J. D. STIRLING LTD ..... APPELLANT;

AND

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

Ottawa 1969
May 22
June 4

Income tax—Business income, computation of—Forgiveness of trade debt—Whether taxable.

Appellant company carried on a contracting business in relationship with the *M* company, which supplied materials and sometimes acted as subcontractor or joint contractor on various jobs. The *M* company held 224 of the 400 shares of appellant, the remainder being held by *S*. In 1961, following acquisition of the *M* company by a foreign company *S* purchased the *M* company's 224 shares in appellant. Under the purchase contract appellant was forgiven its indebtedness to the *M* company of $250,789, the net balance of the contra accounts of the two companies for the three preceding years.

Held, appellant was not taxable in 1961 on the $250,789 so forgiven by the *M* company in that year.

British Mexican Petroleum Co. v. Jackson 16 T.C. 570; *Oxford Motors Ltd v. M.N.R.* [1959] S.C.R. 548, referred to.

Semble: If a man carrying on a business asserts claims in a particular year for goods sold or services rendered in a previous year over and above anything that he may have charged for those goods or services in the year in which they were delivered or sold, and manages to collect such additional amounts even though he has no legal right to do so, the amounts so collected are revenues of his business for the year in which they are realized even though the profits of his business are otherwise computed on a so-called accrual basis.

INCOME tax appeal.

R. deW. MacKay, Q.C. and *Brian Crane* for appellant.

A. Garon, Q.C. and *G. J. Rip* for respondent.

JACKETT, P.—This is an appeal from a re-assessment of the appellant under Part I of the *Income Tax Act* for the 1961 taxation year. The sole question in issue is whether the respondent was wrong in including in the appellant's income for the year an amount of $250,789.43, which is described in the Statement of Adjustments to Declared Income attached to the re-assessment as "Capital gain denied".

For some years prior to the taxation year, the appellant was a corporation whose shares were held as follows:

Miron et Frères Ltée	224
J. D. Stirling	176

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At that time, the company carried on a contracting business under the immediate management of Mr. Stirling and, in the course of that business, had continuing business relations with Miron et Frères Ltée who was a supplier of material to the appellant and acted as subcontractor to the appellant in connection with some jobs and carried on other jobs with the appellant under joint venture arrangements. At that time, the shares in Miron et Frères Ltée belonged to a number of brothers whose surname was Miron, and those gentlemen and Mr. Stirling carried on matters between the two companies in an informal way.

As a result of the business relations between the appellant and Miron et Frères Ltée during the 1959, 1960 and 1961 taxation years of the appellant (which ended on June 30 of each year), there were debts or obligations owing by the appellant to Miron et Frères Ltée and debts and obligations owing by Miron et Frères Ltée to the appellant[1] still outstanding on November 30, 1960, as follows:

Appellant owed Miron et Frères Ltée	$532,711 06
Miron et Frères Ltée owed appellant	281,921.63
Net balance owed by appellant to Miron et Frères Ltée	250,789.43

In May 1960 the Miron brothers sold their shares in Miron et Frères Ltée to a company owned and controlled by La Société Générale de Belgique.

On January 30, 1961, Mr. Stirling bought from Miron et Frères Ltée its 224 shares in the appellant company. The agreement to buy such shares was contained in a letter written to, and accepted by, Miron et Frères Ltée, which letter contained a number of special terms including the following:

> (6) I, and Stirling Ltd, and St. Clair hereby grant to you and your parent, associated and/or subsidiary companies and Miron Cement Inc., and members of the Miron family, and Cimenteries et Briqueteries Réunis, a full final and complete release and discharge of and from all obligations and indebtedness existing at November 30th, 1960, and from any and all actions, claims and demands existing at that date (including without limiting the generality of the foregoing any claims that I, Stirling Ltd., or St. Clair may have for consulting, design, engineering or other services in connection with the cement plant,

[1]Some of these were originally owing to or owing by a wholly-owned subsidiary of the appellant called St. Clair Products & Equipment Ltd.

excepting those expenses already invoiced and paid), except the rights and obligations under existing joint venture agreements.

Reciprocally you and your parent, associated and/or subsidiary companies hereby grant to me and Stirling Ltd., and St. Clair a full final and complete release and discharge of and from all obligations and indebtedness existing at November 30th, 1960, and from any and all actions, claims and demands existing at that date, except for the rights and obligations under existing joint ventures, and except the obligations of me and Stirling Ltd., and St. Clair under Clause 3 hereof.

At the end of the letter agreement appear the words, "We confirm the foregoing insofar as we are respectively concerned", followed by what purport to be signatures on behalf of the appellant and of its subsidiary company.[2]

On September 29, 1961, the appellant's income tax return for the 1961 taxation year was filed and the statement of earned surplus that forms part of the financial statements attached thereto contains an item reading:

Earned Surplus arising from Forgiveness of Debt with Creditors $250,789 43

The auditor's letter to the appellant's shareholders, which also forms part of such financial statement, contains, *inter alia,* a paragraph reading as follows:

We have accepted a legal opinion from company council (*sic*) wherein it has been indicated to us that the $250,789 43 gain arising from a forgiveness of debt with creditors represents non-taxable revenue.

