BETWEEN:

MANDREL INDUSTRIES, INC. .....APPELLANT;

AND

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

Calgary 1965 April 8

Ottawa May 5

Income tax—Federal—Income Tax Act, R.S.C. 1952, c. 148, ss. 11(1)(a), 12(1)(a) and (b)—Income Tax Regulations, s. 1100(1)(c)—Schedule B, Class 14—Payment made to terminate sales agency agreement—Deduction of amounts paid—Capital cost allowance—Whether re-acquired sales right depreciable as a "franchise", "concession" or "licence".

In May 1956 appellant company, a manufacturer of geophysical equipment granted an exclusive right to a subsisting company to sell its products in Canada for a period of five years.

Two years later appellant decided upon a policy of marketing its products on its own account throughout the world. In 1958 appellant paid $150,000 for the assignment of the exclusive Canadian sales contract which had three years to run until expiry. The appellant, at the same

[1] 2 R.T.C. 239. [2] 12 R T.C. 266 at 296.

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time, took over virtually all of the staff and sales organization of the former distributor. The amount of $150,000 was deducted by appellant from its income, which deduction was disallowed by the Minister.

Appellant contended that the payment of $150,000 was a proper deduction as an expense made for the purpose of earning income within the meaning of s. 12(1)(*a*) or, in the alternative, that if the payment was a capital outlay within the meaning of s. 12(1)(*b*) then it was entitled to a capital cost allowance on the basis that in accordance with Regulation 1100 and Claim 14 in Schedule B, the payment was made to acquire a depreciable franchise, concession or licence.

Held,—That the payment made by appellant to reacquire the right to sell its own products and to launch its own selling organization in Canada was made to secure an advantage for the enduring benefit of appellant's trade and was a capital expenditure. That although the 1956 agreement could properly be designated as conferring a "concession", "franchise" or "licence" on the erstwhile distributor, the appellant being in the position of principal, could not itself be said to have acquired property of any kind.

The appeals are dismissed with costs.

APPEALS under the *Income Tax Act.*

R. A. F. Montgomery for appellant.

R. L. Fenerty, Q.C. and *T. E. Jackson* for respondent.

CATTANACH J.:—These are appeals from assessments under the *Income Tax Act*, R.S.C. 1952, c. 148 of Mandrel Industries, Inc. for its 1958 and 1959 taxation years.

The parties filed an "Agreed Statement of Facts" dated April 8, 1965 with appendixes. In addition, the parties agreed that either party might supplement the agreed statement of facts by oral evidence, which the appellant did by calling one witness, David Doyle Mize, who has been president of the appellant company since its inception in 1956.

The "Agreed Statement of Facts" reads as follows:

1. Electro-Technical Labs, Inc., (whose successor is the Appellant Mandrel Industries, Inc.) on May 15th, 1956, entered into an Agreement in writing with Electro-Technical Labs. Canada, Ltd., herein called "the Trading Agreement" whereby Electro-Technical Labs. Canada, Ltd. acquired an exclusive right or dealership in distributing and marketing the products of Electro-Technical Labs, Inc. in Canada for a period of 5 years as more particularly set out in the Trading Agreement (Appendix "A").

2. The Appellant Mandrel Industries, Inc., is hereinafter sometimes referred to as "Mandrel" or "the Appellant".

3. Mandrel's predecessor Electro-Technical Labs, Inc. had also granted an exclusive Sales Contract to Electro-Tech International Inc., a U.S. corporation, by Agreement dated January 3rd, 1956 (Appendix "C") with respect to sales in areas other than Canada and the United States.

4. Electro-Technical Labs, Inc., a company incorporated in the United States, but now extinct, had, prior to July, 1956, carried on the business of manufacturing certain specialized geophysical and seismic instruments and equipment. The equipment the company manufactured was used in exploratory work in the oil and gas industry and was marketed throughout the world.

5. In July, 1956, Electro-Technical Labs, Inc. was dissolved into its parent company Mandrel Industries, Inc. (a United States corporation which at the time was Electric Sorting Machine Company and which changed its name to Mandrel Industries, Inc. in the same month of July, 1956). As a result the Appellant Mandrel Industries, Inc. acquired all the rights of Electro-Technical Labs, Inc. and assumed its various liabilities and obligations, including all rights, liabilities and obligations of Electro-Technicals Labs, Inc. under the Trading Agreement (Appendix "A").

