1960

Oct. 17
July 24

BETWEEN:

ISAAC SHULMAN ..... APPELLANT;

AND

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

Revenue—Income tax—Income Tax Act, R.S.C. 1952, c. 148, s. 137(1)—Management company incorporated by solicitor—Management fees paid to the company not deductible—Income unduly or artificially reduced—Meaning of "unduly" and "artificially"—Appeal dismissed.

Appellant, a solicitor, incorporated a company to act as manager of his office. He agreed to pay it $1,000 per month for which it was to provide all the non-professional services attendant upon his practice. It was to employ all the secretarial and clerical staff, purchase all the equipment, stationery and library and generally manage the office. In fact appellant continued to pay the non-professional staff, and in 1957 he also devoted half his time to the reorganization of the office, maintaining that he was acting as agent of the company. In December of 1957 he paid to the company the sum of $9,500 as a management fee. The company then purchased a home from appellant's wife agreeing to pay $19,000 and assume a mortgage. She then assigned the amount receivable to the appellant who gave her his note for $19,000. The appellant then received from the company the sum of $9,000 by way of payment on this obligation which was returned by him to the law office treasury as working capital. In his income tax return for 1957 appellant deducted this $9,500 paid to the management company and was later re-assessed by respondent who added that amount to his taxable income for the year 1957. Appellant now appeals from that re-assessment.

Held: That the management agreement with the corporation and the way the transactions were carried out unduly or artificially reduced the income of the appellant and the fee paid to the corporation was not deductible from income by virtue of s. 137(1) of the *Income Tax Act* R.S.C. 1952, c. 148.

APPEAL under the *Income Tax Act.*

The appeal was heard before the Honourable Mr. Justice Ritchie, Deputy Judge of the Court, at Vancouver.

M. M. McFarlane, Q.C. for appellant.

C. C. I. Merritt, Q.C. for respondent.

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

RITCHIE D.J. now (July 24, 1961) delivered the following judgment:

The appellant, since 1949, a barrister and solicitor of the Supreme Court of British Columbia, has appealed from a re-assessment made under the *Income Tax Act,* R.S.C. 1952, chapter 148. The re-assessment added $9,500 to the taxable income shown on his 1957 income tax return.

During the taxation year above mentioned the appellant, under the firm name and style of Shulman, Tupper, Southin, Gray & Worrall, was carrying on the practice of law in Vancouver. The other four solicitors whose names were included in the firm name and style and one additional lawyer, whose name was not so included, were his salaried employees. An accountant, five stenographers, a switchboard operator and a law student comprised the non-professional office staff.

Prior to March 15, 1957 the appellant's practice had been conducted with little, if any, overall management or control. The office procedure was comparable to what it would have been had the six lawyers been sharing the office space with each carrying on his practice independently of the others. What supervision did exist was exercised by Mr. Shulman. He, of course, was entitled to disapprove and vary any action taken by any of his employees.

Each lawyer in the office was permitted to engage his own secretary and fix his own charges for professional services. As the work load was not distributed evenly, dissatisfaction and unrest had developed among the stenographic

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staff. Confusion and uncertainty existed in respect of the responsibility for rendering bills and tracing disbursements. When making up accounts it, sometimes, was necessary to spend two or three hours going through files to ascertain the disbursements which should be included. Quite often it was found no account had been rendered because of a misunderstanding between two of the lawyers as to on whom the responsibility for so doing rested. There was no systemized vacation schedule. A lawyer and his secretary might be absent from the office on vacation at the same time and so render it difficult to answer enquiries respecting work he had in hand.

In 1955 the appellant had employed an accountant as an office manager at a salary of around $300 or $350 per month. No improvement in office routine resulted. The other lawyers resisted implementation of any recommendations advanced as to changes in office procedure. It was not long before the office manager was devoting his time exclusively to accounting duties and the office routine had resumed its haphazard course. In Mr. Shulman's opinion the explanation of the failure of this attempt to solve administration problems is that the office manager's lack of legal training permitted the lawyers, by the use of arguments he did not understand, to talk him out of every change he wished to make in the office system.

