BETWEEN:

THE MINISTER OF NATIONAL REVENUE ..... APPELLANT;

AND

CLEMENT'S DRUG STORE (BRANDON) LIMITED ..... RESPONDENT.

Winnipeg 1967 Dec. 12-13

Ottawa 1968 Feb. 5

Income tax—Capital cost allowances—Sale of business to employee—Cost of fixtures specified in contract—Whether amount reasonable—Contract bona fide—Income Tax Act, s. 20(6)(g).

A pharmacist employed in a retail drug store contracted to buy his employer's business for $110,000, of which $45,000 was allotted by the contract to fixtures (principally solid oak shelving and beam fixtures installed in 1913), but no amount was allotted to any other assets. The fixtures had originally cost some $8,700 but their undepreciated capital cost at the time of the contract was $962. The contract provided that if the monthly lease of the store premises were terminated

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within nine years or the rent substantially increased the price of the business should be $33,779 (the value of the stock-in-trade) plus 90% of the profits until termination of the lease, but this contingency did not occur. The contract was assumed by respondent company, which carried on business in the premises under a monthly lease for nearly three years when it entered into a long-term lease for enlarged premises and undertook as a term thereof to make certain alterations, in the course of which it substituted new shelving for the oak shelving. In assessing appellant the Minister applied s. 20(6)(*g*) of the *Income Tax Act* and reduced the capital cost of the fixtures from $45,000 to $3,000 as the amount which could reasonably be regarded as the consideration therefor.

Held (affirming the Tax Appeal Board), the assessment could not stand. The rule in s. 20(6)(*g*) did not apply in the circumstances. The decisive circumstance was the actual cost to respondent of the fixtures which was $45,000, that being the amount actually paid under a *bona fide* contract negotiated at arm's length.

INCOME TAX APPEAL.

F. L. Dubrule and *J. Halley* for appellant.

Frank O. Meighen, Q.C. for respondent.

CATTANACH J.:—This is an appeal by the Minister from a decision of the Tax Appeal Board[1] dated April 22, 1966 in respect to the Minister's assessment to income tax for the respondent's 1960 and 1961 taxation years. By the assessments in question the Minister reduced the capital cost allowance claimed by the respondent in respect of furniture, fixtures and equipment purchased by it from $45,000 to $3,000 and computed the tax payable accordingly.

The transaction which gave rise to this appeal was the sale in 1959 of a retail drug business carried on in the City of Brandon, Manitoba. This business was begun originally by D. E. Clement, a member of the Clement family, in 1913 in a building known as the Clement Block, a five storey building situated in the centre of the downtown area of the city. The four upper storeys contained offices and the street level floor housed a variety of businesses over the years but including the drug store throughout those years. The building was owned by a number of the members of the Clement family of which Mr. D. E. Clement was one.

[1] (1966) 41 Tax A.B.C. 125.

In 1934 Clement's Drug Store Limited was incorporated to acquire and carry on the drug store on the identical site. At that time Mr. W. P. Lowres, who had been associated in partnership with Mr. D. E. Clement prior thereto, acquired a substantial share interest in the Company and eventually, in or about 1948, he became the beneficial owner of all issued and outstanding shares in the Company.

The business carried on throughout the years can best be described as a reputable family pharmacy. While a variety of items normally associated with a drug store were sold, nevertheless, much emphasis was placed upon the expert and accurate filling of prescriptions. The fixtures, the greater portion of which consisted of solid oak shelving and beam fittings, were custom built and installed in 1913 and were in continuous use since that time. They were designed to complement and accentuate the high repute and substantial nature of the pharmacy business to be carried on in the premises. Representations of the mortar and pestle were carved into the oak fixtures to complete the motif and coloured apothecary globes were displayed.

When the fixtures were acquired by Clement's Drug Store Limited in 1934 they were taken into the Company's opening balance sheet at $4,000. Mr. Lowres testified that this was during the depression years when the value of all assets was extremely low. Between 1935 and 1938 there were additions to the fixtures in the amount of $3,042.59 making a total of $7,042.59 the undepreciated capital cost of which was $814.58 as at December 31, 1948. Between 1949 and 1959 further additions were made in the amount of $1,648.76 thereby bringing the total cost of these assets to the Company to $8,691.35, the undepreciated capital cost of which was $962.54 as at December 31, 1959. However, Mr. Lowres said that in the depression years of the thirties many items were claimed as expenses in the year of purchase and not depreciated.

