1962
Oct. 16
1963
May 14

BETWEEN:

DERBY DEVELOPMENT CORPORATION ..... APPELLANT;

AND

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

Revenue—Income tax—Income Tax Act R.S.C. 1952, c. 148, ss. 15(1), 27(1)(2), Quebec Civil Code Arts 1830 and 1831—Contractor to receive fixed fee and twenty-five per cent of any profits for construction of houses in agreement with appellant—Losses fully deductible from taxable income—Profit sharing venture in construction business—Agreement not a partnership agreement—Interpretation of contract—Contract one of principal and agent—Appeal allowed.

Appellant with head office in Montreal, Quebec, was engaged in the business of building houses for sale. He entered into an agreement with a construction company whereby the two would carry on a contracting and construction business. Appellant was to obtain suitable land, subdivide it and arrange financing and sell the homes erected by the contractor who would be reimbursed for all costs and receive a fixed annual fee of $5,000 plus 25% of the profits after payment of a stated salary to a member of appellant's staff. Appellant was to receive 75% of the profits. Losses were incurred which led to the termination of the contract by mutual consent, after 26 months. The total losses were borne by the appellant and it deducted these losses from its income as provided in s. 27(1)(*e*) of the Act. These claimed losses were reduced by 25% by the Minister who contended that the agreement between appellant and the contractor was a partnership one and that losses should be apportioned in the same manner as the profits. An appeal to the Tax Appeal Board was dismissed and a further appeal was taken to this Court.

Held: That the appeal be allowed.

2. That the agreement between the appellant and the contractor was not a partnership agreement but rather a contract for the lease and hire of services or one of principal and agent, that the parties never intended

a partnership and their conduct confirmed that their intention was not to do so.

3. That the agreement did not constitute a partnership agreement.

APPEAL under the *Income Tax Act*.

The appeal was heard before the Honourable Mr. Justice Kearney at Montreal.

Harry Aronovitch for appellant.

Paul Boivin, Q.C., and *Rolland Boudreau* for respondent.

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

KEARNEY J. now (May 14, 1963) delivered the following judgment:

This is an appeal from a decision of the Tax Appeal Board, dated January 8, 1962[1], dismissing the appellant's appeal from a reassessment of its declared income for its taxation year 1959, notice of which was given by the Minister on August 23, 1960, and whereby losses incurred in the construction and sale of homes, amounting to $134,667, during the years 1956 to 1959, inclusive, and claimed in full as deductions by the taxpayer, were disallowed to the extent of 25% thereof or $33,667.

The appellant's income tax return for the year 1959 discloses taxable income amounting to $146,184.74, from which it deducted as a loss the sum of $55,197.08 which included a balance of loss carried forward from the aforesaid previous years, thereby reducing its taxable income to $90,987.66. As a result of the above-mentioned disallowance of $33,667.01, the appellant's taxable income was raised to $124,654.67, thereby adding $13,220.18 to its tax otherwise payable for the said year.

The appellant objected to the said reassessment but on reconsideration the Minister confirmed it on the grounds that the said losses resulted from what constituted a partnership agreement entered into on April 26, 1955 between the appellant and J. H. Smith Construction Co. Limited (hereinafter referred to as "Smith Co.") which stipulated that the profits were to be shared to the extent of 75% by the appellant and 25% by Smith Co. and

[1] 28 Tax A B.C. 221.

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that as consequence losses, although not specifically referred to in the agreement, must be borne by the parties in like proportions.

The appellant denies that the agreement in question constitutes a partnership and submits that it is a management contract entailing lease and hire of services. It also submits alternatively that, even assuming a contract of partnership existed, as claimed by the respondent, nevertheless the appellant was justified in deducting the entire losses incurred, *inter alia,* because it was required to pay them, since Smith Co., which became a declared bankrupt in 1959, was not at any time in a position to pay any portion of them. Consequently, the appellant is entitled to write off as worthless any claim which it might have against Smith Co. to the extent of $33,667.01 and this Court should refer the record back to the Minister to be dealt with accordingly.

The respondent concedes that should it be found that the agreement does not constitute in law and in fact a partnership the appellant is entitled to succeed.

The record for the purposes of the present appeal consists of the evidence of one witness, M. J. Prupas, C.A., who was the auditor of both the appellant and Smith Co. and was heard on behalf of the appellant, together with the transcript of proceedings and the exhibits filed before the Tax Appeal Board.

There is no dispute as to the facts and no disagreement as to the amounts of losses and profits involved.

Counsel also agree that ss. 15(1) and 27(1)(*e*) of the *Income Tax Act* are relevant to the issues and that in order to determine the nature of the agreement recourse must be had to the civil law of the province of Quebec.