Early in 1957 the appellant decided office administration was important enough to warrant an expenditure of whatever portion of his time was required to organize it properly and that drastic and immediate action must be taken if the office was to operate efficiently. On March 15 Mr. Shulman caused Shultup Management & Investments Ltd. to be incorporated. For convenience, this company sometimes hereafter shall be referred to as "Shultup". The authorized capital is 10,000 shares of the par value of $1 each. The paid up capital is the nominal sum of $4 of which $2 was subscribed by the appellant and $2 by his wife. They are the directors and only shareholders of the company. Mr. Shulman is the president and, presumably, the chief executive officer.

Under date of March 15, 1957 the appellant, under his firm name of Shulman, Tupper, Southin, Gray & Worrall, entered into a management agreement with Shultup. As this appeal is of importance I will set out the agreement in full. It reads:

THIS AGREEMENT made in duplicate the 15th day of March, 1957:

BETWEEN:

SHULMAN, TUPPER, SOUTHIN, GRAY & WORRALL,

Barristers & Solicitors, Suite 404-510 West Hastings Street, Vancouver, British Columbia, (hereinafter referred to as "the Solicitor")

OF THE FIRST PART

AND:

SHULTUP MANAGEMENT & INVESTMENTS LTD.

a body corporate, incorporated under the laws of the Province of British Columbia and having its registered office at Suite 404-510 West Hastings Street, Vancouver, British Columbia,

(hereinafter referred to as "the Company")

OF THE SECOND PART

WHEREAS the Solicitor carries on business as Barristers and Solicitors at Suite 404-510 West Hastings Street, Vancouver, British Columbia;

AND WHEREAS the Company has agreed with the Solicitor to perform certain non-professional services as hereinafter set forth;

NOW THEREFORE IN CONSIDERATION of the premises and the terms and conditions hereinafter set forth, IT IS AGREED AS FOLLOWS:

1. The Company shall at such time and from time to time as shall be required or requested by the Solicitor to perform the following non-professional services (hereinafter referred to as the "non-professional services").
   (i) The employment of any and all secretarial and clerical staff.
   (ii) The employment of any and all maintenance staff.
   (iii) The purchasing or acquiring of any and all secretarial and clerical staff's equipment, furniture and fixtures.
   (iv) The purchasing or otherwise acquiring of all general office equipment, furniture and fixtures.
   (v) The purchase of all stationery and legal forms.
   (vi) The purchase of all periodic and professional literature.
   (vii) The purchase of any and all text books and reference materials.
   (viii) Purchasing or leasing of office and waiting room space.
   (ix) Management of all secretarial and clerical staff.
   (x) Management of maintenance staff.

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(xi) Collection of all outstanding accounts, including the taking as agent for the Solicitor of any and all legal proceedings to secure payment of such accounts.

(xii) The appointment of any and all Auditing and Accounting staff.

(xiii) The purchasing or otherwise acquiring and maintenance of transportation facilities to be used by the Solicitor for business purposes.

(xiv) Payment of any and all insurance premiums necessary to maintain good and adequate insurance, including fire, theft, and private and professional liability insurance.

(xv) Preparation and filing of Income Tax Returns.

(xvi) Such other duties as may be agreed upon by the parties from time to time.

2. In consideration of the performance by the Company of the non-professional services agreed to be performed, the Solicitor agrees to pay to the Company a fee (hereinafter referred to as "the management fee") in the sum of One Thousand ($1,000.00) Dollars per month commencing the 15th day of March, 1957 until the end of the first fiscal period of the Company and thereafter a rate to be agreed upon by the parties hereto and in the event the parties shall fail to agree on such rate, the question of determination of the amount of the management fee shall be referred to the Company's Auditor, whose decision shall be binding upon both parties.

Each of the parties hereto agree to make, do and execute or cause to be made done or executed all such further and other acts, deeds, documents, conveyances and assurances as may be necessary or reasonably required to carry out the intent and meaning of this Agreement.

This Agreement shall enure to the benefit of and be binding upon the respective parties hereto, their heirs, executors, administrators, successors and assigns.

IN WITNESS WHEREOF the parties hereto have caused these presents to be executed as of the day and year first above written.