The retail drug business carried on first by Mr. D. E. Clement and then by his successor, the Company owned by Mr. Lowres, was particularly successful and over the years became increasingly more successful. In the Rexall method of drug merchandising this store always stood in the top listings based upon the value of purchases from Rexall.

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Mr. Lowres employed a number of qualified pharmacists. In 1957 he employed John Garth Allen in that capacity on a salary and bonus basis. Mr. Allen was anxious to engage in the drug business on his own account. Some time in 1958 he indicated to Mr. Lowres that he wished to purchase the business to which overture Mr. Lowres was not unduly receptive. Mr. Allen, therefore, investigated the possibility of purchasing two or three other businesses. However Mr. Allen, who was young and ambitious, persisted in his efforts to purchase the business owned by Mr. Lowres with which his employment had made him familiar.

In 1959 Mr. Lowres agreed to sell the business for a price of $100,000.

Accordingly an agreement between Clement's Drug Store Limited as vendor, John Garth Allen as purchaser and William Percy Lowres as convenanter, was entered into on December 30, 1959 whereby the business was sold to the purchaser, Mr. Allen, for $100,000 made up of fixtures at $45,000 and stock-in-trade to be determined and valued as at December 31, 1959. The stock-in-trade was subsequently determined to have been $33,779.23 as at that date.

The purchase price was payable, $20,000 in cash and the balance by equal consecutive annual payments of $8,000 payable at $4,000 on the last day of June and December commencing on the last day of June, 1960.

Interest was payable on the outstanding balance at 3 per cent beginning January 1, 1963 until January 1, 1965 when the interest on the outstanding balance of the purchase price would be at the rate of 4 per cent.

Mr. Allen undertook to employ Mr. Lowres as a business consultant and adviser for a period of ten years or so long as Mr. Lowres or his wife should retain ownership of at least 51 per cent of the shares of the vendor company, whichever should be the earlier date at an annual salary of $4,800 payable monthly.

By the agreement dated December 30, 1959 it was provided by paragraphs 10 and 11 thereof that upon the incorporation of a new company by Mr. Allen that a new agreement substantially embodying the terms of the agree-

ment dated December 30, 1959 would be entered into by the parties and the new company would then, in effect, stand in the place of the original purchaser, Mr. Allen.

A new company was incorporated, which is the present respondent, and an agreement was made dated December 23, 1960 to which the respondent was also a party whereby it acquired the business and assets of the drug store and undertook obligations substantially similar to those in the prior agreement.

The present appeal was heard and argued on the assumption that the respondent herein should be regarded as the original purchaser. A contrary assumption would not have a material bearing on the eventual outcome of the present appeal. If the original purchaser were Mr. Allen personally, and not as agent or trustee for the company to be formed, the respondent would be deemed to have acquired depreciable property at the same capital cost as the capital cost to Mr. Allen (see section 20(4) of the *Income Tax Act*) since any transaction between Mr. Allen and the respondent, which he controlled, would not be at arm's length (see section 139(5) and 139(5a)).

At no time during the conduct of the drug store business did the proprietor have a long term written lease with the landlord. Presumably when Mr. D. E. Clement was the owner of the drug store there was no necessity for a long term lease because he was a co-owner and closely related to the other co-owners of the building and I would presume that similar considerations prevailed when Mr. Lowres first became associated with Mr. Clement in the business. In all likelihood these considerations may have continued when Mr. Lowres acquired the controlling interest of the Company which became the owner of the drug store. The premises were let on a monthly basis and the oral monthly lease could have been terminated on one month's notice, a circumstance which was well known to all parties to the sale of the business.

I have no doubt that the location of the business was one of the paramount considerations present to Mr. Allen's mind when he was negotiating for its purchase. Accordingly the agreements contained a provision covering the contingency that the landlord might terminate the lease.

