

---

1947  
 {  
 Dec. 4  
 —  
 1948  
 {  
 Feb. 18  
 —

BETWEEN:  
 CARDEN S. BAGG . . . . . APPELLANT;  
 AND  
 THE MINISTER OF NATIONAL  
 REVENUE RESPONDENT.

*Revenue—Income Tax—Income War Tax Act, R.S.C. 1927, c. 97, s. 15, 16  
 —Undistributed income of company—Reorganization of corporation  
 and readjustment of capital stock—Capitalization of undistributed  
 income—Receive “an amount by virtue of the reduction” of capital  
 stock—Exchange of shares does not constitute a receipt of “an amount”  
 within meaning s. 16 (1) of the Income War Tax Act—“Class of  
 stock”—Appeal dismissed.*

A company, admittedly had undistributed income on hand on June 3, 1938. At that time by Supplementary Letters Patent it reduced its capital by cancelling certain unissued shares of a par value of \$100 each and by reducing the par value of 1800 issued shares from \$100 each to \$44 each. These were then converted into 1800 preferred shares of par value of \$40 each and 1800 common shares of a par value of \$4 each. Appellant held 518 shares in the company and

in accordance with the provisions of the Supplementary Letters Patent converted those shares into 518 preferred shares and 518 common shares of the company. Respondent added to appellant's net income for 1938 an amount calculated at \$21.15 per share on 518 shares. Appellant appealed from this assessment.

1948  
BAGG  
v.  
MINISTER OF  
NATIONAL  
REVENUE

*Held:* That s. 16 (1) of the Act contemplates a reduction in capital and a distribution among the shareholders of the capital no longer required, and the receipt of new shares in exchange for his old shares by the appellant was not "an amount" received within the meaning of s. 16 (1).

2. That use of undistributed income for the purpose of writing off goodwill does not capitalize the undistributed income.
3. That the readjustment of capital stock of the company resulted in the whole of its undistributed income being capitalized within the meaning of s. 15 of the Act.

APPEAL under the provisions of the Income War Tax Act.

The appeal was heard before the Honourable Mr. Justice O'Connor at Montreal.

*Hazen Hansard, K.C.* and *J. Porteous* for appellant.

*J. G. Ahern, K.C.* and *T. Z. Boles* for respondent.

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

O'CONNOR J. now (February 18, 1948) delivered the following judgment:

This is an appeal under The Income War Tax Act, R.S.C. 1927, chap. 97 from the assessment for income tax for the taxation year 1938.

The appellant on the 3rd of June, 1938, and for some time prior thereto was the owner of 518 shares (of the par value of \$100 each) of the capital stock of Domestic Gas Appliances, Limited, a corporation duly incorporated by Letters Patent of the Dominion of Canada.

The authorized capital of the Company was \$200,000 divided into 2,000 shares of a par value of \$100 each, of which, as of the 3rd June, 1938, 1,800 had been issued as fully paid up.

1948  
 BAGG  
 v.  
 MINISTER OF  
 NATIONAL  
 REVENUE

Included in the capital assets was an item of goodwill of \$140,000. Between 1921 and 1937 there were several write-offs of goodwill, totalling \$140,000, and each in turn was charged to surplus.

This resulted in a reduction of capital from \$180,000 to \$40,000 and changed a surplus of \$38,091.61 into a deficit of \$101,908.39.

These write-offs of goodwill were disallowed by the Department, I assume in each of the years in which they were made.

These disallowances resulted from a taxation view point in the Company having undistributed income of \$38,091.61.

It is admitted by the appellant that for the purposes of this appeal, the Company had on hand undistributed income on the 3rd of June, 1938, of \$38,091.61.

By Supplementary Letters Patent, dated 3rd of June, 1938, granted to the Company under the Dominion Companies Act:—

1. The authorized capital was decreased from \$200,000 to \$79,200, such decrease being effected—

- (a) By cancelling the 200 unissued shares of a par value of \$100 each and
- (b) by cancelling paid-up capital to the extent of \$56 per share upon each of the said 1800 issued shares and thereby reducing the par value of the said 1800 issued shares from \$100 per share to \$44 per share.

