1961
Oct. 4
1962
July 27

BETWEEN:

IRVIN CHARLES SCHACTER .....APPELLANT;

AND

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

Revenue—Income Tax—Income Tax Act, R.S.C. 1952, c. 148, ss. 11(1)(a), 12(1)(a)(b)—Income Tax Regulations, Schedule B, Class 8—Purchase of accountant's business, goodwill and list of clients—Payment deductible under s. 12(1)(a) of the Income Tax Act—List of accounts not depreciable as a tangible asset.

Appellant, a chartered accountant practising in Winnipeg, by an agreement made in 1954 purchased from a retiring accountant "all the right, title and interest of the vendor in and to the goodwill of the accounting business" carried on by the vendor including the right to use the firm name. The agreement provided *inter alia* for the delivery by the vendor of a list of his clients showing the regular annual fees charged by the vendor for the usual annual audit and that the appellant should pay to the vendor as the price of such goodwill seventy per cent of the aggregate of the regular annual fees so charged. The seventy per cent amounted to $17,153.50 and this sum was paid by appellant who in computing his income for the year deducted it as an expense. The deduction having been disallowed by the respondent the appellant appealed claiming that the amount was an expense incurred for the purpose of gaining or producing income from his business and not an outlay of capital. Alternatively he claimed that he was entitled to a deduction of capital cost allowance in respect of the list of clients.

Held: That the expenditure was not of a recurring nature but was made once and for all with a view to bringing into existence an advantage for the long term benefit of the appellant's practice and was an outlay of capital deduction of which in computing income is prohibited by s. 12(1)(*b*) of the *Income Tax Act*.

2. That the goodwill for which the $17,153.50 had been paid was not a tangible capital asset within the meaning of the capital cost regulations made under s. 11(1)(*a*) of the *Income Tax Act* and that the appellant was not entitled to a deduction of capital cost allowance in respect of it. Nor was the appellant entitled to deduct capital cost allowance in respect of the list of accounts, as nothing had been paid for it and there was no capital cost of it to the appellant to which s. 11(1)(*a*) could apply.

APPEAL under the *Income Tax Act*.

The appeal was heard before the Honourable Mr. Justice Thurlow at Winnipeg.

C. V. McArthur, Q.C. for appellant.

A. J. Irving for respondent.

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

THURLOW J. now (July 27, 1962) delivered the following judgment:

In these proceedings the appellant appeals from a judgment of the Tax Appeal Board[1] by which his appeal from a re-assessment of income tax for the year 1955 was allowed in part and the Minister cross-appeals asking that the re-assessment be restored.

The controversy arises over a payment of $17,153.50 made by the appellant pursuant to an agreement which he had made with a Mr. Samuel Albert Portigal. In computing his income for tax purposes for a fiscal period which ended in February 1955 the appellant deducted the sum so paid as an expense but the Minister in making the re-assessment disallowed the deduction and the appellant thereupon appealed. In the Tax Appeal Board the disallowance of the $17,153.50 as a deduction was upheld but the Board sustained an alternative contention that the appellant was entitled to a deduction of capital cost allowance in respect of a list of accounts which the appellant had obtained in the transaction and accordingly allowed the appeal in part and referred the matter back to the Minister to make such an allowance.

The circumstances in which the payment was made were as follows. The appellant has been a chartered accountant since 1934 and since 1936 has practiced his profession at Winnipeg. In October 1954 he learned that Mr. Portigal, an accountant, who for some years had been carrying on accounting practice in Winnipeg under the firm name of George Loos & Co., was about to retire from practice, and he thereupon contacted Mr. Portigal and opened negotiations the purpose of which from the appellant's point of view was to increase his business by securing clients from Mr. Portigal's clientele. He had previously on two occasions purchased lists of accounts from retiring accountants but with some sort of guarantee from the vendor that the clients would stay with him. He could obtain no such commitment from Mr. Portigal but eventually he and Mr. Portigal made an agreement which was embodied in an indenture dated October 20th, 1954.

[1] 25 Tax A.B.C. 91.

