1936
Sept. 15.
1937
Oct. 20.

BETWEEN:

HILLIARD C. McCONKEY.....APPELLANT;

AND

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

Revenue—Income tax—Payment from reserve or depletion fund—Company not in liquidation can only make payment to shareholders by way of return of capital as a step in authorized reduction of capital.

Appellant was a shareholder in Hy-Grade Coal Company of Drumheller Limited from its incorporation in 1919 until its voluntary liquidation in 1933. The company was engaged in coal mining. In May, 1932, the company distributed the sum of $12,000 to its shareholders of which amount the appellant received $5,028. Appellant was assessed income tax on this amount, which assessment was affirmed by the Minister of National Revenue, and from that decision appellant appealed. Appellant contended that such distribution was made out of assets representing the capital of the company and in anticipation of winding up of the company in 1933, and that such distribution was not "income" and was not "annual net profit or gain" to the shareholders within the meaning of s. 3 of the Income War Tax Act.

The Court found that the payment of $12,000 in 1932 was made out of the exhaustion or depletion fund and that this fund was accumulated, during a period of years, with the knowledge and approval of the Minister, and for the purpose of replacing the capital assets of the company, which consisted solely of a wasting property.

Held: That a corporation not in liquidation can make no payment to its shareholders by way of return of capital except as a step in an authorized reduction of capital and that any other payment made to its shareholders can only be made by way of dividing profits.

2. That until a reserve fund is effectively capitalized it retains the characteristics of distributable profits.

3. That the payment of $12,000 by the company in 1932, while still a going concern, must be treated as a distribution of a dividend and not a return of capital, and appellant's share of such distribution was taxable as income.

APPEAL under the provisions of the Income War Tax Act from the decision of the Minister of National Revenue.

The appeal was heard before the Honourable Mr. Justice Angers, at Calgary.

H. S. Patterson, K.C. and *A. W. Hobbs* for appellant.

C. J. Ford, K.C. for respondent.

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

1937

HILLIARD C. McCONKEY v. MINISTER OF NATIONAL REVENUE.

Angers J.

ANGERS J., now (October 20, 1937) delivered the following judgment:

This is an appeal from the decision of the Minister of National Revenue rendered on September 18, 1935, affirming an assessment made by the Commissioner of Income Tax on November 19, 1934. The appeal is brought under sections 58 and following of the Income War Tax Act.

The appellant was a shareholder of Hy-Grade Coal Company of Drumheller Limited, a company incorporated in 1919 under the laws of the Province of Alberta; he remained a shareholder until the voluntary liquidation of the company in 1933.

On January 4, 1919, the company purchased the unexpired portion or term of a coal lease granted by the Drumheller Land Company Limited to J. C. Coward and others dated September 12, 1918. This lease was for a period of twelve years from September 1, 1918, and was afterwards renewed. The lessor, Drumheller Land Company Limited, later assigned the lease to Drumheller Consolidated Collieries Limited. On November 1, 1928, an agreement was entered into between Drumheller Consolidated Collieries Limited and Hy-Grade Coal Company of Drumheller Limited.

Under the terms of this agreement Hy-Grade Coal Company of Drumheller Limited undertook to carry on mining operations on the lands described in the lease according to the most approved coal mine engineering practice so as to extract from the whole area the maximum quantity of coal possible.

The Hy-Grade Coal Company of Drumheller Limited further agreed that it would not abandon or leave unworked any portion of the area leased except with the consent of the lessor and that no block or section of said area would be abandoned or left unworked so long as the coal therein could be mined without actual loss to the lessee.

It was stipulated in the said agreement (*inter alia*) that the lessee would continuously carry on mining operations upon the said area as market conditions would warrant until all the merchantable coal had been removed and would, in each year, mine a minimum of 30,000 tons.

The lease contains other stipulations which have no relevance to the matter at issue in the present case.

Hy-Grade Coal Company of Drumheller Limited commenced mining operations in compliance with the terms of the lease aforesaid in 1919 and continued them until 1933, when the company was wound up.

The notice of appeal after alleging that appellant was a shareholder of Hy-Grade Coal Company of Drumheller Limited, that on January 4, 1919, the company acquired the unexpired portion of the coal lease granted by Drumheller Land Company Limited and that from the said date the company conducted mining operations on the property until June 1, 1933, the date of its winding up, says in substance as follows:

statements have been filed with the Income Tax Department showing that as at April 30, 1932, there was a deficit on revenue account of $28,995.41 and, owing to losses of capital, a deficit on capital account of $63,023.30;

in May, 1932, the company, having in bank a greater balance than would be required to finance the operations of the ensuing season, distributed the sum of $12,000 among its shareholders and the appellant received the sum of $5,028 as his share, which amount has been included in the assessment under appeal as income for 1932;

the statements submitted to the Department show that in May, 1932, the company had no undivided profits or surplus and that its capital was impaired by $63,023.30 on capital account and by $28,995.41 on revenue account including the net loss on operations for the year ended April 30, 1932, of $4,714.14; the distribution in May, 1932, therefore cannot have been made out of the accumulated surplus at the 30th of April, 1932, as there was no surplus, nor out of the profits for the year ended on the 30th of April, 1932, as there were no profits; on the contrary the distribution of $12,000 was made out of assets representing the remaining capital of the company;

such distribution was not "income" and was not "annual net profit or gain" to the shareholders within the meaning of section 3;

the distributions in May, 1931 and 1932, were made in anticipation of the winding up of the company, which it was expected would occur in or about the year 1933 (the

1937

HILLIARD C. McCONKEY v. MINISTER OF NATIONAL REVENUE.

