

BETWEEN:

JAMES GOODFELLOW ROBSON.....APPELLANT;

1951
 Apr. 9
 June 1

AND

THE MINISTER OF NATIONAL }
 REVENUE } RESPONDENT.

Revenue—Income Tax—Income—Income War Tax Act, R.S.C. 1927 c. 97, s. 3—Purchase of shares in a company having earned profits on hand—Object of purchase of shares to obtain distribution of profits—Difference between purchase price and true value of shares is a dividend—Not necessary for purchaser to resell shares in order to attract income tax—Valuation of shares—Appeal dismissed.

On an appeal from assessment for income tax the Court found that the appellant bought shares at a decided under-value from a company that held earned profits and that the object in so buying was to distribute these profits.

Held: That the difference between the price paid for the shares and their true value is a dividend and subject to income tax.

2. That where a party purchases shares that themselves represent a profit the transaction is complete for tax purposes as soon as the shares reach his hands and it does not matter whether he resells them or not.

APPEAL under the provisions of the Income War Tax Act.

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

J. L. Lawrence and *B. W. F. McLoughlin* for appellant.

Dougald Donahy, K.C. and *F. J. Cross* for respondent.

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

SIDNEY SMITH, D.J. now (June 1, 1951) delivered the following judgment:

The appellant appeals from a re-assessment by the Minister of his income for 1944. By this assessment the Minister added \$290,000 to his income for that year. The transaction on which the Minister based his action was as follows:

Appellant was at all times the majority shareholder and managing director of Timberland Lumber Co. Limited, a sawmill company which held half the shares of the Salmon

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River Logging Company Limited. This company supplied the Timberland Company with its logs. It seems to be undisputed that in 1944 the Salmon River Company was nearly out of the type of timber that the Timberland Company used (but not of other types), so that the latter had to open up a new tract of timber, at an expense of something like \$500,000. It had considerable ready money, but lacked \$100,000. It then, in July 1944, sold its Salmon River shares to its shareholders for \$99,000, this sale being claimed by the appellant to have been due to its pressing need for the money. It may be noted that the shares were bought by the shareholders of the Timberland Company, including the appellant, in practically the same ratio as their holdings in the Timberland Company, the slight variation being apparently due to the impossibility of splitting individual shares.

The respondent claims that these shares were sold at a gross under-value, and that in effect the sale was a mere pretence, the real purpose of the transaction being to allow the Timberland Company to distribute the shares among its shareholders as a substitute for a dividend. At the time of the sale the Timberland Company had an earned surplus of about \$700,000; and the respondent claims that the purported sale was merely a shift for distributing part of this surplus in a way that would enable the shareholders to evade income tax. The appellant denies that the shares which were sold for \$100 per share were sold at an under-value, and also argues that even if they were, the profit that he made was a capital profit and not income; and further that until he resold the shares, which was not until 1945, no profit was made; so that, at all events, he was not assessable in 1944.

I think it will be convenient to consider the relative law before I analyze the admitted facts and the evidence. On the facts as claimed by the respondent there can be no doubt that the new Income Tax Act sec. 8(1) (c) would catch the appellant, but he says that there is nothing similar in the Income War Tax Act which governed in 1944. The respondent in answer invokes sec. 18 of the latter Act and also the more general provisions of section 3.

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If the facts are as claimed by the respondent, I have some doubts about the applicability of sec. 18, but I have no doubt that the provisions of sec. 3 would be wide enough to cover the transaction. The Act would have been a dead letter with respect to companies if a company bulging with earned profits, instead of distributing these in cash to its shareholders, could buy with the money, say, a number of motor-cars and distribute them tax free to shareholders; the same would apply to its buying and distributing shares in another company. If that is so, then it cannot be material that the distributing company does not buy the shares expressly for the purpose, but uses shares that it has owned for some time. The same considerations must apply to any variation of the same kind of transaction. If the company cannot give shares away tax free, then what is substantially a gift, such as a pretended sale for a nominal consideration, must be in the same position; and I cannot distinguish between a nominal consideration and an inadequate consideration.

The above conclusion does no violence even to the language of sec. 3 of the Income War Tax Act which includes as income

profits directly or indirectly received . . . from stocks or from any other investment.