2. The said 1,800 issued shares of the par value of \$44 each were converted into 1,800 preferred shares of a par value of \$40 each and 1,800 common shares of a par value of \$4 each.

The preferred shares carried and were subject to the following terms and conditions *inter alia*:—That the Company may redeem all or any of the preferred shares outstanding upon notice, on payment of \$40 plus a premium of 1 per cent and an amount equal to dividends declared and unpaid prior to redemption.

In accordance with the Supplementary Letters Patent, the 518 shares owned by the appellant were converted into 518 preferred shares of a par value of \$40 each and 518 common shares of a par value of \$4 each.

The respondent in determining the appellant's net income for the said year added a sum of \$10,955.70, being

\$21.15 in respect of each of the 518 shares of the capital stock of Domestic Gas Appliances, Limited, held by the appellant.

1948  
 BAGG  
 v.  
 MINISTER OF  
 NATIONAL  
 REVENUE

The then relevant sections of the Act were as follows:—

O'Connor J.

15. When, as a result of the reorganization of a corporation or the readjustment of its capital stock, the whole or any part of its undistributed income is capitalized, the amount capitalized shall be deemed to be distributed as a dividend during the year in which the reorganization or readjustment takes place and the shareholders of the said corporation shall be deemed to receive such dividend in proportion to their interest in the capital stock of the corporation or in the class of capital stock affected.

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 shareholders 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.

16 (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.

The position of the respondent as disclosed by the Statement of Defence is this:—

(a) That upon the 3rd day of June, 1938, being the date upon which Supplementary Letters Patent were granted to Domestic Gas Appliances Limited, and in accordance with which the 518 shares of the said Company owned by the Appellant herein were reduced or redeemed and the Appellant received 518 preferred shares of the par value of \$40 each and 518 common shares of the par value of \$4 each in place thereof, the said Company had on hand undistributed income in the amount of \$38,091.61 or \$21 15 for each of the original common shares, which undistributed income as a result of such reduction or redemption was deemed to be received by the shareholders of the said Company, including the Appellant herein, and became properly taxable pursuant to subsection 1 of section 16 of the Income War Tax Act.

(b) That, in the alternative, if the shares of the said Company were not reduced or redeemed as aforesaid within the meaning of subsection 1 of section 16 of the Income War Tax Act, which the Respondent does not admit but denies, in any case, as a result of the readjustment of the capital stock of the said Domestic Gas Appliances, Limited in accordance with the above mentioned Supplementary Letters Patent, the whole of the said undistributed income in the hands of the said Company at the date of such readjustment was capitalized and is therefore properly taxable in the hands of the shareholders of the said Company pursuant to section 15 of the Income War Tax Act.

1948  
 BAGG  
 v.  
 MINISTER OF  
 NATIONAL  
 REVENUE

O'Connor J.

A copy of the Supplementary Letters Patent, and the audited statement of the corporation as of December 31, 1937, (Exhibit 1), and the audited statement for the year ending December 31, 1938, (Exhibit 2), were filed.

Mr. Hoult, the auditor for the Company, stated that the undistributed income did not appear in either of the annual statements. He stated that nothing was done with the undistributed income on the reduction and conversion. That the net assets behind the stock of the Company as disclosed by the audited statement as of December 31, 1937, amounted to \$75,000, and that there was no material change in the net assets behind the stock of the Company after the reduction and conversion of the 3rd of June, 1938, and prior to the redemption which took place on 30th July, 1938. That there was no reduction in the number of shares, but there was a reduction in the face value of \$100,800. And that all the shareholders received on the 3rd day of June, 1938, was a certificate for one preferred share of the par value of \$40, and a certificate for one common share of the par value of \$4 in exchange for a certificate of one common share of the par value of \$100. That the new shares were issued as fully paid up.

Mr. Johnson stated that he had been the accountant and had custody of the books of the Company and that on the reduction and conversion, no amount (money) had been paid to or received by the shareholders. And that when the capital had been reduced from \$180,000 to \$79,200 he assumed that the undistributed income of \$38,091.61 formed part of the \$79,200. He stated that the preferred shares were redeemed on the 31st July, 1938, and that the Company was wound up in 1941.

