Toronto
1966
Dec. 6-7

BETWEEN:

MORGAN SECURITIES LIMITED .....APPELLANT;

AND

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

Income tax—Business of company promotion—Acquisition of shares in company being promoted—Dividends received in loss years—Sale of shares at loss—Deductibility of loss from trading profit—Income Tax Act, ss. 27(1)(e), 28(1) and (11).

Appellant company (a subsidiary of a stock brokerage company controlled by H, M, and T) was in the business of a bond dealer, underwriter and sharebroker, actively traded in securities on its own account, and engaged in company promotions. In 1955 it participated with H, M, and T in the formation of a private company, Parkton Ltd (controlled by H, M, and T) which acquired 3 transport companies with the object of operating them successfully, converting Parkton Ltd to a public company and selling its stock to the public at a profit. Appellant's part in the transaction was to purchase 2,000 3% cumulative 2nd preference shares in Parkton Ltd for $200,000. Owing to the outbreak of a strike adversely affecting the transport companies the proposed promotion was abandoned and in 1959 appellant sold its shares in Parkton Ltd at a loss of $157,189. Appellant had received dividends from its shares in Parkton Ltd in 1957 and 1958 but its overall operations in those two years (and also in 1960) resulted in losses. Appellant sought to apply the 1959 loss of $157,189 against its income for that year and for 1961.

Held, appellant was entitled under s. 27(1)(*e*) of the *Income Tax Act* to deduct the 1959 loss from its income for 1959 and 1961.

1. The purchase of the shares in 1955 was a transaction in the course of appellant's usual business and not a capital transaction.

2. Inasmuch as appellant could not and in consequence did not deduct from its income the amount of the dividends received from Parkton Ltd in 1957 and 1958 (having had no "income" in those years within the meaning of the *Income Tax Act*) it was not barred by s. 28(11) of the *Income Tax Act* from deducting the loss on the sale of the shares in 1959 from its profits in 1959 and 1961 pursuant to the provisions of s. 27(1)(*e*) of the *Income Tax Act*.

APPEAL from income tax assessment.

R. M. Sedgewick, Q.C. and *R. M. Shoemaker* for appellant.

D. G. H. Bowman for respondent.

GIBSON J.:—In this appeal the quantum of the 1959 and the 1961 taxable income of the appellant is in dispute. The appellant claims that it is entitled to deduct, in computing its 1959 income, a loss of $157,189.97 arising out of the sale for $43,313.33 in that year of 2,000 second preference shares

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in a company by the name of Parkton Limited which had cost it $200,000 approximately three years prior thereto, plus $503.30 legal fees incurred in completing the said sale of the shares. And the appellant further claims that if it is entitled to this deduction in the taxation year 1959, and only in that event, that there will result a balance of business loss in its profit and loss account which it is entitled to use as a deduction in computing its taxable income by reason of the provisions of section 27(1)(*e*) of the *Income Tax Act*[1].

The respondent claims that the said loss of $157,189.97 of the appellant in its taxation year 1959 is a loss of capital within the meaning of section 12(1)(*b*)[2] of the Act, and also that the deduction of this loss in any event is prohibited by section 28(11)[3] of the *Income Tax Act*.

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[1] 27. (1) . . .

(*e*) business losses sustained in the 5 taxation years immediately preceding and the taxation year immediately following the taxation year, but

(i) an amount in respect of a loss is only deductible to the extent that it exceeds the aggregate of amounts previously deductible in respect of that loss under this Act,

(ii) no amount is deductible in respect of the loss of any year until the deductible losses of previous years have been deducted, and

(iii) no amount is deductible in respect of losses from the income of any year except to the extent of the lesser of

(A) the taxpayer's income for the taxation year from the business in which the loss was sustained and his income for the taxation year from any other business, or

(B) the taxpayer's income for the taxation year minus all deductions permitted by the provisions of this Division other than this paragraph or section 26.

[2] 12. (1) In computing income, no deduction shall be made in respect of

. . .