If shareholders, because they are shareholders, are given the chance to buy shares in another company at less than their value, and the selling company then has undistributed profits on hand, then I think sec. 3 is applicable, at least on the assumption that the company is intending to distribute the profits. So I have no serious doubt about the taxability of the transaction if the facts are as the respondent alleged. That must be considered with some care.

The appellant admits that fourteen months after he bought (or purported to buy) the Salmon River shares at \$100 he re-sold them to two other companies, viz., Westminster Shook Mills Limited and B.C. Manufacturing Co., at \$750 each. As he himself said in the box, this was quite a "spread"; but he claims that \$100 was a reasonable price on the facts as known in 1944, and the prospects as they then appeared. He also represents the sale as being necessary for the Timberland Co. because it had to have \$100,000 more cash.

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We have here two factors to consider, first, the adequacy of the price, and secondly, the *bona fides* of the sale; though of course the two have a bearing on each other.

One of the appellant's chief explanations of the price was that the sale was made in the middle of a war, and also that he feared a post-war depression such as he said took place in 1921. I do not find this very convincing. It is general knowledge that the war period, at all events part of it, was an extremely prosperous one for both logging and milling companies, and in July, 1944, the end was not so clearly in sight that anyone had begun to worry about it. Other reasons given for the low price were that the Salmon River Company was depleting its timber supply, especially fir, which was particularly necessary for the Timberland Co. The fir situation of course made a close connection of the two companies less important than before, but the value of the shares did not depend on that connection. The witness Wilson, a member of a firm of accountants which at all times (including 1944) seems to have had a close relation to the running of the companies, gave evidence to the effect that owing to the prospective exhaustion of the Salmon River Company's timber, the value of its shares in 1944 was only \$113. A more disinterested accountant, named Kent, criticized Wilson's figure, pointing out that it ignored the probability that the Salmon River Company would secure another source of timber.

Then we have the evidence of another independent expert Rodgers, who valued the Salmon River Company's assets in 1945 and considered that the value would have been much the same from 1943 to 1945. He valued the assets at \$2,264,200. And the only sizable liability was \$400,000 owing on debentures. Even on the balance sheets prepared by the Company's own accountants for 1943 and 1944, in which one can assume the assets would be very conservatively valued, and appreciation in value of fixed assets due to enhanced prices would not be reflected, the assets are shown as worth many times the liabilities. Even if the company had gone into liquidation in July, 1944, the shares would have proved worth a good deal more than \$100.

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The appellant, apart from testifying vaguely to some improvements in the Salmon River property between July, 1944, and the resale of his shares to the Westminster Co. and the B.C. Manufacturing Co., explained the resale price of \$750 per share by saying that the purchasers were "desperate" for timber. How the appellant could testify as to that I do not quite see. He called no one representing the purchaser companies who could properly state their motives. Renwick, an officer of both purchaser companies, was called by the respondent. He was extremely vague on most points, but did say that his companies got good value for their money, and I do not think he said anything helpful to the appellant. The respondent also called Rodgers, who had valued the Salmon River assets for the purchasers, and his evidence indicated they had been willing to pay \$750 per share because he reported the shares were actually worth more. Then there was a good deal of evidence on value by a witness Beer, who is an accountant in the Income Tax Department. He valued the shares in 1944 on a book value basis at \$395 and on an earning basis at between \$390 and \$490, though he thought any of these figures inadequate because they took no account of appreciation of fixed assets through the general rise in prices.

In view of the evidence given, I think that \$100 per share in 1944 was nothing like an adequate price for the Salmon River shares. It is of some significance that Mr. Wilson's firm, writing to the Income Tax Inspector on 20 June, 1944, disagreed with Wilson's view expressed at the trial, viz., that in 1944 the Salmon River Company's outlook was a poor one; the letter stated that "Salmon River will accumulate funds fairly rapidly from now on."

I turn now to the *bona fides* of the sale transaction, by which I mean the question whether it was an ordinary business transaction, or was designed for distributing part of the profits of the Timberland Co. among its shareholders. Since a company can have only fictitious intentions when it is dealing with its collective shareholders, the question becomes one whether the shareholders' object was to benefit the company by putting \$99,000 at its disposal or to benefit themselves individually by obtaining its property. Since I have no reason to doubt the evidence that the company

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needed \$100,000 to carry on, the shareholders undoubtedly had as one of their objects, the putting of funds at its disposal; the question is whether that was their primary object or merely an incidental one.