The agreement is short and reads as follows:

WHEREAS the Parties hereto desire to associate themselves for the purpose of carrying on a contracting and construction business;

WHEREAS the Parties have agreed upon terms and conditions subject to which their enterprise will be carried on;

NOW THEREFORE IT IS AGREED AS FOLLOWS:

1. That the Party of the First Part will secure suitable land, and will arrange for the subdivision of such land, and the financing, mortgages and sale of the houses and other buildings to be erected thereon, such land to be vested in and belong to the Party of the First Part;

2. That the Party of the Second Part will manage the execution of the said project, carry on the work of construction, supervise all field opera-

tions, set up efficient construction systems, and perform all services, technical and otherwise, that may be required, and keep books of account and cost records in connection therewith. The books of account shall be the joint property of both parties, and accessible to either at any time. The books and accounts shall be audited periodically by an accountant named by the Party of the First Part;

3 That before entering upon any such project, the suitability and cost of such land, as well as the commission to be paid on sales of the buildings to be erected, shall be agreed upon by both Parties hereto;

4. That should opportunities arise, the Party of the First Part shall secure contracts for the construction of buildings, roads and public works;

5. That no bids for such work and no contracts for same shall be entered into without the consent of both Parties;

6 That the execution of such contracts shall be similarly managed by the Party of the Second Part;

7. That the Party of the Second Part shall, while the present agreement is in force, engage in no other activity or enterprise, and shall work exclusively for and with the Party of the First Part;

8. That the present agreement shall be for a period of five years from this date, subject to termination by the Party of the First Part upon giving three months notice in writing to the Party of the Second Part;

9. That the Party of the First Part will reimburse the Party of the Second Part all its disbursements in carrying out the work hereinabove described, together with an annual fee of $5,000 00. Said disbursements shall include rent of office space and salaries to staff required, such staff however, to be engaged after consultation with, and consent of the Party of the First Part;

10. That the profits from the said enterprise shall then be divided in the following proportions:—

To the Party of the First Part, Seventy-five per cent (75%);
To the Party of the Second Part, Twenty-five per cent (25%). The Party of the Second Part shall be allowed to draw on account of such profits the sum of Four hundred dollars ($400 00) per month.

11. That before such profits are so divided, provision shall be made for taxes, and there shall be deducted as an expense a salary of $100.00 per week to a representative of the Party of the First Part.

12. That the Party of the First Part guarantees to the Party of the Second Part a minimum of $10,000 00 to include fee and share of profit, for the first twelve months of the present agreement, or lesser period if notice of termination be given in accordance with paragraph 8 hereof.

Before proceeding with the examination of the legal aspect of the case, the following further facts are worth noting.

I think I should first observe, in passing, that the appellant was incorporated on May 14, 1954, its head office being in the city of Montreal. Smith Co., which also had its head office in the city of Montreal, was incorporated on March 24, 1955.

Shortly after incorporation, the appellant began, on a modest scale, with the aid of one Wilfrid Bédard, building

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contractor, to erect and sell homes on lands it had acquired. The appellant then increased its land holdings and decided to extend its construction and selling operations, and in furtherance thereof, it entered into the aforementioned agreement. Beginning on May 31, 1955, Smith Co. proceeded to build numerous homes on the lands of the appellant. The appellant relied on the building skill of Smith Co. but apparently the type of homes thus built were not readily saleable at remunerative prices and losses ensued which, in its first year of operations ending May 31, 1956, amounted in round figures to $43,000, and in 1957 exceeded $72,000. As a result, although the agreement contemplated continuance for five years, it was prematurely terminated by mutual consent on July 31, 1957 and the relationship between the parties to the contract was severed. The appellant, however, continued its real estate development and its losses in 1958 on the homes constructed by Smith Co. diminished and in 1959 they practically ceased and in the same year, with its new operations, the Company showed a net profit, as we have seen, of more than $146,000.

For as long as the agreement lasted the appellant, as provided in paragraph 9 of the agreement, paid Smith Co. all costs and expenses incurred by it in carrying out the work it had undertaken, with the result, as appears by statements of operations for 1956 and 1957 Exhibits A^3 and A^4, it experienced neither a loss nor a gain. The evidence does not disclose whether Smith Co. took on any other assignments after the dissolution, but it lingered on until, on October 27, 1959, it went into bankruptcy.

