of 5% cumulative convertible preference shares, subject to certain conditions which have no relevance to the case.

Clauses were also included in the supplementary letters patent of the 19th of March, 1929, namely, clauses (*i*) and (*j*), authorizing the company to redeem the whole or part of the said 5% cumulative convertible preference shares, with or without the consent of the holders. The price, in

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the case of redemption without the shareholders' consent, is fixed at 125% of the amount paid up on the shares; in the case of redemption with the shareholders' consent, the price is not determined but it must not exceed 125% of the amount paid up on the shares. In virtue of clause (*k*) the holders of 5% cumulative convertible preference shares were given the right, at any time up to ten days before the date specified in any notice as the day of redemption of such shares, to convert the whole or any part of their shares into a like number of common shares without nominal or par value.

The other clauses in the supplementary letters patent of the 19th of March, 1929, are not material herein.

On the 15th of May, 1929, Massey-Harris Company Limited, after notice given in compliance with the requirements of its letters patent (see exhibit 4), redeemed the 2,900 shares held by the estate of Sir Lyman Melvin Jones for the sum of $319,000, being at the rate of $110 per share.

The appellant received the sum of $319,000 and treated it entirely as capital; it did not include any portion thereof in the income tax return of the estate of Sir Lyman Melvin Jones for the year 1929 nor, in fact, for any subsequent year.

By a letter dated March 6, 1931, from one Hugh D. Patterson, inspector of income tax, to appellant and two assessment notices dated April 28, 1931, the Income Tax Division of the Department of National Revenue assessed the appellant and Mrs. Eallien Crawford Brown, only child of the late Sir Lyman Melvin Jones and one of the life tenants of his estate, in the sum of $29,000 for income received during the year 1929, the said sum representing the difference between the par value of the said 2,900 shares of Massey-Harris Company Limited, to wit $290,000 and the price at which the said shares were redeemed ($319,000), apportioning one-half of the said sum of $29,000 to the estate of Sir Lyman Melvin Jones and one-half to Mrs. Eallien Crawford Brown; the said letter and notices of assessment form part of exhibit 6.

By notices of appeal dated May 18, 1931, included in exhibit 6, the appellant and Mrs. Eallien Crawford Brown appealed the assessments aforesaid.

By a letter bearing date the 26th of October, 1933, the Commissioner of Income Tax allowed the appeal of Mrs.

Eallien Crawford Brown; the letter, which is part of exhibit 6, reads as follows:

Re: Mrs. Eallien Crawford-Brown (now deceased). 1929 Income Tax Appeal.

The appeal of the above named taxpayer against her assessment for 1929 on the ground that she was entitled to a life interest only in the estate of Sir Lyman Melvin Jones and accordingly that she should not be taxed on any portion of the premium received by the estate on the redemption of preferred shares of Massey-Harris Co. Limited owned by the said estate, has received further consideration. You are advised that the appeal filed by Mrs. Crawford-Brown is hereby allowed, as the Department is of the opinion that the premium on the said shares is taxable in the hands of the estate of Sir Lyman M. Jones.

Instructions to issue a revised assessment are being forwarded to the Inspector at Toronto.

By an assessment notice dated November 6, 1933, the whole sum of $29,000 was assessed against the estate; this notice is also part of exhibit 6.

On or about the 15th of November, 1933, the appellant, by it solicitors, served a notice of appeal upon the Minister, setting out the reasons for appeal and the facts relative thereto, in compliance with the provisions of section 58 of the Income War Tax Act.

The Minister of National Revenue confirmed the assessment and notice of his decision was sent to the appellant and to its solicitors on or about the 22nd of December, 1933.

The appellant, having deposited $400 as security for the costs of the appeal, sent to the Minister a notice of dissatisfaction, dated the 10th of January, 1934, containing a statement of additional facts and reasons in support of its appeal, in accordance with section 60 of the Act. The Minister, on or about the 19th of June, 1934, sent a reply to the appellant and its solicitors, denying the allegations and contentions set forth in the notice of dissatisfaction and confirming the assessment.

Complying with the requirements of section 63 the Minister, in due course, caused to be transmitted to the Registrar of this Court the following documents, to wit:

1. The Income Tax Return of the taxpayer for the year 1929.
2. The Notice of Assessment appealed from.
3. The Notice of Appeal.
4. The Decision of the Minister.
5. The Notice of Dissatisfaction.
6. The Reply of the Minister.