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Paragraphs 3 and 4 of the agreement dated December 23, 1960 read as follows:

3. The Purchaser will employ the Vendor as a business consultant and adviser for a period of ten (10) years or so long as the Party of the Fourth Part or his wife shall retain the ownership of at least fifty-one (51%) per cent of the capital stock of the Vendor whichever shall be the earlier date or for such lesser period as the Purchaser may have to assume by reason of the fact that it is no longer able to occupy the premises presently occupied by the Vendor by reason of the refusal of the owners thereof to permit the continued occupancy thereof by the Purchaser either through refusal to continue the rental arrangement presently in existence, by the giving of notice by the Landlord or by the Landlord requiring the Purchaser to pay a rental in excess of Eight Thousand ($8,000 00) Dollars per annum and the Purchaser being unable to obtain substitute business accommodation in the City of Brandon in order to continue the operation of said business. The salary to be paid to the Vendor shall be Forty-eight Hundred ($4,800 00) Dollars per year. If prior to the thirty-first day of December, A.D. 1969 the lease or rental arrangement with respect to the premises to be occupied by the Purchaser shall be terminated as aforesaid or should the Landlord require a rental to be paid in excess of the sum of Eight Thousand ($8,000 00) Dollars per year and the property be surrendered accordingly and the Purchaser shall not be able to acquire suitable premises in the City of Brandon to carry on the said business but shall be desirous of acquiring other premises which it considers will not be so suitable then the salary to be paid hereunder shall be the subject of arbitration. The Purchaser shall appoint one arbitrator, the Vendor another and the two arbitrators so chosen shall choose a third and their decision as to the salary to be paid thereafter shall be final and binding upon the parties hereto.

4 If prior to the thirty-first day of December, A.D. 1969 the lease or rental arrangement with respect to the premises to be occupied by the Purchaser shall be terminated by the Landlord or should the Landlord require a rental to be paid in excess of the sum of Eight Thousand ($8,000 00) Dollars per year and the property be surrendered accordingly and should the Purchaser be unable to obtain other suitable business premises in the City of Brandon to carry on said business the purchase price shall subject to the provisions of this paragraph be reduced on the basis hereinafter set forth, namely:

The value of the stock and fixtures as determined as of the thirty-first day of December, A.D. 1959 in the sum of Thirty-three Thousand Seven Hundred and Seventy-nine Dollars Twenty-three Cents ($33,779 23) and there shall be added thereto ninety (90%) per cent of the profit of the business each year thereafter (after payment of income tax) up to the aforesaid termination of the lease and the Purchaser shall pay unto the Vendor the total amount thereof not to exceed in any event One Hundred Thousand ($100,000.00) Dollars and any payments made hereunder shall be applied thereon. In the event that the termination of the lease should take place in mid-year then the pro-rata portion of the profit for such year shall be determined on the profit of the preceding year. Should the Purchaser find other business premises in the City of Brandon which it considers will not be suitable for

> the carrying on of the said business and should it leave the present premises then the Purchaser may require the balance of the purchase price to be set by arbitration in which case the Purchaser shall choose one arbitrator, the Vendor shall choose one arbitrator and the two arbitrators so chosen shall choose a third and the decision of the majority of the arbitrators so chosen shall be final and binding upon the parties hereto.

The corresponding provisions of the agreement dated December 30, 1959 are contained in paragraphs 4 and 5 of that agreement except that in paragraph 5 the value of the stock and fixtures as shown in the books of the vendor as at December 31, 1959 is to be taken whereas in the second agreement the value of the stock and fixtures is stated in the specific sum of $33,779.23 which sum is the value of the merchandise inventory as at December 31, 1959 determined shortly after that date.

However the contingency contemplated by the foregoing provisions did not arise.

The respondent continued the business in the same premises held under a monthly tenancy for a period of two years and nine months.