By this it was recited that the vendor, Mr. Portigal had agreed to sell and the purchaser, the appellant, to purchase "all the right, title and interest of the Vendor in and to the goodwill of the accounting business" carried on by the vendor under said firm name and style of George Loos & Co., including the right to use the said firm name, on the terms and conditions thereinafter contained. The document went on in para. 1 to provide for such sale and purchase of the goodwill of the business, including the exclusive right to the use of the firm name effective from November 1, 1954 but to except the accounts of certain firms. In para. 2 it was agreed that "To facilitate the taking over by the Purchaser of said accounting business and the continuation of the accounting services by the Purchaser in the place of the Vendor," the parties would inform the clients that they were associating to carry on the accounting business and that for six months the vendor should not disclose to them that he intended to retire but that he should in the meantime upon request and without remuneration assist in completing their work for the year. At the end of six months or sooner if requested by the appellant, the vendor was to advise the clients of his retirement from the association and from the accounting business. The agreement also provided for delivery by the vendor to the appellant without remuneration of the vendor's records relating to the accounts "the goodwill relating to which has been hereby agreed to be sold and purchased" and for delivery of a list in duplicate of such accounts showing the regular annual fees charged by the vendor for the usual annual audit such list to be identified by the signatures of the parties and to be attached as a schedule and form part of the indenture. Para. 8 stated "So soon as such list of accounts shall have been agreed upon by the Parties hereto and identified by them and attached to this Agreement as aforesaid, seventy percent (70%) of the aggregate of said regular annual fees shown on said list shall then become the price to be paid by the Purchaser to the Vendor for the said goodwill". Subsequent paragraphs provided for collection by the appellant for the vendor without remuneration of the fees owing to the vendor, for a commission to be paid by the appellant on the fees from any new business which the vendor might refer to him and finally that the vendor would not engage in the business of accountancy within 400 miles of the City of Winnipeg for

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10 years except in connection with the work of some of the clients whose accounts had been excepted from the transaction.

The list referred to in the indenture was simply a three sheet list of 124 clients showing in separate columns amounts of fees for work done for the clients in 1953, the expected amounts of fees to be earned in 1954, which totalled $24,505, the amounts of unpaid accounts rendered for 1953 totalling $22,772.10 and the amounts of fees earned in 1954 to October 31, totalling $11,020.

In 1953 the vendor had lost his records in a fire and though he had later taken a new office the only records which he was in a position to turn over to the appellant were copies of certain financial statements which had been prepared by him for his clients and which had accompanied their income tax returns. The appellant did not occupy the office used by Mr. Portigal nor did he make use of the firm name of George Loos & Co.

As matters turned out a considerable number of Mr. Portigal's clients did not employ the appellant and by the end of the first year following the making of the agreement he had lost or failed to retain 41.3 per cent. of the dollar volume of the business. At the time of the trial however some seven years after the transaction he still retained 39 of the 124 clients and these accounted for 45 per cent. of the dollar volume of the business. As a result of the transaction and of the efforts which the appellant made to hold Mr. Portigal's former clients the income of his practice increased by about $10,000 per year and he found it necessary to engage two additional employees and to use more office space and consequently to pay a higher rent.

The 70 per cent. referred to in para. 8 of the indenture was calculated on the $24,505 shown on the list of accounts as the anticipated earnings for 1954 and amounted to $17,153.50. This amount was paid by the appellant to the vendor at the time of the execution of the indenture and the question to be determined in the appeal is whether it is properly deductible in computing income from the appellant's practice for income tax purposes.

The case for the appellant is that the $17,153.50 was an expense incurred for the purpose of gaining or producing income from his business which would on accepted accounting principles be deductible in computing the profit from

such business, that it was within the exception to the prohibition of s. 12(1)(*a*) of the *Income Tax Act* R.S.C. 1952, c. 148 and not within the prohibition of s. 12(1)(*b*) and was accordingly properly deductible in computing the appellant's income from his business for income tax purposes. The contention put forward on behalf of the Minister was that the expenditure was not an expense falling within the exception to s. 12(1)(*a*) and was moreover an expenditure of capital deduction of which was prohibited by s. 12(1)(*b*).