THE COMMON SEAL of SHULTUP MANAGEMENT & INVESTMENTS LTD. was affixed hereto in the presence of:	(Sgd.) W. J. Worrall
(No signature)	(Sgd.) J. Graham
SIGNED, SEALED and DELIVERED by SHULMAN, TUPPER, SOUTHIN, GRAY & WORRALL, per: in the presence of:	(Sgd.) Harold W. Tupper
(Signature illegible)	

No evidence was lead as to the authority of Messrs. Worrall and Graham to execute the agreement on behalf of the company nor as to whether they were officers thereof. They were both employees of the appellant.

The management fee of $1,000 per month is an arbitrary figure set by the appellant. For the period from March 15 to December 31, 1957, pursuant to the terms of the agreement, Shultup was paid $9,500. The payment was made in a lump sum on December 27, 1957.

Immediately after its incorporation, Shultup, through the appellant as agent, took over the control and supervision of the law office administration. Mr. Shulman previously had devoted not more than one hour per day to administrative duties. In the ensuing nine and one-half months of 1957, he spent from one-third to one-half of his time reorganizing the office setup and endeavouring to evolve a more efficient administrative system. Any proposed change in procedure was, before being implemented, discussed with the other lawyers in the office. After discussions with Ediphone executives extending over some months there was installed in September 1957 a mechanical dictation system whereby each of the lawyers, by merely switching a button on his desk, could dictate direct to any one of the stenographers. The new system of dictation speeded up office production and improved secretarial morale. It became the rule rather than the exception for dictation to come back engrossed on the same day.

The dictation equipment cost slightly more than $7,000. While the purchase was negotiated by Shultup it was billed to the law office under an agreement covering payment by monthly instalments. In September 1958, when the interest rate on the deferred payments under the purchase agreement increased sharply, Shultup borrowed from a bank the amount required to pay the balance owing and paid out the Ediphone account. The law office then, over a period of time, reimbursed the company.

The use of printed forms, sold over the counters of stationery stores, was discontinued and, in lieu thereof, Shultup installed a set of office forms especially drafted to meet the type of transactions usually encountered in the office practice. Substantial savings were effected by purchasing an inferior quality paper for use in drafting documents and a superior quality paper for engrossing them in final form. A new car was acquired by the law office but the purchase

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was negotiated by the appellant as the agent of Shultup. Part time staff were employed to handle seasonal tasks, such as the preparation and filing of annual reports on behalf of corporate clients.

A more efficient accounting method was inaugurated to effect a better control of trust accounts and a time control system adopted to maintain a record of the time spent by each lawyer on the business of clients. Lists of accounts receivable and disbursements were prepared each month. Bills, for the most part, were rendered monthly, after first having been submitted to the appellant, as the agent of Shultup, for approval and a comparison of costs.

Additional office space was leased and a more satisfactory floor layout devised. Any changes necessary in the office staff, vacation periods, et cetera, were arranged by Mr. Shulman in his capacity as the agent of Shultup.

Prior to Shultup assuming administrative control, each of the lawyers had purchased law books for the office account as he saw fit. No record was kept of books loaned. The binding of law reports and periodicals was neglected. When Mr. Shulman checked the library he found no inventory existed and that text book duplications had resulted from the haphazard purchasing system. A library inventory was compiled and a system set up whereby a record was kept of all books loaned and the binding needs attended to monthly. New purchases for the library were made by the appellant as agent of Shultup but for the account of the law office.

The expense, if any, incurred by Shultup in respect of the law office management was negligible. It had no employees, no letter-heads, no stationery and no files. Any Shultup correspondence or memoranda were kept in the law office files. Staff salaries were paid and all disbursements made by the law office. Although the appellant spent from one-third to one-half of his time performing the duties which Shultup had contracted to perform, he received no remuneration from the company.

In effect the only service rendered by Shultup was making Mr. Shulman available to perform the management duties as its agent. The non-professional staff, apart from the accountant, would not notice any change in office management procedure.

The assets of Shultup include the house in which the appellant resides, an interest in "Cambridge Enterprises", an interest in "Burnham Enterprises" and shares in the capital stock of "Public companies". Cambridge Enterprises is the owner of shares in the capital stock of a company which deals in real estate and also conducts an insurance agency. Burnham Enterprises is an "Oil company".

