Toronto 1967 June 14-15 Aug. 3

BETWEEN:

HAMILTON MOTOR PRODUCTS (1963) LIMITED ................ APPELLANT;

AND

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

*Income tax—Income tax regulations s. 1101(1)—Income Tax Act, R.S.C. 1952, ss. 20(1), 79C(1) to (4), (6), (7), (9), (15), 137(1)—Deferred profit sharing plan—Change of franchises by automobile agency—Capital cost allowance—Failure to pass amending by-law pursuant to the Minister's request—Registration of deferred profit sharing plan made invalid—Nature of business not affected by change of franchises—Artificial reduction of income—Recapture of capital cost allowance inapplicable—Appeal allowed.*

The appellant operated a new and used car agency holding a Chevrolet/Oldsmobile franchise. Another company carrying on another new and used car agency holding a Buick/Pontiac franchise carried on business at the same time in the same city. The main shareholder of the latter company was the father of the principal shareholder of the appellant. The father wished to retire from the latter business and the said son wished to change franchise, viz., by giving up the Chevrolet/Oldsmobile franchise and by acquiring the Buick/Pontiac franchise and also to take over the premises on which the company controlled by his father did business.

Accordingly, the appellant acquired an option to buy in bulk the assets and franchise of the agency controlled by the father and at the same time the appellant gave an option to buy the assets and the franchise of its own agency to another company.

The two options were exercised on October 4, 1963, at which time the appellant discharged its employees, except the principal shareholder and his brother and took over all the assets and hired all employees of Buick/Pontiac agency.

On September 27, 1963, just prior to closing these two transactions, the appellant submitted an application to the Minister for approval of a deferred profit sharing plan under section 79c of the *Income Tax Act*. On September 30, 1963, the Minister requested the appellant to

amend a certain by-law passed on September 13, 1963. The appellant revised the particular article of the by-law in question whereupon the Minister did approve the registration of the plan on October 4, 1963 and made it effective as of September 27, 1963.

The principal shareholder of the appellant who along with his brother and its accountant were trustees of the plan received from the appellant on September 27, 1963 the sum of $103,500 representing the amounts allocated under section 79c(7) of the *Act* to the employees of the appellant listed in the appellant's minutes of September 14, 1963.

The Minister disallowed the deduction for income tax purposes of the whole sum of $103,500; and also caused to be recaptured a capital cost allowance, under section 20(1) of the *Act*.

The taxpayer appealed the Minister's reassessment.

*Held,* 1. that this appeal is allowed in part and the matters were referred back to the Minister for reassessment.

2. that the appellant remained in the same business at all material times with the meaning of section 1101(1) of the regulations of the *Income Tax Act* and therefore no recapture of capital cost allowances should have been added to the appellant's income for the year 1963 pursuant to section 20(1) of the *Act*.

3. that the sum of $103,500 paid under section 79c of the *Act* was not deductible for two reasons namely,

   I. Because, either no valid by-law was passed revising the by-law setting up the plan; or that the revised by-law was never validly passed until October 2, 1963, at which time there were only two employees and therefore there was no basis for setting up a deferred profit sharing plan by reason of the limits placed on the allocation of monies in respect of each employee in such plan by section 79c(7) of the *Act*, and

   II. The appellant never intended to set up a *bona fide* profit sharing plan and section 137(1) of the *Act* was applicable in that what was done here was a mere sham, and was a transaction or operation designed to unduly or artificially reduce the income of the appellant for the taxation year 1963.

APPEAL from the Minister's assessment.

*Wolfe D. Goodman* and *B. Sischy* for appellant.

*G. W. Ainslie* and *B. Verchere* for respondent.

GIBSON J.:—On the hearing of this appeal two issues were raised, namely: (1) the deductibility for income tax purposes of a payment made in September 1963 by the appellant in the sum of $103,500 to certain trustees purporting to be in respect to a deferred profit sharing plan within the meaning of section 79c of the *Income Tax Act*; and (2) the recapture of certain capital cost allowances included in the income of the appellant for the year 1963, purportedly pursuant to section 20(1) of the *Income Tax Act*.