I might here interject that, apart from the appellant, its president, Mr. Ezra Shamoon, signed the agreement in his personal capacity as Party of the First Part. Mr. Jack H. Smith, president of Smith Co., likewise, was made a party, and he and his company are together described as Party of the Second Part. It would appear that Mr. Shamoon, who was a man of means, was made party to the agreement in order to guarantee the performance of the undertakings of the appellant company and that Mr. Smith, who was supposed to supply the building skill, was made a Party of the Second Part in order to guarantee that the Smith Co. would be assured of his personal services. Neither of the two presidents were in any way impleaded nor was it sug-

gested that anything turned on the fact that they were parties to the agreement, and I think the two companies alone can be regarded as Party of the First Part and Party of the Second Part respectively.

Did the agreement in question constitute in fact and in law a contract of partnership?

The first article of the Civil Code with which we are most concerned is Art. 1830, which reads as follows:

> It is essential to the contract of partnership that it should be for the common profit of the partners, each of whom must contribute to its property, credit, skill or industry.

A glance at some of the provisions of the agreement, particularly paragraphs 1, 2 and 10 thereof, suffices to show that one party was to contribute skill and the other credit, and both would participate in profits, and as paragraphs 3 and 5 indicate that the work was to be undertaken by mutual consent, at first sight it would appear that all prerequisites to a partnership have been met and that the appeal must fail. Such a conclusion could only be reached, however, if Art. 1830 is to be read as constituting a definition of the contract of partnership and provided the agreement does not contain other clauses which, as suggested by the appellant, tend to show that we are here concerned with a more common type of contract whereby the appellant hired the services of Smith Co. as manager of construction projects at a fixed fee plus a commission or bonus of 25% of the net profits realized.

Art. 1830 C.C. does not purport to define the contract of partnership nor does it include all the essential elements necessary to constitute such a contract, as stated in Mignault, *Droit Civil Canadien*, vol. 8, p. 81, "Le Code ne définit pas la société." The same author, after discussing the elements of mutual contribution by the parties to the partnership and the right to participate in the benefits to be derived from it, makes mention in the following terms at page 183, *supra*, of another essential element which often serves to distinguish it from the kindred contract of lease and hire of services—namely "l'intention de contracter une société", or (as it is often called by the authors) *affectio societatis*:

> Il ne suffit pas qu'il y ait un apport réciproque ou même un partage de bénéfices, il faut de plus qu'il y ait intention de contracter une société.

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See also:

Affectio societatis discussed Revue Trimestrielle de Droit, 1925, vol. 24, p. 761; notes on element of risk, p. 775.

Bourboin v. Savard[1], Rivard J.:

. . . pour qu'il y ait société, il faut à défaut de contrat exprès, que les faits fassent apparaître clairement, chez l'un et l'autre des prétendus associés, l'intention de former un contrat de société et non pas tel ou tel autre contrat qui peut présenter avec la société plus ou moins d'analogie. C'est à cela que revient ce que les auteurs ont appelé *affectio societatis*.

Pinsky v. Poitras et al.[2], where the importance of the intention of the parties is stressed and where, in this connection, the following admonition is found:

On ne doit pas recourir aux autorités anglaises, vu qu'il semble que les principes du droit anglais sur ce point ne sont pas semblables aux nôtres.

Planiol & Ripert, *Droit Civil,* vol. 11, p. 236:

981. . . .

5° aux quatre éléments énumérés ci-dessus on en ajoute généralement un cinquième consistant dans l'*affectio societatis,* c'est-à-dire l'intention de former une société ou, de façon plus exacte et plus précise, la volonté de coopérer en acceptant délibérément certains risques. C'est parfois sur l'absence de cet élément que l'on s'est oppuyé de façon prépondérante pour refuser le titre d'associé l'employé ou au prêteur d'argent participant aux bénéfices. . . .

Dalloz, *Nouveau Répertoire,* vol. IV (S-W), p. 156:

106. Pour qu'il y ait contrat de société, il faut, en troisième lieu, que toutes les parties contractantes aient consenti à former entre elles une *société,* et non pas tel ou tel contrat présentant avec la société plus ou moins d'affinité (prêt, ou louage de services, accompagné d'une clause de participation aux bénéfices, par exemple).

110. La société se distingue, en particulier, du *contrat de travail avec participation aux bénéfices,* dans lequel l'employé conserve une situation subordonnée et ne contribue pas normalement aux pertes de son patron.

Laurent, *Droit Civil Français,* vol. 26, p. 152:

. . . Il est incontestable que la participation aux bénéfices éventuels d'une entreprise est de l'essence de la société, et que sans cette participation il n'y a pas de société possible. Mais de là il ne faut pas conclure que toute convention dans laquelle se rencontre cet élément constitue nécessairement une société. Il y a d'autres éléments dont il faut tenir compte. La cour de cassation les énumère dans un arrêt rendu sur le rapport de M. Bau: «Le contrat de société exige comme conditions essentielles de sa formation l'intention des parties de s'associer, une chose mise en commun, et la participation aux bénéfices et aux pertes de l'entreprise.»