6. Electro-Tech International Inc. a company incorporated in the United States, Electro-Technical Labs (Alberta) Ltd. a company incorporated in Canada, and Electro-Technical Labs. Canada, Ltd., a company incorporated in Canada, were all at all material times controlled by Mr. H. A. Sears, a resident of Harris County, Texas, who owned beneficially all of the shares of each of the said companies.

7. At all material times Electro-Technical Labs (Alberta) Ltd., by arrangement with Electro-Technical Labs. Canada, Ltd. constituted the sales organization in Canada by which sales were made in Canada pursuant to the rights granted to Electro-Technical Labs. Canada, Ltd. under the Trading Agreement (Appendix "A").

8. At all material times neither the said H. A. Sears nor Electro-Tech International Inc., nor Electro-Technical Labs (Alberta) Ltd., nor Electro-Technical Labs. Canada, Ltd. had any share interest or control in Mandrel or in any predecessor in interest of Mandrel.

9. In July of 1957 the Appellant held discussions with Mr. H. A. Sears relating to acquisition of the shares or assets of Electro-Tech International Inc., Electro-Technical Labs (Alberta) Ltd. and Electro-Technical Labs. Canada, Ltd. These negotiations broke down.

10. By letter of August 10th, 1957, (Appendix "B") the Appellant purported to terminate the exclusive sales contract with Electro-Tech International Inc., dated January 3rd, 1956 (Appendix "C"). In September 1957, the Appellant sued Electro-Tech International Inc. and H. A. Sears in the United States District Court for the Southern District of Texas, Houston Division (Appellant's Original Complaint is Appendix "D"). In October, 1957, Electro-Tech International Inc. and H. A. Sears defended the action and filed a Counterclaim and Cross Action is (Appendix "E"). The Appellant then filed an Answer to the Cross Action (Appendix "F").

11. Towards the end of April, 1958, negotiations between Mandrel, Electro-Tech International Inc., Electro-Technical Labs. Canada, Ltd., Electro-Technical Labs (Alberta) Ltd. and H. A. Sears were commenced resulting in settlement of the said lawsuit and other matters as evidenced by written Agreement dated the 27th day of June, 1958 (Agreement with Exhibits "A" to "J" attached, is Appendix "G").

12. The amount of $490,853.18 U.S. Funds was the balance of the account owing by Electro-Tech International Inc. to the Appellant as at June 27th, 1958 for goods sold and services rendered by the Appellant to Electro-Tech International Inc. to such date.

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13. Executed copies of Appendix "G" were delivered to all parties on June 27th, 1958. The closing took place on July 15th, 1958 at Houston, Texas.

14. That a Resolution of the Directors of Electro-Technical Labs (Alberta) Ltd. was passed effective as at July 15th, 1958 (Appendix "H"), approving the agreement marked as Appendix "G" between Electro-Technical Labs (Alberta) Ltd. and the Appellant.

15. A Special Resolution of the Shareholders of Electro-Technical Labs (Alberta) Ltd. was passed effective as at July 15th, 1958 (Appendix "I"), approving the Resolution of the Board of Directors of Electro-Technical Labs (Alberta) Ltd.

16. Attached hereto is a Certificate executed by Electro-Technical Labs (Alberta) Ltd. dated July 15th, 1958 (Appendix "J"), certifying that the said Resolutions set forth in Appendixes "H" and "I" are in full force and effect.

17. At the closing on July 15th, 1958, Electro-Technical Labs (Alberta) Ltd. delivered to the Appellant an Agreement in writing dated July 15th, 1958 between Electro-Technical Labs (Alberta) Ltd. and the Appellant (Appendix "K").

18. On July 7th, 1958, Electro-Technical Labs. Canada, Ltd. passed a Resolution (Appendix "L"), authorizing the Directors to assign to the Appellant the Trading Agreement (Appendix "A"), a true copy of which Resolution is attached to a Certificate executed by Electro-Technical Labs. Canada, Ltd., dated July 7th, 1958 (Appendix "M").