Angers J.

operations of the company being continued because it was bound under contract with the lessor to extract all merchantable coal) and in June, 1933, the company went into voluntary liquidation; the statements already filed show that even after charging against capital account the distributions in May, 1931 and May, 1932, there was still a deficit in revenue account of $21,445.38;

the appellant is informed that following a ruling of the Commissioner of Income Tax (memorandum 55 1932-33, October 20, 1932) the distribution of $12,000 is deemed by the Department to be a dividend paid by the company while a going concern and therefore taxable in full in the hands of the shareholders as the company did not reduce its capital by an amendment to its memorandum of association; in regard to this the appellant says that the said memorandum was not in force at the time of the said distribution and that the Minister was not competent by any such memorandum to alter the intention of the Act and to make taxable moneys which by the terms of the Act are not included in the definition of income.

On September 18, 1935, the Minister, represented and acting by the Commissioner of Income Tax, rendered his decision affirming the assessment; the decision reads in part as follows:

> The Honourable the Minister of National Revenue, having duly considered the facts as set forth in the Notice of Appeal and matters thereto relating, hereby affirms the said assessment on the ground that the dividend was declared and paid in the year 1932 by Hy-Grade Coal Company of Drumheller Limited while a going concern; that the said dividend is taxable in the hands of the recipient shareholders within the meaning of the Act as provided by section 3 and other provisions of the Income War Tax Act in that respect made and provided. The only occasion on which a shareholder may receive back capital from a company is on the reduction of the company's capital by Supplementary Letters Patent or on the winding up of the company.

The notice of dissatisfaction, dated October 4, 1935, repeats the facts and reasons set out in the notice of appeal.

Income tax returns were filed in due course by Hy-Grade Coal Company of Drumheller Limited from the date of its organization to the date of its winding up, viz., from 1919 to 1933, and the Minister of National Revenue, pursuant to section 5, subsection (*a*) of the Income War Tax Act, made from year to year an allowance for the exhaustion of the mine.

The material provisions of section 5 and subsection (*a*) read as follows:

"Income" as hereinbefore defined shall for the purposes of this Act be subject to the following exemptions and deductions:

(*a*) Such reasonable amount as the Minister, in his discretion, may allow for depreciation, and the Minister in determining the income derived from mining and from oil and gas wells and timber limits shall make such an allowance for the exhaustion of the mines, wells and timber limits as he may deem just and fair. And in the case of leases of mines, oil and gas well and timber limits, the lessor and the lessee shall each be entitled to deduct a part of the allowance for exhaustion as they agree and in case the lessor and the lessee do not agree, the Minister shall have full power to apportion the deduction between them and his determination shall be conclusive; . . . .

A statement entitled "Summary of Income Tax Assessments" was filed as exhibit 5, which shows the respective amounts of the exhaustion or depletion allowance, of the taxable income, of the tax and of the interest for each year from 1919 to 1933 inclusive; it may be convenient to reproduce here this statement in extenso:

	Depletion allowance.	Taxable income.	Tax.	Interest.
1919	$ 6,857 14	***$ 8,517 25***	.....	.....
1920	20,571 43	23,685 24	$ 2,276 95	$ 41·60
1921	6,449 05	43,715 83	4,380 15	257·21
1922	7,261 80	58,615 18	5,944 59	82·70
1923	10,585 70	59,649 98	6,053 24	.....
1924	11,584 50	78,147 01	7,995 43	36·15
1925	7,669 40	49,258 72	4,253 28	54·79
1926	4,295 60	***4,091 20***	.....	.....
1927	6,184 70	***2,360 00***	.....	.....
1928	8,890 93	11,703 95	776 32	.....
1929	6,578 82	38,816 32	2,945 30	28·57
1930	10,860 70	5,685 74	368 57	11·31
	$107,789 77	$354,309 52	$ 34,993 83	$512 33
1931	6,119 69	***24,748 08***	.....	.....
1932	7,130 76	***6,154 20***	.....	.....
1933	7,866 55	7,874 43	984 30	.....
	$128,906 77	$331,281 67	$ 35,978 13	$512·33

John Henry Williams, a chartered accountant, who acted as auditor for Hy-Grade Coal Company of Drumheller Limited for practically the whole period of its existence and prepared its income tax returns every year, referring to the statement or summary of income tax assessments filed as exhibit 5 says that he made it himself and that it

1937

HILLIARD C. McCONKEY v. MINISTER OF NATIONAL REVENUE.

Angers J.

is correct; it seems to me expedient to cite an extract of his testimony on the subject:

Q. And you have made, prepared, a summary from the returns filed by this company, from the years 1919 to 1932 inclusive?

A. From the returns as amended after agreement on the figures with the Department.

Q. That is, I should say from the assessment as finally agreed upon?

A. Yes.

Q. I am showing you a summary which purports to be a summary of income tax assessments for the Hi-Grade Coal Company of Drumheller?

A. Yes.

Q. That is a correct summary of the assessments from year to year?

A. Yes.

Q. And in the first column you have the depletion allowance?

A. Those figures represent the amounts which were allowed by the Department for depletion of the coal lease in arriving at the taxable income.

Q. And in the second column you have items under "Taxable income"; what are those figures?

A. The black figures represent the amount of income on which assessments were levied; the italicized figures represent the losses during those years, the amounts of which were agreed with the Department.