Subsections (*a*) and (*b*) of s. 12(1) provide:

> 12.(1) In computing income, no deduction shall be made in respect of
>
> (*a*) an outlay or expense except to the extent that it was made or incurred by the taxpayer for the purpose of gaining or producing income from property or a business of the taxpayer,
>
> (*b*) an outlay, loss or replacement of capital, a payment on account of capital, or an allowance in respect of depreciation, obsolescence or depletion except as expressly permitted by this Part,

In *B.C. Electric Railway Co. Ltd. v. M.N.R.*[1] Abbott J., speaking for the majority of the Court, after referring to the less stringent nature of the provisions of s. 12(1)(*a*) and (*b*) compared with the corresponding provisions of the *Income War Tax Act* said at p. 137:

> Since the main purpose of every business undertaking is presumably to make a profit, any expenditure made "for the purpose of gaining or producing income" comes within the terms of s. 12(1)(*a*) whether it be classified as an income expense or as a capital outlay.
>
> Once it is determined that a particular expenditure is one made for the purpose of gaining or producing income, in order to compute income tax liability it must next be ascertained whether such disbursement is an income expense or a capital outlay. The principle underlying such a distinction is, of course, that since for tax purposes income is determined on an annual basis, an income expense is one incurred to earn the income of the particular year in which it is made and should be allowed as a deduction from gross income in that year. Most capital outlays on the other hand may be amortized or written off over a period of years depending upon whether or not the asset in respect of which the outlay is made is one coming within the capital cost allowance regulations made under s. 11(1)(*a*) of *The Income Tax Act*.

On the facts of the present case I have no difficulty in reaching the conclusion that the expenditure in question was one that was made or incurred for the purpose of gaining or producing income from the appellant's business in the broad sense referred to by Abbott J. in the passage quoted and I therefore turn to the question whether it was an outlay of capital within the meaning of s. 12(1)(*b*).

[1] [1958] S.C.R. 133.

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In the same judgment Abbott J. continued at p. 137:

> The general principles to be applied to determine whether an expenditure which would be allowable under s. 12(1)(*a*) is of a capital nature, are now fairly well established. As Kerwin J., as he then was, pointed out in *Montreal Light, Heat & Power Consolidated v. Minister of National Revenue,* applying the principle enunciated by Viscount Cave in *British Insulated and Helsby Cables, Limited v. Atherton,* the usual test of whether an expenditure is one made on account of capital is, was it made "with a view of bringing into existence an advantage for the enduring benefit of the appellant's business".

This was reiterated in similar terms by the same Judge speaking for the Court in *M.N.R. v. Haddon Hall Realty Inc.*[1] at p. 110.

> The general principles to be applied in determining whether a given expenditure is of a capital nature are fairly well established: *Montreal Light Heat and Power Consolidated v. Minister of National Revenue; British Columbia Electric Railway Company Limited v. Minister of National Revenue.* Among the tests which may be used in order to determine whether an expenditure is an income expense or a capital outlay, it has been held that an expenditure made once and for all with a view to bringing into existence an asset or an advantage for the enduring benefit of a trade is of a capital nature.

In the present case the expenditure in question was not of a recurring nature but one made once and for all and it also appears to me to have been made with a view to bringing into existence an asset or, perhaps more accurately, an advantage for the enduring benefit of the appellant's business. It is I think plain on the evidence that the expenditure was not made merely in the expectation of gaining additional business for the current year by securing the opportunity to complete Mr. Portigal's work for that year for such of the clients as would permit the appellant to do so. Had that been the purpose there would have been no occasion for a restrictive covenant of ten years duration. Moreover the size of the amount paid in comparison with that of the vendor's annual gross revenue appears to me to preclude such a conclusion for it was greater than the expected gross revenue for the remainder of the year, probably greater than the net revenue for a full year and in view of the fact that the appellant could scarcely hope to retain all of the clients, probably greater by an even larger amount than the net revenue which the appellant could expect to obtain from the clients in any single year. In my view what the appellant sought to obtain by making

[1] [1962] S.C.R. 109.

the agreement and paying the sum in question was the long term benefit of an expansion of his own clientele and the various provisions of the indenture were directed to enable him to achieve this expansion through the transfer to him of such of the goodwill attaching to Mr. Portigal himself and to the name of George Loos & Co. as could be retained on Mr. Portigal's retirement from practice. And while the actual retention of the clients must have depended to a great extent on his own ability and efforts to win and hold their confidence the size of the amount he was prepared to pay for such goodwill as Mr. Portigal could transfer to him and the fact that some seven years after the transaction he still retained a substantial number of the clients with a substantial proportion of the volume of their business in my opinion shows the long term or enduring nature of the advantage which he sought to obtain.

To my mind the enduring quality of the advantage sought also appears from the transfer of the right to use the name of George Loos & Co. which, though the appellant never used or intended to use the name, permanently prevented Mr. Portigal from using it or transferring his right to use it to any competitor who might thereby attract clients which Mr. Portigal had served.