19. At the closing on July 15th, 1958, Electro-Technical Labs. Canada, Ltd delivered to the Appellant an Assignment Agreement dated July 15th, 1958 (Appendix "N") with respect to the Trading Agreement (Appendix "A").

20. At the closing on July 15th, 1958 two Promissory Notes for $154,853 18 and $150,000 00 in U.S. Funds made by Electro-Tech International Inc. in favour of the Appellant were delivered by Electro-Tech International Inc. to the Appellant. An unexecuted copy of each of the said Notes is attached hereto and marked respectively as Appendixes "O" and "P". The originals or executed copies of such Notes are not in the hands of the Appellant. The originals of such Notes were forwarded to the President of the Appellant in California on July 15th, 1958 for endorsement, assignment and/or execution by the Appellant to Electro-Technical Labs (Alberta) Ltd. and Electro-Technical Labs. Canada, Ltd. respectively, as provided for in the form contained on Appendixes "O" and "P". Such Notes were so endorsed, assigned and/or executed by the Appellant and were returned to the Attorneys for the Appellant on July 18th, 1958 and were delivered immediately to the respective Assignees, Electro-Technical Labs (Alberta) Ltd. and Electro-Technical Labs. Canada, Ltd.

21. The Appellant first registered as a corporation in Alberta on July 2nd, 1958. On July 15th, 1958, it took over all the personnel of Electro-Technical Labs (Alberta) Ltd. and Electro-Technical Labs. Canada, Ltd. with the exception of Mr. Donald Barton who did not choose to join the Appellant's organization. The Appellant did not participate in any sales or carry on business in Canada prior to July 15th, 1958.

Mr. Mize testified that upon the expiry of the exclusive right or dealership with Electro-Technical Labs. Canada, Ltd. there was no intention whatsoever of renewing it

because the policy of the appellant had been changed so that it would market its products on its own account throughout the world by means of branch sales and service offices to be established. There were no such branches established in 1957 but subsequent thereto between 21 and 30 branches were set up in strategic areas.

In furtherance of this avowed policy discussions were held in July 1957 with Sears to acquire the exclusive Canadian sales contract held by him, for which at that time, Mize testified the appellant offered to pay $200,000 based upon $50,000 (being the annual profit realized by Electro-Technical Labs. Canada, Ltd.) for each of the four years the contract had to run. However the negotiations were broken off by Sears.

In August 1957 a similar exclusive arrangement with Electro-Tech International Ltd. with respect to marketing the appellant's products in areas other than Canada and the United States was purported to be terminated which resulted in the instigation of the law suit referred to in paragraph 10 of the Agreed Statement of Facts during the currency of which the trading agreement with Electro-Technical Labs. Canada, Ltd. was honoured.

Mr. Mize further testified that in negotiating the settlement of the law suit a value of $150,000 was placed upon the Canadian sales contract being on the basis of $50,000 per year for the three unexpired years.

The appellant herein had obtained an injunction restraining Electro-Tech International Inc., from using any funds it received from the sale of equipment of the appellant. Because of this Sears was in financial difficulty and made overtures to the appellant to effect a settlement. Sears was therefore negotiating from a position of weakness whereas the appellant was negotiating from a position of strength.

The promissory note for $150,000 (Appendix "P") made by Electro-Tech International Inc. to the appellant was endorsed by the appellant to Electro-Technical Labs. Canada, Ltd. without recourse upon the appellant. This was done, Mr. Mize testified, because the original obligation to pay was between sister companies.

The appellant in preparing its income tax returns for the years 1958 and 1959 claimed amounts as deductions on

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account of amortization allowances with respect to the acquisition of the trading agreement. However in its Notice of Appeal from the assessments the appellant alleges that it should not have claimed amortization allowances, but rather should have claimed the payment of $150,000 as a deduction which would result in a loss in both the 1958 and 1959 taxation years and accordingly claims a refund of taxes and interest paid.

The appellant in its income tax return for 1958 disclosed a loss of $7,538.26 and in computing that loss it had deducted "Amortization of payment to Electro-Technical Labs. Canada, Ltd. $26,286.96".

Similarly in its 1959 return the appellant disclosed a net income of $20,680.68 in the computation of which there was deducted $52,573.93 described as "Amortization of trading franchise".