Q. So that all these figures were agreed between yourself and the Department?

A. Yes.

The statement or summary exhibit 5 shows that the total net profits, after deduction of the exhaustion or depletion allowance, up to April 30, 1930, amounted to $354,309.52. Williams explains how these net profits were dealt with by the company; his explanations appear on pages 12 and 13 of his deposition. The witness summarized his version in this respect in a statement which was filed as exhibit 6. This statement discloses that, after payment of income taxes and interest thereon and dividends, for the years 1920 to 1929 inclusive, there was left on April 30, 1930, a sum of $18,053.36.

A dividend of $36,000 was paid in May, 1930, the excess over $18,053.36 being drawn out of the depletion reserve. This distribution was taxed in full by the Department as income to the shareholders. In 1931 a further distribution of $18,000 was made and the same was also taxed as income to the shareholders; the appellant paid the tax on his share and made an application for refund. Another distribution of $12,000 was effected in 1932, being the one in question in the present suit. The appellant's share of this distribution amounted to $5,028; it is the tax assessed thereon that is in issue herein.

All profits that were available in 1930 were included in the distribution of $36,000 made in that year; in 1931 the company had a loss of $24,748.08 and in 1932 another of $6,154.20; it follows that there were no profits left in 1932 from which the sum of $12,000 could have been paid. It seems obvious that this sum was drawn from the exhaustion or depletion reserve.

Let us consider briefly the circumstances in which the distribution of the sum of $12,000 took place.

On May 23, 1932, the directors of Hy-Grade Coal Company of Drumheller Limited passed a resolution reading as follows:

That the directors recommend to the shareholders that a disbursement of capital of $4 per share be declared on all shares issued, payable June 1, 1932.

On the same day the shareholders passed a resolution in the following terms:

That (on) consideration of the directors' recommendation that a disbursement of capital be declared, do hereby adopt this resolution and declare a disbursement of $4 per share on all shares issued for the fiscal year ending April 30, 1932, payable June 1, 1932.

Pursuant to these resolutions the sum of $12,000 was distributed to the shareholders; the appellant's share, as previously stated, was $5,028.

On May 22, 1933, the shareholders of Hy-Grade Coal Company of Drumheller Limited decided to wind up the company; the following resolution was adopted:

Whereas, all merchantable coal on the company's lease will have been extracted by the 31st day of May instant, and whereas the company will after that date have no further reason for continuing its existence, and whereas it is expedient that the company should be wound up voluntarily under the Companies Act, 1929, as from that date.

Be it resolved, that this company be wound up voluntarily under the Companies Act, this resolution to take effect on the first day of June, 1933, and be it further resolved that H. C. McConkey be and he is hereby appointed liquidator of the company at remuneration of three hundred dollars ($300) per month for the first four months and two hundred dollars ($200) per month for the next four months if the liquidation should continue for that length of time, such appointment to be effective as from the said 1st of June, 1933, and that he be bonded for the sum of five thousand dollars ($5,000) in conjunction with the Drumheller Coal Agy. Ltd.

Provided that if this resolution is not strictly in accordance with the requirements of the Companies Act the winding up shall be deemed to have commenced on the 22nd day of May, 1933.

The company went into liquidation as at the 1st of June, 1933, in accordance with the above resolution and H. C. McConkey, the appellant, was appointed liquidator.

1937

HILLIARD C. McCONKEY v. MINISTER OF NATIONAL REVENUE.

Angers J.

Williams says that he acted for the liquidator in settling his returns and assessments with the Department. According to him there were no disputes regarding these returns and assessments with the Department and a clearance certificate was issued by the Commissioner of Income Tax on November 21, 1934.

Dealing with the effect of the payment to the shareholders of the sum or $12,000 in 1932, of the sum of $18,000 in 1931 and of an approximate sum of $18,000 (exactly $17,946.64) in 1930, Williams testified as follows:

Q. Now what was the effect, so far as the distribution to shareholders was concerned, of this payment of $12,000 paid in 1932?

A. The effect was that when he became liquidator there was that much less available for distribution to the shareholders because they had already received that.

Q. Was that a distribution of dividends or capital?

A. A distribution of capital because there were no profits left to distribute.

Q. So that the amount the shareholders received was proportionately reduced on account of this?

A. Certainly.

Q. And also by the distribution of eighteen thousand?

A. Yes, in the previous year.

Q. And also approximately eighteen thousand in the previous year?

A. In the year 1930.

The witness then proceeded to say that the amounts paid by the liquidator to the shareholders totalled $76,500. He filed as exhibit 8 a copy of a report made, in his capacity as auditor, to the shareholders of the company dated February 27, 1934, showing (*inter alia*) that the liquidator had, between June 1, 1933, and February 26, 1934, distributed to the shareholders a total amount of $75,000. The report indicates that there was a balance at the bank and on hand of $1,569.12; of this balance, $1,500 was distributed to the shareholders after June 27, 1934, date of the report aforesaid. The liquidation being closed, the liquidator obtained his discharge and transferred to the Royal Trust Company, as trustee for the individual shareholders, the remaining assets, consisting of accounts receivable amounting to $18,722.57 (to mention only those considered good) and of about $200 in cash.

The several amounts distributed to the shareholders by the company and the liquidator and the accounts receivable and cash transferred to the Royal Trust Company form a total of approximately $143,000. The exhaustion or

depletion allowance, as shown by the statement exhibit 5, amounts to $128,906.77. The difference of $14,093.23 was realized from the sale of machinery and chattels and constituted a distribution of capital.

The respondent claims that the distributions of $17,946.64 in 1930, $18,000 in 1931 and $12,000 in 1932 should be regarded as income. On this basis the capital recovery by the shareholders would only be $95,422.57, as follows:

Amounts distributed by the liquidator..	$76,500 00
Accounts receivable ($18,722.57) and amount of money (about $200) transferred to Royal Trust Company.. ..	18,922 57
	$95,422 57

The total depletion allowance being $128,906.77, there would be a shortage in capital recovery of approximately $33,484.20.