Sometime in the late summer of 1962 a rumour came to the attention of Mr. Allen while he was on vacation that the landlord was negotiating for a lease to a chartered bank for the entire ground floor area of the Clement Block. Such negotiations had been in progress in fact but had broken down, of which circumstance Mr. Allen was unaware and the landlord did not communicate it to him. He therefore cut short his vacation and returned to negotiate a lease for the premises occupied by the drug store. At that time on the ground floor there was a small area occupied by a clothier adjacent to the drug store premises and on the other side of the clothier were premises occupied by a travel agency operated by D. W. Clement who was one of the co-owners of the building. The landlord had experienced difficulty in obtaining satisfactory tenants for the space occupied by the clothier because of the small area. The landlord considered that it would be more advantageous to eliminate that space by dividing it and adding to the areas occupied by the drug store and travel agency. This addition of space was a condition precedent to the landlord entering into a long term lease with Mr. Allen who felt impelled to comply.

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Accordingly a lease dated September 30, 1962 was entered into between the landlord and the respondent covering the increased area for a period of seven years at a monthly rental of $550. By a memorandum annexed to and forming part of the lease, the landlord undertook the necessary construction work to expand the premises, but the respondent undertook to install a new store front to the expanded area of the drug store. The installation of a new store front had been casually broached to Mr. Lowres by the landlord but was never a matter of serious consideration between them. There was no evidence that the possibility of the landlord requiring a new store front to be installed had ever been brought to Mr. Allen's attention.

Mr. Allen investigated the feasibility of matching the oak fixtures already in use in the acquired area but found the cost to be prohibitive. Accordingly he removed the original oak fixtures and installed modern metal fixtures throughout the store. Nothing was realized upon the discarded oak fixtures because they had been custom built for the premises where used and were useless elsewhere. An attempt to realize scrap value was unsuccessful.

Under the terms of the original agreements for sale the balance of the purchase price was to be secured by a chattel mortgage. However, it was not until February 15, 1963 that this requirement was complied with by two instruments bearing that date covering the fixtures and stock-in-trade used in the business securing the then outstanding amount of $68,000 and subject to a prior chattel mortgage in favour of the respondent's bank.

Mr. Allen testified that when he purchased the fixtures he had no intention of replacing them and that his decision to do so was necessitated by the circumstances outlined above. He added that they were more than satisfactory for the purpose of conducting a retail drug store. As an indication of the efficiency of the fixtures it was established that the business under Mr. Allen's management increased its Rexall rating to first and second in 1961 and 1960 respectively. Rather than becoming obsolete the fixtures had become enhanced in value.

He also testified that certain of the equipment originally purchased was still in use, a schedule of which was filed in evidence as Exhibit 11. Mr. Allen assigned values to each

such item totalling $12,170. No consistent method of evaluation was adopted. In some instances cost was used, in others replacement value and in some instances a depreciated value was used, but in any event I am certain that Mr. Allen's estimate of $12,170 represents a value very approximate to the value of those items still in use. In addition he had also purchased an outside neon sign which he valued at $1,500.

Mr. Lowres gave evidence to like effect as to the efficiency of the fixtures and further testified that he would not have sold them for less than $45,000. In fixing a price of $100,000 in response to Mr. Allen's desire to purchase the business he said that such was the worth of the business to him. I should add that subsequent to the agreement dated December 30, 1959 Mr. Lowres deposited $10,000 in the vendor company's current bank account. This account was purchased and transferred to the respondent. Mr. Lowres said that he did this to facilitate Mr. Allen carrying on the business and that it was in the nature of a loan. By paragraph 15 of the agreement dated December 23, 1960 the amount of $10,000 was added to the purchase price. I should also add that by the two agreements the respondent assumed all trade liabilities of the vendor as at December 31, 1959 which totalled $18,275.

I would add that in preparing his tax return Mr. Lowres reported the sale of the fixtures and equipment at $45,000 and brought into income capital cost allowance recaptured in the amount of $1,650.80.

The amount of $45,000 as the price of the fixtures and equipment as recited in both of the two agreements for sale dated December 30, 1959 and December 23, 1960 was arrived at by negotiation between Mr. Lowres and Mr. Allen. An evaluator was not engaged to fix prices on the assets, but the amount was settled upon by the vendor and purchaser.

The value of the total assets sold was $128,275 consisting of current assets such as cash on hand, bank account, accounts receivable, merchandise inventory and prepaid expenses, to the total amount of $45,844.02, investments in the total amount of $1,055 fixed assets at $45,000 making a total of tangible assets of $91,899.02 added to which was goodwill at $36,375.98. When the total of liabilities

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assumed in the amount of $18,275 is deducted from the total of the assets acquired being in the amount of $128,-275, the net sale price is $110,000. The only figures in dispute between the parties is the $45,000 attributed to fixtures and equipment by the respondent and an amount of $36,375.98 to goodwill.