In assessing the appellant the Minister disallowed both the amounts of $26,286.96 and $52,573.93 as not being proper deductions under the *Income Tax Act*.

The appellant objected to the assessments by notices dated April 1961. The respondent confirmed the assessments from which assessments the appeals are brought to this Court.

There is no dispute as to the amounts involved but the dispute is as to the taxability thereof. The face value of the note endorsed by the appellant is $150,000 in United States funds. It is agreed that the corresponding value in Canadian funds is $144,578.31.

There are three issues in the present appeals. In the first instance the Minister disputes that the note in question was given solely in consideration for the acquisition or cancellation of the exclusive sales contract and says that the appellant received other benefits as well. If that contention is correct, it follows that the appellant has failed to discharge the onus of proving the expenditure.

The second issue is whether the payment of $150,000 U.S. funds (assuming such to have been established) in the circumstances outlined above, made by the appellant to Electro-Technical Labs. Canada, Ltd. constitutes an outlay or payment on account of capital within the meaning of section 12(1)(*b*) of the *Income Tax Act* and accordingly is not properly deductible as a current expense in computing income, as contended by the Minister.

This issue involved consideration of section 12(1)(*b*) of the Act which provides as follows:

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, ...

The third issue arises if the second issue is resolved against the contention of the appellant and the payment is held to have been a capital outlay. The appellant then contends that the acquisition of the trading agreement was a purchase of a franchise, concession or licence which had approximately three years to run and accordingly the appellant is entitled to deduct the amount of the payment of $144,578.31 in Canadian funds, by way of capital cost allowance over a three year period in accordance with section 11(1)(*a*) of the *Income Tax Act* and the regulations promulgated thereunder.

Section 11(1)(*a*) reads as follows:

11. (1) Notwithstanding paragraphs (*a*), (*b*) and (*h*) of subsection (1) of section 12, the following amounts may be deducted in computing the income of a taxpayer for a taxation year:

(*a*) such part of the capital cost to the taxpayer of property, or such amount in respect of the capital cost to the taxpayer of property, if any, as is allowed by regulation;

...

The pertinent regulation is 1100(1)(*c*) of Part XI of the Income Tax Regulations, reading as follows:

1100. (1) Under paragraph (*a*) of subsection (1) of section 11 of the Act, there is hereby allowed to a taxpayer, in computing his income from a business or property, as the case may be, deductions for each taxation year equal to

(*c*) such amount as he may claim in respect of property of class 14 in Schedule B not exceeding the lesser of

(i) the aggregate of the amounts for the year obtained by apportioning the capital cost to him of each property over the life of the property remaining at the time the cost was incurred, or

(ii) the undepreciated capital cost to him as of the end of the taxation year (before making any deduction under this subsection for the taxation year) of property of the class;

Property of class 14 in Schedule B is described as follows:

Property that is a patent, franchise, concession or licence for a limited period in respect of property ...

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(The exceptions subsequently outlined are not applicable.)

The question so raised for determination is whether what the appellant acquired was a "patent, franchise, concession or licence for a limited period in respect of property" within the meaning of the introductory words of class 14 of Schedule B, it being common ground that the appellant is entitled to such allowance if the rights acquired by it so qualify.

In view of the conclusions I have reached on the second and third issues raised in these appeals, it is not necessary for me to consider the first issue referred to above, that is, whether the payment of $150,000 U. S. funds was given solely for the acquisition or termination of the exclusive sales contract between the appellant and Electro-Technical Labs. Canada, Ltd. For the purpose of considering the remaining issues I assume that it was without in any way deciding the matter.

The first question for determination is, therefore, whether the payment was an outlay or payment on account of capital.

The matter was succinctly put by Abbot, J. in *British Columbia Electric Railway Company Limited v. The Minister of National Revenue*[1] as follows:

> Once it is determined that a particular expenditure is one made for the purpose of gaining or producing income, in order to compute income tax liability it must next be ascertained whether such disbursement is an income expense or a capital outlay. The principle underlying such a distinction is, of course, that since for tax purposes income is determined on an annual basis, an income expense is one incurred to earn the income of the particular year in which it is made and should be allowed as a deduction from gross income in that year. Most capital outlays on the other hand may be amortized or written off over a period of years depending upon whether or not the asset in respect of which the outlay is made is one coming within the capital cost allowance regulations made under s. 11(1)(*a*) of *The Income Tax Act*.