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The relevant facts in brief are these: In the summer of 1963, the appellant operated a new and used car agency in the City of Hamilton, Ontario holding a Chevrolet/Oldsmobile franchise from General Motors of Canada Limited. Another company carrying on another new and used car agency holding a Buick/Pontiac franchise from General Motors of Canada Limited carried on business in the City of Hamilton at the same time. The main shareholder of the latter company was the father of the principal shareholder of the appellant. The father wished to retire from the latter business and the said son wished (i) to change franchises, *viz*, by giving up the Chevrolet/Oldsmobile franchise and by acquiring the Buick/Pontiac franchise, and also (ii) to take over the premises on which the company controlled by his father did business, which premises were more desirable than the premises where the appellant carried on business under the Chevrolet/Oldsmobile franchise.

Accordingly, at the said time, the appellant acquired an option to buy in bulk the assets of the new and used car agency of the company controlled by his father, (which held the Buick/Pontiac franchise) and at the same time the appellant gave to Motors Holding Company of Canada Limited an option to buy in bulk the assets of the appellant's new and used car agency where it operated the Chevrolet/Oldsmobile franchise.

Both options were exercised and on or about October 4, 1963, both contracts of purchase and sale were completed.

In the result, the appellant did two things which are relevant regarding the second issue raised on this appeal and a third thing which is relevant regarding the first issue raised on this appeal. The first two things are namely:

(1) the appellant sold all the assets used at the premises where it carried on the Chevrolet/Oldsmobile Agency and discharged all its employees who worked there from its employ, save and except the principal shareholder of it and his brother. (The new purchaser purchased these assets and hired these said employees); and

(2) the appellant acquired all the assets used at the premises where the Buick/Pontiac Agency was carried

on and hired all the employees of the company (controlled by his father) which had formerly carried on that agency at those premises.

The third thing done by the appellant relevant to the first issue raised in this appeal was namely:

(3) Just prior to closing these two transactions, *viz,* September 27, 1963, the appellant wrote an undated letter to the Department of National Revenue, Ottawa, (Ex. I) and enclosed with it a Trust Agreement and a copy of its By-Law No. 7 (Ex. J). This letter was an application, and the Trust Agreement and By-Law were the supporting documents, for approval of a deferred profit sharing plan pursuant to the enabling provisions of section 79c of the *Income Tax Act.* Said By-Law No. 7, according to the company Minute Book (Ex. 4) the appellant purports to have passed on September 14, 1963.

Then, subsequently on September 30, 1963 the Department of National Revenue wrote requesting an amendment to Article V, sub-paragraph (3) of the said By-Law No. 7 of the proposed deferred profit sharing plan of the appellant, and on October 2, 1963 the solicitors for the appellant forwarded to the Department of National Revenue a copy of a revised Article V, sub-paragraph (3) of the said By-Law (see Ex. 5). Following this, the Department of National Revenue (see Ex. 6) approved the registration of the plan under section 79c of the *Income Tax Act,* and pursuant to the enabling statutory provisions in section 79c stated that the approval was as of the date of the application, namely, September 27, 1963.

At this time, there were only two employees of the appellant, namely, the principal shareholder and his brother who was a nominal shareholder.

As stated, although the Minutes of the appellant company record that By-Law No. 7 was passed on September 14, 1963, there was no amending by-law passed by the appellant authorizing the change requested by the Minister to Article V, sub-paragraph

(3) of By-Law No. 7 of the deferred profit sharing plan.

On September 27, 1963, there was paid to the three trustees (who were the principal shareholder of the appellant, his brother and its accountant) the sum of $103,500 for the purpose of this plan (see Ex. 7).

Attached to the Minutes of the appellant company of September 14, 1963 authorizing the payment of this sum is a list of employees to whom certain amounts were allocated pursuant to the enabling provisions contained in section 79c(7) of the *Income Tax Act.* The maximum allocated to any employees was $1,500 which is the maximum permitted by the said subsection.

To permit this plan to be implemented under the statute utilizing the payment of $103,500, it was necessary for the appellant to have a sufficient number of employees (because of the $1,500 limit per employee permitted under section 79c(7)), or otherwise the said sum could not have been paid into such a deferred profit sharing plan.

When the approval retroactively to September 27, 1963 was given by the Minister on October 4, 1963, there were in fact only two employees of the appellant, *viz,* the principal shareholder and his brother.