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In its notice of appeal the appellant, after setting out the facts which I have briefly summarized, states its reasons for appeal as follows:

(a) That no interest should be charged prior to the 6th day of November, 1933, on the ground that the Commissioner of Taxation stated that the question of whether this tax was payable should stand in abeyance until there had been a decision made by the Exchequer Court of Canada in regard thereto.

(b) That in no event should more than one-half the interest be charged on the ground that one-half of the amount in dispute was assessed against Mrs. Crawford Brown until the 26th day of October, 1933.

(c) That the entire sum of $319,000 paid to the executors of the estate of Sir Lyman Melvin Jones was capital and the Income War Tax Act does not apply.

The appellant then adds:

The Massey-Harris Company Limited had prior to and including the year 1929, built up a surplus account of some six million dollars. The said company, as shown by their annual statements, had two separate accounts: an income account and a surplus account. The company entered up its net earnings for any given year in the income account. After deducting dividend requirements and other charges, the balance was transferred to the surplus account. The submission of the appellant is that all moneys transferred to the surplus account became in the strict sense a surplus account which was necessary for the proper carrying on of the business of the company, and was available to the company for many purposes other than the payment of dividends or for distribution to the shareholders, and that therefore funds in the surplus account were not "undistributed income on hand."

The appellant concludes in saying that the only relevant sections of the Act appear to be sections 13, 15, 16 and 17 and he discusses briefly each of these sections. I shall deal with these various sections later.

In its notice of dissatisfaction the appellant, after discussing the scope of sections 16 and 17, submits what it considers to be another reason for appeal; perhaps I had better quote the text of the notice:

The appellant has already set out in its notice of appeal several reasons why section 17 does not apply. In addition to the said reasons, the appellant submits that the word "premium" has many meanings.

The notice then cites definitions of the words "premium" and "bonus" from Murray's New English Dictionary and it continues as follows:

The appellants submit that a fair and usual interpretation to be placed on the word "premium" is that it is a bonus, i.e., an extra dividend.

The appellants did not receive any extra dividend, i.e., bonus or premium. They only received the prearranged contract price.

There is no authority for saying that the difference between the par value and the fixed redemption price of a preferred stock is a premium.

If it can be called a premium at all, it is (in the case of the Massey-Harris stock) a fixed premium and the Income War Tax Act recognizes a distinction between "premium" and "fixed premium" by making references to each respectively in said sections 16 and 17. Section 17 refers to "a premium" and it is submitted that had it been intended to tax a "fixed premium" section 17 should have said so in unequivocal language, particularly in view of the exemption given to a fixed premium in section 16 (2).

In his decision, maintained, as we have seen, by the reply to the notice of dissatisfaction, the Minister affirmed the assessment

on the ground that under the provisions of section 17 and other provisions of the Income War Tax Act in that respect made and provided the premium paid on the redemption of the said shares is deemed to be a dividend and to be income received by the shareholders and accordingly has been properly assessed against the taxpayer. The provisions of subsection 2 of section 16 of the Act have no application whatever as the said subsection does not exempt from tax any premium paid on the redemption of shares.

No witnesses were called by either party.

In addition to the documents previously referred to, the appellant filed the annual reports of Massey-Harris Company Limited for the years 1928 and 1929; they are exhibits 3 and 5. In the "Consolidated balance sheet" of the report for the year ending on the 30th of November, 1928 (exhibit 3), we find among the liabilities, under the heading "Capital and Surplus," the following items:

7% Cumulative Preferred Shares		
Authorized	$12,500,000 00	
Issued		$12,089,900 00
Common Shares—No par value		
Authorized	500,000 shares	
Issued	483,596 shares	$12,089,900 00

In the "Consolidated balance sheet" included in the report for the year ending on the 30th of November, 1929 (exhibit 5), we find among the liabilities, under the same heading, the following items:

5% Cumulative Convertible Preferred Shares		
Authorized	$15,000,000	
Issued		$12,089.900 00
Common Shares—No par value		
Authorized	1,000,000 shares	
Issued	725,970 shares	$26,612,180 00

It is obvious that the 7% cumulative preferred shares were, to the extent of their par value, redeemed either with the 5% cumulative convertible preferred shares or with the proceeds of the sale thereof, the amount of the issue of the latter being equal to the amount of the issue of

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the former. Now if we turn to what is called the report of the operations and affairs of Massey-Harris Company Limited and subsidiary companies for the year ending on the 30th of November, 1929, appearing on the first page of the annual report for that year, we see, under the caption "Surplus account," the following entries:

The surplus at 30th November, 1928, was..		$6,982,098 02	
Less Bond Discount and Expense	$ 900,970 20		
Less Premium on 7% Preference Shares redeemed	$1,100,770 00	2,001,740 20	$4,980,357 82

This shows clearly that the amount of $10 per share paid on the 7% preferred shares, over and above their par value, came out of the so-called surplus account.

