

1938
March 28
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Dec. 6.
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BETWEEN:

WALTER E. H. MASSEY'S EXECU- } APPELLANTS;
TORS

AND

THE MINISTER OF NATIONAL } RESPONDENT.
REVENUE

*Revenue—Income—Income War Tax Act, R.S.C., 1927, c. 97, s. 17—
“Corporation having undistributed income on hand”—Redemption
of company's shares at a premium—Premium paid out of and charged
against surplus account of company—Liability for tax.*

S. 17 of the Income War Tax Act, R.S.C., 1927, c. 97, at the material
time herein, read as follows:—

“Where a corporation, having undistributed income on hand,
redeems its shares at a premium paid out of such income, the premium
shall be deemed to be a dividend and to be income received by the
shareholder.”

Massey-Harris Co. Ltd. in 1929 redeemed its outstanding 7 per cent
cumulative preference shares at 110 per cent of their par value.

The premium of 10 per cent was paid out of and charged against the
Surplus Account of the company as shown in its Annual Report for
the year 1929.

Appellants received the sum of \$91,220 as a premium on the redemption
of shares owned by the estate of W. E. H. Massey. This sum was
assessed for income tax, which assessment was affirmed by the Min-
ister of National Revenue.

Held: That the premium was paid out of “undistributed income on
hand,” and therefore taxable.

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. Jus-
tice Maclean, President of the Court, at Ottawa.

C. H. A. Armstrong, K.C. for appellants.

F. P. Varcoe, K.C. and A. A. McGrory for respondent.

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

THE PRESIDENT, now (December 6, 1938) delivered the
following judgment:—

This is an appeal taken by the Executors of the Will
of the late W. E. H. Massey, of Toronto, from the decision
of the Minister of National Revenue affirming an assess-
ment for income tax, for the taxation period of 1929. The

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point in issue here is precisely the same as that decided in the case of *National Trust Company Ltd., Executor of the will of Sir Lyman Jones v. The Minister of National Revenue* (1), from which decision there was no appeal. In that case no oral evidence was adduced by either party upon the issue of fact there involved, that is, whether or not a premium paid on the redemption of an issue of 7 per cent. preference shares of Massey-Harris Company Ltd., manufacturers of agricultural implements, was paid from "undistributed income on hand"; in the case now before me there was tendered evidence on behalf of the appellant and respondent, directed to that issue of fact, and it was the submission of Mr. Armstrong for the appellant, that the facts here disclosed materially distinguished the two cases, and that this appeal was put before the court on a different footing from that in the case of the Estate of Sir Lyman Jones.

I might at once refer to the provision of the Income War Tax Act relevant to the assessment for income tax here appealed from. It was sec. 17 of Chap. 97, R.S.C., 1927, and it read as follows:—

Where a corporation, having undistributed income on hand, redeems its shares at a premium paid out of such income, the premium shall be deemed to be a dividend and to be income received by the shareholder. This section was superseded by a new section 17 which reads:—

Where a corporation redeems its shares at a premium, the premium shall be deemed to be a dividend and to be income received by the shareholder.

The distinction between the former and the present section is that in the latter case all reference to "undistributed income on hand" is omitted, and the source of the funds from which a premium is paid on redeemed corporate shares is immaterial. Now, whatever the source, the premium paid on the par value of corporate shares redeemed shall be deemed to be a dividend and to be income received by the shareholder.

The late Mr. Massey was the owner of 9,122 shares of the 7 per cent. cumulative preference stock issued by Massey-Harris Company Ltd., hereafter referred to as "the Company," which shares were redeemable by the Company, after due notice, at one hundred and ten (110%)

(1) (1935) Ex. C.R. 167.

per cent. of their par value. In the month of May, 1929, the Company did give notice of redemption and did redeem all its outstanding 7 per cent. cumulative preference shares at one hundred and ten per cent. of their par value, and the Executors of the will of Massey received the sum of \$91,220 as a "premium" on the redemption of the said 9,122 shares, and that amount of premium is now claimed by the Minister of National Revenue to be assessable income.

By Supplementary Letters Patent, dated March 19, 1929, the Company was authorized to vary its capital stock structure by creating 150,000 five per cent. cumulative convertible preference shares, of the par value of \$100 each, and to increase its authorized common shares from 500,000 shares to 1,000,000 shares, without nominal or par value. Later, during the Company's fiscal year of 1929, the Company redeemed all of its outstanding 7 per cent. cumulative preference shares at the price of \$110 per share, with accrued dividend up to the date of redemption, and in substitution a new issue of 5 per cent. cumulative convertible preference shares was made, for the same amount, namely, \$12,089,900, thus reducing the annual charge for dividends on preference shares by \$241,798. And 241,798 new common shares were taken up by the shareholders, or the public, at \$60 per share, which yielded something over 14 million dollars. As already stated, the appellants surrendered the certificates for the 9,122 shares of the 7 per cent. cumulative preference shares, and on May 15, 1929, the redemption date, they were paid \$110 per share together with accumulated dividends to the date of surrender, the premium itself amounting to \$91,220.