The house was purchased from Mrs. Shulman on December 5, 1957 for the price of $33,500, apportioned $4,300 to land and $29,200 to the building. Adjustments of $31.60 for taxes and $54.40 for insurance brought the total cost to $33,586. The property was subject to a mortgage for $14,583.86 which Shultup assumed. The difference of $19,002.14 between the total cost and the amount of the mortgage was an account payable by the company to Mrs. Shulman. This indebtedness of the company was assigned by his wife to the appellant who then gave her his promissory note for $19,002.14 and set up a credit to himself of the same amount on the books of the company. The Crown concedes this was a perfectly proper transaction.

Mr. Shulman admits part of the revenue of the company, derived basically from the management fee, was paid to his wife on account of the purchase price of the house and that as a result he, as a shareholder of the company, acquired an indirect beneficial interest in the house.

As above mentioned, payment of the $9,500 management fee was made by the law office to Shultup on December 27, 1957. On the same day $9,000 of that payment was paid by the company to the appellant on account of its $19,002.14 indebtedness to him. Then, also on the same day, the appellant paid the $9,000 into the law office bank account for use as working capital, particularly in respect of financing disbursements. The $9,500 was received as income and disbursed as an operating expense. When the $9,000 came back into the law office account it was in the form of "a loan" for capital purposes. On the law office balance sheet there is an item "Loan Payable $9,000". How Mr. Shulman could loan $9,000 to himself was not explained. In the end result the payment of the $9,500 management fee reduced the cash resources of the law office by only $500.

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William Joseph Worrall, a barrister and solicitor of the Supreme Court of British Columbia who has been associated with Mr. Shulman since his admission to the Bar in 1956, corroborated the appellant's evidence regarding the inadequacy of the office administration, particularly in respect of the secretarial and accounting services. He testified that immediately after becoming associated with the Shulman office in 1956, he noticed the administrative procedure was far less efficient than in the office with which he had been articled as a student. To illustrate how haphazard the accounting methods were, Mr. Worrall said that for the same type of services his charges would vary in accordance with the views of the senior lawyer with whom he happened to be working. Based on personal observation, it was his opinion Mr. Shulman, in 1957, spent almost one-half of his time on duties pertaining to office administration. Mr. Worrall also said he knew of at least three mining companies who had contracted with "management companies" to supply management services on a fee plus cost basis and that in those instances the records were kept by the mining company staffs.

On his 1957 return the appellant showed the gross revenue from his law practice to be $96,888.07 and his net income therefrom to be $14,892.30. Operating expenses were shown as $81,995.77, including the management fee of $9,500; staff salaries were $48,782.72; travelling and auto expense totalled $1,302.16; and provision for depreciation was $3,713.40. The gross revenue figure of $96,888.07 covered a full fiscal period of twelve months while the management fee applied to a period of only nine and one-half months. Neither the total nor individual remuneration paid the other five lawyers is disclosed. Such remuneration was included in the staff salaries total of $48,782.72, more than 50% of the gross revenue.

According to the tax return figures, the appellant's practice netted him only 15.37% of the gross fees for professional services. Had the $9,500 management fee, 9.8% of the gross, not been deducted the net profit would have been 25.18%.

By the re-assessment, dated May 27, 1960, the Minister of National Revenue disallowed the deduction of the $9,500 management fee and added it back to income. The

tax on the so revised taxable income was computed to be $6,019.10. Had the management fee not been disallowed, the tax would have been $2,151.89. The difference is $3,867.21.

The first income tax return filed by Shultup was for its fiscal year ending March 15, 1958, a period of twelve months. Gross income was shown as $12,612.50 comprised of the $12,000 management fee (for twelve months) and $612.50 derived from property rentals. Operating expenses were shown as $2,948.01 computed as follows:

Accounting	$ 65.00
Insurance	13.57
Mortgage Interest	226.26
Property Taxes	81.68
Secretarial Services	250.00
Sundry	1.50
Depreciation—Buildings	2,310.00
	$2,948.01

There is no evidence as to who received the remuneration for the accounting and secretarial services nor as to the activities of the company in respect of which such services were rendered. Net income was shown to be $9,664.49 on which was paid an estimated tax of $1,932.90, computed at 20%, the rate on corporate taxable incomes not exceeding $25,000. Pending the disposition of this appeal, the Shultup assessment has been held in abeyance.