The Minister says that an amount of $3,000 only can reasonably be attributed to the consideration for the fixtures and equipment from which it follows that an amount of $78,375.98 would be attributed by the Minister to goodwill, an increase of $42,000 over the amount of $36,375.98 attributed to goodwill by the respondent.

The issue between the parties, therefore, resolved itself into the problem of determining on the facts as disclosed by the evidence, what part of the total purchase price can reasonably be regarded as having been the consideration for the depreciable property purchased, i.e. the fixtures and equipment.

The statutory provision under which the matter arises reads as follows:

> 20. (6) For the purpose of this section and regulations made under paragraph (*a*) of subsection (1) of section 11, the following rules apply:
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> . . .
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> (*g*) where an amount can reasonably be regarded as being in part the consideration for disposition of depreciable property of a taxpayer of a prescribed class and as being in part consideration for something else, the part of the amount that can reasonably be regarded as being the consideration for such disposition shall be deemed to be the proceeds of disposition of depreciable property of that class irrespective of the form or legal effect of the contract or agreement; and the person to whom the depreciable property was disposed of shall be deemed to have acquired the property at a capital cost to him equal to the same part of that amount;
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> . . .

The argument of counsel for the respondent, as I understood it, was that the sale was an arm's length transaction between two knowledgeable persons both of whom were completely familiar with the business and knew its potentialities and who also knew the value of the fixtures as they were. He also pointed out that although the oak fixtures custom built for the premises were replaced by modern metal ones within twenty-one months of the purchase, this was done only for the reason that to obtain a

long term lease the respondent was obliged to rent a larger area. He emphasized that although the greater bulk of the oak fixtures had to be discarded, nevertheless, some of the equipment which had been purchased was still being used in the renovated premises which equipment had a conservatively estimated value of $12,170. This fact, he contended, leads to an irrefutable conclusion that the amount of $3,000 attributed by the Minister as consideration for the purchase of the depreciable property is not reasonable and that the true consideration for the depreciable assets was the price of $45,000 arrived at by the parties to the sale thereof.

The assessments carry a statutory presumption of validity and stand until they have been shown to be erroneous either in fact or in law. Therefore, to succeed in this appeal the respondent must prove that the finding of the Minister that the capital cost to the respondent of the depreciable assets in question was $3,000 was erroneous. (*Vide Johnston v. M.N.R.* [1948] S.C.R. 486 at 489).

I am completely satisfied on the evidence that the assets were not inefficient, obsolete or in need of replacement at the time of their purchase. On the contrary I am satisfied that the respondent would have continued to use them for a long period of years and that the decision to replace those fixtures with modern metal ones was dictated by the respondent's desire for a long term lease of the premises which the landlord would not give unless an enlarged area was covered by such a lease.

The crux of the argument put forward by counsel for the Minister was, as I understood it, that, assuming the statutory rule outlined in section 20(6)(*g*) of the *Income Tax Act* applies, the question is then, what amount can reasonably be regarded as having been consideration for the depreciable property. He contended that an amount of $3,000 is the amount which can be reasonably so regarded, upon which assumption the Minister based his assessments and that the balance of the purchase price, after deducting the value of the inventory purchased, can be reasonably regarded as being in consideration of something else, i.e. goodwill.

In support of the foregoing submission he pointed out that the overall price was to be $100,000, later increased to

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$110,000, and that the only item for which a specific allocation was made in the agreements for sale was that of fixtures and equipment where $45,000 was specified as the price. He added that the delay of the vendor in obtaining a chattel mortgage on the fixtures and stock-in-trade in accordance with the agreement for sale to secure payment of the purchase price of the business was indicative of an overvaluation of the fixtures and equipment. I think this circumstance is equally susceptible of the interpretation that the vendor was satisfied with the integrity of the respondent and its ability to pay from the proceeds of the business in which he acted as a consultant and that resort to this additional security was had when a prior chattel mortgage was placed on the stock-in-trade and new fixtures to secure the respondent's bank loan. Therefore, I do not consider this circumstance to be conclusive either way. His principal submission is, however, that no price was in fact fixed as the purchase price of the drug business at the date of the sale, December 30, 1959, which is the material date, and that it was only when the respondent entered into a lease with its landlord on September 30, 1962 that the price of $110,000 became fixed and determined.