(*b*) an outlay, loss or replacement of capital, a payment on account of capital or an allowance in respect of depreciation, obsolescence or depletion except as expressly permitted by this Part,

[3] 28. (11) Where a corporation has, in its return of income under this Part for a taxation year, deducted under this section an amount in respect of a dividend, no loss arising from transactions with reference to the share in respect of which the dividend was received shall be allowed to reduce the income of the taxpayer for that or a subsequent taxation year unless it is established by the corporation that

(*a*) the corporation owned the share 365 days or longer before the loss was sustained, and

(*b*) the corporation did not, at the time the dividend was received, own more than 5% of any class of the issued share capital of the corporation from which the dividend was received.

At all material times the business of the appellant, Morgan Securities Limited, was that of bond-dealer, underwriter, and share broker, and for its own account was most active in trading all types of securities and commodity futures, and on numerous occasions did the financial work in the promotion of companies. All of its net receipts from these activities were declared and taxed as income and none as belonging to capital account. At all material times also the appellant, Morgan Securities Limited, was a wholly owned subsidiary of Houston & Company Limited, brokers and underwriters, a member of the Toronto Stock Exchange, or of the individual partners of the predecessor partnership firm, Houston & Company.

The transaction in September 1955, which the appellant entered into as a result of which it expended the said sum of $200,000 and received the said 2,000 second preference shares in Parkton Limited was as follows:

The appellant, Morgan Securities Limited, mainly through the aegis of James Houston, Reginald F. Morgan, and Ralph H. Tetlaw, controlling shareholders of Houston & Company Limited, and partners in the predecessor partnership firm of Houston & Company, caused a private Ontario company to be incorporated under the name of Parkton Limited, and then caused Parkton Limited in September 1955, to buy all the shares of three car transport companies from one Harold Hoare, namely Gillson Automobile Transport Limited, Roadway Carriers Limited, and Automobile Transport Limited for $690,000 which was paid for as follows: firstly, by a note to Harold Hoare for $65,000 and by issuing and delivering 250,000 first preference shares of Parkton Limited to him and by paying him $375,000 in cash. (The $375,000 in cash was raised by Parkton Limited firstly by issuing 3,000 second preference 3 percent cumulative non-voting shares for $100 each, of which 2,000 were purchased by the appellant, Morgan Securities Limited, and 500 by one C. M. Williams and one C. W. E. Scott, neither of whom was in any way financially interested in the appellant company or Houston & Company Limited or the predecessor partnership); secondly, by Parkton Limited issuing 10,000 no par value common shares for one dollar each which was subscribed for and paid by James Houston who acquired 4,000 shares, by

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Ralph H. Tetlaw who acquired 1,000 shares, by Reginald F. Morgan, who acquired 1,000 shares, by G. M. Park who acquired 2,000 shares, by C. M. Williams who acquired 1,000 shares, and by C. W. E. Scott who acquired 1,000 shares; and thirdly, by utilizing for the balance the surplus in Gillson Automobile Transport Limited after moving the necessary sum of money to Parkton Limited by way of inter-company dividend. Thus subject to the note of $65,000 and the $300,000 first preference shares of Parkton Limited held by Harold Hoare, at the date of this acquisition the major shareholders of Houston & Company Limited, or its predecessor partnership, controlled Parkton Limited through the appellant, that is to say James Houston, Ralph H. Tetlaw and Reginald F. Morgan.

The cause for the disposition by the appellant in September 1958, which was during its 1959 taxation year, of the said 2,000 second preference shares for $43,313.33 resulting in said loss of $157,189.97 (which sum includes the said sum of $503.30 of legal fees) was as follows: It was intended after this acquisition to build up a successful earnings history for Parkton Limited through the operation of these three car transport companies acquired by it and through other company acquisitions. Two more companies were in fact acquired for this purpose. It was then proposed that Parkton Limited would be caused to go public, at which time a profit to the promoters and to the appellant was anticipated. This did not happen however. Instead, immediately after this transaction of acquisition by Parkton Limited there was a General Motors strike which commenced around the end of September 1955, and lasted for five months, which seriously affected the earnings of the three car companies so acquired as they in the main hauled cars from the General Motors plant in Canada. There resulted also because of this strike, extensive use of equipment which caused maintenance charges to become high and replacements necessary; and generally during the three year period in which these companies were operated for various other reasons there resulted a poor earning history for Parkton Limited. Finally, in September 1958, the appellant and the three promoters, Messrs. Houston, Tetlaw and Morgan, caused the Parkton Limited shares which the appellant held and the common shares which were held as