I may note incidentally that the figures mentioned in the report show that this alleged premium of $10 was paid on only 110,077 of the 120,899 7% cumulative preference shares which were replaced by an equal number of 5% cumulative convertible preference shares. Were the remaining 10,822 7% cumulative preference shares merely exchanged for as many 5% cumulative convertible preference shares or were they redeemed at par, we do not know; there is nothing in the record to indicate it; even the statement contained in the clause entitled "Capital" at the foot of the second page of the report exhibit 5, which purports to be explanatory, is indefinite and throws no light on the subject. The question, at all events, offers little, if any, interest.

In order to complete the résumé of the facts it is convenient to state that an admission was made at the hearing that the quotations of the 7% cumulative preference shares of Massey-Harris Company Limited, from February to June, 1929, on the Toronto Stock Exchange, fluctuated between a low of 109 and a high of 112½.

The whole case narrows down to a question of determining whether the sum of $29,000 paid by the Massey-Harris Company Limited to the plaintiff, as sole executor of the will and trustee of the estate of Sir Lyman Melvin Jones, when the company redeemed the 2,900 7% cumulative preference shares held by the estate, the said sum representing $10 per share over and above the par value

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thereof, was, for the purpose and within the meaning of the Income War Tax Act, income or capital. If the sum is to be considered as income, it is taxable and the assessment must be confirmed; if it is capital, it is not subject to taxation under the Act and the assessment must be set aside.

I do not think that sections 13 and 15 have any application in the present case. Section 13 applies to undivided or undistributed gains and profits of a corporation; it enacts that the share of a taxpayer in these gains and profits shall not be deemed to be taxable income, unless the Minister is of opinion that the accumulation of such gains and profits is made for the purpose of evading the tax and is in excess of what is reasonably required for the purposes of the business. Section 15 deals with the capitalization of undistributed income as a result of the reorganization of the corporation or the readjustment of its capital stock; it provides that the amount capitalized shall be deemed to be distributed as a dividend and that the shareholders shall be deemed to receive such dividend in proportion to their interest in the capital stock of the corporaton or in the class of capital stock affected. These two sections deal exclusively with cases where accumulated profits or income of a corporation have not been distributed among the shareholders. In the case now under consideration the premium which is sought to be taxed was paid to the appellant.

It was argued on behalf of the appellant that the amount of the net profit at the end of each year was undistributed income on hand while it remained momentarily in suspense in the "income account," but that its transfer to what is called the "surplus account" was equivalent to a distribution of income. The conclusion drawn from this argument was that Massey-Harris Company Limited, having only $620,781.74 in cash in the bank at the end of November, 1928, and current liabilities amounting to $5,984,342.88 as appears from the report, exhibit 3, did not and could not redeem its 7% preferred shares out of undistributed income, since it had none. This proposition, in my opinion, is fallacious: the transfer of profits or income from an account called "income account" to another one called "surplus account" does not change the character of the funds transferred. The income account is kept

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separate from the surplus account in order that the company may determine its net profits for the current year. At the end of each fiscal year the net profit is transferred to the surplus account; the income account for the following year is then started on what I may call a clean sheet. The surplus account is thus built up of the net earnings or profits of each year. At the end of November, 1928, Massey-Harris Company Limited had a surplus, derived from the net earnings or profits of the previous years, amounting to $6,982,098.02; it is out of this amount that the company paid the premium of $10 per share when it redeemed its 7% cumulative preference shares in May, 1929, as is shown by the surplus account in the directors' report for the year ending on the 30th of November, 1929 (exhibit 5).

It was urged on behalf of the appellant that the case with which we are concerned comes within the ambit of section 16 and that the exception contained in subsection 2 of said section 16 relieves the appellant, and in fact all holders of the 7% cumulative preference shares of Massey-Harris Company Limited, whose shares were redeemed on the same occasion and under the same conditions, from the obligation of paying the income tax on the premium of $10 paid by the company on these shares over and above their par value.

Section 16 reads as follows:

16. Where a corporation having undistributed income on hand reduces or redeems any class of the capital stock or shares thereof, the amount received by any shareholder by virtue of the reduction shall, to the extent to which such shareholder would be entitled to participate in such undistributed income on a total distribution thereof at the time of such reduction, be deemed to be a dividend and to be income received by such shareholder.