Applying the test referred to in the passages cited from *B.C. Electric Railway Co. Ltd. v. M.N.R.* and *M.N.R. v. Haddon Hall Realty Inc.* these considerations suggest that the expenditure in question was of a capital rather than of a revenue nature. Nor do I see in the circumstances any special features pointing to an opposite conclusion. On the contrary the conclusion which it suggests appears to me to be indicated as well by the fact that the expenditure was not an ordinary incident of the appellant's day to day practice and by the terms of the document pursuant to which the payment was made. The indenture refers to the transaction as a sale of the goodwill of the vendor's business including the exclusive right to use the firm name of George Loos & Co. and it will be recalled, specifically identifies the sum in question as the price to be paid for such goodwill. It is true that the document also required the vendor to render certain services for which no separate consideration or part of the sum in question was particularly assigned but to treat the sum as paid in whole or in part

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for such services would appear to be contrary to the express provision of the agreement. Moreover while the vendor's services were to be rendered "without remuneration" so also were the services to be rendered by the appellant in collecting the vendor's accounts amounting to some $33,000 and in view of these mutual and somewhat complementary undertakings, affording as they do some consideration in fact for one another, I do not think a conclusion that the sum in question was paid for anything but what the document expressly provides for would be warranted. It may be conceded that not every expenditure which may have the effect of increasing the goodwill of a business is necessarily one of a capital nature but to my mind the fact that in the present case the sum in question was the consideration for the purchase of the goodwill of an established undertaking suggests that it was an outlay of capital rather than an expenditure on revenue account. *Vide Associated Newspapers Ltd. v. Federal Commissioner of Taxation*[1] where Latham, C.J., said at p. 91:

> The effect of the payment was to enlarge the goodwill of the enterprise, which was one of its most valuable assets. There is no doubt that the goodwill of the Sun newspaper became worth very much more as the result of the agreement which prevented the publication of a competitive newspaper within the same area, possibly at a lower price, by persons who had the control of a press and the necessary plant, together with a newspaper organisation in being. In the case of *Anglo-Persian Oil Co. v. Dale,* reference was made by *Lawrence,* L.J., to the fact that in that case the company by making the payment in question did not improve its goodwill. So also in *Nevill v. Federal Commissioner of Taxation,* reference is made to the increasing of the value of the goodwill of a company as a relevant circumstance, at p. 303:—"enlargement of the goodwill of a company" and at p. 306:—"permanent improvement in the material or immaterial assets of the concern". The goodwill of a business is an asset of the business and is plainly a capital asset. It is radically different from assets which are turned over and bought and sold in the course of trading operations.

Nor in my view is the matter affected by the fact that goodwill in the case of an accountant and particularly one who practices alone is largely personal to the particular practitioner and scarcely capable of being sold with any assurance that the purchaser will obtain any benefit from it. No doubt one who pays for so tenuous an advantage takes a risk but there is nothing uncommon about professional men acquiring the undertakings of established practitioners with whatever goodwill can be retained in the

[1] 5 A.T.D. 87.

transfer and I know of no reason why if they see fit, as appears to have occurred in this case, they cannot in such a transaction agree upon a consideration for such goodwill. The fact that in the result no goodwill may be acquired or that the benefits of the purchase may soon disappear appears to me to be irrelevant for the present purpose for in the test referred to in the cases cited what matters is the nature of the advantage sought rather than the benefit actually obtained.

Accordingly I am of the opinion that the expenditure in question was an outlay of capital the deduction of which in computing income for income tax purposes is prohibited by s. 12(1)(*b*). The appeal therefore fails.

There remains the cross-appeal against that part of the judgment of the Tax Appeal Board which holds the appellant entitled to a deduction of capital cost allowance under Class 8 of Schedule B of the *Income Tax Regulations* in respect of the value of the list of accounts which the appellant acquired in the transaction in question. The reasons for so holding were thus expressed in the decision of the Board:

> As I am of the opinion that by far the larger part of the purchase price of the list of accounts was paid for whatever goodwill existed in connection with the clients who were purportedly being turned over by Mr. P to the appellant herein, this was therefore a capital expense which is not allowable as a deduction from income as claimed by the appellant. However, some small part of the purchase price was represented by the list of accounts turned over by Mr. P. to the appellant herein, and those accounts, in my opinion, constituted a tangible asset of the appellant which would be subject to capital cost allowance under the Income Tax Regulations. I leave the determination of the amount representing the value of this list for the consideration of the Minister, as I have no evidence on which to base even an estimate of the value of the said list of accounts.
>
> In the circumstances, the appeal is allowed in part, and the matter is referred back to the respondent for him to determine the value of the list of accounts paid for by the appellant upon which capital cost allowance under Class 8 of Schedule B of the Income Tax Regulations may be afforded.