[1] 40 R.J.Q. (B.R.) 68, 71. [2] 44 R. de J. 63 at 74.

Furthermore, in endeavouring to ascertain the true intent and meaning of the type of agreement here in issue consideration, I think, must be given to such additional factors as the language in which it is couched; whether and to what extent mutually shared elements of speculation or risk exist; the extent of inequality, if any, of the authority which it vested in the parties; and the *de facto* conduct of the parties in giving effect to the agreement. See notes and authorities, beginning with paragraph 2 on page 337, in *Traité de Droit Civil du Québec,* Trudel Series (Hervé Roch and Rodolphe Paré), vol. 13.

Speaking of the rule of interpretation where the language of a convention is doubtful or obscure, in *Dufort v. Dufresne*[1] Duff J. (as he then was) said:

> The rule of interpretation for such a case (in substance it is the same in the province of Quebec as in France), seems to be well settled. Where the language of a private convention is doubtful or obscure, to quote Huc, *Commentaire du Code Civil,* vol. 7, Art. 175,
>
> «le juge doit, avant tout, rechercher quelle a été la commune intention des parties pourvu cependant que cette intention paraisse douteuse. Cette intention peut d'ailleurs être recherchée, en dehors de l'acte, dans d'autres écrits et les circonstances de la cause. Comme aussi l'exécution donnée par les parties à une convention en sera souvent le meilleur interprète.»

After the above-mentioned quotation, the learned Judge goes on to say:

> The authorities recognize in the most explicit way the principle adverted to in the concluding words that the conduct of the parties in the execution of a contract expressed in doubtful language affords a very important clue to their real intention.

In my opinion, the following provisions of the agreement indicate that we are here concerned with a contract of lease and hire of services, or one of principal and agent, rather than partnership. Paragraph 1 makes it clear that the title to the ownership of the homes to be erected was vested solely in the appellant. Paragraph 7 states that the Party of the Second Part, during the continuance of the agreement, shall engage in no other activity or enterprise and shall work exclusively *for* and with the appellant (emphasis supplied)—which signifies the notion of master and servant and the subservience of the Party of the Second Part to the appellant. This, I think, is accentuated by the fact that the Party of the First Part was in no way

[1] [1923] S.C.R. 130, 131.

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bound to give its whole or any designated part of its time and attention to the enterprise referred to in the agreement.

The above observations, I think, are equally apposite in respect of paragraph 8, wherein the Party of the Second Part was firmly bound for a period of five years and could not earlier terminate the agreement, except for cause, and such dominant right was reserved to the Party of the First Part.

By paragraph 9 the Party of the First Part undertook, in addition to paying all expenses incurred by the Party of the First Part in the enterprise, to pay an annual fee of $5,000 to the Party of the Second Part. In short, the Party of the Second Part was insured against losses and guaranteed a remuneration of $5,000 per annum.

Paragraph 12 goes even further and it guarantees for the first twelve months, or such shorter time as the agreement might be in effect, that the Party of the Second Part will receive, *as a minimum,* $10,000, to include fee and share of the profits, if any, which meant that, if profits exceeding $5,000 were realized, the Party of the Second Part, in addition, would be entitled to 25% thereof, and if losses, regardless of the amount, were incurred, it would, nevertheless, be remunerated to the extent of $10,000.

The foregoing provisions serve to indicate, I think, that rather than being a partner in the accepted sense of the term, the Party of the Second Part, which, it is admitted, had no financial resources to speak of, who had only skill to offer, accepted a subservient role in consideration of guaranteed payment of services and repayment of all its disbursements, including materials and operating costs, in carrying out the work. Thus, during the 26 months which the agreement lasted Smith Co. received about $16,000 as remuneration for services, without any risk of having to pay losses incurred in the event that the costs of construction and sale of the houses exceeded their realizable market value, while, at the same time, retaining the right, if the enterprise prospered, to share in any profits which might be realized. Insofar as consultation and consent is concerned, as the agreement did not provide any arbitration clause if Smith Co. failed to give its consent the agreement was heavily loaded in favour of the appellant since the right to terminate it was vested in him alone.

It appears to me unlikely that the Party of the Second Part intended to enter into an agreement which, according to the respondent, *inter alia* entailed the assumption vis-à-vis third parties of losses to which it could not put an end in less than five years and which it was in no position to pay. By the same token, it is unreasonable to suppose that the Party of the First Part, who was underwriting all losses, would not reserve the sole control of bringing the enterprise to an end at any time on three months' notice.