If the management fee is allowed as a deduction from his income, the personal tax of the appellant for 1957 will, as above mentioned, be $2,151.89. Computing the 20% corporate rate on the full $9,500 as income in the hands of Shultup, without any deduction for expenses and without regard to the rental income, would mean a tax of $1,900. On that basis the personal tax of $2,151.89 plus a corporate tax of $1,900 total $4,051.89, an amount $1,967.21 less than that of the revised assessment.

While insisting the management fee was not an expense incurred for the purpose of producing income and its deduction had artificially or unduly reduced the income of the appellant, Crown counsel concedes he was an honest witness and no question of a deceitful purpose is involved herein. Mr. Shulman's manner on the stand was frank.

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His credibility was not attacked.

To support the re-assessment the Minister submits:

1. the payment of the $9,500.00 to Shultup is not an outlay or expense for the purpose of gaining or producing income from the business of the tax payer and its deduction from taxable income is, accordingly, precluded by section 12 (1) (*a*) of the Act;
2. the outlay of the $9,500.00 is not the expenditure of an amount that, in the circumstances, is reasonable as a management fee and so falls within the provisions of section 12 (2); and
3. the management agreement with Shultup is a transaction artificially reducing the income of the appellant and so the deduction of the $9,500.00 is forbidden by section 137(1).

The sections above mentioned read:

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

(*a*) an outlay or expense except to the extent that it was made or incurred by the taxpayer for the purpose of gaining or producing income from property or a business of the taxpayer.

12 (2) In computing income, no deduction shall be made in respect of an outlay or expense otherwise deductible except to the extent that the outlay or expense was reasonable in the circumstances.

137 (1) In computing income for the purposes of this Act, no deduction may be made in respect of a disbursement or expense made or incurred in respect of a transaction or operation that, if allowed, would unduly or artificially reduce the income.

The income of a tax payer for a taxation year is defined by section 3 of the Act to include "income for the year from all businesses". Section 4 states income from a business "is the profit therefrom". The word "business" is defined by section 139 (1) (*e*) to include a profession.

Two principles which have direct application to the determination of this appeal are that a corporation is an entity distinct from its shareholders and that a taxpayer is entitled to arrange his affairs, if he can do so within the law, so as to attract upon himself the least amount of tax. Those two principles must, however, be considered having regard to the fact that in enacting the Income Tax Act, Parliament undoubtedly intended to impose a tax on income.

Wherever the law draws a line, any action taken by a tax payer must be on one or the other side of it. If on the safe side, the action is not illegal. If on the wrong side,

it is illegal. If the management fee is not deductible it must be because of some provision or prohibition contained in the Act.

The rule of strict construction applies to the two sections of the Act upon which the Minister rests his revised assessment. The letter of the law and not its assumed or supposed spirit must govern. The intention of Parliament to impose a tax must be gathered solely from the words by which it had been expressed and from reading them in the sense they ordinarily are used. *Executors of David Fasken v. M.N.R.*[1]

Because the management fee was paid to a corporation of which the appellant and his wife are the only shareholders and, so far as the record discloses, the management agreement was negotiated between the appellant in his personal capacity and the appellant in his capacity as the agent of Shultup does not, *per se,* preclude the management fee from being a legitimate operating expense of the law practice. The personal and corporate entities are distinct. *Salomon v. Salomon*[2], *Pioneer Laundry & Dry Cleaners Limited v. M.N.R.*[3], *Duke of Westminster v. C.I.R.*[4]

In the absence of precise evidence as to how the terms of the management agreement were settled, I assume they were thought out by Mr. Shulman in his dual capacities. The signatures of the individuals who executed the agreement on behalf of the corporation suggest the possibility the appellant, speaking as the owner of the law practice, may have discussed the terms of the agreement with those individuals as representing Shultup. Discussions respecting the agreement with his employees as dummy representatives of the company, or with his wife, as a director of the company, would be a mere formality.