No employee of the appellant, other than the principal shareholder and his brother ever was told of the precise terms of this plan at any time.

On the discharge by the appellant of its employees other than the principal shareholder and his brother by September 30, 1963, the sum of a little over $19,000 less withholding tax was allocated among and paid to such former employees and a T-4 income tax form was subsequently filed (see Ex. 9) by the trustees, on which was noted the Department of National Revenue file number of the plan.

Then in December 1963, pursuant to and as permitted by the provisions of this particular alleged deferred profit sharing plan, all of the funds in it were transferred to a suspense account and then re-allocated

in the proportion of 60% thereof to the principal shareholder and 40% to his brother.

So much for the facts of this case.

In respect to the issue of recapture of certain capital cost allowances included in the income of the appellant for the year 1963, I am of the opinion that the appellant was still in the same business at all material times (namely, the new and used car sales and service business) within the meaning of section 1101(1) of the Regulations of the *Income Tax Act* when it took the necessary action above recited in brief to change franchises, namely, from the Chevrolet/Oldsmobile to the Buick/Pontiac franchise and accordingly, no recapture of capital cost allowance should have been added to the income of the appellant for the year 1963 pursuant to the provisions of section 20(1) of the Act.

In respect of the issue of the payment made by the appellant in September, 1963 in the sum of $103,500 purporting to be in respect of a deferred profit sharing plan within the meaning of section 79c of the *Income Tax Act,* I am of the opinion that it is not deductible by the appellant for income tax purposes for at least two reasons, hereinafter recited.

Section 79c of the *Income Tax Act* in the wording in which it was in 1963 was added to the statutes in 1961. Section 79c(1)(*a*)[1] defines "Deferred Profit Sharing Plan". Section 79c(1)(*b*)[2] defines "Profit Sharing Plan". Section

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[1] (*a*) "deferred profit sharing plan" means a profit sharing plan accepted by the Minister for registration for the purposes of this Act, upon application therefor in prescribed manner by a trustee under the plan and an employer of employees who are beneficiaries under the plan, as complying with the requirements of this section; and

[2] (*b*) "profit sharing plan" means an arrangement under which payments computed by reference to his profits from his business or by reference to his profits from his business and the profits, if any, from the business of a corporation with whom he does not deal at arm's length are made by an employer to a trustee in trust for the benefit of employees of that employer or employees of any other employer, whether or not payments are also made to the trustee by the employees.

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79c(15)[3] prescribes that the payments to such a plan must be made "out of profits". The payments may be made by an employer to the trustee of such a plan for the benefit of any employee. If the plan is accepted by the Minister for registration, then the payments to the plan are deductible for income tax purposes subject to certain ceilings on the amount that may be allocated to any employee, namely, $1,500 under section 79c(7)[4]. The profit from such a plan is not subject to income tax, subject to certain modifications under section 79c(6)[5]. The employees are not taxable on monies paid into such a plan unless and until they actually receive the monies from the plan under section 79c(9)[6].

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[3] (15) Where the terms of an arrangement under which an employer makes payments to a trustee specifically provide that the payments shall be made "out of profits", such arrangement shall be deemed, for the purpose of subsection (1), to be an arrangement for payments "computed by reference to his profits from his business".

[4] (7) There may be deducted in computing the income of an employer for a taxation year the aggregate of each amount paid by the employer in the year or within 120 days after the end of the year, to a trustee under a deferred profit sharing plan for the benefit of employees of the employer who are beneficiaries under the plan, not exceeding, however, in respect of each individual employee in respect of whom the amounts so paid by the employer were paid by him, an amount equal to the lesser of

(*a*) the aggregate of each amount so paid by the employer in respect of that employee, or

(*b*) $1,500 minus the amount, if any, deductible under paragraph (*g*) of subsection (1) of section 11 in respect of that employee in computing the income of the employer for the taxation year,

to the extent that such amount was not deductible in computing the income of the employer for a previous taxation year.

[5] (6) No tax is payable under this Part by a trust on the taxable income of the trust for a period during which

(*a*) the trust was governed by a deferred profit sharing plan, and

(*b*) not less than 90% of the income of the trust for the period was from sources in Canada, and for the purpose of this paragraph contributions to or under the plan shall not be included in computing the income of the trust.