Apart from seeking to ascertain the intention of the parties as reflected in the wording of the agreement, it is important, as stated earlier, to examine the manner in which it was treated by the parties.

In the above connection, counsel for the respondent drew attention to the fact that Exhibit A[2], which brought about the cancellation of the agreement, mentions that it was "subject to a rendering of accounts between them, all Parties reserving such rights and recourses as to them in law and justice appertain in the premises." I do not think such clause, which is not uncommon, serves to indicate the existence of any particular type of agreement. In the instant case it would serve to cover such contingencies as unfinished construction or prior commitments signed by Smith Co. for undelivered material or labour yet to be furnished and the unpaid proportion of the $5,000 fee payable to the said Company.

As appears from the testimony of M. J. Prupas, C.A., he was auditor for the appellant before he had any dealings with Smith Co. and, as it was privileged to do, the appellant appointed him as the auditor of the latter Company. The auditor recognized that the agreement was expressed in doubtful language, and on being informed, after consultation with the parties, that Smith Co. was acting in the capacity of a general contractor, he accordingly set up the books of the said Company to reflect the existence of a contract of lease and hire of services.

The evidence before this Court is that which was filed by consent and nowhere does it appear that either of the parties to the agreement held out to the public that by registration, as required by Art. 1834 of the Civil Code, or otherwise a partnership existed between them. Apparently,

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the subcontractors who dealt with Smith Co. knew only Smith Co. and the purchasers of homes from the appellant only knew and dealt with the latter.

In the *Dufort* case *(supra)*, the Court in coming to the conclusion that a partnership existed was influenced by the fact that the parties repeatedly described their contract and themselves by the words "société" and "associé", which are the French equivalent of "partnership" and "partners". Mignault J. (p. 136):

> Après avoir examiné le contrat du 1er septembre 1912, je suis d'avis que c'est un contrat de société. Les parties déclarent expressément qu'elles consentent à se mettre en société, et les mots «société» ou «associés» sont répétés presque à chaque clause. Sans doute les termes dont les parties se servent pour désigner le genre de contrat fait par elles ne constituent pas toujours un indice infaillible de la nature juridique de ce contrat, mais cela aide beaucoup à découvrir quelle a réellement été leur intention, et si les conventions peuvent se concilier avec la description que les parties en ont faite, cet indice peut être accepté comme décisif par les tribunaux.

Nowhere in the instant agreement did the parties to it make use of the words "partnership" or "partner". The nearest approach to doing so is a single instance in the opening paragraph which states, "The parties hereto desire to *associate* themselves for the purposes of carrying on a contracting and construction business." The words "associate" and "association" are generic and have a much wider meaning than "partner" or "partnership", and although they may include the latter they may also signify a mere companion or companionship.

Counsel for the respondent, in support of disallowance by the Minister of the 25% of the losses which he claimed should be charged to Smith Co. and cannot be claimed by the appellant, refers to Art. 1831 C.C. and comments thereon by Mignault.

> Art. 1831. Participation in the profits of a partnership carries with it an obligation to contribute to the losses.
>
> Any agreement by which one of the partners is excluded from participation in the profits is null. An agreement by which one partner is exempt from liability for the losses of the partnership is null only as to third persons.

Mignault at page 212 *(supra)*, states:

> ... Il est évident que les parties peuvent régler ce partage comme elles l'entendent, à la condition toutefois de ne point accorder tous les bénéfices à l'un des associés ou d'en priver entièrement l'un d'eux (art. 1831). Si elles établissent une règle pour le partage des bénéfices, sans parler des pertes, celles-ci se partageront dans la même proportion.

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As pointed out, however, by the same author at p. 184, Art. 1831 has no application to agreements other than a partnership, and in order to make it applicable, one must necessarily suppose the existence of a partnership. For the reasons already mentioned, in my opinion, it is established that the agreement in issue did not constitute a contract of partnership, that the parties to it never intended to enter into such an agreement and their conduct serves to confirm that their intention was not to do so.

In view of the above-mentioned conclusion, I find it unnecessary to deal with the appellant's subsidiary submission—namely that even if a partnership did exist the appellant was entitled to regard the $33,667 owing by Smith Co. as uncollectable and that the decision of the Minister to disallow it as a deduction should be set aside and the record referred back to the respondent for revision accordingly.

The appeal is consequently allowed with costs and the record will be accordingly referred back to the Minister for the purpose of reassessment.

Judgment accordingly.