The Minute Books of the Company and the books of account were not placed in evidence.

Mr. Gregory, Assistant Chief Auditor, Corporation Assessor in the Montreal office of the respondent, said that the Company wrote off goodwill in the amount of \$140,000 between 1922 and 1937, leaving \$40,000 out of the original capital of \$180,000 and the write-off of goodwill from a taxation standpoint reduced the surplus in the books of the Company. The write-offs were disallowed and that resulted in an undistributed income of \$38,000. The share

capital, reduced to \$79,200, consists in his opinion of \$40,000—the balance left of the original capital of \$180,000, plus the undistributed income of \$38,000.

1948  
BAGG  
v.

MINISTER OF  
NATIONAL  
REVENUE

The sole date and transaction in issue is that of 3rd of June, 1938, and the questions are:—

O'CONNOR J.

1. Did the appellant receive “an amount by virtue of the reduction” which took place on the 3rd of June, 1938, within the meaning of Section 16 (1)?

While Section 16 (1) provides that “where a corporation having undistributed income on hand reduces or redeems any class of the capital stock or shares thereof”, here only a reduction (and conversion) took place on the 3rd of June, 1938. What the respondent contends is that “amount” in Section 16 (1) means “consideration” and the consideration which the appellant received on the reduction and conversion was one share of preferred and one share of common.

But in my opinion Section 16 (1) contemplates a reduction in capital and a distribution among the shareholders of the capital no longer required. The “amount” mentioned in the section refers to a payment to a shareholder of his proportion of the capital not required. The receipt of the new shares in exchange for his old share by the appellant was not “an amount” received within the meaning of Section 16 (1).

The question of whether on the redemption, which took place on 31st July, 1938, the appellant received an amount within Section 16 (1), is not an issue raised in the pleadings. But as counsel dealt with the matter in argument, I should perhaps express my opinion. If there were an undistributed income on hand on 31st July, 1938, when the corporation redeemed the preferred shares, undoubtedly the appellant received an amount by virtue of the reduction which took place on the redemption.

But the shares which were redeemed on 31st July, 1938, were, pursuant to the conditions set out in the Supplementary Letters Patent, redeemable on payment of \$40, the amount paid up thereon, plus a fixed premium of 1 per cent. And, as they then come within the class defined in subsection 2 of Section 16, the provisions of subsection 1 of Section 16 do not apply.

1948  
 BAGG  
 v.  
 MINISTER OF  
 NATIONAL  
 REVENUE  
 O'Connor J.

Counsel for the respondent contended that the "class of stock", mentioned in Section 16 (2) refers to the original shares of the corporation and not the shares issued on the conversion. While I think that is a very ingenious argument, I am of the opinion that subsection 2 refers to the shares issued on conversion and not to the original shares.

2. The second question is was the undistributed income capitalized as a result of the reduction and conversion of June 3, 1938, within the meaning of Section 15?

The appellant does not contend that the disallowances were improperly made. The appellant admits for the purpose of this case that on the 3rd of June, 1938, the company had an undistributed income in the amount of \$38,091.61.

The appellant contends first that if the undistributed income was capitalized, it was capitalized between 1922 and 1937. That is, that it was capitalized when the earned surplus was used for the purpose of writing off the capital asset of goodwill.

The difficulty that arises is due to the word "capitalize" which is most inapt. This was pointed out by Lord Dune-din in *Inland Revenue Commissioners v. Blott* (1):—

I confess I am shy of the word "capitalize". It seems to me to leave one in a hazy state of mind as to what is the legal operation which is so described.

While profit may be capitalized in a number of ways the question here is how can undistributed income be capitalized in accordance with the provisions of the Dominion Companies Act, 1934 Statutes of Canada, chap. 33. As Lord Sumner said in the *Blott* case at pages 207-8:—

To call it "capitalization" is neither here nor there, for, apart from the Companies Act, profits may be capitalized in more ways than one. What has to be asked and answered in this case is how could they be "capitalized" in accordance with those Acts, without either leaving the holder of the new shares liable to pay them up with new money or sharing out, the profits to the allottees, whether in cash or in account, so that the share-out of the money should be used to pay up the shares.