It is the contention of the appellants that the said premium was not paid out of "undistributed income on hand"; that the Company at the date of the payment of such premium had not any "undistributed income on hand"; that if the premium were paid out of "undistributed income on hand" it was out of accumulated profits on hand prior to January 1 1917, which, it is claimed, would not be taxable; that the obligation to pay the premium was a capital one, and that the premium was paid out of the new capital received from the sale of the new common shares; and that therefore the premium

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received by the appellants was not subject to the income tax. I understood it to be argued that the words "on hand" have, for income tax purposes, a definite meaning and contemplate a realized fund on hand from which the premium might be paid. In point of fact the payment of the premium was charged against the "Surplus Account" of the Company, as will appear from the Surplus Account of the Company appearing in its Annual Report for the year 1929. The issue therefore narrows down to this: Does the Surplus Account reflect undistributed income on hand? This requires a brief examination of the Company's Surplus Account, and the state of that Account at the time material here.

We may first turn to the Company's Income Account for the year 1929. The Surplus Account of any Company is built up from annual net profits or income and in practice the net profit or income, less any sums distributed, is transferred to the Surplus Account. The Company's Income Account for 1929, as appearing in its Annual Report for that year, is as follows:—

INCOME ACCOUNT

The Income from the year's operations before deducting interest and appropriations was	\$4,740,915 58	
Add Profit from sale of Assets.....	127,990 75	\$4,868,906 33
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From this there has been deducted for:		
Interest on borrowings	\$ 448,542 39	
Bond Interest and Expense	609,835 00	
Appropriation for depreciation	745,035 92	
" for taxes	210,000 00	
" for Pension Fund	54,679 67	2,068,092 98
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Leaving a net profit of		<u>\$2,800,813 35</u>

The Company would be assessed for the corporation tax on \$2,800,813.35, subject perhaps to some adjustments. The net profit above stated for 1929 was transferred to the Surplus Account, and that Account is to be found in the same Annual Report and is as follows:—

SURPLUS ACCOUNT		1938
The Surplus at 30th November, 1928, was	\$6,982,098 02	W. E. H. MASSEY'S EXECUTORS
Less Bond Discount and Expense	\$ 900,970 20	v. MINISTER OF NATIONAL REVENUE.
Less Premium on 7% Preference Shares redeemed.....	\$1,100,770 00 2,001,740 20	Maclean J.
Adding Net Profit for 1929....		\$4,980,357 82
		2,800,813 35
		<u>\$7,781,171 17</u>
Deducting dividends paid in 1929:—		
On 7% Preferred Shares—15th February and April..	\$ 423,146 50	
On 5% Preferred Shares—15th July and October	302,247 50	
On No Par Common Shares—75c, 15th April, July and October	1,269,439 50	
		1,994,833 50
The Surplus at 30th November, 1929, was		<u>\$5,786,337 67</u>

From this Account it will be seen that the surplus, on November 30, 1929, was \$5,786,337.67. Against the Surplus Account, in 1929, was charged the premium paid on the redeemed 7% preference shares, and certain dividends on the old and new preference shares, and on the common shares.

It will be convenient now to turn to the Consolidated Balance Sheet, also appearing in the Company's Annual Report for 1929, and there we find what the Current Assets (not the Capital Assets) consisted of. That is as follows:—

CURRENT ASSETS	
Inventories—Raw materials, goods in process and finished goods (valued at cost, not exceeding replacement value)	\$31,814,545 10
Prepaid freight and expenditures on account of next year's operations	304,393 88
Bills and accounts receivable (accrued interest of approximately \$925,000 not taken into account)	22,810,950 39
Cash	76,648 74
	<u>\$55,006,538 11</u>

It will be observed that the Current Assets amounted to \$55,006,538.11, a very substantial amount.

I now turn to the state of the Company's cash position on the last day of April, 1929, and down to May 15 of

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the same year, the redemption date of the 7 per cent. preference shares, and to this the appellant seems to attach some importance. I do not think it necessary to go into this at any great length. It will suffice to say that on April 30th, the Company's current bank account was overdrawn and altogether it was indebted to its bankers in a sum exceeding 6 million dollars. From May 1 to May 15, it received \$3,737,000 from the new common stock subscriptions, 11 million dollars from the sale of the new preference shares, and \$398,693 from its business operations. In the same period it paid off its indebtedness to the bank, it disbursed on account of ordinary business operations nearly 1 million dollars (the Company's expenditures on ordinary business operations usually exceeded receipts at that time of the year), and it transferred from time to time from its current bank account to what was called the Preference Dividend Account such sums as were necessary to meet any cheques drawn against that account in redemption of the old preference shares. The Preference Dividend Account was utilized for the redemption of the 7 per cent. preference shares. It was from the Preference Dividend Account that the Executors of the Massey will were, on May 15, 1929, by cheque, paid the amount necessary to redeem the preference shares owned by the late Mr. Massey. What transpired after that date, down to the end of the Company's financial year, would not seem to me to be of any assistance in determining the issue here. It required \$1,100,000 to pay the premium on all the preference shares redeemed, and this was later charged against the Surplus Account.