A solicitor is not precluded from entering into a contract with a corporation to perform the non-professional duties relating to the management of his law office which he, if so minded, could perform himself. Unless I find fraud or improper conduct, I cannot disregard the separate legal existence of Shultup and hold the fee payable under the

[1] [1948] Ex. C.R. 580, 589; [1948] C.T.C. 265.
[2] [1897] A.C. 22 (H.L.).
[3] [1940] A.C. 27 (P.C.).
[4] [1936] A.C. 1.

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management agreement is not a legitimate operating expense solely because the appellant and his wife are the only shareholders of Shultup and because the appellant, as a lawyer, negotiated with himself, as the president of the company. If the re-assessment is to stand, justification for deduction of the $9,500 fee being brought within either or both of the sections of the Act upon which the Minister relies must be found in the procedure by which the terms of the agreement were implemented and the results flowing therefrom.

Mr. Shulman admits that whatever he did as the agent of Shultup he could have done in his personal capacity as a lawyer. He also admits that had the management fee been paid to him personally as compensation for the time spent on administrative work it would have been income in his hands.

The explanation advanced for incorporating Shultup and entering into the management agreement is that had the appellant undertaken the management duties in his personal capacity the office records would have shown him as a very small contributor to the gross income earned by the law office. I do not understand that explanation. So far as the effect of the time devoted to administrative duties on his contribution to the professional income is concerned, the result would be the same whether that time was spent as the agent of Shultup or in his personal capacity.

When questioned as to whether his assuming the responsibility of management had resulted in loss of income for the law office, the appellant stated he was satisfied that if the time he consumed in management duties had been devoted to performing professional services, it would have produced fees grossing at least $2,000 per month; that, as a result of the administrative duties he performed as the agent of Shultup, his personal professional billings for 1957 decreased but the gross revenue of the law office and his own net professional income increased; and that had he not, as the agent of Shultup, devoted from one-third to one-half of his time to office administration, his own net income from the professional fees of the law office would have been less.

There is no evidence as to how many income producing hours the appellant applied to his law practice in 1957 and in the years prior thereto. Also lacking is evidence as to the

gross income of the office and the net professional income of Mr. Shulman in the years prior to 1957. His testimony, couched in general terms, as to the increase, because of his efforts as the agent of Shultup, in the gross revenue of the office and in his own professional income has not, however, been contradicted.

Payment of a management fee is not objectionable, *per se*. In the absence of special circumstances the payment of such a fee is an expenditure deductible in accordance with accepted business practice. The employment of an office manager, sometimes a chartered accountant, is not unusual in law offices having a volume of business necessitating a staff of employees and an accounting system requiring more supervision that any lawyer in the office can exercise without encroaching on time he should devote to revenue producing professional services. In some cases a managing partner supervises the office manager. In the case at bar the appellant chose to incorporate a company to assume the responsibility of the office management and then chose to perform the duties pertaining to such management himself, as the agent of the company.

I attach no importance to the fact the management agreement was a departure from the previous office management procedure of the appellant. The fact the $9,500 was not paid to Shultup until December 27, just before the taxation year end, has not in my view, any special significance. The 1957 profit of the law office would not be ascertained at that date. I do not regard the payment to Shultup as being a distribution of profits. Shultup had no right to participate in the profits earned by the law office.

In view of the uncontradicted evidence of Mr. Shulman, I am not prepared to find the provisions of section 12(1)(*a*) demand the dismissal of the appeal. According to Mr. Shulman's testimony the duties he performed as the agent of Shultup had a direct relation to increasing the income of the office and his own professional income. In such circumstances I am unable to find payment of the management fee, standing by itself, was not an outlay or expense that can be justified on the ground of having been made in accordance with the ordinary principles of commercial trading or

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accepted business practice. Despite the nature of their relationship, the appellant and Shultup are separate legal entities.