In my opinion a company may add undistributed income to capital so as to (a) issue shares to the extent to which it still has shares authorized but unissued or (b) increase the authorized capital and issue new additional shares or

increase the paid-up capital in each share thereby increasing the par value of each share.

1948  
BAGG  
v.  
MINISTER OF  
NATIONAL  
REVENUE  
O'Connor J.

In my opinion using the undistributed income for the purpose of writing off goodwill did not capitalize it.

The second contention is that the reduction and conversion did not capitalize the undistributed income.

It is correct that on the reduction the unissued shares were cancelled and no new additional shares were issued and the paid-up-capital in each share was in part cancelled and not increased.

But, in my opinion, the reduction did result in the capitalization of the undistributed income.

By the Letters Patent of 3rd of June, 1938, the capital stock was decreased from \$200,000 to \$79,200 by (a) cancelling 200 unissued shares of a par value of \$100 each (\$20,000) and (b) by cancelling paid-up capital to the extent of \$56 per share upon each of the 1,800 issued shares and thereby reducing the par value from \$100 per share to \$44 per share, viz., \$100,800, and the Letters Patent state:—

. . . . . which amount viz., one hundred thousand eight hundred (\$100,800) dollars, has been lost or is unrepresented by available assets.

That is, that the capital that had been lost or was unrepresented by available assets was \$100,800. But in fact the goodwill had been written off in the sum of \$140,000. And the capital stock was to be decreased to \$79,200 on the basis that this sum had not been lost, but on the contrary was represented by assets. That arose from the fact that the Company regarded the sum of \$38,091.61 as capital and "used" it as capital and represented it to be capital in the Petition to the Secretary of State. And that position is quite in accordance with the first contention of the appellant that it was capitalized when it was used for the purpose of writing off the good will.

But on the admission of the appellant for the purpose of this case, this sum, on the 3rd of June, 1938, was undistributed income.

If the Petition had disclosed that \$140,000 had been lost or was unrepresented by assets and the capital remaining was only \$40,000, although the company had in addition undistributed income of \$38,091.61, the capital



1948  
 BAGG  
 v.  
 MINISTER OF  
 NATIONAL  
 REVENUE  
 O'Connor J.

stock would have been decreased to \$40,000 not \$79,200. This would have been accomplished by cancelling the 200 unissued shares and by cancelling paid-up capital of \$77.15 per share of the 1,800 issued shares, thereby reducing the par value of each from \$100 to approximately \$22.85.

If the company then desired to convert the undistributed income into capital, the capital stock would then have been increased from \$40,000 to \$79,200 by increasing the paid-up capital to the extent of \$21.15 per share upon each of the 1,800 shares, thereby increasing the par value from \$22.85 to \$44 per share of the said 1,800 shares.

That procedure did not take place because the company represented that the loss was only \$100,800 and not \$140,000, and that \$79,200 was represented by available assets, whereas only \$40,000 was represented by available assets. As a result, it is clear that precisely the same position was reached as if the capital stock had first been decreased to \$40,000 and then increased to \$79,200 by first, cancelling the paid-up capital in each of the issued 1,800 shares of \$77.15 and then, increasing the paid up capital in each share by \$21.15.

What the appellant contends is that the \$38,091.61 was undistributed income before the reduction and was undistributed income after the reduction and conversion. That it was not converted into capital by the reduction.

If that is so then after the reduction the paid-up capital in each share was only \$22.85 and not \$44 and the company still had undistributed income of \$38,091.61.

But under the Letters Patent the paid-up capital upon each share was \$44. It was reduced from \$100 to \$44 by cancelling paid up capital to the extent of \$56 upon each share.

Therefore, after the reduction the paid-up capital in each share was \$44 and not \$22.85. And the difference of \$21.15 per share is the undistributed income of \$38,091.61 that was capitalized on the reduction.

For these reasons I find that as a result of the reorganization of the company or the readjustment of its capital stock, the whole of its undistributed income was capitalized within the meaning of section 15 of the Income Tax Act.

The appeal will be dismissed with costs.

*Judgment accordingly.*