2. The provisions of this section shall not apply to any class of stock which, by the instrument authorizing the issue of such class, is not entitled on being reduced or redeemed to participate in the assets of the corporation beyond the amount paid up thereon plus any fixed premium and a defined rate of dividend nor to a reduction of capital effected before the sixteenth day of April, one thousand nine hundred and twenty-six.

Section 16 has nothing to do with the taxation of premiums on shares. The principle under this section is that, irrespective of the amount received by the shareholder in the event of a reduction or redemption of any class of the capital stock, if there is any undistributed income on hand, the amount so received, to the extent to which the share-

holder would be entitled to participate in the undistributed income on a total distribution thereof at the time the reduction is made, shall be deemed to be a dividend and to be income received by the shareholder.

Subsection 2 of section 16 makes an exception in the case of a stock which, by the instrument authorizing its issue, is not entitled to participate in the assets of the company beyond the amount paid thereon plus any fixed premium and a defined rate of dividend. It seems fair and reasonable that the holder of a stock, not entitled to share in the undistributed income of the company in the event of a total distribution thereof, should not be required to pay an income tax on the amount which he receives in reimbursement of the capital invested by him in the company. This shareholder however would, in my opinion, have to pay the tax on the dividend received by him at the time of the reduction or redemption; this dividend is, I think, an income within the meaning of the law. With regard to the premium, the case, to my mind, is governed by section 17, which says:

17. Where a corporation, having undistributed income on hand, redeems its shares at a premium paid out of such income, the premium shall be deemed to be a dividend and to be income received by the shareholder.

The report of the Directors of Massey-Harris Company Limited for the year ending on the 30th of November, 1929 (exhibit 5), shows, as we have seen, that the premium of 10% paid on the 7% cumulative preference shares of the company, when they were redeemed, came out of the surplus account, made up of accumulated earnings or profits.

The word "shall" in section 17 is imperative and must be so interpreted: see Interpretation Act, R.S.C., 1927, ch. 1, section 37 (24). The text of section 17 is unambiguous.

I agree with counsel for the appellant when he says that the mere fact of calling premium that which is not a premium does not make it a premium. But I believe that the company was right in considering that the amount of $10 which it paid on each of its 7% preferred shares, over and above the par value thereof, was a premium and in calling it so. And the fact that these preferred shares were in virtue of the supplementary letters patent redeem-

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able at a premium of $10 and that the company could not redeem them at a lesser price does not, in my opinion, alter the situation.

The Massey-Harris Company Limited, not being authorized to impair its capital (R.S.C., 1927, ch. 27, section 110), when redeeming its 7% cumulative preference shares at a premium, could only pay this premium out of its profits or earnings, and this is what it has apparently done.

The fact that the 7% cumulative preference shares of Massey-Harris Company Limited sold, on the Toronto Stock Exchange, between February and April, 1929, at prices varying from 109 to 112½ does not appear to me to be material.

There remains the question of interest. The premium of $29,000 was received by the estate of Sir Lyman Melvin Jones on or about the 15th of May, 1929; it should have been included in the Income Tax Return made by the appellant on the 31st of March, 1930. The taxpayer had until the 30th of April, 1930, to make the return and the interest on the amount of the assessment, at the rate of 6% per annum, began to run from that date: sections 33 and 48 of the Income War Tax Act. The Commissioner of Income Tax, however, assessed the estate of Sir Lyman Melvin Jones for one-half of the said premium and Mrs. Eallien Crawford Brown for the other half. The latter appealed and on the 26th of October, 1933, the Commissioner notified her solicitors that the appeal was allowed. On the 6th of November, 1933, a new notice of assessment was sent to the estate of Sir Lyman Melvin Jones in which was included the total premium of $29,000. I believe, in the circumstances, that the appellant ought to pay the interest on one-half of the amount of the income tax levied on the said premium from the 30th of April, 1930, date on which the tax became exigible, and on the total amount of the said income tax from the 6th of November, 1933, date on which the whole premium was assessed against the estate.

There will be judgment dismissing the appeal of the appellant and confirming the decision of the Minister and *ipso facto* the assessment, with this variation, however, that the interest on the income tax levied on the afore-

said premium of $29,000 shall be calculated as hereinabove stated.

The respondent will be entitled to his costs against the estate of the said Sir Lyman Melvin Jones.

Judgment accordingly.