I find the appellant's evidence on this point unconvincing. It was perhaps natural enough that the company should turn to its members for financing, rather than borrow from the bank, as it could have done. But the form the transaction took militates against the probabilities of the appellant's story. If he really felt the doubts that he mentions about the value of the Salmon River shares, one would have expected him to take merely a mortgage or pledge of the shares and not an outright transfer. Moreover, the Timberland Co. at the time owned a large number of Salmon River debentures, which had consistently been paying 7 per cent interest. These and not the Salmon River shares were the appropriate security for obtaining an advance. If the appellant really felt the doubts he has testified to about the shares, here was the obvious solution; for the debentures were not only the more stable commodity, but they could have priority over the shares if the Salmon River Co. met with disaster. The fact that the appellant chose to take the shares instead, and to take an absolute transfer, indicates to me that he considered them more desirable than the debentures, and that his object was to benefit himself and not the company.

If there remains any doubt about the object being to distribute the company's profits, it seems to be dispelled by the correspondence that took place in October 1943 and June 1944, between the accountants representing the company and the income tax inspector at Vancouver.

The accountants wrote on 5 October, 1943, to the inspector:

. . . it is the intention of Timberland Lumber Company Limited to distribute its investment in the shares and debentures of Salmon River Logging Co Ltd. to its shareholders as a dividend. In order to make this distribution it is essential that the value of the shares of Salmon River Logging Co. Ltd. be agreed to by your department.

The letter then argued that the value should be based on asset values rather than on book values, and that asset values should be small because of the taxes that would be

deducted before the shareholders could get their money out. The inspector replied that

for the purpose of the contemplated distribution the book value thereof will be used as the basis of the distribution.

On 20 June, 1944, 24 days before the sale of shares to the appellant and other shareholders, the accountants again wrote to the inspector, and after complaining of his avowed basis of valuation, continued:

as we pointed out in our discussions of 10 June, 1944, this basis of value would result in very onerous taxation of the Timberland shareholders since they would first of all be charged with their proportion of Salmon River surplus included in the book value, and would then be subject to personal income tax when this surplus of Salmon River was distributed as a dividend. In effect they would be taxed twice on the same surplus.

In order to avoid this duplication we proposed that Salmon River Logging Company declare a dividend of its entire earned surplus, setting up the dividend as a liability . . . In this way the book value of Salmon River shares would be reduced to par and it is proposed that the transfer be made on this basis.

Here I point out that it did not follow that even if a dividend exhausting the reserve had been declared, the asset value of the shares would drop to par; for any enhanced value of the fixed assets due to rising markets had still to be taken into account. The accountants' letter continued:

. . . We find that there has been a substantial change in Timberland's financial position. The quantity of fir logs available from Salmon River has decreased . . .

In consequence, the letter said the company had to acquire a timber stand of its own, for which it needed \$100,000 and perhaps another \$200,000 for working capital. The letter adds:

It is apparent therefore that the company will be short of working capital, and for this reason it may be deemed advisable to sell Salmon River shares to Timberland shareholders rather than distribute the shares as a dividend. As no further principle of taxation is involved should the shares be sold on the basis of book value, after the declaration of the dividend covering all accumulated profit of Salmon River Logging Co. Ltd., we assume that either method will be acceptable to you.

In a later letter of 2 August, 1944, the accountants repeated that the Timberland Co. wished to sell to its own shareholders the Salmon River shares,

but before doing so wish you to advise them the fair market value of the shares.

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The inspector answered that he was not in a position to advise on the fair market value.

It will be noted that before the accountants wrote on 2nd August, the Timberland Co. had already passed a resolution for selling the shares to its members, from which I infer that they acted without the accountants' advice.