Applying such test to the facts of this particular case, it is clear that the payment was made for the ultimate purpose of gaining or producing income in the sense that greater profits would accrue to the appellant but in my view such payment cannot be construed as an income or operating expense. What the appellant acquired was the right and the means to sell in Canada. As indicated in paragraph 21 of the "Agreed Statement of Facts" the

[1] [1958] S.C.R. 133 at 137.

appellant took over the entire staff, with one exception, of Electro-Technical Labs. (Alberta) Ltd. and Electro-Technical Labs. Canada, Ltd. To me this was not an expense of running the business in Canada but rather an expense incidental to launching its own selling organization in Canada. To be able to do that it had to rid itself of the covenants in the sales agreement.

In order to determine whether a particular outgoing represents an outlay of capital, several tests have been proposed, one of which is that of Lord President Clyde in *Robert Addie & Sons' Collieries Ltd. v. I.R.*[1]

> Is it an expenditure laid out as part of the process of profit earning? Or, on the other hand, is it a capital outlay? Is it expenditure necessary for the acquisition of property or of rights of a permanent character, the possession of which is a condition of carrying on its trade at all?

The most notable and frequently cited declaration as to what constitutes a capital outlay is that of Viscount Cave in *British Insulated and Helsby Cables Limited v. Atherton*[2]:

> ...But when an expenditure is made, not only once and for all, but with a view to bringing into existence an asset or an advantage for the enduring benefit of a trade, I think there is very good reason (in the absence of special circumstances leading to an opposite conclusion) for treating such an expenditure as properly attributable not to revenue but to capital.

In *Vallambrosa Rubber Co. Ltd. v. Farmer*[3] Lord Dunedin said in part at page 536:

> I do not say this consideration is absolutely final or determinative; but in a rough way I think it is not a bad criterion of what is capital expenditure to say that capital expenditure is a thing that is going to be spent once and for all, and income expenditure is a thing that is going to recur every year.

In applying the foregoing classical tests to the present case, I cannot but think that the payment here in question was an outlay on account of capital. What the appellant did here was to make a payment once and for all, with a view to bringing into being an advantage for the enduring benefit of the trade. There is no question that the payment was made once and for all. I also think it is clear that what the payment brought into being was an advantage in that the appellant could operate its own selling operation in Canada without being in breach of its previously existing exclusive sales contract with Electro-Technical Labs.

[1] 8 T C. 671 at 676.
[2] [1926] A.C. 205 at 213.
[3] 5 T.C. 529.

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Canada, Ltd. Furthermore, under arrangement for settlement of the Texas law suit, the appellant acquired not only an unfettered right to sell to any prospective customer directly on its own account rather than only to Electro-Technical Labs. Canada, Ltd. but also acquired an existing sales and servicing organization as a whole. In my view, therefore, what the appellant did was to make a capital outlay for these purposes. Once acquired, other expenditures would be made in the course of operating that organization. Such expenditures would be current.

It is true that the advantage acquired in this case was the right to begin selling operations in Canada three years earlier than the appellant would otherwise have been able to do and a question might be raised as to whether such a right is of "enduring benefit" or of a "permanent character". These phrases were introduced in some of the judicial dicta on this subject to indicate that an asset or advantage acquired must have enough durability to justify its being treated as a capital asset and the terms are not used synonymously with "everlasting". There have been many instances where an "advantage" has been held to be "enduring" despite the fact that it had a very limited life or duration.

Counsel for the appellant placed much reliance on the authority of the decision in *Anglo Persian Oil Company Limited v. Dale*[1]. However, in my view such case is readily distinguishable in that the decision was based on the relationship which existed between the Company and its agents. Lawrence L.J. in commenting on the Crown's argument said at pages 140 and 141, "The fallacy underlying the whole of this argument, in my judgment, consists in treating the agent as if he were an independent trader and not the agent of the Company carrying on the Company's trade . . . it (the Company) merely effected a change in its business methods and internal organization". In the present case Electro-Technical Labs. Canada, Ltd. was carrying on a business on its own account in Canada and not a part of the business of the appellant company. It was, in fact, an independent trader.