The reference in the Statement of Adjustments to Declared Income to "Capital gain denied" (referred to in the opening paragraph of these reasons) is presumably a reference to these two portions of the financial statement attached to the appellant's Income Tax Return for the taxation year.

By its notice of appeal, after referring to the other facts outlined above, the appellant refers to the agreement of November 30, 1960, as follows:

12. On or about November 30, 1960, it was decided between Appellant and Miron et Frères Ltée, that settlement should be made of the contra accounts above referred[3] to and, accordingly, by written agreement dated January 30, 1961, a copy of which will be produced at the Hearing hereof, Appellant and Miron et Frères Ltée entered into an agreement whereby each gave to the other a complete release and discharge of and from all obligations and indebtedness existing at November 30, 1960, with the consequence that the said net balance

[2] No doubt has been raised as to the validity of this agreement or as to its being binding on the appellant.

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of indebtedness of $250,789.43 (the capital gain denied by the assessment in respect of the 1961 taxation year of Appellant) was in effect forgiven by Miron et Frères Ltée to Appellant.

The appellant's notice of appeal states its reason why the appeal should be allowed as follows:

> 13 Appellant alleges that the said capital gain denied in respect of its taxation year 1961 in the amount of $250,789 43 constitutes a forgiveness of debt by Miron et Frères Ltée as a result of an offer of settlement at the time of their ceasing to carry on joint ventures, which cessation arose from the change of ownership of Miron et Frères Ltée and properly constitutes a "windfall" or capital gain.

The respondent's reply contains the following allegation of fact:

> 4. In making the assessment for the 1961 taxation year, the Respondent assumed that:
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> (*a*) the sum of $250,789.43 which the Appellant claims was the net balance of accounts payable by Appellant to Miron et Frères Ltée, actually represented overcharges in ordinary contracts in the carrying on of its business by its majority shareholder, Miron et Frères Ltée, in various joint and other projects during the Appellant's taxation years ending June 30, 1959, June 30, 1960, and June 30, 1961, and which overcharges were intimately related to the Appellant's earnings in the said years, and which reduced the Appellant's income for these years, and that the reconciliation of the said sum constitutes income to the Appellant for 1961 within the meaning of sections 3 and 4 of the Income Tax Act.

and sets out the respondent's reasons as follows:

> 6 The Respondent states that the $250,789 43 from which the Appellant was released by Miron et Frères Ltée, constituted income to the Appellant for 1961 within the meaning of sections 3 and 4 of the Income Tax Act
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> 7. The respondent states that the $250,789 43 constituted overcharges by Miron et Frères Ltée, to the Appellant in the ordinary course of operations of their joint and other projects while carrying on business during the Appellant's 1959, 1960 and 1961 taxation years, and was a reduction in the course of its operations of the excessive costs to the Appellant to a fair and equitable sum which overcharges were intimately related to the Appellant's earnings in the said years, and which reimbursement of the overcharges represented income to the Appellant in the year 1961 within the meaning of sections 3 and 4 of the Income Tax Act.

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[3] The "contra accounts above referred to" are, apparently, the amounts on the books on November 30, 1960, according to which the appellant had accounts payable to Miron et Frères Ltée in the aggregate amount of $532,711.06, and Miron et Frères Ltée had accounts payable to the appellant aggregating $281,921 63. See paragraph 8 of the notice of appeal.

At the hearing of the appeal evidence was adduced from which it appeared that, following the change in control of Miron et Frères Ltée from the Miron brothers to the Belgium company, it became clear to both Mr. Stirling and the new management of Miron et Frères Ltée that the old method of carrying on business in a close and informal relationship had to come to an end and that some change in the ownership of the appellant's shares would be expedient. Mr. Stirling thereupon instructed an officer of the appellant to prepare, as a "ploy" to be used in the inevitable negotiations between him and Miron et Frères Ltée, such "claims" by the appellant against Miron et Frères Ltée as could be built up from the situations that had arisen out of the imprecise business relations that had existed between the appellant and Miron et Frères Ltée.

Claims were prepared accordingly, totalling $410,679.89. A large proportion of these "claims" were claims, to be put forward by Mr. Stirling on behalf of the appellant, that settlements previously made between the two companies involved allowances by the appellant to Miron et Frères Ltée of amounts on current account that were larger than they should have been from the point of view of what was fair and just, or claims that Miron et Frères Ltée should pay to the appellant amounts for services rendered by the appellant to Miron et Frères Ltée in respect of which no claim for payment had previously been made. Included in the claims, however, were, in addition, other amounts such as amounts which, if they had been collected, would have been received on capital account (*i.e.*, payments for office furnishings).

These claims, according to the evidence, while they were regarded by the officer who prepared them for the appellant as having "no foundation in fact", were taken seriously by officers of Miron et Frères Ltée other than the Miron brothers (who would have been best qualified to appraise them but were no longer available to do so); and such officers concluded that, while some of such claims were without any foundation, there was a substantial amount of merit in others. In addition, there were other possibilities,[4]

[4] Reference was made to a possibility that the appellant might claim to be entitled to a percentage of the cost of a cement plant built by Miron et Frères Ltée for engineering services provided by the appellant for which no charge had been made.