It is obvious that when the management agreement was executed the appellant did not expect he, as the agent of Shultup, would spend all his working hours in attending to the requirements of office management. Had he had any such expectation, the monthly management fee would have been, at least, double and there would have been some provision for his personal remuneration. It may be a competent full time office manager could have been secured at a salary less than $2,000 per month and a part time manager for less than $1,000 per month. Mr. Shulman has sworn he would have welcomed the opportunity to obtain a competent manager capable of controlling his professional staff; that he would have had to pay to a competent manager of Shultup, other than himself, a salary approximating $1,000 per month; and that he had not been able to obtain such a manager. There is no evidence as to the scale of salaries competent office managers command in Vancouver. There is the testimony that results were nil from an office manager paid a salary of $350 per month. In the circumstances there is no foundation on which I can apply section 12 (2) and apportion the extent to which the management fee was reasonable in the circumstances. It must stand or fall in its entirety.

The disposition of the appeal, in my view, rests on section 137 (1). On behalf of the appellant it was urged the words "made or incurred in respect of a transaction or operation" in subsection (1) add nothing to its meaning and that the subsection should be read as though they were not included therein. Counsel for the appellant further submitted the word "that" in the phrase "that if allowed" should be construed not as relating to the immediately preceding words "transaction or operation" but as relating to the words "a disbursement or expense". The meanings to be ascribed to the words "unduly" and "artificially" also were the subject of argument.

While the language of section 137 (1) is not as clear and explicit as, on first examination, it appears to be, I do not regard any of it as surplus.

In my opinion the word "that" relates to "deduction". I interpret "unduly" as relating to quantum and meaning "excessively" or "unreasonably". In the context found here, "artifically" means "unnatural",—"opposed to natural" or "not in accordance with normality".

I construe subsection (1) as though it read:

> In computing income for the purpose of this Act no deduction that if allowed would unduly or artificially reduce the income may be made in respect of a disbursement or expense made or incurred in respect of a transaction or operation.

In considering the application of section 137 (1) to any deduction from income, however, regard must be had to the nature of the transaction in respect of which the deduction has been made. Any artificiality arising in the course of a transaction may taint an expenditure relating to it and preclude the expenditure from being deductible in computing taxable income.

In my opinion, the primary object of injecting Shultup into the management setup was to reduce the income tax payable by the appellant on his professional income. Had the main objective of the appellant not been so to order his affairs as to reduce tax, he would have drawn some salary as compensation for the time spent on management duties as the agent of Shultup. The intention of the appellant would appear to have been to forego any salary for the time spent on management duties and obtain remuneration for having performed such duties by way of any capital gain which might result from using the tax savings to build up the assets back of the issued shares in the capital stock of Shultup.

The non-payment of any direct remuneration to the appellant for the services performed as agent for Shultup is opposed to the usual and natural relationship existing between a company and an agent who devotes from one-third to one-half of his time to the business of the company. The dividing line between the appellant as the owner of the law practice and the appellant as the agent of Shultup was so thin as to be invisible to his own employees. By a simple exercise in mental acrobatics the appellant was able to move, at will and instantaneously, over, or through, that invisible line. The transition from one capacity to the other could be

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effected without anyone other than the appellant himself being aware it had occurred. As he put it, "From the point of view of the employees they were not aware of any change".

The manner in which the management agreement was implemented cannot be regarded as natural. Shultup was used as a two way conduit pipe through which to withdraw $9,500 from the operating revenue of the law office and then return $9,000 of that withdrawal to the law office treasury as a loan for use as urgently needed working capital. That is clearly an artificial transaction. Mr. Shulman cannot loan money to himself.

Notwithstanding the separate entities of the appellant and Shultup, the uncontradicted testimony of the appellant and the fact his credibility has not been attacked, I, after most careful consideration, have reached the conclusion that, having regard to the primary object of creating Shultup to assume the functions of office management being, in my view, to reduce tax, the manner in which the management agreement was implemented and the non-payment of any salary to Mr. Shulman for the management duties he performed, the procedural mechanics of

(a) the December 27, 1957 payment of the $9,500.00 fee;

(b) the application of $9,000.00 of such payment to reduction of the indebtedness of the company to the appellant; and immediately thereafter

(c) the return of $9,000.00 to the law office treasury by way of "a loan" from the appellant to himself

add up to an artificial reduction of the taxable income of the appellant by the sum of $9,500.

The appeal will be dismissed, with costs.

Judgment accordingly.