The accountants' letters quoted are disarming in their candour, and may perhaps be taken as evidence that they did not value the Salmon River shares as highly as later events showed they should have done. But it is extremely obvious that the sale actually carried out was not at all the transaction that the accountants proposed and had attempted to convince the inspector would not be subject to tax. The accountants' proposal was for the Salmon River Co. to declare a dividend that would exhaust its reserve of between \$550,000 and \$600,000 (which it had not the funds to pay at once); *then* the Timberland Co. would sell the shares—apparently *ex dividend*—at par. Actually however the Salmon River Co. did not declare the dividend; this is proved by the company's balance sheet at the end of 1944, which shows the reserve still intact, and in fact increased; yet in spite of this the Timberland Co. still sold the shares to its members at par, though these then carried the right to participate in the reserve when it should be resorted to.

So even if the accountants were right in valuing the shares at par if a certain course was taken (on which I am far from satisfied), still that course was not taken and therefore a par value ceased to have any justification.

In view of the accountants' letters it seems to be quite impossible to say that the object of this transaction was no to distribute part of the Timberland's Co.'s profits, and the accountants themselves recognized that so far as the sale price might fall below the true value, the recipients were liable to tax. Rightly or wrongly, the accountants thought they had worked out a plan for reducing the value of the shares to par, at which price they planned to sell. But the plan, whether good or bad, was not followed by the company.

There seems to be no reported Canadian or English case in which a shareholder has been held to have received a

dividend because he has bought shares at an under-value from a company that has earned profits on hand. But the American case of *Timberlake v. Commissioner of Internal Revenue* (1); and also the Supreme Court case of *Palmer v. Commissioner of Internal Revenue* (2), recognized that a benefit given in such a way might be taxable as a dividend though in that instance it was held that the company was not intending to distribute profits and that the price at which it offered shares to members was at the time an adequate price. The cases of *Taplin v. Commissioner of Internal Revenue* (3), and *Commissioner of Internal Revenue v. Van Vorst* (4), in which sales of assets to a shareholder at an under-value were held not to render him liable to tax are, I think, distinguishable because the Court held that nothing equivalent to payment of a dividend was intended. In those cases there was nothing like a rateable distribution to shareholders generally. At all events, the decisions turned on findings of fact. I do not think it material that the *Timberlake* case, *supra*, turned on a specific statutory provision; the section merely declared what I think would be implied as a matter of law without express enactment.

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I will now consider the appellant's other point, namely, that even if he bought the Salmon River shares at an under-value, still he could not be taxed on the benefit thereby received until he resold them and thereby fixed the amount of profit. The *Palmer* case *supra*, is perhaps the strongest authority for him on this point, but a case of that kind turns on different principles from this. When a transaction is dealing with goods representing capital, there is nothing in the way of profit till the goods are resold and nothing to which the tax can attach; but where, as here, the party is getting shares that themselves represent profit, the transaction is complete for tax purposes as soon as the shares reach his hands; and it does not matter whether he resells them or not. The price on resale would only matter so far as it threw light on the value at the date of receipt. The case of *Timberlake v. Commissioners of Internal Revenue, supra*, is in point.

(1) (1942) 132 Fed. (2nd) 259.

(3) (1930) 41 Fed. (2nd) 454.

(2) (1937) 302 U.S. 63.

(4) (1932) 59 Fed. (2nd) 677.

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I therefore hold that the appellant bought the Salmon River shares at a decided under-value from a company that held earned profits and that the object was to distribute these. I hold that as a result the difference between the price paid and the true value was a dividend, and subject to income tax.

It remains to consider the value: the Minister fixed the true value at \$600 per share, basing this apparently on the fact that fourteen months later the shares resold for \$750. I am concerned with the value at the date of the purported sale. The witness Wilson fixed it at \$113 per share, but for reasons already given, I am unable to accept this figure. The Crown's witness Beer put the book value at approximately \$400 and value computed on earnings at something more. He pointed out that this made no allowance for war-time appreciation in fixed assets due to rising prices. These would seem to account largely for the willingness of the Westminster Shook Co. and the B.C. Manufacturing Co. to pay \$750 in 1945. Appellant tried to account for this willingness by saying they were "desperate" for timber; but his evidence is met by that of their valuer Rodgers who indicated that they paid this price because he valued the shares at even more. He also gave evidence that the value of Salmon River shares remained much the same from 1943 to 1945. In view of this, I find myself unable to say that the Minister's figure of \$600 is unjustified.

The appeal therefore fails.

Judgment accordingly.