Williams, on the other hand, who acted as auditor for the company and for the liquidator, claims that the three distributions aforesaid in 1930, 1931 and 1932 were made from capital. In this case the capital recovery would amount to $143,369.21, as follows:

Amount distributed in 1930..	$ 17,946 64
" " " 1931..	18,000 00
" " " 1932..	12,000 00
Amounts distributed by the liquidator ($75,000 and $1,500)..	76,500 00
Accounts receivable and money assigned to Royal Trust Company.	18,922 57
	$143,369 21

If we deduct the amount assigned to the Royal Trust Company, namely, $18,922.57, for accounts receivable and cash on hand, we are left with a balance of $124,446.64. The capitalized value of the lease to the company was $240,000; at least the promoters of the company received $240,000 in stock for the lease.

It is submitted on behalf of the appellant that the shareholders did not obtain a return of capital commensurate with the amount allowed by the Minister for the exhaustion of the mine or with the capital value of the lease. It is further submitted on behalf of the appellant that the

1937

HILLIARD C. McCONKEY v. MINISTER OF NATIONAL REVENUE.

Angers J.

Minister should not in equity be permitted to violate the settlements made with the company under which the fund out of which the distribution was made was earmarked as a capital fund.

On the other hand, it is urged for the respondent that the payment of $5,028 to the appellant, being his share of the $12,000 paid by the company to its shareholders in 1932, constituted a dividend from stocks and came within the definition of income under section 3 of the Act; that moreover, as this amount was not paid to him in winding up proceedings or in the way of an authorized reduction of the capital of the company, it must be regarded as a payment to the appellant of his share of a dividend of $12,000 declared and distributed to the shareholders.

The only question arising for determination is whether the sum of $12,000 distributed in 1932 by Hy-Grade Coal Company of Drumheller Limited to its shareholders was income or capital.

"Income" is defined in section 3 of the Act, the relevant provisions whereof read thus:

> For the purpose of this Act, "income" means the annual net profit or gain or gratuity, whether ascertained and capable of computation as being wages, salary, or other fixed amount, or unascertained as being fees or emoluments, or as being profits from a trade or commercial or financial or other business or calling, directly or indirectly received by a person from any office or employment, or from any profession or calling, or from any trade, manufacture or business, as the case may be, whether derived from sources within Canada or elsewhere; and shall include the interest, dividends or profits directly or indirectly received from money at interest upon any security or without security, or from stocks, or from any other investment, and whether such gains or profits are divided or distributed or not, and also the annual profit or gain from any other source. . . . .

There follows an enumeration of various sources foreign to the question in controversy, which it is inexpedient to quote.

Then section 5 sets out the deductions and exemptions allowed; subsection (*a*), as previously noted, deals with the depreciation and exhaustion in the case of mines, oil and gas wells and timber limits.

Stress was laid by counsel for respondent on the fact that the definition of income contained in section 3 includes dividends from stcoks, his conclusion being that if the receipt by the appellant of the sum of $5,028 is a dividend, the question is settled adversely to him.

I must say that I am unable to follow this reasoning. Section 5 says that "income" as hereinbefore defined, i.e., as defined in section 3, is subject to the following exemptions and deductions, which are enumerated in several subsections, particularly subsection (*a*) dealing, as we have seen, with depreciation and exhaustion. It does not matter from what source the income is derived; if it comes within the scope of any of the subsections of section 5, it is subject to the exemptions and deductions therein stated.

I may repeat that the only point for decision on the present appeal is whether the sum of $12,000 distributed by Hy-Grade Coal Company of Drumheller Limited to its shareholders in 1932 was capital or income.

Counsel for the appellant submitted that the onus was on the respondent to establish that the distribution of $12,000, of which the appellant received $5,028, was taxable and, in support of his contention, cited the following decisions: *Secretary of State in Council of India* v. *Scoble et al.* (1) and *Spooner* v. *Minister of National Revenue* (2). The rule that it is the duty of the party who asserts and not of the party who denies to establish the proposition sought to be established is well settled: Taylor on Evidence, 12th ed., vol. 1, 252, para. 364; Best on Evidence, 12th ed., 248, para. 269.

Has the respondent succeeded in establishing that the sum of $12,000 distributed by Hy-Grade Coal Company of Drumheller Limited to its shareholders in May, 1932, was income? That is the question which I have to determine.

In support of his contention that the sum of $12,000 was income, counsel for respondent relied mainly on the following cases: *Hill* v. *Permanent Trustee Company of New South Wales Limited* (3) and *Northern Securities Co.* v. *The King* (4).

In the case of *Hill* v. *Permanent Trustee Company of New South Wales Limited* (*supra*) the facts were briefly as follows. The respondent company, as trustee of the will and codicils of one Richard Hill, deceased, held 40,800 shares in a company known as the Buttabone Pastoral

(1) (1903) A.C. 299 at 302.
(2) (1931) S.C.R. 399 at 407.
(3) (1929) 29 N.S.W. St. R. 53; (1930) A.C. 720.
(4) (1935) Ex. C.R. 156.

1937

HILLIARD C. McCONKEY v. MINISTER OF NATIONAL REVENUE.

Angers J.

Company Limited and, as trustee under a declaration of trust, it held 17,600 additional shares in the same company.

In November, 1927, the respondent company received from the Buttabone Pastoral Company a sum of £19,380 in respect of the 40,800 shares and a sum of £8,360 in respect of the 17,600 shares. The respondent company issued an originating summons in the Supreme Court of New South Wales to determine whether the said sums should be treated as capital or income under the respective trusts.