indicated to be sold to said Harold Hoare and he became the sole owner of Parkton Limited then and also in turn through Parkton Limited owner of the three car companies and the two companies which Parkton Limited had acquired during the three year period. For the $200,000 which the appellant had paid for the second preference shares in Parkton Limited it received $43,313.33 or $157,189.97 (including the said sum of $503.30 of legal fees) less than it had paid for them.

The questions for decision in this appeal, namely, firstly, was this loss of $157,189.97 a capital loss or an income loss, and secondly, was the deduction of this loss in any event prohibited by section 28(11) of the *Income Tax Act*, may be answered briefly.

As to the first question, I am of opinion that the appellant in acquiring these 2,000 second preference shares of Parkton Limited for $200,000 in September 1955 was engaging in its usual business. It intended to make a profit from this transaction through the way that Parkton Limited was organized. The appellant was in the controlling position to do so in a variety of ways if Parkton Limited was financially successful. And this type of transaction was one of its usual sources of income. The appellant did not make this expenditure to develop a new source of income different and distinct from its usual business. It follows that the expenditure in 1955 was therefore on income account and not on capital account; and therefore the loss in September 1958, which was during the taxation year of 1959 of the appellant, was an income loss and not a capital loss.

As to the second question, I am of opinion that section 28(1)[1] of the *Income Tax Act* cannot be invoked by a

[1] 28. (1) Where a corporation in a taxation year received a dividend from a corporation that

(*a*) was resident in Canada in the year and was not, by virtue of a statutory provision, exempt from tax under this Part for the year,

. . .

(*d*) was a non-resident corporation more than 25% of the issued share capital of which (having full voting rights under all circumstances) belonged to the receiving corporation, or

(*e*) was a foreign business corporation more than 25% of the issued share capital of which (having full voting rights under all circumstances) belonged to the receiving corporation,

an amount equal to the dividend minus any amount deducted under subsection (2) of section 11 in computing the receiving corporation's income may be deducted from the income of that corporation for the year for the purpose of determining its taxable income.

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taxpayer so as to enable him to carry forward a loss, (by reason of the enabling provisions of section 27(1)(*e*) of the Act), which is greater than the business loss of such taxpayer. In other words a taxpayer, from a tax point of view from inter-company dividends under section 28(1) when he suffers a loss, only gets a benefit therefrom when he has a profit in a taxation year. The meaning of the words "income" and "taxable income" in the concluding words of that subsection make this clear. (See also sections 3 and 4 and 139(1)(*x*) of the Act.[1])

The appellant therefore in the taxation years 1957 and 1958 when it received a dividend from Parkton Limited, but still suffered a business loss, was not entitled to the benefit of section 28(1) and therefore section 28(11) is no bar to the appellant to a deduction of this loss of $157,-189.97 arising out of this transaction in its taxation year 1959 with reference to these Parkton Limited second preference shares.

The appeal is therefore allowed with costs and the matter is referred back for reassessment for the 1959 and 1961 taxation years of the appellant, not inconsistent with these reasons.

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[1] 3. The income of a taxpayer for a taxtion year for the purposes of this Part is his income for the year from all sources inside or outside Canada and, without restricting the generality of the foregoing, includes income for the year from all

(*a*) businesses,

(*b*) property, and

(*c*) offices and employments.

4. Subject to the other provisions of this Part, income for a taxation year from a business or property is the profit therefrom for the year.

139. (1) . . .

(*x*) "loss" means a loss computed by applying the provisions of this Act respecting computation of income from a business *mutatis mutandis* (but not including in the computation a dividend or part of a dividend the amount whereof would be deductible under section 28 in computing taxable income) minus any amount by which a loss operated to reduce the taxpayers income from other sources for purpose of income tax for the year in which it was sustained;.