[6] (9) There shall be included in computing the income of a beneficiary under a deferred profit sharing plan for a taxation year each amount received by him in the year from a trustee under the plan, minus any amounts deductible under subsections (10) and (11) in computing the income of the beneficiary for the year.

Sections 79c(2) and (3)[7] of the Act prescribe that certain matters must be included in a deferred profit sharing plan failing which such a plan will not be accepted for registration. The Minister in any event, is not bound to accept any plan. The Minister, if he accepts a plan, may back-date a plan for its effective date, pursuant to section

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[7] (2) The Minister shall not accept for registration for the purposes of this Act any profit sharing plan unless, in his opinion, it complies with the following conditions:

(*a*) the plan provides that each payment made by an employer to a trustee in trust for the benefit of employees of that employer or employees of any other employer who are beneficiaries thereunder, is an amount that is the aggregate of amounts each of which is identifiable as a specified amount in respect of an individual employee;

(*b*) the plan does not provide for the payment of any amount to an employee or other beneficiary thereunder by way of loan;

(*c*) the plan provides that no part of the funds of the trust governed by the plan may be invested in notes, bonds, debentures or similar obligations of

(i) an employer by whom payments are made in trust to a trustee under the plan for the benefit of beneficiaries thereunder, or

(ii) a corporation with whom that employer does not deal at arm's length;

(*d*) the plan provides that no part of the funds of the trust governed by the plan may be invested in shares of a corporation at least 50% of the property of which consists of notes, bonds, debentures or similar obligations of an employer or a corporation described in paragraph (*c*);

(*e*) the plan includes a provision stipulating that no right or interest under the plan of an employee who is a beneficiary thereunder is capable, either in whole or in part, of surrender or assignment;

(*f*) the plan includes a provision stipulating that each of the trustees under the plan shall be resident in Canada; and

(*g*) the plan, in all other respects, complies with regulations of the Governor in Council made on the recommendation of the Minister of Finance.

(3) The Minister shall not accept for registration for the purposes of this Act any employees profit sharing plan unless all the capital gains made by the trust governed by the plan before the date of application for registration of the plan and all the capital losses sustained by the trust before that date have been allocated by the trustee under the plan to employees and other beneficiaries thereunder.

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79c(4)[8], namely to the date of the application for the registration of the plan or when in the application for registration a later date is specified as the date upon which the plan is to commence as a deferred profit sharing plan, on that date.

Once the Minister has accepted a plan, the monies do not have to be paid into the plan so that they irrevocably vest in the employees in the proportion that they are allocated to such employees. (This was changed by subsequent legislation).

The purported plan in this action provided for the vesting of monies in any employee only if he was an employee when he reached the age of 65, but if any such employee died before that time or left the employ of the employer he had no rights under this plan.

On the evidence, two things are obvious. Firstly, no valid by-law was passed amending By-Law No. 7 pursuant to the request of the Minister in October, 1963, or alternatively, By-Law No. 7 was never validly passed until some time after October 2, 1963. At that time there were only two employees, all the other employees having been discharged from service. There therefore was no basis for setting up a deferred profit sharing plan by reason of the limits placed on the allocation of monies in respect of each employee in such plan by section 79c(7) of the Act.

I therefore find as a fact and conclude as a matter of law that no valid deferred profit sharing plan under section 79c was ever set up by the appellant.

Secondly, and in any event, section 137(1)[9] of the *Income Tax Act,* in my opinion, is clearly applicable. The

[8] (4) Where a profit sharing plan is accepted by the Minister for registration as a deferred profit sharing plan, the plan shall be deemed to have become registered as a deferred profit sharing plan

(*a*) on the date the application for registration of the plan was made, or

(*b*) where in the application for registration a later date is specified as the date upon which the plan is to commence as a deferred profit sharing plan, on that date.

[9] 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.

appellant never intended to set up a *bona fide* profit sharing plan. What was done was a mere sham, and on the evidence, beyond any doubt, was a transaction or operation that was designed to unduly and artificially reduce the income of the appellant for the taxation year 1963.



The matters are referred back to the Minister for reassessment not inconsistent with these reasons.

Success being divided, there shall be no order as to costs.