Richard Hill died on August 19, 1895; at the time of his death he was the owner of a grazing property known as "Buttabone Station." A suit brought by certain beneficiaries under the will against the trustee of the testator's will and codicils was compromised with the approval of the court and in pursuance of an order of the court a company called Buttabone Pastoral Company Limited was formed, which purchased from the trustee "Buttabone Station" and another property. As consideration for this purchase the company issued fully paid shares of £1 each, 85,000 shares being received by the trustee of the will as representing the capital of the testator's estate employed in the said business and 91,000 shares being issued to the individuals whose income arising from the estate had been used for capital purposes.

In 1914, the declaration of trust aforesaid was executed in the exercise of powers contained in the will for the purpose of settling upon certain trusts one of the shares of the estate, and some of the 85,000 shares of the company were appropriated to these trusts. Some of the settled shares held under the will having been distributed upon the deaths of tenants for life leaving issue, the result was that, at the time of the institution of the action, the trustee company held the said 40,800 shares and the said 17,600 shares in the capacities aforesaid.

Buttabone Pastoral Company Limited carried on business from the date of its incorporation; its business included wool-growing, sheep and cattle breeding and the buying and selling of live stock.

In 1924, the board of directors of the company determined to dispose of the lands and stock to the best advantage of the shareholders. Between December 9, 1924, and April 22, 1925, the whole of the lands, live stock and other

1937

HILLIARD C. McCONKEY v. MINISTER OF NATIONAL REVENUE.

Angers J.

assets were sold. As to some of the land the terms of the sale allowed six years for the payment of the total purchase price. The proceeds of the sale of the capital assets, except so far as some part had been distributed, were invested and the income from these investments and the interest paid by the purchasers of the land sold on terms, were distributed periodically in the form of dividend among the shareholders.

No resolution was ever passed for the winding up of the company, but on April 12, 1926, a resolution for voluntary liquidation proposed by a shareholder was defeated.

On April 28, 1926, the board of directors declared and subsequently paid to the shareholders an interim dividend at the rate of 11s. 8¾d. per share, such dividend being moneys arising wholly out of profits derived from the sale of the company's lands and improvements thereon and the shareholders were advised by letter that the directors had "decided to pay this dividend for the purpose of making a distribution of capital assets in advance of the winding up of the company, as the company had ceased to carry on its business."

No question arose for decision on the appeal with regard to this dividend of 11s. 8¾d. per share.

On November 11, 1927, the Board declared and subsequently paid to the shareholders a dividend at the rate of 9s. 6d. per share. The shareholders were advised, by means of a circular letter, that this dividend "is being paid out of the profits arising from the sale of breeding stock, being assets of the company not required for purposes of resale at a profit, and that it is free of income tax."

Under its articles of association the Buttabone Pastoral Company Limited had power by resolution to increase its capital.

Regarding dividends, the articles of association contained, among others, the following provisions:—

Art. 122. No dividend shall be payable except out of the profits arising from the business of the company, and no dividend shall carry interest.

Art. 124. The directors may from time to time pay to the members (on account of the next forthcoming dividends) such interim dividends as in their judgment the position of the company justifies. Subject as aforesaid the dividends shall be declared by the company at its ordinary general meetings.

1937

HILLIARD C. McCONKEY v. MINISTER OF NATIONAL REVENUE.

Angers J.

By special resolution passed in 1926, article 122 was altered by striking out the words "arising from the business"; article 124 was cancelled and the following substituted therefor:

Art. 124. The directors may from time to time pay to the members such interim dividend as in their judgment the position of the company justifies.

It was in connection with the dividend of 9s. 6d. that the originating summons was issued by the trustee.

The Supreme Court of New South Wales held that the distribution in question should be treated as capital (1).

The trial Judge, after discussing the decisions in *Knowles* v. *Ballarat Trustees, Executors and Agency Company Ltd.* (2), *Fisher* v. *Fisher* (3), *Drew* v. *Vickery* (4) and *In re Bates* (5), concluded as follows (p. 63):

In the present state of the authorities, therefore, it seems to me that the question for my determination resolves itself into a question of fact, as to what was the intention of the company in making the distribution in question, and that the principles upon which the question must be determined are (1) that conversion of profits into share capital is not necessary to convert them into capital for the purpose of a case between life tenant and remainderman; (2) that, although due weight will be attached to expressions of intention on the part of the company, the determining factor is the substance of the transaction; and (3) that if the distribution is in substance a distribution of the assets in anticipation of the liquidation of the company, and is in effect expressed so to be, the assets so dstributed will, in a case between life tenant and remainderman, be received as capital and not as income of the investment.

In the present case, taking all the admissible evidence into consideration, the conclusion is, I think, irresistible that the substance of the transaction was, to use the language of Harvey J. in *Drew* v. *Vickery* (19 S.R. 245, at 251), "a distribution of the assets in anticipation of the liquidation of the company"; . . .

An appeal was taken from the judgment of the Supreme Court of New South Wales to the Judicial Committee of the Privy Council. The decision of the Judicial Committee is reported, as previously mentioned, in (1930) A.C., 720.

The Judicial Committee expressed the opinion that "the two sums mentioned in the originating summons should be treated as income."

(1) (1929) 29 N.S.W., St. R. 53.
(2) (1916-17) 22 C.L.R., 212.
(3) (1916-17) 23 C.L.R., 337.
(4) (1919) 19 N.S.W., St. R. 245
(5) (1928) Ch. 682.