In this court the position taken by the appellant was that if the sum paid was not deductible as an expense, the list of accounts which the appellant obtained in the transaction was a tangible capital asset depreciable at the rate of 20 per cent. under Class 8 of the *Income Tax Regulations*. The Minister's submission was that no tangible capital asset was acquired in the transaction and that no part of the outlay was subject to capital cost allowance.

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Section 11(1)(*a*) of the *Income Tax Act* provides as follows:

11. (1) Notwithstanding paragraphs (*a*), (*b*) and (*h*) of subsection (1) of section 12, the following amounts may be deducted in computing the income of a taxpayer for a taxation year:

(*a*) such part of the capital cost to the taxpayer of property, or such amount in respect of the capital cost to the taxpayer of property, if any, as is allowed by regulation;

The regulation invoked by the appellant in support of his contention reads: (1955 Canada Gazette, Part II, 1954-1917).

1100.(1) Under paragraph (*a*) of subsection (1) of section 11 of the Act, there is hereby allowed to a taxpayer, in computing his income from a business or property, as the case may be, deductions for each taxation year equal to

(*a*) such amount as he may claim in respect of property of each of the following classes in Schedule B not exceeding in respect of property

(1)—(vii) . . .

(viii) of class 8, 20%,

(ix)—(xv) . . .

Class 8 is defined as:

Property that is a tangible capital asset that is not included in another class in this Schedule except land, or any part thereof or any interest therein, and also excepting

(*a*) an animal,

(*b*) a tree, shrub, herb or similar growing thing,

(*c*) a gas well,

(*d*) a mine,

(*e*) an oil well,

(*f*) radium,

(*g*) railway track,

(*h*) railway grading,

(*i*) a railway subway,

(*j*) a railway street crossing,

(*k*) a right of way,

(*l*) timber limit, and

(*m*) tramway track.

The *Shorter Oxford English Dictionary,* 3rd Edition, revised 1956, gives the following definitions of "tangible":

(1) Capable of being touched, affecting the sense of touch; touchable. Hence, material, externally real, objective.

(2) That may be discerned or discriminated by the sense of touch, as a tangible property or form.

(3) That can be laid hold of or grasped by the mind, or dealt with as a fact; that can be realized or shown to have substance.

In Funk & Wagnall's *New Standard Dictionary of the English Language* (1961) "Tangible" is defined as meaning:

(1) Perceptible by touch, also within reach by touch.

(2) Figuratively, capable of being apprehended by the mind; having definite shape; not elusive or unreal.

(3) Perceptible to the senses; corporeal; as tangible property; opposed to incorporeal property such as franchises.

In number (3) of the *Shorter Oxford English Dictionary* definitions and number (2) of the Funk & Wagnall definitions the meaning appears to be broad enough to include incorporeal concepts as well as corporeal objects. However in *Accounting Terminology,* a volume published in 1957 by the Canadian Institute of Chartered Accountants, the definition given for "tangible assets" and "tangibles" is:

All assets except the intangible assets such as goodwill, patents, copyrights, trademarks.

In my opinion the nearest of the definitions to the meaning of "tangible" as used in the definition of Class 8 of the regulations is number (3) of the Funk & Wagnall definitions and I do not think that either goodwill or "accounts" constitute "a tangible capital asset" within the meaning of that expression in the regulation. The contention was however made that the list of accounts is itself tangible property in respect of which capital cost allowance may be claimed. The answer to this in my opinion is that on the evidence there was no capital cost of the list to the appellant within the meaning of s. 11(1)(*a*) in respect of which a capital cost allowance may be made. The whole of the $17,153.50 was paid for goodwill. The list was not goodwill but was simply a document prepared by Mr. Portigal which in the course of the transaction became a schedule to and part of the indenture. It was not sold to the appellant and nothing was paid by the appellant for it. The cross-appeal accordingly succeeds.

In the result therefore the appeal will be dismissed with costs and the cross-appeal will be allowed with costs and the re-assessment restored.

Judgment accordingly.