The payment was not a commutation of profits as in *Johnston Testers v. M.N.R.*[2] and in *Kelsall Parsons & Co. v. C.I.R.*[3] although the basis of the valuation of the

[1] [1932] 1 K.B. 124.
[2] [1955] C.T.C. 116.
[3] 21 T.C. 608.

payment was an estimate of profits for the three years the exclusive sales contract had to run. Neither was it a payment to an agent or servant of the appellant of a revenue nature.

I also think that the facts of the present case are distinguishable from those in *Scammel & Nephew Ltd. v. C.I.P.*[1] also relied on by the appellant in that the expenditure in that case was made to protect a revenue item, an account receivable, and an expenditure to protect a revenue item is itself a revenue item.

For these reasons I, therefore, hold that the expenditure of $150,000, if made by the appellant in consideration of the assignment of the exclusive sales contract, was a capital outlay and not properly deductible as a current expense under the provisions of the *Income Tax Act*.

This, therefore, brings me to a consideration as to whether the outlay was for an asset falling within the capital cost allowance regulations made under section 11(1)(*a*) of the *Income Tax Act* quoted above.

As a basic premise I accept the submission of counsel for the appellant that what the appellant granted to Electro-Technical Labs. Canada, Ltd. as a result of the exclusive sales contract between them dated May 11, 1956 was in all likelihood a "concession", "franchise" or a "licence". I think that such words must be given the meaning or sense in which they are employed in ordinary commercial usage and they extend not only to certain kinds of rights, privileges or monopolies conferred by or pursuant to legislation or by governmental authorities, but also extend to analogous rights, privileges or authorities created by contract between private persons.

But acceptance of the foregoing premise does not resolve the present issue because the question here is whether what the appellant acquired is property which was a "concession", "franchise" or "licence" for a limited period.

What the appellant did acquire was freedom to carry on selling operations in Canada without being in breach of contract three years earlier than it previously would have been able to do. The appellant, at all times, had the inherent right to sell in Canada, but during the currency of the exclusive sales contract to do so would have involved a breach of contract. It could now sell its products to any

[1] 22 T.C. 479.

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customer in Canada and was not restricted by contract to selling only to Electro-Technical Labs. Canada, Ltd.

The transaction by which the appellant obtained the discharge from its covenants in the exclusive sales contract was accomplished by way of an agreement between it and Electro-Technical Labs. Canada, Ltd. dated July 15, 1958 in which the parties were termed "assignor" and "assignee" respectively whereby the assignor (Electro-Technical Labs. Canada, Ltd.) purported to grant and assign unto the assignee (the appellant) the exclusive sales contract and all rights, title and interest thereto for the assignee's own use and benefit. I must assume that the parties to the assignment deliberately and consciously adopted this method rather than by the more direct method of release or cancellation of the exclusive sales contract.

However, I am obliged to look at the substance of the transaction and the consequences which flow therefrom. In so stating I have not overlooked the statements of the House of Lords in *The Commissioners of Inland Revenue v. The Duke of Westminster*[1] that every man is entitled to order his affairs, by his ingenuity, so that a tax attaching is less than otherwise. But here what must be done is to consider the proper legal operation of the agreement.

It is axiomatic at common law that a person cannot contract with himself. It is meaningless to say that a person can accept something from himself which is already his own. Therefore,the appellant herein could not grant a "concession", "franchise" or "licence" to itself. As against this, counsel for the appellant contends that the doctrine of merger, which is dependent on intention, does not apply and that what the appellant intended to acquire was the right to go into business in Canada three years earlier than it ordinarily would by purchasing the exclusive sales contract. But as I have mentioned before, what the appellant acquired was a release from its covenant to sell exclusively to Electro-Technical Labs. Canada, Ltd. It did not acquire property. Therefore it follows that the appellant did not acquire property that is a "concession", "franchise" or "licence" within the meaning of the introductory words of class 14 in Schedule B to the regulations under section 11(1)(*a*) of the *Income Tax Act*.

The appeals are, therefore, dismissed with costs.

[1] [1936] A.C. 1.