Under the provisions of paragraph 1 and paragraph 15 of the agreement dated December 23, 1960 the purchase price was stated to be $110,000 subject to the assumption by the respondent of accounts payable as at December 30, 1959. Since the tenancy of the premises was a monthly one, provision was made in paragraph 4 of the aforesaid agreement, that in the event of the landlord terminating the monthly tenancy, or exacting a rental in excess of $8,000 per year and the respondent could not obtain suitable premises elsewhere in the city, then the purchase price would be reduced to a value of $33,779.23 for the stock and fixtures plus 90% of the yearly profits of the business to the termination of the lease. Provision was made for a *pro rata* determination of profits if the lease were terminated in mid-year and for arbitration of the purchase price if the respondent carried on the business in premises it considered unsuitable.

Counsel for the Minister contended that the respondent did not obligate itself to pay a purchase price of $110,000 but rather that the minimum amount that the respondent bound itself to pay was the consideration set out in para-

graph 5 of the agreement dated December 30, 1959 and paragraph 4 of the agreement dated December 23, 1960. On the assumption that the landlords gave the respondent notice to quit on December 31, 1959, as they were entitled to do and that the respondent would be required to vacate on January 31, 1960, he then computed, by an application of the formula outlined in the foregoing paragraphs of the agreements, the minimum amount which the respondent obligated itself to pay to be approximately $35,000. On that basis he contended that a consideration of $3,000 for the purchase of the depreciable property is a most reasonable proportion bearing in mind that $33,779.23 was the determined value of the merchandise inventory and that the amount of $45,000 attributed by the contract as the consideration therefor is unreasonable.

I am unable to accede to the Minister's contention in this respect. The question is not whether the respondent absolutely bound itself to pay $110,000 for the business, but whether it paid that amount for the business in accordance with the terms of the contract. While it is true that the parties took account of, and provided for, the contingency of the respondent being dispossessed, nevertheless, that contingency did not arise.

Under section 11(1)(*a*) of the *Income Tax Act* it is provided that certain "amounts may be deducted in computing the income tax of a taxpayer in a taxation year" including "such amount in respect of the capital cost to the taxpayer of property, if any, as is allowed by regulation". Section 1100(1)(*a*) by the regulations enacted under section 11(1)(*a*) of the Act provides for deductions for each taxation year equal to the rates specified in paragraph (*a*) applicable to an amount remaining after deducting the amount determined under section 1107 of the regulations, from the undepreciated "capital cost" to the taxpayer. The amount so to be deducted under section 1107, as applicable to the 1954 and subsequent taxation years to the 1966 taxation year, is an amount equal to (*a*) the capital cost of the property that was acquired, (*b*) minus the proceeds of disposition of that property.

It is, therefore, clear that the capital cost allowance is computed upon the actual "cost" of the depreciable assets to the taxpayer for which reason it is incumbent upon me to determine that cost.

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In my view the cost of the depreciable property here in question is $45,000 as determined by the contract among the parties to the sale thereof. That is the amount, under the terms of the contract, the respondent paid for the fixtures and equipment in question. The contract was the subject of arm's length negotiations over a protracted period and was not a mere sham or subterfuge but represents the bargain arrived at by the parties and in my opinion is decisive in the circumstances of this case.

The statutory rule outlined in section 20(6) of the *Income Tax Act* quoted above applies only "where an amount can reasonably be regarded as being in part consideration for disposition of depreciable property of a taxpayer of a prescribed class and as being in part consideration for something else". No question therefore arises under that provision as the circumstances of this particular appeal do not fall within the ambit of the provision.

I do not accept the original premise of counsel for the Minister that the rule so outlined applies here for the simple reason that the parties to the sale of the depreciable property agreed on the capital cost thereof to the respondent, the purchaser.

The appeal is, therefore, dismissed with costs.