1937

HILLIARD C. McCONKEY v. MINISTER OF NATIONAL REVENUE.

Angers J.

Lord Russell of Killowen, who delivered the judgment of the Judicial Committee, after stating the facts and referring to the terms of the will says (p. 730):

> The learned judge in the present case decided that the two sums in question should be treated as corpus and not as income. The grounds of his decision appear to have been that the answer to the question depended upon what was the intention of the company in making the distribution, and that upon the whole of the evidence he came to the conclusion that the distribution was in fact, and was intended by the company to be, a distribution of capital assets in anticipation of liquidation. He further held that in order to convert profits into corpus as between tenant for life and remainderman, no conversion by the company of the profits into share capital was necessary, but that profits distributed might be corpus as between tenant for life and remainderman, even though no part of the fund was retained by the company in a capitalized form. As regards this part of his decision he realized that such a view was in conflict with the judgment of Eve J. in *In re Bates* (1928 Ch. 682), but he felt himself bound to consider the law as settled otherwise by reason of two decisions of the High Court of Australia—namely, *Knowles* v. *Ballarat Trustees, Executors and Agency Co.* (22 C.L.R. 212) and *Fisher* v. *Fisher* (23 C.L.R. 337).

Lord Russell of Killowen then states that, before considering these authorities and deciding which of them is based on a correct interpretation of the law, it would seem advisable to draw attention to certain salient points relevant to the issue. Among these points, there are two which appear to me particularly relevant to the present case and I deem it apposite to quote the observations of the learned Lord thereon (p. 731):

> (2) A limited company not in liquidation can make no payment by way of return of capital to its shareholders except as a step in an authorized reduction of capital. Any other payment made by it by means of which it parts with moneys to its shareholders must and can only be made by way of dividing profits. Whether the payment is called "dividend" or "bonus," or any other name, it still must remain a payment on division of profits.
>
> (3) Moneys so paid to a shareholder will (if he be a trustee) *prima facie* belong to the person beneficially entitled to the income of the trust estate. If such moneys or any part thereof are to be treated as part of the corpus of the trust estate there must be some provision in the trust deed which brings about that result. No statement by the company or its officers that moneys which are being paid away to shareholders out of profits are capital, or are to be treated as capital, can have any effect upon the rights of the beneficiaries under a trust instrument which comprises shares in the company.

The judgment then deals with the case of a company having power to increase its capital and possessing a fund of undivided profits, the whole of which is applied in paying up new shares which are allotted proportionately to the shareholders who would have been entitled to receive these

1937

HILLIARD C. McCONKEY v. MINISTER OF NATIONAL REVENUE.

Angers J.

profits had they been divided and paid as dividend. I do not think that the point in question has any materiality in the present case.

After reviewing the decisions which had formed the basis of the judgment of the Supreme Court of New South Wales, namely, *Knowles* v. *Ballarat Trustees, Executors and Agency Co.* (*ubi supra*) and *Fisher* v. *Fisher* (*ubi supra*), Lord Russell of Killowen concludes as follows (p. 735):

> These were the two authorities which in the present case Long Innes J. felt constrained to follow, in preference to adopting the reasoning of Eve J. in the later case of *In re Bates* (1928 Ch. 682).
>
> There the directors of a limited company had made payments to shareholders out of distributable profit, but had stated: "It must be clearly understood that this is neither a dividend nor a bonus, but is a capital distribution." Eve J. held that the payments were income receivable by a tenant for life. This appears to their Lordships to be an authority directly applicable to the present case, and their Lordships find themselves in complete agreement with the learned judge, both as regards his decision and the reasoning upon which it is based. Their Lordships desire to adopt the language used by Eve J., and to say in regard to the fund out of which the sums of £19,380 and £8,360 were paid by the Buttabone Company to the trustee company: "Unless and until the fund was in fact capitalized it retained its characteristics of a distributable property . . . . . no change in the character of the fund was brought about by the company's expressed intention to distribute it as capital. It remained an uncapitalized surplus available for distribution, either as dividend or bonus on the shares, or as a special division of an ascertained profit . . . . . and in the hands of those who received it it retained the same characteristics."
>
> For these reasons their Lordships are of opinion that the two sums here in question should be treated as income and not as corpus. They are "net income or profits derived from such investment or investments"; they are not "capital of my said trust estate."

It was urged on behalf of the appellant that the case of *Hill* v. *Permanent Trustee Co. of New South Wales* differs from the present one in that:

(*a*) it was a contest between life tenant and remainderman;

(*b*) the distribution was admittedly made from profits;

(*c*) in the case at bar there is an agreement between the parties that the fund from which the sum of $12,000 was distributed in 1932 was to be considered as capital;

(*d*) in the case at bar the company went into liquidation and the capital distribution to the shareholders was reduced *pro tanto* by the distribution of the sum of $12,000.

Counsel for the appellant submitted that, in the present case, once the depletion or exhaustion allowance is identi-

fied as a capital fund the converse of Lord Russell of Killowen's statement is equally the law as the company is prohibited by article 122 of its articles of association from paying any dividend except out of the profits arising from the business of the company.

Article 122 reads as follows:

Interest may be paid out of the capital where by virtue of the statutes it is lawful so to do, but no dividend shall be payable except out of the profits arising from the business of the company.

The decision in the *Hill* case was discussed by the President of this Court in *Northern Securities Company* v.*The King* (1). In this case, the suppliant, a company incorporated under the laws of the State of New Jersey, a non-resident of Canada, sought to recover from the Crown a tax of 5% levied on the amount of a dividend received from Crow's Nest Pass Coal Company Limited, a company incorporated under the Companies Act (Canada) for the chief object of mining.