It may at once be conceded that the Company, on April 30, 1929, had no cash on hand, and that its position in that respect thereafter improved by revenue derived from the sale of the new preference and common shares. Now, the question for decision is whether the Surplus Account constituted "undistributed income on hand," and whether the premium in question was, in fact, paid from that Account. The amount of the Surplus Account was doubtless represented largely, if not altogether, by the Current Assets on hand. Mr. Edwards, a chartered accountant, called by the appellants, stated that there was a time when profits or surplus were regarded "as money in a

bank" but that in modern business practice this is no longer so, and that profits are now ascertained by appraising assets and liabilities, and that "the best way to handle a surplus is to re-employ it as working capital in the business." Accountants would seem to be in agreement that when a man is in business his profits for the year are the excess of his receipts from his business during the year over his outlay for his business; the difference between the value of his stock and plant at the end and at the beginning of the year being taken as part of his receipts or as part of his outlay, according as there has been an increase or decrease of value. It is the practice to transfer undistributed annual net profits to Surplus Account, to be employed as capital if necessary. Sec. 13 of the Income War Tax Act recognizes this practice and it provides that if undistributed profits are, in the opinion of the Minister, in excess of what is reasonably required for the purposes of the business, then the amount of the undistributed profits which the Minister regards as excessive, shall be deemed to have been received by the shareholders as a dividend, and taxable. The undistributed profits there referred to would be shown in the Surplus Account. The business operations of the Massey-Harris Company in 1929, and for several years prior thereto, realized net profits and such as were not distributed were yearly transferred to Surplus Account.

The amount standing to the credit of the Surplus Account was always dealt with by the Company as undistributed profits or income on hand and I do not see how the same could be otherwise classified. Out of such Surplus Account the Company paid the premium in question. It was not an illusory account but one capable, within limits, of responding to actual demands made upon it. If the Surplus Account here were made up of realized profits, and dealt with in that way by the Company, then I think the surplus must be treated as "undistributed income on hand." In paying the premium out of Surplus Account the Company affirmed that to that extent there was undistributed income on hand. The courts and accountants seem, generally, to agree that if accumulated profits shown in the Surplus Account have really been earned and used in the business, the replenishment of the cash position of

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the Surplus Account through borrowing for the purpose of paying a dividend is not objectionable, and that principle would be equally applicable in the case of the payment of a premium on corporate shares redeemed. The Company here may have temporarily used funds in its current banking account, which were derived from capital sources, to pay the premium in question, but that is merely a matter of form and not of substance. The Company's receipts from capital and trading sources, and from borrowings, would be commingled in the Company's current banking account and the source or sources of such receipts could not be ascertained from that banking account. It is the accounting, the books of account, which allocate or distribute all receipts and expenditures, debits and credits, profits and losses, arising in the affairs of a business concern, to their proper destination, and that is determined by established business and accounting practices.

This is a case where the amount of the Surplus Account was actually realized as income, and was not distributed. It was treated by the Company, and the shareholders' auditors, as undistributed profits, and that was the view of Mr. Vardon, a chartered accountant and Assistant to the Financial Comptroller of the Company. I am unable to see how it can be said that the amount standing to the credit of that Account was not "undistributed income on hand," available for any purpose to which the Company might apply the same. I do not see how else it could be described or treated. The fact is that the Company paid the premium in question out of Surplus Account, that is to say, it was charged against that Account. The premium payable on the preference shares if redeemed does not seem to have been charged as a contingent capital liability in the Balance Sheet, and possibly some accountants would suggest that this should have been done, but it would seem to have been the policy of the Company to pay the same from surplus, if and when it should be decided to redeem such shares. The premium in question was not treated, and apparently was never intended to be treated, as a capital liability. I have carefully considered the grounds advanced in support of the appeal so ably presented by Mr. Armstrong, but I have reached the conclusion that the premium in question was paid out of the Company's

undistributed profits, which means, in my opinion, "undistributed income on hand," and therefore taxable.

It appears that a portion of the Surplus Account, about \$1,800,000, was earned prior to the coming into force of the Income War Tax Act, 1917, when the Company's surplus was about 10 million dollars, and it was contended that if the premium had to be paid out of surplus it should be out of that portion of undistributed surplus earned prior to 1917. Subsection five of section three of Chapter 55 of the Statutes of Canada, 1919, provided that dividends or bonuses, paid to shareholders exclusively out of a surplus or accumulated profits on hand prior to the first day of January, 1917, would not be taxable as income; that provision remained in force until the first day of January, 1921, when section 3 of Chapter 49 of the Statutes of Canada, 1920, came into effect. After January 1, 1921, any distribution made out of accumulated surplus by way of dividend, regardless of when such surplus was accumulated, became taxable as income. Therefore, in 1929, the taxation period in question here, it was not open to the appellants to say that the premium should be paid out of any balance of undistributed profits on hand and accumulated prior to January 1, 1917; now, any undistributed surplus accumulated prior to that date, if distributed as a dividend after January 1, 1921, is subject to the tax, just as would any surplus accumulated subsequent to that date, if distributed as a dividend. And the premium in question here is deemed to be a dividend.

I am of the opinion that the appeal must be dismissed and with costs.

Judgment accordingly.

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