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according to an officer of the Miron company, of claims by the appellant for payments for services not included in the prepared "claims" which, while of little merit, involved such large amounts that they could not be overlooked in considering any settlement of claims between the two companies.

During the course of negotiations toward the agreement under which Mr. Stirling became the owner of all the shares in the appellant, the management of Miron et Frères Ltée reached the conclusion that these claims put forward on behalf of the appellant as a bargaining "ploy", taken with the other potential claims to which I have referred, should be regarded as roughly equivalent to the balance of accounts payable according to the books by the appellant to Miron et Frères Ltée, in the sum of $250,789.43, and the result was that the agreement for mutual releases quoted above was included in the ultimate agreement.

Clearly, the release of a debt (such as the sum of $250,789.43 that was the balance of accounts as between the two companies in this case as it appeared from their respective books) does not of itself give rise to revenue from the debtor's business even though the amount released is a debt that has been taken into account as an expense of that business. See *British Mexican Petroleum Co. v. Jackson.*[5] A release of a trade debt may, however, be a means of effecting a payment that is part of the current revenues of a business. Compare *Oxford Motors Ltd. v. M.N.R.*[6]

The respondent does not however, by its reply, contend that there is any such basis for treating the sum of $250,789.43 as revenue of the appellant's business. What he says, in effect, as I understand the meaning of the reply according to the submission of counsel for the respondent during argument, is that Miron et Frères Ltée had, during the three specified years, charged the appellant certain amounts in excess of the contract prices (overcharges), that these overcharges, which had become reflected in the books of both companies, were subsequently discovered by the appellant who had persuaded Miron et Frères Ltée to agree that they were overcharges and that such "reconciliation" of that amount was income of the appellant in the year in which it was accomplished.

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[5] 16 T.C. 570.

[6] [1959] S.C.R. 548.

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I do not find that this view of the facts is supported by the evidence. In so far as the claims asserted by way of "ploy" are in respect of alleged "overpayments" by the appellant to Miron et Frères Ltée, all the evidence is that the amounts originally agreed on and taken into the books were in accordance with "contract", and the "validity" of the claim, if any, was based only on a sense of what was fair as between persons who had been operating in a close and informal relation and not on an understanding of the contractual relations between the parties. Other claims were claims asserted for services rendered, which claims do not appear to have been asserted previously. These claims could in no sense be regarded as claims for adjustment of an "overcharge". I have heard no evidence that suggests to me that anything in the whole list of claims prepared as a "ploy" could be regarded as a claim to redress an overcharge in the sense of a payment or allowance of an amount in excess of what was payable in accordance with contract.[7]

The difficult question on the facts in this case, although I am doubtful that it arises on the pleadings, is whether the appellant derived income in the year in question by the assertion of, and collection of, claims on revenue account. I have no doubt that, if a man carrying on a business asserts claims in a particular year for goods sold or services rendered in a previous year over and above anything that he may have charged for those goods or services in the year in which they were delivered or sold, and manages to collect such additional amounts even though he has no legal right to do so, the amounts so collected are revenues of his business for the year in which they are realized even though the profits of his business are otherwise computed on a so-called accrual basis. If I had come to the conclusion that that is what had happened in this case, I would be inclined to give the parties an opportunity, if they so desired, to amend their pleadings on appropriate terms.

[7] If there had been on the facts any such "reconciliation" of overcharges in previous years, it would have been a question whether it could be taken into income for the taxation year of the reconciliation or whether it would have had to be taken back to the various years of overcharge. On the view I take of the facts, however, that question does not arise in this case.

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In this case, however, there was no payment as such of the claims asserted by the appellant in 1960-1961 against Miron et Frères Ltée and the difficult question as to whether the giving of a release by Miron et Frères Ltée of its claim against the appellant was a means adopted of making such a payment was not raised by the pleadings, and neither any part of the evidence nor any part of the cross-examination was directed to such question. In the circumstances, it would, in my view, be unjust to make a finding that there was any such payment.

Furthermore, any possibility that I might have concluded that this is a case where there should, at this stage, be an opportunity to apply for an amendment to pleadings with a possibility of a new trial is obviated in my mind by the fact that the respondent had ample opportunity on discovery, by questions obviously arising from the issues that were pleaded, to ascertain the facts that had not previously appeared on the record and could, then, if he had chosen to do so, have taken steps to amend the pleadings before trial.[8]

The appeal will be allowed and the assessment will be referred back to the respondent for reassessment on the basis that the amount of $250,789.43 which was added to the "Declared Income" should not have been so added. (There may be consequential adjustments but that direction will be sufficient.) As the appeal is successful, the appellant will be allowed its costs of the appeal.

[8] I have in mind that, as far as appears from the record, the appellant did not reveal the existence of its claims against Miron et Frères Ltée in the sum of $410,679 89 prior to discovery. They should, however, have come to light on examination for discovery if it followed the obvious course.