The assessment had been made under subsection 2 (*a*) of section 9 B of the Income War Tax Act; subsection 2 (*a*) reads thus:

2. In addition to any other tax imposed by this Act an income tax of five per centum is hereby imposed on all persons who are non-residents of Canada in respect of

(*a*) All dividends received from Canadian debtors irrespective of the currency in which the payment is made, ...

I may note that the Crow's Nest Pass Coal Company Limited was a mining company subject to section 98 (2) of the Companies Act (Canada) and as such entitled to pay dividends out of funds derived from its operations, notwithstanding that the value of the net assets of the company might thereby be reduced to less than the par value of the issued capital stock.

After reviewing the decisions in *Hill* v. *Permanent Trustee Company of New South Wales Limited* (*ubi supra*), *Bouch* v. *Sproule* (2), *Knowles* v. *Ballarat Trustees, Executors and Agency Co.* (*ubi supra*), *In re Bates* (*ubi supra*) and *Lee* v. *Neuchatel Asphalte Co.* (3), the President came to the conclusion that the suppliant must fail. He said that, even if the dividends paid out were derived from capital, they could lawfully be paid therefrom by virtue of section 98 of the Companies Act; and he added (p. 165):

(1) (1935) Ex. C.R. 156. (2) (1887) 12 A.C. 385.
(3) (1889) 41 Ch. D. 1.

1937

HILLIARD C. McCONKEY v. MINISTER OF NATIONAL REVENUE.

Angers J.

But while this provision of the Companies Act permitted the company to pay a "dividend," even if it impaired capital, that does not make the payment of the "dividend" a distribution of capital, which might have been done by reducing the capital of the company, if the company had acquired the power to do so; it permits that which was done here, the payment of "dividends" to shareholders, from funds derived from the mining operations of the company, which, I think, must be held to constitute income in the hands of the shareholders, because it is a dividend upon shares of the capital stock of the company. The exception, as to the payment of dividends, in favour of mining companies where capital is impaired, does not give a new characteristic to the dividend paid; it is like any other dividend and is not a return of capital.

The learned judge however said that he did not think it necessary to rely upon decided authority to determine the point at issue before him; he thought it was sufficient to look at section 9 B alone. Answering the question as to what the legislature intended by enacting this section, the learned judge said (p. 165):

Plainly, I think, it was to impose a tax upon two classes of dividends, and also upon interest payments,—excepting those made in respect of bonds of the Dominion of Canada—paid by Canadian debtors, regardless of the source from which they came. It is a tax quite distinct from the income taxes contemplated by sec. 9 of the Act, and the other provisions of the Act have no application to sec. 9 B. It is a tax upon certain dividend and interest payments payable by the recipient thereof. A reference to the first clause of 9 B will show that the tax is payable only on dividends received by residents of Canada when the same is payable in a currency which is at a premium in terms of Canadian funds. The purpose of this clause is quite obvious. Then dividends paid to non-residents of Canada are taxable, with the object, I assume, of placing all shareholders in Canadian companies on a parity, in respect of dividends paid by such companies. Then under subsec. 5 of sec. 9 B, the tax is imposed on many of the persons, companies, associations, etc., that are exempt from income tax under sec. 4 of the Act. But for the sake of convenience it seems to me sec. 9 B might have been enacted as an independent statute, because it only purports to tax specific receipts of moneys, when paid as dividends or interest, by Canadian debtors, and in respect of which no deductions are allowable. I do not think one is required to go behind the payments and inquire into anything antecedent. Therefore it would seem to me to be unnecessary to look beyond the four corners of sec. 9 B to determine the question at issue here.

It was submitted on behalf of the appellant that the case of *Northern Securities Company* v. *The King* differed from the present one in the following respects:

the decision in that case related to the meaning of section 9 B and the Court held that the question of whether the fund was capital or income was immaterial;

the Court was not satisfied that the distribution had the effect of depleting the capital, whilst in the present

case it is clear that the distribution had this effect, there being no other funds from which it could have been made;

the Crow's Nest Pass Coal Company was a mining company subject to section 98 (2) of the Companies Act (Canada) which, because of the fluctuating value of mining assets, relaxes the distinction between capital and income;

the Hy-Grade Coal Company was prevented by its articles from paying a dividend out of capital;

the Crow's Nest Pass Coal Company did not go into liquidation, which might have revealed the true character of the fund; in the present case liquidation followed and the capital which the shareholders would otherwise have received was reduced by the amount of the distribution in question.

Counsel for the respondent also relied on the case of *Lee* v. *Neuchatel Asphalte Company* (1). The head-note, which contains a concise and fair summary of the facts and of the decision, may conveniently be cited:

Where the shares of a limited company have, under a duly registered contract, been allotted as fully paid-up shares in consideration of assets handed over to the company, it is under no obligation to keep the value of its assets up to the nominal amount of its capital, and the payment of a dividend is not to be considered a return of capital, merely on the ground that no provision has been made for keeping the assets up to nominal amount of capital.

There is nothing in the Companies Acts to prohibit a company formed to work a wasting property, as, e.g., a mine or a patent, from distributing, as dividend, the excess of the proceeds of working above the expenses of working, nor to impose on the company any obligation to set apart a sinking fund to meet the depreciation in the value of the wasting property. If the expenses of working exceed the receipts, the accounts must not be made out so as to shew an apparent profit, and so enable the company to pay a dividend out of capital, but the division of the profits without providing a sinking fund is not such a payment of dividends out of capital as is forbidden by law.

At page 24 Lord Lindley says:

Now we come to consider how the *Companies Act* is to be applied to the case of a wasting property. If a company is formed to acquire and work a property of a wasting nature, for example, a mine, a quarry, or a patent, the capital expended in acquiring the property may be regarded as sunk and gone, and if the company retains assets sufficient to pay its debts, it appears to me that there is nothing whatever in the Act to prevent any excess of money obtained by working the property over the cost of working it, from being divided amongst the shareholders, and this in my opinion is true, although some portion of the property itself is sold, and in some sense the capital is thereby diminished.

(1) (1889) 41 Ch. D. 1.

1937

HILLIARD C. McCONKEY v. MINISTER OF NATIONAL REVENUE.

Angers J.

It seems to me expedient to quote an extract from the remarks of Eve J. in *In re Bates* (1):

That no doubt was done with the intent, which was indeed expressed, to protect the recipients from liability to taxation, but the mere impressing of these distributions with the appellation of "capital distributions" cannot in my opinion determine their true character. One must inquire a little closer for the purpose of ascertaining whether they were in fact distributions of capital or distributions of something which, although in one sense capital, in that it originated by the realization of assets and not from the ordinary income of the company's business, could not properly be regarded as capital for all purposes. The suspense account represented realized profit on the company's capital assets, and inasmuch as the equilibrium between capital and liabilities on the one side and assets on the other was maintained without any necessity to resort to this fund, it represented what I think is spoken of in one of the cases as "the total appreciation of the capital assets"; . . . . . In this state of affairs it was a fund which the company could treat as available for dividend and could distribute as profits, or having regard to its power to increase capital could apply to that purpose by, for example, increasing the capital, declaring a bonus and at the same time allotting to each shareholder shares in the capital of the company paid up to an amount equivalent to his proportion of the bonus so declared. Unless and until the fund was in fact capitalized it retained its characteristics of a distributable profit, and on the authority of the passages which have been read from Lord Herschell's speech in *Bouch* v. *Sproule* (12 App. Cas. 385, 399), the only method by which a company with power to increase its capital can capitalize such a fund is to increase its capital by an amount equivalent to the sum sought to be capitalized.

McNeil v. *Federal Commissioner of Taxation* (2) may also be consulted with interest.

See Palmer's Company Law, 15th ed., 223:

The rule prohibiting payment of dividend out of capital as formerly understood was very much modified by some far-reaching decisions of the Court of Appeal, of which the following are the most important: *Lee* v. *Neuchatel Asphalte* Co., 41 Ch. D. 1; *Verner* v. *General Commercial Trust* (1894) 2 Ch. 239; and *Wilmer* v. *Macnamara* (1895) 2 Ch. 245; below referred to as the *Lee* v. *Neuchatel* series of decisions. These decisions were very strongly criticized by the author at the time; but they have remained unaltered for many years and have been followed and applied in *Ammonia Soda Co.* v. *Chamberlain* (1918) 1 Ch. 266 (C.A.), and *Lawrence* v. *West Somerset Rail. Co.*, (1918) 2 Ch. 250, and the principles based upon them and now generally accepted may be stated as follows:—

1. . . . . .

2. . . . . .

3. To divide the net income arising from a company's property is not to be regarded as in any sense a return of capital, even when the income arises from a wasting property acquired by an expenditure of capital, for instance, from a lease of ten acres of coal, one acre of which is worked out each year.

(1) (1928) Ch. D. 682 at 687.

(2) Australasian Income Tax Decisions (Ratcliffe and McGrath) 35.

4. Therefore, though an express power in the memorandum to return capital to shareholders can only be exercised with the sanction of the Court, a power in the articles to apply the proceeds arising from a wasting property in paying dividends, is free from objection, although the result is much the same. *Lee* v. *Neuchatel, &c. Co.*, 41 Ch. D. 1.

See also Wegenast, The Law of Canadian Companies, 615.

The facts are simple and are not disputed. There is no doubt, in my mind, that the payment to the shareholders of the sum of $12,000 in 1932 was made out of the exhaustion or depletion fund and that this fund was accumulated, during a period of years, with the knowledge and approval of the Minister. This exhaustion or depletion reserve was built up for the purpose of replacing the capital assets of the company, which consisted solely of a wasting property.

The cases cited are not identical with the present one although to a certain extent analogous; they may, in some measure, be distinguished; I do not deem it expedient, however, to dwell on this particular phase. It will suffice to note that they lay down categorically the following principles by which I feel I must be governed:

that until a reserve fund is effectively capitalized it retains the characteristics of distributable profits;

that a corporation not in liquidation can make no payment to its shareholders by way of return of capital except as a step in an authorized reduction of capital and that any other payment made to its shareholders can only be made by way of dividing profits.

A careful perusal of the evidence, oral and literal, as well as of the precedents has led me to conclude, not entirely without hesitation I must admit, that the sum of $12,000 distributed to the shareholders in 1932 and of which the appellant received $5,028 as his share must be treated as income and not as capital. If this sum had been held by the company until the winding up and had been distributed to the shareholders by the liquidator, it would very likely, and should in my opinion, have been considered as capital. This sum having been paid by the company while still a going concern the payment cannot, in the face of the decisions aforesaid, be considered as a return of capital but must be treated as the distribution of a dividend. The share received by the appellant was accordingly taxable as income.

1937

HILLIARD C. McCONKEY v. MINISTER OF NATIONAL REVENUE.

Angers J.

Reliance was placed by the appellant on section 18 of the Act; I do not think that this section has any application in the present case.

For these reasons I believe that the assessment must be affirmed and the appeal dismissed.

The respondent will have his costs against the appellant.

Judgment accordingly.